L.5.2

RFD 360

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Division of International Finance

REVIEW OF FOREIGN DEVELOPMENTS

June 20, 1961

Britain's Economic Position and the Budget for 1961-62

10 pages

James C. Wallace

June 20, 1961

Britain's Economic Position and the Budget for 1961-62

James C. Wallace

The British economy over the past eighteen months has been under almost unrelieved pressure on two fronts. The high level of home demand has threatened to create inflationary strains while at the same time the current account of the balance of payments has suffered from a decline in demand in several major foreign markets for British exports. In an effort to solve these problems, the British Government introduced monetary and quantitative restrictions designed to hold down home demand and at the same time made a concerted effort at export promotion. The effects of those restrictions on home demand tended to fall almost exclusively on certain industries (i.e., automobiles and consumer durables) and to increase interest rates to a level that proved especially attractive to foreign-owned short-term funds. The inflow of these volatile funds masked the substantial deficit in the balance of payments and created a potential threat to the exchange stability of the pound sterling should they be withdrawn precipitously.

In an effort to combat more successfully these problems of excess pressure on the country's economic resources and a continuing deficit in the current account, the British Government has presented a budget which includes a greatly reduced Treasury borrowing requirement in the fiscal year 1961-62 and the introduction of two new special tax "economic regulators." With these measures, the authorities hope to get more maneuverability to control demand pressures in the economy.

The total budget

The over-all budget deficit is estimated at £69 million for 1961-62 compared with a deficit of £394 million in the fiscal year 1960-61. The substantial increase in the current surplus, due primarily to revenues from rising incomes and profits, reduced the over-all deficit. Only 12 per cent of the increase in revenues is attributable to new budget measures.

Table 1

United Kingdom Budget 1961-1962
(In millions of pounds)

	1961-62 estimated	1960-61 actual	Change
Current revenue			
Direct taxes	3,598	3,212	+ 386
Indirect taxes	2,665	2,516	+ 149
Miscellaneous	245	206	+ 39
Total	6,508	5,934	+ 574
Current expenditure			
Defense and civil	5,187	4,989	+ 198
Miscellaneous	815	798	+ 17
Total	6,002	5,787	+ 215
Current surplus	506	147	+ 359
Net loans to nationalized industries	575	541	+ 34
Over-all deficit	69	394	- 325

Current revenue

Direct tax changes -- The principal tax concession in the budget is the abolition of surtax on earned income below the £5,000 bracket. It is estimated that this tax relief will decrease receipts from surtaxes by £58 million in 1962-63 and by £83 million in the first year (1963-64) when it will be fully effective. In addition, flat rate allowances for National Insurance Contributions are to be increased. This measure will reduce receipts by £12 million this year and by £15 million for a full year. To partially offset these reductions, taxes on corporate profits are to be increased by 2.5 percentage points to 15 per cent, which is expected to raise £1.5 million extra tax revenue this year and £70 million in a full year. The over-all effects of these new direct tax proposals (along with several minor changes) will be to reduce receipts by £12 million this year and by £26.75 million in a full year.

Indirect tax changes -- The principal changes in indirect taxes were on fuel oils and motor vehicle licenses. The rebate allowable on fuel oil was reduced 2 pence per gallon, which will yield £47.5 million this year and £49.5 million in a full year. The increase in the excise tax on all motor vehicle licenses (excluding buses and coaches) will raise an additional £25 million this year and £26 million in a full year. The over-all effects of these new indirect tax proposals (along with several minor changes) will be to increase receipts by £80 million this year and by £84.5 million in a full year.

Changes in revenue from the new proposals will add £68 million net in the new year. By contrast, the increase in revenue, attributable to the growth in national output, is estimated at £506 million. Therefore, the total increase in revenue in 1961-62 is £574 million (see Table 1). This increase in total revenue is the sum of the three categories: (1) estimated rise in direct taxes from increasing national output will be £398 million but this will be reduced by £12 million as a result of the tax cuts; (2) indirect taxes are estimated to rise by £69 million from increases in national output and this figure will be supplemented by £80 million more from the new measures; and (3) income from miscellaneous items is expected to increase by £39 million in 1961-62 as a result of the growth in national output.

Current expenditure

On the other side of the account, the estimates for civil and defense expenditure, published earlier in the year, are to be increased by £198 million net (see Table 1). Other expenditures are to rise by £17 million, making the total increase in current expenditure of £215 million.

