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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

March 1, 1974

CONFIDENTIAL (FR)

To: Federal Open Market Committee

From: Arthur L. Broida

Attached for your information is a staff analysis of the current and prospective economic position of the United Kingdom.

Attachment

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Office Correspondence

Date March 1, 1974

To Board of Governors (through Mr. Bryant)

Subject: The Economic Situation in the United Kingdom

From Larry Promisel

I. Introduction. Prior to mid-October, the outlook for the British economy -- in real terms -- seemed quite bright. Investment expenditures -- particularly by manufacturing industries -- had begun to rise rapidly, as the Government had hoped, with private and public consumption expenditures rising relatively slowly. The volume of exports, both in absolute terms and relative to the volume of imports, also was showing welcome strength. Unemployment, which had been falling sharply since mid-1972, was reaching its desired lower limit. There was, in short, reason to hope that the economy -- after growing very rapidly during the year ending early in 1973 -- would land on a growth path coincident with the growth of potential output, i.e., with growth at a 3-1/2 per cent rate.

This picture -- even before October -- was marred chiefly in two respects. The rate of increase in prices and wages was likely to remain excessive in 1974. And the balance of payments had deteriorated further than had previously been expected, largely because the depreciation of sterling and rising world commodity prices had led to a severely adverse movement in the terms of trade; in spite of some expected improvement the balance of payments situation in 1974 was likely to remain unfavorable. The magnitude of these problems generated considerable controversy as to whether the Government's policy stance was not, in fact, too expansionary.

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Statistics now available for the third quarter and October indicate that the economy was slowing faster than had previously been expected. Perhaps more significantly, petroleum cutbacks and price increases first announced in mid-October and a series of very important labor disputes beginning in early November -- involving notably the coal miners, locomotive engineers, and electrical power workers -- combined not only to exacerbate the price and balance of payments outlook but also to threaten seriously the outlook for industrial activity.

The appropriate policy response thus became even more difficult to determine. In actuality, the Heath Government responded in two ways. It adopted a series of measures designed to conserve and allocate scarce energy resources including notably the limiting of electricity use for industrial purposes to only 3 days each week. And on December 17, it announced (1) a "mini-budget" designed essentially to curtail the growth of public expenditures and (2) a tightening of credit.

On February 7, when no settlement of the coal miners' dispute seemed imminent, the Conservative Government called a General Election for February 28. With the Labor Party winning a plurality but not a majority, as now seems to be the case, the outlook for policy is unclear. However, any Government that is formed is now faced with three problems requiring immediate attention. It must first settle the miners' dispute. The settlement, which will probably come soon, will undoubtedly involve larger wage increases for the miners than

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they were previously offered. The Government can cite the recent Pay Board hearings which tended to substantiate the miners' claim that they were relatively underpaid. A Labor Government could, in addition, simply declare the statutory incomes policy inoperative.

The Government must also decide what policy actions are appropriate in light of the expected huge current account deficit this year. The Government may try to borrow heavily abroad to finance this deficit, as Tory Chancellor Barber indicated he would do, but the exchange rate may also be allowed to depreciate somewhat and domestic demand management policies might be more restrictive than they would otherwise be. This raises the final issue of what actions will be contained in the Budget for fiscal year 1974/75 beginning on April 1; the Budget is typically announced in March, but may well be pushed back to April, partly because it will take some time for the new Government to formulate its policies, and partly because an unusual degree of uncertainty exists about the implications of the miners' strike. There is considerable debate as to what impact on aggregate demand that Budget should strive to achieve.

Finally, assuming a Labor Government is formed, it remains to be seen how quickly and how strictly the Government acts on its avowed intention to nationalize much of British industry and to renegotiate the terms of Common Market membership.

