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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

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Martin J. Kohn

21 pages

Recent Economic Developments in the United Kingdom: December 1966-June 1967

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A number of economic indicators suggest that the recession in the U.K. has bottomed out.[1/] In fact, national income may have increased slightly in the first quarter. However, signs of recovery, or continued recovery, are limited, and the government is unlikely to undertake large-scale reflationary action at this time. The threat to the British balance of payments posed by the embargo by several Arab nations of oil shipments to the U.K. is only part of the explanation. Even before the war in the Middle East and the other blows to the pound in recent weeks--such as discouraging reports on Britain's trade performance, de Gaulle's negative response to Britain's latest bid for EEC membership and the riots in Hong Kong--the government demonstrated its reluctance to push expansion with any vigor. For example, the budget presented by Chancellor Callaghan in April--when confidence in sterling was strong and the balance of payments was known to be in surplus--reflected the government's belief that the improvement in Britain's overall economic situation was not sufficient to permit major stimulative measures.

In his budget presentation, the Chancellor avoided any further moves in the direction of fiscal stimulus, and the budget for fiscal 1967-68 contained no significant tax changes or other fiscal changes.

1/ For a review of earlier developments see "Recent Economic Developments in the United Kingdom: July-December 1966," dated January 13, 1967.

Nevertheless, largely because of previous spending commitments, public sector spending will rise in 1967--by 5 per cent on current account and 8.5 per cent on capital account in real terms--and the government's borrowing requirement will increase.

The government will continue to rely to some extent on prices and incomes policy to support its budget framework. Over the past twelve months, incomes policy has been effective in stabilizing the price/wage picture. While incomes restraints will be moderated after June 30, it is evident that the authorities regard some form of incomes policy as a permanent element of the total British stabilization effort.

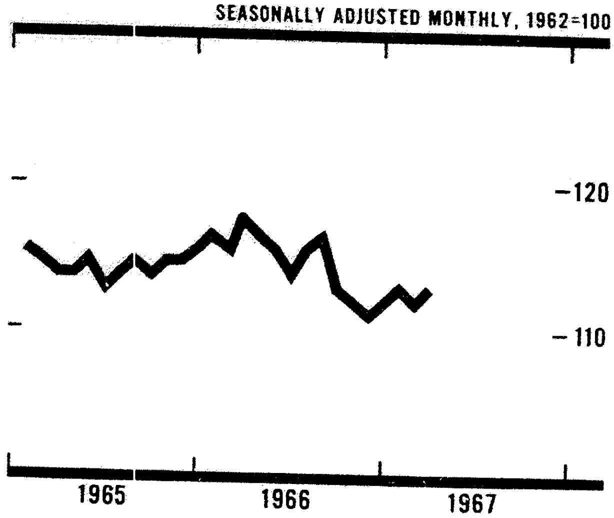
Perhaps the most significant aspect of the budget speech were the major policy changes in the Chancellor's statement, which constituted a basic re-ordering of fundamental economic objectives. Specifically, the authorities have accepted a somewhat higher "normal" level of unemployment, have announced a somewhat lower economic growth rate up to 1970, and have decided in favor of regional subsidies and other aids for pockets of high unemployment instead of increasing aggregate demand for this purpose.

The Chancellor said that he expected growth of 3 per cent per year from 1967 through 1970, compared with the government's 1964 goal of an annual growth rate of 4-1/4 per cent. Three per cent is also the officially predicted growth rate during 1967, but even this moderate rate of increase is considered high by other forecasters. The National Institute, for instance, at the beginning of June predicted that growth from the end of 1966 to the end of 1967 would amount to only 2 per cent.