Financing the nationalized industries

Budget estimates indicate that net loans to the nationalized industries will rise by £34 million in 1961-62. The Government has recently taken steps to make the nationalized industries and health scheme more self-supporting and thus to decrease their drain on current Treasury revenue. The first move was to increase the payments by the patients under the National Health Service. This was soon followed with the announcement by the National Coal Board that the price of coal to the consumer would be increased. The thinking behind both of these steps was made clear with the publication of a White Paper1/ in early April 1961. This paper proposed that the statutory requirement that the nationalized industries should "pay their way" over an indefinite period should be replaced by a specific requirement that over a 5-year period surplus on revenue account should at least be sufficient to cover deficits. /Separate proposals for some of the nationalized transport undertakings, including the railways, were published last December (Cmd. 1248)./ In the latest White Paper, the Government accepted the view of the Report of the Radcliffe Committee that unguaranteed borrowing by the nationalized industries on the open market was not "a realistic alternative, at least for the present," to borrowing from the Treasury.

Amount to be borrowed

The amount of the over-all budget deficit to be financed from all sources is considerably below that of recent years. The Government expects to be able to obtain all of the needed cash fron nonmarket sources (proceeds of the National Savings Movement, Tax Reserve Certificates, increased fiduciary issue, and the sterling accruals from expected losses to the gold and foreign exchange reserves). Because of this, the Chancellor does not expect to have to go to the government securities market for new funds during the fiscal year.

In the calendar year 1960, net sales of British Government securities by the authorities amounted to £86 million. This compares with net purchases by the authorities of £305 million in 1959. The successful efforts of attracting nonbank investors into the government securities markets in 1960 may have been primarily due to increasingly attractive yields. These yields rose continuously throughout 1960 and by early 1961 stood at all-time peaks. Between early 1960 and the end of the second quarter of 1961, the yield on undated 3-1/2 per cent War Loan increased from 5.40 per cent to 6.41 per cent. By contrast, stock yields were between 3.75 and 4.90 per cent throughout the period.

1/ The Financial and Economic Obligations of the Nationalized Industries, Cmd. 1337, H.M.S.O.

Purchases of securities by nonbank investors featured promenently in gilt-edged developments during 1960. These purchases included £373 million of bonds and £286 million of Treasury bills; they almost exactly offset the heavy sales of bonds and Treasury bills by the London clearing banks, as may be seen in the following figures on changes in holdings during calendar 1960 (in millions of pounds):

	Government securities	Treasury bills
Discount houses	+ 134	- 68
London clearing banks	- 438	- 212
Scottish banks	- 49	- 3
Total	- 363	- 283
Overseas official holders	+ 66	- 4
Other home and overseas nonofficial holders	+ 373	+ 286
Total	+ 438	+ 282
Over-all total	+ 86	- 1

Source: Quarterly Bulletin of the Bank of England, March 1961.

The large sales of government securities by the London clearing banks represent a decline in their medium- and long-term investments over the year April 1960 to April 1961 of £325 million (see Table 2); as a result, the ratio of investments to deposits declined, despite a decline in deposits, from 22.9 per cent to 16.1 per cent, and by the middle of May 1961 had fallen to 15.0 per cent. This large decline in investments was to finance the growth in advances and to hold the ratio of liquid assets to gross deposits above the minimum acceptable 30 per cent level. Advances to the private sector during the year 1960-61 increased by £334 million compared with a rise of £697 million in 1959-60. With the rise in advances, the consequent reduction in liquid assets would have effected the liquidity ratio even more if it had not been for the decline in deposits. Nevertheless, the liquidity position was very tight in late 1960 and early 1961.

Table 2

London Clearing Banks: Change in net Deposits and Principal Assets
(In millions of pounds)

	April			
	1957 to 1958	1958 to 1959	1959 to 1960	1960 to 1961
1. Net deposits	+ 203	+ 161	+ 302	+ 159
2. Private sector				
Advances	- 44	+ 439	+ 679	+ 334
Commercial bills	- 36	+ 16	+ 34	+ 84
Total	- 80	+ 455	+ 713	+ 418
3. Public sector				
Short-term[a]	+ 95	- 72	+ 134	- 15
Securities	+ 167	- 252	- 445	- 325
Total	+ 262	- 324	- 311	- 340

a/ Includes Treasury bills and call money.
Source: Monthly Statements of the eleven London clearing banks.