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II. The underlying economic situation in the United Kingdom. The Government's economic objectives, prior to the oil crisis and the current labor problems, were (1) to control aggregate demand to achieve an annual growth rate of real GDP of 3-1/2 per cent, assumed to be the rate of growth of potential output; (2) to change the composition of demand away from consumption expenditures (both public and private), to free resources for exports and investment; and (3) to reduce the rate of increase of prices and wages. To achieve these objectives, the Government announced in May that the growth of public expenditure would be restrained. It was felt that the growth of private consumption expenditures would slow without specific policy actions, in part because the increase in prices had reduced the growth of real personal disposable income. Export demand was expected to become increasingly strong as the lagged effects of the devaluation of sterling came into play. And it was hoped -- and expected -- that manufacturing industry, in particular, would respond to the favorable outlook for both foreign and domestic demand by sharply increasing its investment expenditures. These developments were expected to take some time; in the interim, the underlying balance of payments problem would be met by some combination of a further devaluation of sterling and foreign borrowing by the public sector; in this manner the deficit could be financed without a significant loss of reserves. Wages and prices would be kept in check by statutory controls until inflationary expectations were removed and a stable non-inflationary growth path had been achieved.

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The first objective of gradually reducing the rate of growth of gross domestic product to about 3-1/2 per cent seems to have been met, although the slowdown may have been somewhat faster than desired. GDP had been rising at exceptionally fast rates from mid-1972 through the first quarter of 1973. Over this period GDP (S.A.) rose in real terms at an annual rate of nearly 10 per cent. But from the second to the third quarters of 1973 the rate of growth slowed down to around the potential rate of 3-4 per cent.[1/] Very provisional data, based on output statistics, indicate that GDP in the fourth quarter may have fallen slightly, but this was partly related to the losses of output associated with the cutbacks in electricity in December, 1973.

The second objective of achieving a shift in the composition of demand also appeared to be meeting with some success. Provisional estimates show an increase in real private consumption expenditures of 2-1/4 per cent (annual rate) from the third to the fourth quarters of 1973. The average level in the second half of 1973 as a whole was only 1/4 per cent above the first half level. The slow growth in consumption expenditures was a contrast with a very rapid upswing in private fixed investment expenditures of 15 per cent between the first half and the third quarter of 1973. (No estimates are available for the fourth quarter as yet).

There also was a considerable swing in resources absorbed by the export sector. From the first half of 1973 to the third quarter,

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1/ Three separate estimates of GDP are made in Britain, on the basis of income, expenditure, and output data; an average of the 3 estimates showed a rise in this period at a 3 per cent rate; based on output data alone the rate of growth was 4 per cent.

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Table 1. United Kingdom: Selected Economic Indicators

	1972				1973				1974	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Jan.	Feb.
Industrial Production (% change from preceding period; SAAR)										
All industries	-9.6[a/]	19.2[a/]	-1.2	12.9	17.8	0	3.6	-5.4	n.a.	n.a.
Manufacturing	-2.4[a/]	11.8[a/]	1.2	14.6	20.0	-1.0	6.2	-4.7	n.a.	n.a.
Prices (change from same period in previous year)										
Wholesale, manufactured products	5.4	4.4	4.8	6.5	6.6	5.8	7.5	9.4	12.8	n.a.
Retail, excluding seasonal foods	7.9	6.3	6.2	7.4	7.3	8.1	8.5	9.3	10.8	n.a.
Average Earnings (% change from same period in previous year)	10.2	11.4	12.2	15.8	13.8	14.3	14.6	12.7	n.a.	n.a.
Unemployed, excluding school leavers and adult students (S.A.; Great Britain only)										
Average (thousands)	865	836	809	754	667	604	562	489	535	548
as per cent of employees	3.8	3.7	3.6	3.3	3.0	2.7	2.5	2.2	2.4	2.4
Adult Vacancies (thousands; S.A.)	124	135	146	176	228	289	334	364	304	278

a/ The coal miners' strike in the first quarter of 1972 distorted the normal pattern of production.
Source: Miscellaneous U.K. sources.

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exports rose at an annual rate of only about 5 per cent, but on a longer-term comparison, from the second half of 1972 to the third quarter, they rose at a rate of nearly 12 per cent. Over that latter period, imports of goods and services (S.A.), at constant prices, rose at an annual rate of only 6-1/2 - 7 per cent.