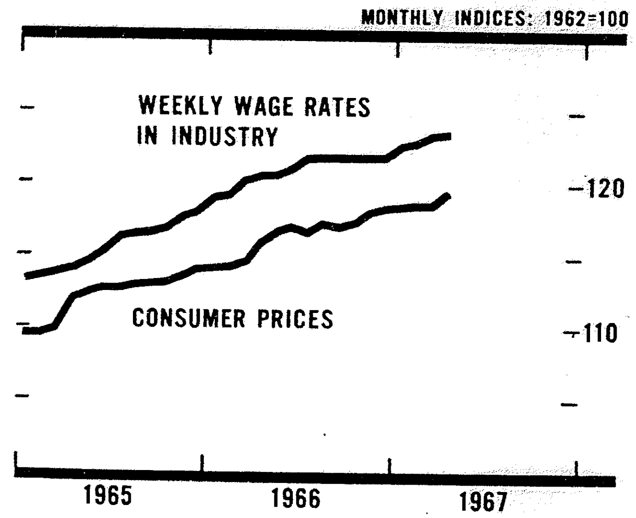
CHART 1

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

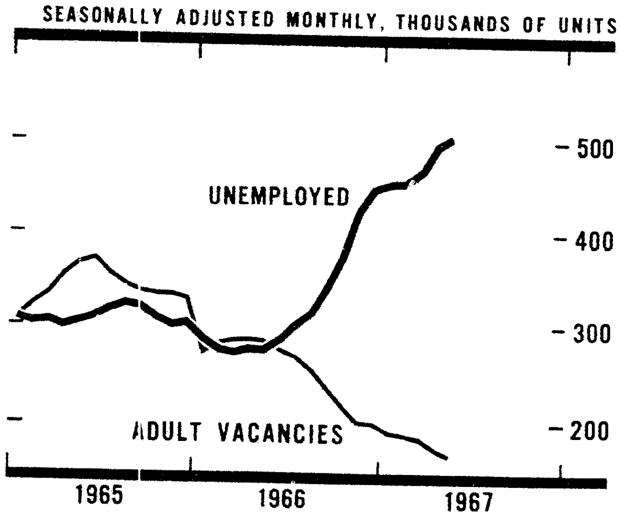
INDUSTRIAL OUTPUT



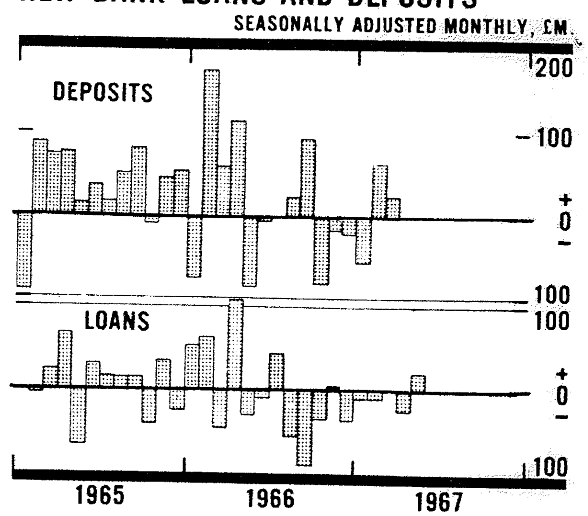
PRICES AND WAGES



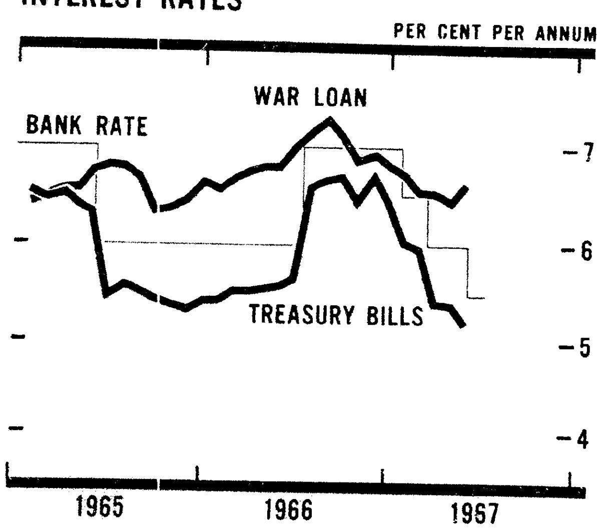
LABOR MARKET



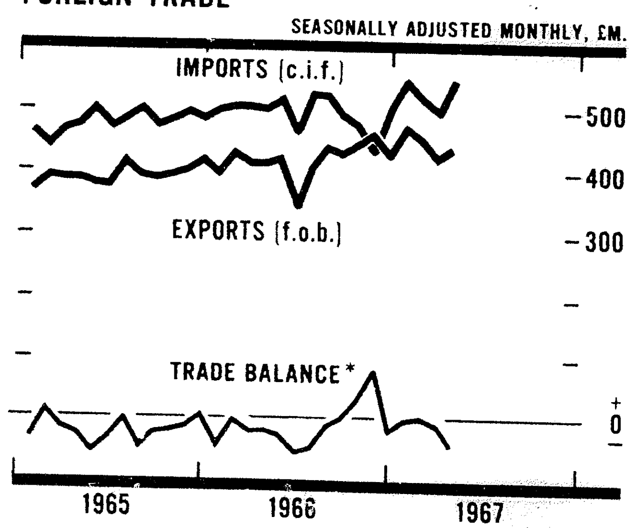
NEW BANK LOANS AND DEPOSITS



INTEREST RATES



FOREIGN TRADE



* BALANCE OF PAYMENTS BASIS

Highlighting developments in the early months of the year was the large inflow of capital--reversing the outflow of mid-1966--which came with the return of confidence in sterling. Very heavy accumulations of reserves permitted Britain to repay all foreign central bank assistance provided last summer, to prepay part of its IMF obligations, and to pay off forward-exchange contracts. Despite these massive repayments, Britain's official gold and foreign currency reserves decreased only slightly, from $3,100 million at the end of December to $2,954 million at the end of May.

The influx of funds which came with a return of confidence in sterling and relatively attractive covered yields on sterling investments (the forward pound had strengthened and interest rates had declined in other countries) permitted the authorities to move to lower interest rate levels. The Bank of England has reduced Bank Rate in three steps this year--moving from 7 per cent to 5-1/2 per cent between January 26 and May 4--and on each occasion has followed the lead of other central banks. (See chart.) British discount policy thus provides another example of the authorities' extremely cautious approach to any policy initiatives.

