RFD 629

L.5.2.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

January 5, 1968

17 pages

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Domestic Aspects of The U.K. Devaluation

This paper reflects the personal opinion of the author and must not be interpreted as representing the opinion of the Board of Governors.

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Domestic Aspects of The U.K. Devaluation

We are talking tonight about the devaluation of sterling and the weakness in the balance of payments which brought that devaluation about.[1/] But we are also talking about the fact that the improvement in Britain's external position which the authorities hope to bring about will come largely from major changes within Britain's domestic economy. These internal resource adjustments are central to the new economic program, and the extent to which the authorities are able to bring these shifts about will largely determine the success or the failure of that program.

The need to shift domestic resources

On the external side, the goal of the British authorities is an improvement in the balance of payments of £500 million ($1.2 billion) a year by the end of 1968. This means a shift from an external payments deficit of about £400 million for the last half of 1967 to a surplus of about £100 million for the second half of 1968 -- that is, at an annual rate of £200 million -- with a further substantial improvement thereafter.[2/] To achieve this goal, the Chancellor has estimated that the program will

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1/ Presented at a panel discussion on "Sterling Devaluation: Its causes and consequences" at the School of Advanced International Studies, Johns Hopkins University, Washington, D. C., on December 11, 1967. Certain statistical and factual materials have been added to the original version. This paper reflects the personal opinion of the author and does not reflect the views of the Board of Governors of the Federal Reserve System.

2/ Speech of Chancellor Jenkins, Hansard, December 5, 1967, Column 1199.

require a transfer of resources within Britain of about £750 million to £800 million a year -- £500 million to improve the balance of payments and up to £300 million to compensate for the deterioration in Britain's terms of trade because the sterling price of imports will rise more than the sterling price of export sales. If the entire improvement in the balance of payments were to come from the export side, exports in 1968 would have to increase over the 1967 volume by an additional 9 per cent. In recent years, the Common Market Countries have recorded comparable increases in a number of years. At the same time, imports would also have to be held in check.

The improvement in the external accounts requires both:

a. Reduced U.K. consumption, both of foreign goods and of British goods saleable abroad; and

b. Enlarged U.K. production of goods, both for sale abroad and to displace foreign goods on the home market.

But Britain can effect such shifts of goods from the home market to exports only by limiting local consumption.

For this reason, the focal point of the British program is to achieve a reduction in aggregate domestic spending in the period immediately ahead. Without such limitations, there would simply not be room within the British economy to accommodate both additional exports and additional home consumption.

This need for stern retrenchment has undoubtedly disappointed the expectations of at least some proponents of devaluation who had hoped that a lesser degree of domestic deflation would be required to balance Britain's accounts at a lower exchange rate than would have been needed at the $2.80 parity for sterling. 1/ But devaluation is not -- and, if it is to be successful, can never be -- an "easy option." On the contrary, devaluation itself adds inflationary fuel to the domestic economy because some prices and costs must automatically rise and because goods availabilities must be reduced. Only by deflation of aggregate domestic spending can the British authorities hope to succeed in bringing about the export-led expansion in domestic activity which is the primary goal of government policy.

To this end, former Chancellor Callaghan has estimated that the bulk of the increase in personal consumption -- which, before the devaluation, had been expected to rise by 3 per cent during 1968 -- would

> "be transferred to exports and we shall get rid of the deficit. This is the price we shall have to pay." 2/

Not before 1969 would the U.K. be able to afford a rise in personal consumption. On November 18, he announced cuts in the rate of growth in

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1/ See, for example, the article "Austerity-plus and the dangers it carries" by C. Gordon Tether in The Financial Times, December 28, 1967, p. 9, who was concerned that "the importance now being attached to the need for a greater-than-ever austerity emphasis in British economic management will seriously inhibit the resumption of the economic growth that alone can restore the country permanently to health."

2/ New York Times, November 21, 1967, p. 75.

government spending by £400 million or almost $1.0 billion. Some £200 million ($500 million) would be direct spending by the government sector:

a. Some £100 million ($240 million) in planned defense expenditures; and

b. Some £100 million in capital expenditure programs of the nationalized industries and in other public expenditure.

An additional $500 million will involve reduced transfer payments by the central government, including:

a. Some £100 million from the termination of Selective Employment Tax refunds and premia payments outside development areas and other tax changes; and

b. Some £100 million from the withdrawal of export rebates.

At the same time, interest rates were sharply raised and credit availabilities reduced -- which are bound to curtail spending and investment in the private sector. The Bank of England's discount rate was raised from 6-1/2 to 8 per cent, the highest level in 50 years. In the British banking system, a higher Bank Rate brings with it a general rise in the entire structure of interest rates. (See Table 1).