Two major problem areas have marred the success achieved in the past 1-1/2 - 2 years in eliminating the degree of unused resources, in bringing the rate of growth of actual output in line with the rate of growth of potential, and in shifting resources from consumption to investment and exports. These problem areas involve a sharp increase in Britain's current account deficit and rapid price and wage inflation.

In 1972, Britain had a small current account surplus; in 1973, the current account was in deficit by £1-1/2 billion, or about $3-1/2 billion. Moreover, the rate of deterioration during the past year is even more worrisome than the performance for the year as a whole. During 1973 the current account (S.A.) balance deteriorated sharply and steadily, from a deficit of £187 million in the first quarter to one of £748 million (or close to $7 billion at an annual rate) in the fourth quarter. In January 1974 the deficit reached £312 million.

Within the current account, Britain's customary surplus on services and transfers has continued to grow, partly in response to

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Table 2. United Kingdom: Balance of Payments, 1972-73
(£ millions; quarterly or quarterly rate)

	1972				1973				1974
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Jan.
Seasonally adjusted									
Exports (fob)	2184	2307	2058	2586	2634	2811	2988	3046	3075p
Imports (fob)	2301	2358	2343	2817	2997	3222	3537	4001	4224p
Balance	-117	-51	-285	-231	-363	-411	-549	-955	-1149p
Services and Transfers (net)	198	181	174	215	177	203	233	213p	213p
Current Account	79	131	-110	-17	-187	-208	-317	-742p	-936p
Not seasonally adjusted									
Investment and other capital flows 1/	1	-845	-71	129	71	655	-68	n.a.	n.a.
Capital transfers 2/	-	-	-	-	-38	-19	-1	n.a.	n.a.
Balancing item	79	-387	141	-395	385	-76	146	n.a.	n.a.
TOTAL CURRENCY FLOW	57	-1045	-79	-198	69	377	-258	n.a.	n.a.

p Provisional estimates
1/ Includes short-term capital flows and changes in foreign countries' exchange reserves held in sterling
2/ For example, payments made to implement the guarantee clause of the Sterling Agreements
Source: U.K. Central Statistical Office

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the depreciation of sterling, since foreign earnings are denominated in foreign currencies. But the merchandise trade account has deteriorated sharply, from a surplus in 1971 to a deficit of £2284 in 1973 -- again, with a sharp deterioration during the year (all figures on a balance of payments basis). In January 1974 the trade deficit (S.A.) reached £383 million; much of the higher deficit in that month is attributable to payments for imports of crude oil of £210 million, compared to an average monthly bill of £108 million in 1973 (c.i.f., not seasonally adjusted).

The British have taken some comfort from the fact that in volume terms, exports have been growing fairly strongly -- absolutely and relative to imports -- as cited above. Instead, the deterioration in value represents a worsening of the terms of trade by 16 per cent from the fourth quarter of 1972 to the fourth quarter of 1973, as export and import unit values rose 17 and 39 per cent, respectively.

So far as the other components of the balance of payments are concerned, the most significant development this past year has been the increase in foreign currency borrowing by the U.K. public sector. Since March 1973, when such borrowing was first encouraged by the offering of exchange rate guarantees, the public sector has borrowed $2-1/2 billion equivalent of foreign exchange (through January 1974). Because of this borrowing, U.K. official reserves rose $830 million in 1973, despite the sizable current account deficit. After a fall of almost $300 million in January, U.K. reserves stood at $6.2 billion.