Despite the improvement in Britain's external financial position this year, the foreign trade performance has been generally very uneven. (See Table 1.) Because of the dock strike last July and the removal of the import surcharge in November, it is difficult to ascertain the underlying trend. On a seasonally-adjusted basis, however, exports apparently rose steadily to the end of the year and then tended

Table 1. United Kingdom: Selected Economic Indicators 1966-1967

	Trade Balance a/				Financial Indicators			Physical Indicators	
	Exports b/	Imports	Difference	Balance of Trade c/	Yield on 3-1/2% War Loan d/	Changes in Bank Loans e/	Spot Price of Pound f/	Manufacturing Production g/	Unemployment h/
Quarterly									
1966 - I	430	507	-77	-24	6.75	23	279.35	137	284
II	410	495	-85	-35	7.00	23	278.94	135	282
III	441	513	-72	-23	7.13	-33	279.15	136	322
IV	460	470	-10	28	6.82	-22	279.02	131	417
1967 - I	465	523	-58	- 7	6.52	- 7	279.74	134	458
Monthly									
1966 - October	460	478	-18	28	6.87	-35	279.10	132	377
November	475	437	38	78	6.92	5	279.06	130	424
December	441	507	-66	-21	6.82	-35	279.02	133	449
1967 - January	489	550	-61	- 7	6.71	-10	279.25	134	454
February	468	522	-54	- 1	6.54	-10	279.28	133	454
March	438	499	-61	-13	6.52	0	279.74	134	467
April	456	549	-95	-44	6.44	-25	279.88	n.a.	495
May	453	527	-74	-25	6.62	20	279.46	n.a.	505

a/ Monthly average. £ million. Seasonally adjusted.
c/ Balance of payments basis.
e/ Monthly average. £ million. Seasonally adjusted.
g/ 1958 = 100. Seasonally adjusted.