In addition, tighter restraints on installment credit are intended to reduce consumption of durable consumer goods. Downpayments on installment purchases of automobiles were raised from 25 to 33-1/2 per cent and the maximum repayment period was reduced from 36 to 27 months. Earlier, in June and again in August (1967), installment buying regulations had been eased. Before the reduction in terms in June, however, a minimum downpayment of 40 per cent and a maximum repayment period of 24 months had been in effect.

Table 1. United Kingdom: Selected financial indicators, 1967

(in per cent per annum)

	Sept. 7	Oct. 19	Nov. 9	Dec. 14
Bank of England discount rate	5-1/2	6	6-1/2	8
Money-market rates (3-month)				
Treasury bills (tender)	5.29	5.73	6.31	7.53
Local-authority deposit	5.53	6.31	6.75	7.81
Government securities:				
4-year (1971)	6.42	6.82	7.02	7.65
8-year (1975)	6.82	7.07	7.21	7.53
17-year (1984)	6.78	7.00	7.09	7.27
37-year (2004)	6.61	6.78	6.85	7.36
War Loan (undated)	6.83	6.98	7.06	7.20
Clearing bank lending rates: 1/	6-1/2-7-1/2	7 to 8	7-1/2-8-1/2	9 to 10

1/ Rates on bank advances are usually tied to Bank Rate and change automatically with changes in Bank Rate. The majority of private borrowers probably pay between 1 and 2 per cent above Bank Rate.

If home demand can be held back, the authorities believe that the transfer of resources to the export industries can be made. In November, the United Kingdom had some idle capacity. Some 2.3 per cent of the labor force was unemployed -- an exceptionally high figure for the United Kingdom during the post-war period -- and some manufacturing capacity is currently not in use. A survey of nearly 1,500 firms by the Confederation of British Industry on the eve of devaluation (October 4) indicated that the proportion of firms working below a satisfactory full-rate operation was "at the highest level for eight years."[1/]

Keeping prices and incomes under control

However, the British authorities face two major problems in their attempt to carry out their economic program. In the first place, there is the question: will Britain be able to avoid losing the competitive edge associated with devaluation because of domestic price and wage advances? And secondly, will the authorities be able to cut back domestic demands enough to effect the shift of resources to the export sector?

A smaller devaluation in 1967 (14.3 per cent) has provided the United Kingdom with a greater competitive advantage than was obtained from the larger devaluation in 1949 (30 per cent). For, unlike the

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1/ Press Release, Confederation of British Industry, October 19, 1967, p. 2.

situation in 1949, Britain's major industrial competitors did not also devalue. The International Monetary Fund has estimated that in 1949 the industrial countries which followed the United Kingdom in devaluing accounted for half the world's exports but in 1967 the industrial countries devaluing accounted for only 2 per cent of total exports.[1/] Britain will also benefit from the decision of a few major suppliers of basic food and materials also to devalue in holding down the sterling costs of some vital imports.

In retrospect, Britain's post-war price performance has not been very good. Since 1950, prices have advanced an average of nearly 3-1/2 per cent a year. More recently, the index of retail prices rose by around 4 per cent in 1965 and in 1966. (See Table 2).

In addition, Britain's wage performance has been equally unsatisfactory, and the authorities undoubtedly face some major difficulties in this field. During the post-war period, wages have been pushed up not only by excess demand (which appropriate fiscal action can reduce) but also by cost-push factors (which budgetary policy can't do much about).

Britain's economic difficulties have undoubtedly been materially aggravated by the price-wage spiral experienced between 1964 and 1966. During this period, labor's earnings have gone up rapidly, mainly

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1/ "A comparison of the Devaluation of 1949 and 1967," International Financial Statisrics (IMF), January 1968, page ii and following.

Table 2.

United Kingdom: Hours, wages and prices, 1962 to 1967

(unit as indicated)

	1962	1963	1964	1965	1966	1967 (April)
Hours worked (actual hours):						
Average hours worked	45.3	45.4	45.8	45.3	44.3	44.2
Normal hours worked	42.4	42.4	42.2	41.4	40.6	40.6
Hours at overtime rates	2.9	3.0	3.6	3.9	3.7	3.6
Wages and earnings (1962 = 100):						
Average hourly wage	100	104.0	111.9	122.4	132.2	134.9
Hourly rates of earnings	100	103.7	109.0	115.9	123.6	126.3
Prices (1962 = 100)						
Consumer goods and services	100	101.3	104.2	108.8	113.0	a) 115.0
Retail prices	100	102.0	105.4	110.4	114.7	a) 117.8
Export unit values	100	102.9	104.9	106.9	110.8	a) 112.7

Sources: Hours and wages, Ministry of Labor Gazette

Prices, National Institute, Economic Review

a) Second Quarter

from three sources. In the first place, the normal work week has been shortened -- from 42.2 hours per week in 1964 to 40.6 hours in 1966 (See Table 2). Since labor gets the same pay for the reduced work week, the average hourly wage rate rises when the work week is reduced. Secondly, the shorter normal work week meant that labor was paid at overtime rates for more hours after 1963 than before. (See Table 2). Wage increases well in excess of 5 per cent from these two factors occurred against an average gain in productivity of under 3 per cent over the last six years, the lowest among major industrial countries.