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Inflation has been the Government's other major concern. In January 1974, the general index of retail prices and the wholesale price index for manufactured products (home market sales) were 11 and 13 per cent, respectively, above the January 1973 levels. Moreover, price increases have been accelerating in recent months, in spite of the Government's counter-inflation program. The explanation for the rapid rate of increase in prices over the past year lies largely in the rising costs of non-labor inputs and in rising food prices -- just as in all other industrial countries. The situation was particularly aggravated in the United Kingdom, where the depreciation of sterling combined with rising world prices of food and raw materials -- which are so important to Britain -- to raise the sterling price even more sharply. Thus, the wholesale prices of basic materials and fuel purchased by the manufacturing industry were 65 per cent higher in January 1974 than in January 1973. Given this price increase, most of which can be passed on under the rules of the counter-inflation program, the rise in wholesale prices of manufactured products seems reasonably modest. Similarly, the rise in retail prices must be viewed against the sharp increases in food prices.

Increases in labor costs have also exerted upward pressure on prices since mid-1973. Under Stage I of the Government's counter-inflation program, which began in November 1972, wages were virtually frozen. Under Stage II, which lasted from April to the end of October 1973, wage rates rose almost 10 per cent, as did average earnings (S.A.),

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so that by October wages and earnings were about 12 per cent above year-earlier levels. Given the influence on earnings of a very large number of overtime hours worked, and the influence on wages of two important pre-freeze settlements, the outturn was not too inconsistent with original estimates. Nevertheless, because of the lack of growth of output after the first quarter, and consequently the slowdown in the rate of growth of productivity, unit labor costs in the third quarter rose at an annual rate of about 10 per cent in manufacturing industries, and by over 16 per cent for the economy as a whole (both seasonally adjusted). A complicated set of rules dictates the extent to which increases in labor costs can be passed on in prices under Stage III of the counter-inflation program; very roughly half of the increase must be absorbed. The threat of sharply rising labor costs reinforced the Tory Government's determination to maintain a statutory incomes policy.

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III. The energy crisis in the United Kingdom. Unlike the situation in other countries, the British energy crisis involves not just oil, but also coal and electricity. Indeed, since the Arab countries consider Britain to be a "friendly" country, and have given Britain assurances that British oil needs will be met, the availability of oil does not appear to be a major problem.

The increase in the price of oil, however, will clearly have major implications -- now and over the long run. There are two direct price effects that can be cited. First, higher prices for oil will tend to raise the general price level over what it would otherwise have been -- perhaps by 2 per cent. Second, higher prices for oil will raise the oil import bill -- at least in the short run, since the short run price elasticity of demand is surely low -- and thus, in the first instance, increase the trade and current account deficits. British imports of crude petroleum ran at an annual rate (N.S.A.) of about 800 million barrels in the first 11 months of 1973. If it is assumed that imports in 1974 run at the same rate, a $6/barrel increase in the price of oil (roughly the combined increases in October and December) would add $4.8 billion, or about £2 billion, to Britain's import bill. This figure of £2 billion is broadly consistent with estimates made by the National Institute of Economic and Social Research and by the Society of Business Economists -- both respected British groups -- and by the O.E.C.D. Secretariat, although it is not clear how much indirect price effects

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on domestic demand and on other prices are taken into account in those estimates. These indirect effects are clearly important.

But in the short run, at least, the total effects on Britain of higher oil prices are swamped by the effect of serious labor disputes and of the measures adopted by British authorities to reduce and allocate energy consumption. On November 12 the 260,000 members of the National Union of Mineworkers began a ban on overtime work, which cut coal production by about 40 per cent. The union, bound by an annual conference decision of last July, was seeking a wage increase well in excess of that allowable under Stage III of the Government's counter-inflation program. The agreement would operate from March 1, when the present agreement expires.

Stage III, which runs from November 7, 1973 until the autumn of 1974, puts a general ceiling of 7 per cent, or £2.25 a week, on wage increases, with an individual maximum of £350 per year. Threshold agreements are allowed, with pay to be increased by not more than 40p. per week if the increase in the retail price index reaches 7 per cent during Stage III, and with an additional 40p. per week (maximum) allowed for every 1 per cent increase in prices above 7 per cent. The rules of Stage III also permit a considerable degree of flexibility, by allowing workers to be compensated for working "unsocial hours," for increased efficiency, and for some other factors.