b/ Includes re-exports.
d/ Last Thursday before end of period.
f/ Last Friday before end of period. U.S. cents.
h/ Wholly unemployed, excluding school leavers, for Great Britain only--that is, excludes Northern Ireland. Thousands. Seasonally adjusted.

to flatten out. Even allowing for deferred arrivals from the import surcharge action, imports in 1967 remain at a high level. The trade deficits in April and May were considerably larger than earlier in the year--largely because of heavy imports--suggesting that a moderate balance of payments surplus in 1967 was the best to be hoped for.

Budget deficit to rise but taxes left unchanged

The British budget for fiscal 1967-68 (April 1, 1967-March 31, 1968) calls for expenditures to rise more than revenue, with a deficit of almost £1 billion expected. (See Table 2.) Last year by contrast, the budget initially planned for a deficit of somewhat less than £300 million.

Table 2. United Kingdom: Budgetary Receipts and Expenditures 1966-67 and 1967-68
(£ million)

	1966-67 Budget	1966-67 Actual	1967-68 Budget	1967-68 Budget as % of 1966-67 Actual
I. Overall budget:				
Revenues	10,224	10,279	11,704	114
Expenditures	9,177	9,541	11,067	116
Surplus	1,047	738	637	61
Government loan (net)	1,334	1,478	1,580	107
Deficit	- 287	- 740	- 943	127
II. Effects of Selective Employment Tax:				
Revenue	610	600	1,100	183
Expenditure	295	342	924	269
Balance	315	258	176	68

Even though the impact on aggregate demand this year of increased expenditures accompanied by a large deficit will necessarily be expansionary, the budget reflects the government's caution in reflating the economy. Thus, taxes were not lowered despite such symptoms of slack as a high and still rising level of unemployment.

The projected increases in total expenditures and revenue in the current year exaggerate the extent to which the government's role in the economy will expand this year, primarily for two reasons: First, payments of the selective employment tax to the government will increase sharply, as will subsequent refunds and premia payments to some of the initial payers. On a net basis, the government will take somewhat less out of the economy via the SET this year than last--£176 million vs. £258 million. Second, the government will spend £166 million in investment grants to private business this year. However, these grants replace the previously used system of encouraging investment through tax concessions based on a firm's capital expenditures. Consequently, the change is administrative and does not represent a larger economic contribution to private investment.

The direct impact of public sector spending is best reflected in government outlays on goods and services. Government purchases on current account are scheduled to total £7,065 million in fiscal 1968, a rise of about 8 per cent in current prices. In constant prices the increase is estimated by the government to be about 5 per cent. However, government expenditures will include £176 million (about 1/3 of the increment in current prices) for purchase of U.S. military aircraft with a loan from the United States. This outlay will have no direct stimulative effect on the British economy.

The biggest proportionate increase in public sector spending will come in capital formation, where outlays are planned to total £3,676 million, an increase of 14 per cent in current prices over the £3,227 million spent in 1966-67. In constant prices, the government estimates that this represents an increase of 8.5 per cent.

On the revenue side, the decision to leave taxes unchanged means that the government is counting on rises in income to provide virtually all of the increase in its receipts. In his April 11 budget speech, the Chancellor forecast a rise in national income of about 3 per cent during 1967. His projection has been challenged, however, by other forecasters. The National Institute, for example, predicted at the beginning of June that growth during 1967 will be only 2 per cent. Expectation of lower growth rates for exports and consumer spending by the National Institute explains the difference between the two forecasts.

In the budget speech, the Chancellor stressed the need for financing the deficit in a non-inflationary manner, outside the banking system. He voiced optimism that this could be achieved, citing the huge volume of sales of British government securities--£410 million--in the fourth quarter. At that time, however, prospects for interest rate declines were bright and a rapid slide in yields did in fact take place from early December to mid-February. But interest rate developments since then have made gilts a less attractive investment than they were late last year and early this year.