This slowdown in the rate of increase of advances in 1960, after the phenomenal growth in 1959, reflected restrictive actions of the authorities, including the introduction of the Special Deposits scheme and the reintroduction of installment credit restrictions early in the second quarter of 1960. The Special Deposits scheme was designed to reduce the liquidity of the London clearing banks by forcing them to keep on deposit at the Bank of England a sum equal to 2 per cent of their gross deposits while the Scottish banks were required to keep 1 per cent of their gross deposits at the Bank of England.[2]

The reintroduction of installment credit restrictions, after their complete removal 18 months earlier, appears to have had a greater direct deflationary effect than did the Special Deposits scheme. The installment credit debt, which had arisen by £107 million in 1958 and £281 million in 1959, rose only by £62 million in 1960. In fact, between June 1960, when the restrictions first took effect, and January 1961, when they were partially relaxed, the installment credit debt declined about £2.7 million on a monthly average.

2/ For full details, see the Quarterly Bulletin of the Bank of England, December 1960, page 18.

Innovations of policy

Monetary and credit measures were featured in the Treasury's efforts in 1960 to restrain the growth in effective demand. The Special Deposits introduced in 1960 affected only the clearing banks leaving the credit creating operation of other financial institutions unimpaired; further, the installment credit controls contributed to a substantial cutback in automobile and consumer durables production. Rising money and bond yields, following in the wake of the increase in Bank rate from 4 to 6 per cent during the first three quarters had the effect of bringing in a substantial flow of foreign owned funds to London. The inflow of these short-term funds has been estimated to be as high as £900 million during the year. They tended to hide the need for remedial measures to halt the deterioration in the balance-of-payments position, and now stand as a potential threat to the exchange stability of the pound. The change in the yield on British Treasury bills and long-term bonds over the past 18 months was (in per cent):

		Treasury bills	3-1/2 per cent War Loan
1960:	Jan. 8	3.75	5.43
	July 1	5.68	5.82
	Dec. 2	4.63	5.80
1961:	March 30	4.48	6.18
	June 9	4.47	6.41

To get greater flexibility in fiscal policy and to relieve some of the burden on monetary policy, the Chancellor introduced two new regulatory devices in the 1961-62 budget. The first gives the Treasury the power to impose a general surcharge (or allow a rebate) not exceeding 10 per cent of the amount of duty or purchase tax and other excise taxes on goods with only minor exceptions (the television license duty, the excise license duties other than the bookmakers license duty and the protective and antidumping duties). The second device gives the Treasury authority to impose a surcharge on employers who are liable to pay the National Insurance employers contribution. This tax, which will not exceed a maximum rate of 4 shillings per employee per week, is designed to discourage hoarding of labor. The Chancellor estimates that the maximum effect of each of these measures on total spending will be in the neighborhood of £200 million if they were to be made fully effective. These rates can be altered by the Treasury within the limits specified without referral to Parliament. These proposals are in line with the general recommendation of the Radcliffe Report which noted that

"There are, however, some changes /in taxes/ that would be useful for influencing total demand and could be made fairly easily. It is feasible to make changes in certain other taxes

> between Budgets -- such changes have occurred in recent years -- and they might sometimes be made without calling in question more than one a year either departmental expenditures or the equitable distribution of taxation. Professor Meade has directed attention to the possibility of more frequent variations of national insurance contributions. The more flexible the fiscal weapon can be made, the less will it be necessary to rely on monetary measures."3/

The budget and the current account

Although the budget should greatly increase the British authority's manouverability and control over demand in the domestic economy, the direct effects of the budget on the country's external position will also be of prime importance. The sharp increase in the deficit in the trade balance in 1960 was highly unsatisfactory. While exports increased by 6 per cent over the year, imports rose sharply by 14 per cent. The quarterly averages of seasonally adjusted monthly trade figures are as follows (in millions of pounds):

	Imports	Exports	Trade balance
1960 - 1st quarter	369	315	- 54
2nd quarter	375	306	- 69
3rd quarter	385	303	- 82
4th quarter	390	307	- 83
1961 - 1st quarter	385	320	- 65
April	354	318	- 36
May	367	290	- 77

Imports -- The extent to which the increased control over demand, afforded by the budget, can halt the rapid rise in imports will be primarily a matter of how much home demand contributed to the rise in imports through the phenomenal increase in inventories of imported goods which began late in 1959. Stocks of imported goods (at 1954 prices) increased by £104 million in 1960 compared with a rise of £15.5 million in 1959 (wholly in the fourth quarter) and a decline of £3.5 million in 1958. Certainly this factor was of importance in 1960.