The National Coal Board purportedly exploited the provisions of Stage III as much as possible, to offer the most attractive package

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to the miners that it could. The Government strongly objected to making an exception to the rules for the miners, not so much because of the inflationary burden of an excessive miners' settlement per se, but rather because of the incentive it would provide for other strong unions to adopt tactics similar to those of the miners. Assurances given by the Trades Union Congress that special treatment for the miners would not be used by other unions to strengthen their own wage claims were considered unenforceable.

On January 24 the Pay Board issued a report on "pay relativities." This report is concerned with devising, in the context of an incomes policy, a long-term approach to determining the relative pay of various groups of employees. The Heath Government overcame its initial reluctance to use this report to settle the miners' dispute and proposed to the miners that if they returned to their normal work, the Pay Board would then consider the miners' claim that their wages should be raised relative to those of other workers. The miners rejected this proposal and instead went on strike on February 10. Nevertheless, on February 18 the Pay Board began hearings on the relative position of the miners. It was discovered that the statistics upon which the mineworkers' union had based its claims in the past several years overstated their wages relative to the wages of other workers, i.e. that the miners had a stronger case than they had realized. These findings are likely to be cited in any settlement of the dispute.

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The problem of the coal shortage was exacerbated by other industrial disputes. Train drivers belonging to the Associated Society of Locomotive Engineers and Firemen (ASLEF) also began a ban on overtime and rest-day working and a "policy of non-cooperation" on December 11. The power stations typically rely on coal for about 70 per cent of their generation of electricity, and given the oil situation can only switch to oil to a limited extent. With coal in short supply, and with most coal typically transported by rail, disruption of the rail service rendered the supply of coal to the power stations quite uncertain. An overtime ban by power engineers aggravated the electricity situation further. These disputes have now been settled, or are at least no longer disruptive. But the net results of these disputes, coming on top of the coal shortage and the threat of oil cutbacks, is that the supply of electricity in the United Kingdom was threatened.

On November 13 the Government declared a state of emergency (under the provisions of the Emergency Powers Act of 1920). In so doing, the Government assumed the right to regulate the distribution of food, electricity, oil, gas and other refinery products, as well as British ports. Curbs were imposed on floodlighting and advertising displays, and on heating in commercial plants, effective November 14. Nationalized industries were ordered to cut power and fuel usage by 10 per cent, and an appeal was made to the public to cut energy consumption. It was announced that exports of gasoline and fuel oils will be controlled.

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On November 19 the Government ordered an across-the-board cut of 10 per cent in oil companies' deliveries of all petroleum products, with some exceptions. Motorists were asked to observe a 50 m.p.h. speed limit. Gas coupons were issued in late November, as a precaution in case rationing were to become necessary. A variety of further measures to restrict energy consumption were taken on December 7.

Finally, in an address presented to the House of Commons on December 13, Prime Minister Heath asked all households to restrict their use of electricity for space-heating to one room, and then only if no other form of heating is available. There is to be no television after 10:30 p.m. Industrial use of electricity for continuous processes is to be cut to 65 per cent of normal consumption. Other industrial and commercial users of electricity will be assigned only 3 days per week on which they will receive electric power, beginning January 1 (from December 17 to December 31 users could choose any 5 days); they cannot work longer-than-normal hours on those days. Some critical industries are exempt from these restrictions.

So far it appears that the 3-day work week has caused a smaller loss of output than many had expected. Most estimates suggest that production is about 20-25 per cent below what it would otherwise have been, although the impact on particular firms and industries varies widely, ranging from virtually no production cut for those firms that have private generators to perhaps a 50 per cent cut for some others. Somewhat surprisingly, the impact does not seem to be getting worse as

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time goes on, with some firms even reporting that their output is rising as they learn to adapt to the new situation. On the other hand, shortages of materials -- especially steel -- may be assuming increased importance. Because of the nature of the steel-making process, much of the steel industries' limited supply of coal must be used to keep the ovens hot, and steel production has been cut about in half.