"Real" indicators imply easing of recession

National income statistics are not available for 1967, but a number of indicators (all seasonally adjusted) imply that an easing of the recession began around December 1966 and has continued since. Manufacturing output, for example, which fell six per cent from July through November, posted a large gain in December and remained virtually level through the first quarter. (See Table 1.) The number of persons totally unemployed has continued to rise this year, but the increment in December-May was less than 40 per cent of what it had been in July-December.

The volume of retail sales (which account for about half of total consumer expenditures) reached their low point in September and and were only slightly higher in the first quarter of 1967 than in the fourth quarter of 1966. But registrations of new automobiles--auto sales are not included in retail sales in British economic statistics--were over 40 per cent higher in the first than the fourth quarter, though within the first quarter registrations declined from month to month.

Homebuilding has picked up this year, in both the private and public sectors. Private housing starts in the first four months of 1967 were over 35 per cent higher than in the corresponding period last year. For the public sector a better than 25 per cent increase has been reported.

Wages resume rise; but some prices increase at slower rate

The freeze on wage and price increases instituted in July was supplanted at the beginning of 1967 by a period of "severe restraint," which will last until the end of June. During this period the government was prepared to permit wage increases that either were delayed by the imposition of the freeze or are justified, in its view, by productivity increases. Wage demands by lower paid workers--a category not yet clearly defined--also are supposed to receive sympathetic treatment. As for price increases, only those which appear justified by unavoidable cost increases are to be permitted.

The effect of the easing of incomes policy was immediate. Weekly wage rates, for example, which had stayed unchanged for the five consecutive months August through December rose steadily through the first three months of 1967; for the quarter as a whole, they were 0.9 per cent higher than in the preceding quarter. (See Table 3.)

Prices have also advanced since the end of the freeze, but for some prices the rate of increase has actually been slower than it was in the final quarter of 1966. Retail prices, for example, were 0.8 per cent higher in the fourth than in the third quarter, but only 0.5 per cent higher in the first than in the fourth quarter. The explanation is that during the freeze--in large measure a misnomer with respect to prices--sellers were allowed to raise prices in response to normal seasonal developments and to absorb the costs of the selective employment tax and additional sales taxes imposed last summer.

Table 3. United Kingdom: Wage and Price Indices 1965-1967

	Labor Market Indicators				Price Indices	
	Weekly Wage Rates	Hourly Wage Rate	Normal Weekly Hours	Average a/ Weekly Earnings	Retail Prices	Wholesale Prices b/
Per Cent Changes from Preceding Year						
1964	4.7	5.1	-0.4	6.5	3.3	3.3
1965	4.3	6.3	-1.8	6.7	4.8	4.6
1966	4.6	6.6	-1.9	5.7	3.9	2.8
From Year Ago						
1965 - II	4.7	7.2	-2.3	7.0	4.6	4.1
1966 - I	5.2	7.9	-2.6	6.6	4.4	3.6
II	5.2	7.6	-2.3	7.1	3.8	2.6
III	4.6	6.2	-1.6	5.9	3.7	2.8
IV	3.7	4.9	-1.2	3.4	3.8	2.3
1967 - I	2.7	n. a.	n. a.	n. a.	3.6	1.8
From Preceding Quarter						
1965 - IV	0.9	1.2	-0.4	1.3	0.6	0.4
1966 - I	1.8	2.6	-0.8	2.6	0.7	0.7
II	0.9	1.2	-0.3	2.5	1.9	1.0
III	0.9	1.0	-0.2	-0.6	0.3	0.7
IV	0.02	0.01	0	-1.1	0.8	0.0
1967 - I	0.9	n. a.	n. a.	n. a.	0.5	0.2

a/ Coverage for earnings is not identical to coverage for wage rates and hours worked.

b/ All manufacturing, home market sales.