A third factor contributing to Britain's cost difficulties has been what is technically called "wage drift." Take the year-to-year percentage increases in wage rates as specified in union contracts and compare them with the increases in earnings (including bonuses and other special wage payments) but not including overtime. This difference measures "wage drift" or the excess over contract wages paid by local employers to retain their labor force. Wage drift rose sharply during 1964 and 1965. (See Table 3).

To bring this wage-price spiral under control, the government imposed a prices and incomes standstill on July 20, 1966 on all wages and salaries and on the prices of all goods and service in order to provide "a breathing-space of 12 months in which productivity can catch up with the excessive increases in incomes which have been taking place." For six months (to December 1966) there was to be a standstill followed by six months of "severe restraint".

Table 3. United Kingdom: Calculation of "wage drift", 1962 to 1967

(percentage increases over corresponding month in previous year)

	1962		1963		1964		1965		1966		1967
	Apr.	Oct.	Apr.	Oct.	Apr.	Oct.	Apr.	Oct.	Apr.	Oct.	April
Average hourly wage earnings (excluding the effect of overtime)	5.2	4.4	4.0	3.6	6.5	8.1	8.0	9.5	9.7	6.5	3.1
Average hourly wage rates	4.1	4.2	3.6	2.3	4.9	5.7	5.3	7.3	8.0	5.6	2.8
Difference - "wage drift"	1.1	0.2	0.4	1.3	1.6	2.4	2.7	2.2	1.7	0.9	0.3

Source: Ministry of Labor Gazette

The effectiveness of these measures can be seen in a sharp slowdown in wage drift between mid-1966 and mid-1967 -- from an increase of 2.7 per cent in the year ending April 1965 to one of only 0.3 per cent by April 1967. (See Table 3). At the same time, advances in the index of retail prices and in hourly wage rates and weekly earnings also slowed down. (See Table 2).

This freeze came to an end in mid-1967 and numerous wage adjustments -- which had been deferred during the standstill -- began to be processed in Britain's wage-negotiation machinery. Even before devaluation, therefore, these (and other) labor negotiations were expected to result in substantial -- and unavoidable -- wage increases during 1968.

At the same time, the government's legal authority to impose the price and wage freeze also expired. Because of opposition of some Labor Party ministers, many party supporters and most trade unions, the Cabinet decided not to seek an extension of these powers. Consequently, the authorities will be trying to hold back wage advances -- during a period of general price increases -- purely on the basis of voluntary cooperation of labor and management, backed up, of course, by fiscal and credit measures to check aggregate demand.

Allocating resources to exports

The second major question about Britain's devaluation program is whether an adequate flow of domestic resources into export industries will materialize. Britain has been at the bottom of the "growth league" among the larger industrial countries. Since 1950, growth has not reached an annual average of 3 per cent and has exceeded 4 per cent per annum in only four years. But, fortunately, the outlook for domestic expansion during 1968 is good. The Chancellor has already stated that growth this year "should be quite a bit above the 3 per cent originally postulated" by the authorities. Some financial journalists and economists have advanced estimates in excess of 4 per cent. Such an acceleration in output should make it easier to meet the export target.

There have been, in addition, two favorable recent developments of a longer-run character. In the first place, wage costs per unit of output reached a peak in early 1966 and had declined by mid-1967, thanks in part to some acceleration in productivity gains in British industry.

Furthermore, changes of a longer-term character have been underway in the economy for several years which should help to sustain productivity gains. The elaborate processes of consultation on industrial problems between labor, management and government under the National Economic Development Council which was established late in 1961 -- unprecedented in modern British history -- are expected to bring about sustained improvements in labor productivity and plant efficiency in a range of industries. You will recall that last November's widely-publicized rail and dock strikes -- like so many others in the United Kingdom -- were not over wage rates but represented resistance to changes in working practices. Strikes of this character confirm that things are changing within British industry, even if there they also demonstrate that there is, in many cases, strong resistance to such changes.

A better output performance in 1968 would mean more goods available within the country to meet the government targets. But added output means added incomes. Hence, the government will have to make sure, through its incomes and fiscal policies, that added personal incomes don't absorb too much of the added product in the private sector.

Resource flows to the public sector

But the authorities will also have to limit the flow of resources to the public sector. Briefly, the steady year-to-year increases in capital spending by the local authorities and the nationalized industries which have taken place since 1961 must be halted. (See Table 4). Such a slowdown means, of course, cutbacks in spending for new schools, for new electricity-generating capacity, for many other public purposes -- each project highly desirable and fully justified in terms of Britain's needs.