The reduction in electricity consumption is running at not quite 20 per cent, compared to the targeted 25 per cent savings. But because of the unusually warm weather, stocks of coal remain fairly high, and as spring approaches, the critical level of coal stocks becomes smaller.

Finally, it had been expected that many firms would have financial difficulties as their cash flow was reduced. Generally, however, no serious liquidity problems seem to have developed so far.

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IV. Economic policy issues in the United Kingdom. Even before Britain was engulfed in the uncertainties generated by higher oil prices and domestic labor disputes, there was considerable controversy concerning the Government's policy stance. Many critics argued that the Government's policy was too expansionary given the rate of increase of prices and the huge current account deficit. Various critics relied on one or more of the following arguments. First, in a view expressed most forcefully by economists at Cambridge University's Department of Applied Economics, it was argued that since the net financial position of the domestic private sector is relatively stable, the public sector's net financial position is inversely correlated with the net foreign position. That is, the larger the deficit incurred by the public sector, the larger the current account deficit will be, since increased net dissaving by the public sector must be matched by increased net foreign saving, if there is no change in the position of the domestic private sector. Thus, the huge public sector deficit in fiscal 1973/74, forecast to be about £4-1/2 billion, or about 7 per cent of GNP, was to blame for Britain's balance of payments problems.

A second line of argument was based on the contention that the financing of the public sector deficit would result in a huge increase in the money supply, since the Government was not prepared to accept the interest rate consequences of selling public sector debt only to the non-bank private sector. Indeed, as of mid-January 1974, the broadly defined money supply (M3, S.A.) was almost 30 per cent above the January 1973 level. Such an increase in the money supply is clearly excessive, it was argued.

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Table 3. United Kingdom: Selected Financial Indicators

	1972				1973				1974	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Jan.	Feb.
Money supply (% change from preceding period; SAAR)										
M3	19	28	18	28	23	19	34	26	9	n.a.
M1	16	16	6	16	-	26	-12	-1	2	n.a.
Short-term interest rate (3-month sterling CD; last Friday in period)	4.88	7.75	7.56	9.00	9.81	8.12	13.34	16.12	16.12	14.25 a/
Long-term bond yield (3-1/2% War Loan; last Friday in period)	8.81	9.48	9.57	9.81	10.20	10.33	11.45	12.21	13.11	13.55 a/
Share prices (FT Actuaries All-share Index; last working day)	214.7	206.1	199.7	216.9	190.6	193.1	181.5	149.8	141.96	145.74 a/

a/ These figures refers to the levels on February 22.
Source: Miscellaneous U.K. sources.

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Finally, some critics merely pointed to a considerable body of qualitative evidence which suggested that resources were becoming increasingly scarce. Although the unemployment rate remained above levels reached in previous cycles, there was reason to believe that the underlying structure had changed in such a way that the labor market was actually tighter than the statistics indicated. Moreover, there were clearly regional disparities; resources were definitely more scarce in the populous Southeast than elsewhere, for example. Since it takes some time for policy actions to be effective, restrictive policy actions should be taken promptly.

Counter-arguments can, and were, made on all of these points. First, the financial position of the domestic private sector is not, in fact, very stable in the short, or even medium, run. Moreover, reliance on the accounting identities embodied in the financial accounts tends to confuse ex-ante and ex-post saving.

The issue of the rate of growth of the money supply is more difficult. The broad definition of the money supply was considered the most useful and informative until developments following the introduction of a new system of Competition and Credit control in the fall of 1971 rendered it difficult to interpret. Among other factors, the recent low level of clearing bank lending rates relative to money market rates has provided an incentive for large borrowers to utilize their overdraft rights at the clearing banks to invest in sterling CD's and

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other money market assets; this has the effect of raising M3. In contrast the narrowly defined money supply (M1, S.A.) has recently been falling, and in January was less than 5 per cent above a year earlier.