The government will allow its powers (granted last summer) to prevent or revoke price and wage increases to lapse in August, but before then will activate its powers under the Prices and Incomes Act to delay price and wage increases. The government has thus made clear its long-term commitment to a relatively stringent incomes policy.

Though committed to the program in principle, the authorities seem less than optimistic about the efficacy of incomes policy in the near future, if one can judge by the government's expectation that wage rates will be about 6 per cent higher at the end of 1967 compared to mid-1966.

Bank credit continues to decline

The volume of bank credit outstanding has continued to decline in 1967 but at an appreciably slower rate than in the last five months of 1966. The overall decline for the clearing banks in the nine months from July to May was about 5 per cent, seasonally adjusted.

In his budget speech, the Chancellor announced the removal of the ceiling on clearing bank credit. Under a ruling of May 1965, the banks and other financial institutions were in effect forbidden to increase credit above 105 per cent of the amount outstanding in March 1965. The lifting of the ceiling is of no practical significance at this time, however, since bank loans are currently far below the permissible limit.

In announcing the end of the credit ceiling, the Chancellor disclosed that henceforth the authorities will place greater reliance on special deposits to control bank lending. Previously, the special deposit instrument has tended to be activated only in crises. Now the authorities plan to use this device more continuously, making flexible reserve requirements a more or less routine method of credit control.

For the present, the 105 per cent ceiling remains in effect for financial institutions other than the clearing banks.

The fall in the volume of installment credit outstanding, which began last August, has continued this year with little diminution in the rate of decline. A drop of 16 per cent took place from the end of July to the end of March, reflecting the curtailment of consumer spending on durable goods--chiefly automobiles--resulting primarily from the more stringent hire purchase regulations imposed last summer. Restrictions on installment purchases of automobiles were eased in early June.

Perhaps in line with the predicted fall in capital spending in the private business sector this year, new market borrowing by U.K. companies has declined thus far in 1967. In the first four months of the year such borrowing was running at a rate almost 25 per cent below the 1966 total.

Money market rates fall

Money market rates have fallen more or less steadily this year in conjunction with the three reductions in Bank Rate. For example, the yield on 90-day Treasury bills has fallen about 1-1/4 points, that on call money about 1-1/2 points since the end of 1966.

Because of declines in rates elsewhere, however, differences between U.K. and foreign short-term rates for the most part have been to the U.K.'s advantage in 1967. For example, the covered differential between 90-day local authority and Euro-dollar deposits--in favor of Euro-dollars last year--has been in favor of local authorities much of this year, though recent rises in Euro-dollar rates have again erased London's advantage. Differentials in yields between the Continent and the U.K. have also moved to the U.K.'s advantage. The covered differential between the 90-day German interbank loan rate and 90-day local authority deposits, for instance, stood almost a percentage point in favor of London deposits at the end of May. (See Table 4.) In 1966 the gap was consistently in Germany's favor, exceeding two percentage points in late August and early September. Short-term capital has moved out of Germany in large amounts this year.

Bond prices break in early May

In contrast to short-term rates, yields on long-term government securities generally ceased to fall after early February, fluctuated within a narrow range through the end of April and moved up sharply in May and early June. The recent slide in bond prices reflected uneasiness over a combination of domestic and foreign events--most notably the increase in the trade deficit in April; de Gaulle's rebuff to the U.K.'s Common Market application; the riots in Hong Kong; and the threat and ultimate outbreak of war in the Middle East--foreshadowing the possibility of further difficulties for sterling.