But there is one hard fact which the government has had to face. Too large a proportion of total investment has been concentrated in the public sector -- where only a small proportion of Britain's export goods originate -- compared to the growth in private manufacturing capacity -- where the bulk of them are produced. Since 1961, private investment in Britain has fluctuated from year to year, largely because of Britain's "stop-go" economic policies of recent years, while public-sector investment has continued to grow rapidly. (See Table 4).

To curtail resource flows to the public sector, the International Monetary Fund laid down -- as one specific condition for a $1.4 billion stand-by credit to support the British program -- that the

Table 4. United Kingdom: Gross domestic (national) product at market prices in 1958 prices, 1960 to 1968

(in millions of pounds)

	Actual est's.	Year-to-year changes					Estimated Changes:	
	1961	1962	1963	1964	1965	1966	1967	1968
<u>Private sector expenditures</u>:								
Consumer expenditures	17,156	373	845	704	332	313	328	428
Private investment	2,757	-92	-12	451	111	-95	a/	a/
Inventories	335	-248	134	369	-225	-165	-36	172
Total, private	20,248	33	967	1,524	218	53	--	--
<u>Public sector expenditures</u>:								
Public current spending	3,964	127	62	76	133	150	136	68
Investment: Public author.	887	63	23	209	40	71	a/ 208	a/ 180
Nationalized indus.	880	4	69	124	57	87		
Total, public	5,731	194	154	409	230	308	---	---
<u>Net demands, foreign sector</u>:								
Exports (goods & services)	5,259	91	230	209	276	224	176	444
Imports (goods & services)	5,444	102	207	538	80	118	372	108
Net foreign balance	-185	-11	23	-329	196	106	-196	336
<u>Gross domestic product at market prices</u>	25,794	216	1,144	1,604	644	467	440	1,184
(Year-to-year percent change)	---	0.84	4.40	5.91	2.39	1.59	1.47	3.90

Source: 1961 to 1966, <u>Economic Trends</u>, Central Statistical Office; 1967 and 1968 estimates, National Institute <u>Economic Review</u>, November 1967, p. 10.

a) Not shown separately.

central government should limit its borrowing requirement during the coming year to £1.0 billion. Earlier it had been expected that some £1.5 billion would have to be borrowed next year to finance the current and capital spending of the public sector.

Late in December, the Chancellor and the Prime Minister let it be known that government spending programs would be cut by £800 million.[1/] They decided that, in addition to the £200 million reductions promised in the original statement on November 18, ministers would be asked to agree to further economies of £600 million and that a general review of government spending would be undertaken by the Cabinet during the month of January.

Concluding observations

The domestic economic magnitudes in Britain's stabilization program are entirely realistic. The proposed improvement in the balance of payments could amount to substantially less than half the gain in new production which one can reasonably expect to be achieved by Britain in 1968. For illustrative purposes, estimates for 1967 and 1968 by the National Institute have been added in Table 4 to suggest the rough magnitudes of the readjustments in resource allocation implicit in the government program. As you can see, the major shifts will be flows into

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1/ The Financial Times (London), December 22, 1967, p. 1.

the export sector -- which would become the major claimant on new output in 1968. In addition, and for the first time since 1964, inventories and work in progress would also increase substantially during the year. Because the Institute expects the main beneficial effects of devaluation on exports to come only in 1969, the projections call for a larger increase in consumer expenditures than would be possible if the government's export targets were to be met during the last half of 1968.

So we have come a full circle. Britain's devaluation program can succeed only if there is a temporary interruption to the recent expansion in private consumption spending and a willingness on the part of British labor and industry to maintain price and wage discipline. Because of the danger that the benefits of devaluation could be eroded through advancing costs, the authorities are taking a strong stand against wage and price increases in discussions they will be holding with the Trades Union Congress in early January. The TUC has asked for a general increase of 3-1/2 to 4 per cent for all workers from July 1968; in turn, the Department of Economic Affairs has responded that a "nil norm" for pay raises should be continued throughout 1968 and exceptions to the norm should be limited strictly to "low paid" workers. From July to October 1967 -- after the removal of the freeze but with a "nil norm" -- wages increased at an annual rate of over 5 per cent.

Thus, Britain's primary domestic problem is not so much economic or even -- in the short run -- technological as it is political and administrative. Prospects for the program depend, therefore, on the answers to two main questions:

a. Can the government get the growth in public investment under control? and

b. Can the authorities get the support of labor and management to limit price and cost advances?

How the British government -- and, more important, the British nation -- answer these two questions is likely to determine the success of this devaluation. It will also help to determine the role which the United Kingdom can be expected to play, in partnership with this country, on the world scene in the years immediately ahead.