Finally, the Government argued that although pressure on resources was surely increasing, the rate of growth of the economy would slow without a clear swing towards more restriction. For example, private consumption expenditures would not rise as rapidly because higher prices were reducing real disposable personal income. The statistics cited above suggest that the Government was right on this point, although the data are not conclusive.

The imposition of the 3-day work week changed the calculation, however. Arguing that "the fall in output will be greater than the fall in demand," the Chancellor of the Exchequer Anthony Barber introduced a "mini-budget" on December 17, to reduce domestic demand. He announced that in the fiscal year beginning April 1, 1974, public expenditure will be cut £1.2 billion, or 4 per cent, from a previously estimated £29.3 billion to £28.1 billion, all in 1973 prices (G.D.P. in 1973 was about £70 billion). The largest cuts will be for capital expenditure by the nationalized industries and on roads and other environmental and social services -- excluding housing -- and for defense procurement. Instead of rising 2 per cent, as indicated in the previous budget, total public expenditure in 1973-74 is now expected

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to fall 2 per cent; purchases of goods and services will fall 3-1/2 per cent, instead of rising 3 per cent. Actually, these figures overstate the likely fall in expenditures in 1974/75; expenditures amounting to about £1/2 billion which were originally scheduled for 1973/74 have been delayed and will not be made until 1974/75.

No changes in either direct or indirect taxes were announced, except a 10 per cent surcharge on tax liabilities above standard rate, which will affect people who earn more than £5000 per year, and a tax on transactions in land designed to curb property speculation (sales by owner-occupiers are exempt). A complete statement of Government revenue will not be provided until the Budget for fiscal 1974-75 is presented in March or April.

The choice of measures announced on December 17 is somewhat puzzling. Since the impact of the energy crisis is likely to be especially severe in the short run (i.e., while the 3-day work week is in force), it would have seemed appropriate to take some action which would have had an immediate effect. Expenditure cuts for the year beginning in April clearly do not fall into this category. Indeed, the announced budgetary actions seemed to be in large part politically motivated; the Government avoided raising taxes for anyone except for those with very high relative incomes or property speculators -- the latter being particularly unpopular with the general public.

A further measure, likely to have a more immediate impact, is the reimposition of controls -- abolished in 1971 -- on hire purchase,

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credit sales, and rental agreements. Banks and finance houses were asked not to lend to persons on terms more favorable than those permitted under the hire purchase controls; provision of credit through credit cards is similarly constrained.

In conjunction with the Chancellor's mini-budget, the Bank of England announced a new system of Special Deposits, different from that operating under Competition and Credit Control. Effective December 18, all banks and deposit-taking finance houses were asked to be prepared to place with the Bank of England non-interest bearing deposits in an amount related to the growth of their interest-bearing liabilities in excess of some specified minimum percentage rate, calculated on a 3-month moving average basis. The growth in each institution's liabilities is measured from the average of the amounts outstanding on the three monthly reporting days prior to each activation of the scheme. No deposit will be required within the first 6 months of the scheme.

Initially, the specified rate of growth is 8 per cent. If the average of an institution's interest-bearing liabilities on the reporting days for April, May, and June 1974 exceeds the average on the reporting days for October, November, and December 1973 by more than 8 per cent, then the institution must place a deposit with the Bank of England in July 1974 according to the following scale: if the excess is 1 per cent or less, the institution must make a deposit of 5 per cent of the excess; the institution must make a deposit of 25 per cent of any excess of more than 1 per cent but not more than 3 per cent; a deposit of 50 per cent

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of any excess of more than 3 per cent is required. After July 1974 requirements will be assessed monthly. The Special Deposits are repayable in full if the excess growth of liabilities is eliminated, or in part if the excess is reduced.

The Bank of England revoked the calls for Special Deposits, each of 1/2 per cent of eligible liabilities, which were due to be paid on December 27 and January 2. These calls were revoked because the reserve asset position of the banks in the early part of this year was expected to be tight in any case. When monetary conditions subsequently turned out to be even tighter than expected, the Bank repaid some of the Special Deposits made prior to December 17.