Table 4. United Kingdom: Covered Yield Differentials[a/]
(per cent per annum)

	Covered 90-Day[b/] Local Authority Deposits	90-Day Euro-Dollar Deposits	Difference	Covered 90-Day[c/] Local Authority Deposits	90-Day German Interbank Loan Rate	Difference
1966						
July	5.99	6.37	-0.38	5.70	6.88	-1.18
August	6.51	6.75	-0.24	4.74	6.75	-2.01
September	6.50	6.88	-0.38	5.66	6.75	-1.09
October	6.66	6.75	-0.09	6.24	7.18	-0.94
November	6.71	6.88	-0.17	6.94	7.31	-0.37
December	6.54	6.44	+0.10	5.09	7.00	-1.91
1967						
January	5.82	5.63	+0.19	5.06	5.08	-0.02
February	5.59	5.56	+0.03	5.33	5.31	0.02
March	5.40	5.31	+0.09	5.76	4.88	0.88
April	4.85	4.63	+0.22	4.76	4.00	0.76
May	4.39	5.00	-0.13	4.87	3.56	0.83

a/ Final Friday of the month.
b/ Actual yield minus forward discount on pound.
c/ Actual yield minus forward discount on mark.

Equity prices changed little during January and February but rose rapidly in the following two months, reflecting confidence that the economy had entered a recovery stage. The Financial Times index of 500 industrials rose about 12 per cent between the end of February and the middle of May. Some ground was lost in the next few weeks, but the index was still 10 per cent above the end-of-February level just after the cease fire in the Middle East. The index is still 8 per cent below the 1966 high recorded July 4.

Pound rises above par in April, then falls

The revival of demand for sterling this year was reflected in the rise in the spot pound from just over 279 cents at the beginning of the year to a level slightly over the par value of 280 cents in mid-April. The high was reached immediately after the Chancellor's budget speech, mirroring the financial community's approval of the government's decision not to lower taxes despite the continuing slackness of demand.

In May, however, the pound fell sharply under the impact of the discouraging trade figures and the disheartening political developments abroad. The outbreak of the war at the beginning of June gave sterling a further downward push, the spot pound falling below 279.10 cents. The pound rebounded, however, as the war appeared to have come to a quick close.

The forward market has been firm this year. The three-month forward discount has tended to widen with rises in the spot rate and to narrow when spot sterling softened. The discount has ranged from 0.4 to 1.0 per cent per annum.

Balance of payments in surplus; but trade performance disappointing

During the fourth quarter the U.K. recorded a large surplus in its balance of payments, measured according to current and long-term capital account. The move from deficit to surplus was largely accounted for by the steep reduction in imports resulting from expectation of the surcharge removal. (See Table 1 and Table 5.)

Table 5. United Kingdom: Balance of Payments
1964-1967
(£ millions)

	Annual			Quarterly				
				1966				1967
	1964	1965	1966	I	II	III	IV	I
Imports (f.o.b.)[a/]	5,016	5,065	5,261	1,374	1,320	1,323	1,244	1,440
Exports (f.o.b.)	4,471	4,784	5,110	1,289	1,217	1,209	1,395	1,344
Visible balance	- 545	- 281	- 151	- 85	- 103	- 114	151	- 96
Invisible balance	150	163	92	50	27	2	13	99
Current balance	- 395	- 118	- 59	- 35	- 76	- 112	164	3
Balance on long-term capital	- 368	- 239	- 128	- 73	9	- 28	- 36	20
Balance of current and long-term capital transactions	- 763	- 357	- 187	- 108	- 67	- 140	128	23
Balancing item	32	108	15	68	- 26	34	- 61	154
Balance of Monetary Movements	731	249	172	40	- 93	106	- 67	- 177

a/ Includes payments for U.S. military aircraft and missiles.

During the first quarter a deficit in the trade balance reappeared. It averaged only £7 million, however, compared with an average monthly deficit of £27 million for the first nine months of 1966, and the overall balance of payments, chiefly because of capital inflows, remained in surplus.

In April, however, the trade deficit increased from £13 million the month before to £41 million, as imports, after two months of decline, soared 10 per cent over the March total. In May the deficit narrowed to £25 million as imports declined 4 per cent.