The new scheme of Special Deposits was designed specifically to give the Bank of England better control over bank lending and the money supply. The fact that the old Special Deposits paid interest, generally equal to the Treasury bill rate, meant that the banks were not strongly discouraged from bidding for deposits, even though rates paid on sterling CD's, for example, have been well above Treasury bill rates. Now, however, the payment of Special Deposits will be significantly more onerous.

As in the case of the budgetary measures, this new system of credit control is unlikely to help reduce the level of domestic demand in the short run. Moreover, the Bank of England has been reluctant to restrict the banks too much because of concern about possible liquidity problems arising out of the 3-day work week, and because of the need to ensure that the recent failure of some "fringe" banks will not endanger the whole banking system.

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The economic policy problem facing any new Government is whether further restrictive actions are called for in the forthcoming Budget. On the one hand, the problems of both inflation and the balance of payments are likely to be more acute than they would have been if the Conservatives had remained in power. In the short run, wages are likely to rise faster, and net capital inflows, according to general belief, will be reduced. The latter seems plausible in so far as private flows are concerned, but it is less convincing with regard to official flows.

On the other hand, the deflationary implications of the higher price of oil were not fully appreciated late last year. And there is increasing evidence -- based largely on surveys -- that investment plans have been reduced significantly in the wake of the 3-day week and the surrounding uncertainty. With a minority Government or a precarious coalition it is not likely that business confidence will be restored quickly.

My own view is that policy should not become more restrictive. I am inclined to agree that greater efforts should be made to reduce the growth of M3, even though I do not believe that anyone can currently assess the implications of U.K. money supply statistics with confidence. The growth rates of M3 observed in the past year clearly should not be sustained indefinitely and the level of both long- and short-term interest rates, at around 14 per cent per annum, is very close to the expected rate of inflation. Accordingly, a reduction in the growth of M3 could probably be achieved without affecting investment demand adversely.

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However, given the difficulties in interpreting both the likely trend of economic activity and the present policy stance, the appropriate question to ask now is whether it is more appropriate to err on the side of excessive or of insufficient stimulus.

Along with many others, I have a relatively sanguine view of the long-run outlook for the British balance of payments. There is considerable underlying strength in Britain's merchandise exports already, and Britain has not yet received the full benefit from the depreciation of sterling since mid-1973 (not to mention the further depreciation in the past month). Moreover, particularly in the light of recent developments in the petroleum market, the favorable impact on British trade later in the decade of oil and gas in the North Sea is likely to be very large. Given a favorable long-run outlook, I see no reason why Britain should not be prepared to "finance" a deficit for even a few years, if necessary, by means of borrowing abroad or partially running down Britain's official reserves, or even by allowing a temporary further depreciation of sterling. It should be emphasized, however, that the magnitude of the balance of payments problem is likely to be formidable for at least a year or two. And even to the extent that a fall in world commodity prices improves Britain's terms of trade -- which will tend to improve the trade position significantly -- the adverse impact of that on the reserves of some sterling area countries could exert downward pressure on the sterling exchange rate.

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It is clear that inflation is an important problem in the United Kingdom, as elsewhere. But the increase in the general price level has derived in large part from a necessity for relative prices to change -- with the prices of food and raw materials and now oil rising relative to other prices. Relative price changes tend to occur asymmetrically by some prices rising but without other prices falling. Refusing to validate such a rise in the general price level by restricting monetary growth does not seem to me to be an appropriate policy response: it will render the price adjustment more difficult and will involve a risk of greater domestic unemployment.

The risk of higher unemployment -- even abstracting from the energy crisis -- is a serious one. It is serious first in the sense that an excessive slowdown in activity is not unlikely. But it is also serious because it may reduce investment demand for some time to come. If Britain is to exploit the opportunities provided by a structure of exchange rates unusually favorable to U.K. exports, the resource shift which has begun to take place must be allowed to continue. Maintenance of strong demand is essential to that process. The meshing of long-term objectives with short-term pressures has too frequently been resolved in favor of yielding to the latter.