Britain's trade performance has been disappointing in recent months. Imports in the six months since the removal of the surcharge were 7.9 per cent higher than in the preceding six months. Even when the two months immediately preceding and following the lifting of the surcharge--and, because of the seamen's strike, June 1966--are eliminated from the calculation, the picture does not look favorable. The monthly average of imports in February-May was about 2 per cent higher than in July-September. The failure to check the rise in imports when the economy is still in a relatively slack state suggests that imports may rise more rapidly than is consistent with a balance of payments surplus when the economy's growth rate accelerates.

The unexpectedly rapid rate of increase in imports has been attributed to the removal of the surcharge, but a comparison of the growth patterns of surcharge and non-surcharge imports does not substantiate this explanation. Imports of finished manufactures, chemicals, and other industrial materials exclusive of basic materials--the three categories which account for most of the goods subject to the surcharge--have, to be sure, increased more rapidly since the surcharge ended. But even when the surcharge was in effect, imports of surcharge commodities were growing at a faster rate than total imports. (See Table 6.)

Table 6. United Kingdom: Changes in Imports[a]

	Indices of Change		
	Imports Subject to Surcharge[b] [c]	Other Imports	Total Imports
Dec. 1966-April 1967 / July-November 1966	115.9	100.7	106.8
Feb.-April 1967 / July-September 1966	104.8	99.9	101.9
Calendar Year 1966 / Calendar Year 1965	107.9	100.7	103.5

a/ Computations are made from seasonally adjusted values of imports.
b/ Surcharge was 15 per cent when imposed in October 1964; it was lowered to 10 per cent in April 1965 and remained at this level until its removal November 30, 1966.
c/ Surcharge imports included chemicals, other industrial materials exclusive of basic materials and finished manufactures.

The export performance has not been encouraging, either. Exports for the first five months taken together were 6.7 per cent greater (in value terms) than in the January-May period in 1966, but, seasonally adjusted, only 1.1 per cent higher than in the final five months of 1966. During 1967 exports have moved erratically. After rising sharply in January, they fell in both February and March. A rise was registered in April, but the value of exports in April was lower than the monthly average in the final quarter of 1966. In May, exports remained virtually unchanged.

The slowdown in economic activity in Western Europe and the United States is hampering the growth of British exports. In Europe the recession in West Germany--Britain's third largest customer in 1966--threatens to be particularly damaging. British exports to Germany have fallen sharply this year. Seasonally adjusted, they were about 10 per cent lower in the first than the fourth quarter.

Developments in the U.S. are also critical. U.K. exports to the U.S., which in 1966 bought more than twice as much from the U.K. than any other country did, grew by over 50 per cent from 1964 to 1966 and accounted for over 12 per cent of British exports in 1966. (See Table 7.) Total British exports increased 6-1/2 per cent last year, those to the U.S. 24 per cent. In the first quarter this year British sales to the U.S. increased slightly over the fourth quarter, but within the quarter declined from month to month.

Table 7. United Kingdom: Exports and Imports by Area

(£ million, monthly average)

	Exports to:[a]					Imports from:				
				1967[e]					1967[c]	
	1964	1965	1966	IQ	Apr.	1964	1965	1966	IQ	Apr.
Sterling area	128	137	132	145	144	157	150	148	152	161
Western Europe	139	145	158	167	166	151	158	172	185	200
E.E.C.	75	75	77	82	83	78	92	87	97	104
E.F.T.A.	52	56	62	67	66	62	65	70	76	82
U.S.A.	34	42	52	55	48	54	56	60	60	63
Canada	16	17	18	20	17	38	38	35	40	39
Latin America	12	13	13	14	15	25	24	24	27	24
U.S.S.R. and Eastern Europe	8	9	12	13	13	16	18	20	19	22
Rest of world	30	32	35	37	39	33	35	36	37	40
Total	368[b]	394[b]	420	450[b]	440[b]	475[b]	479	496[b]	523[b]	549

a/ Excludes re-exports.
b/ Totals differ from sum of components because of rounding.
c/ Seasonally adjusted.