However, imports have also reflected the structural problem of the competitiveness of British goods in the domestic market compared with substitutes from abroad. The competitiveness of British goods in the domestic economy has declined since 1954. Since that date, imports have grown out of all proportion to the expansion in gross national production. This rise in imports has not been particularly associated

3/ Report of the Committee on the Working of the Monetary System, H.M.S.O., Cmd. 827, August 1959.

with those categories of imports that have been liberalized.[4] A slowing down of domestic expansion would to some extent reduce the demand for imports of raw materials and semifinished goods. But the larger part of the rise in recent years has consisted of manufactured goods competing with home products; it would take more than a moderate deflation of purchasing power to produce a large saving on these. Thus, while that part of any future rise in imports connected with the growth of inventories may be more effectively curtailed by the restraints on domestic demand that the new budget affords the authorities, the basic underlying weakness in the competitive strength of British manufactured goods in their home market will receive little direct aid from these measures.

Exports -- As in the case of imports, the extent of help offered by the budget to exports does not seem to be substantial. The failure of British exports to rise in 1960 in relation to British imports and to the increases in exports of other industrialized countries was merely a continuation of earlier trends. In the ten years since 1950, British exports in volume terms increased by 22 per cent but those of her major competitors increased very much more.

Volume of Exports
(1953 = 100)

	1950	1955	1960	Change: 1950-1960
United Kingdom	106	112	128	+ 22
United States	92	117	149	+ 57
Germany	58	142	256	+ 198
Japan	78	174	325	+ 247

Source: International Financial Statistics.

This relatively small increase in exports has reduced Britain's share of world export markets for manufactures by 40 per cent between 1950 and 1960. The following figures indicate the performance of the United Kingdom as compared with those of her principal competitors (as a per cent of total value of world exports):

	1950	1955	1960	Change: 1950-1960
United Kingdom	25.5	19.6	16.3	- 9.2
United States	27.3	24.5	22.1	- 5.2
Germany	7.3	15.4	18.8	+ 11.5
Japan	3.4	5.1	6.7	+ 3.3

Source: Economic Review, Table 21.

4/ S. J. Wells, "International Finance," London and Cambridge Economic Bulletin, December 1960.

The budget measures would directly aid exports if there were evidence that the excess level of domestic demand tended to reduce the level of goods for export. However, the industries that have had most success in export markets in recent years have been those that have also enjoyed rising sales at home. In addition, a recent study by the National Institute for Economic and Social Research indicates that the major decline in the share of British exports of manufactured goods in world markets over the past few years has been due to a fall off in competitiveness.[5]

How exports will be boosted by abolishing surtax on earned incomes below £5,000 is unpredictable. According to a recent study for the Joint Economic Committee of the Congress,

> " ... neither in Great Britain nor in the United States is there any convincing evidence that current high levels of taxation are seriously interfering with work incentives. There are, in fact ... a number of good reasons for believing that considerably higher taxes could be sustained without injury to worker motivation should the need arise."[6]

Total current account balance -- The adverse effects of exports and imports on the current account balance in 1960 were reinforced by the decline in invisible earnings on both private account -- principally from shipping and petroleum -- and public account -- from the increase in net payments for defense expenditure overseas. The total net proceeds from invisibles amounted to only £22 million in 1960 compared with £120 million in 1959 and £229 million in 1958. This small surplus combined with the deficit on visible trade of £366 million created a current account deficit of £344 million -- the worst deficit since 1951. The deterioration in 1960 is in marked contrast with the favorable outturn in 1958, as is seen in the following table (in millions of pounds):

	1958	1959	1960
Visible trade balance	+ 62	- 69	- 366
Invisible balance	+ 229	+ 120	+ 22
Current balance	+ 291	+ 51	- 344

Concluding remarks

The British budget for 1961-62 was designed to cope with domestic inflationary pressures and with the foreign trade deficit. On both of these fronts, however, there is some question about the effectiveness of

5/ R. L. Major, "World Trade in Manufactures," Economic Review, July 1960.
6/ G. R. Break, "The Effects of Taxation on Work Incentives" in Federal Tax Policy for Economic Growth and Stability, Joint Committee on Economic Report, G.P.O., 1955, page 199.

the budget in the light of Britain's present difficult economic position.

On the domestic side, demand pressures are mounting. Tightness in the labor market and tendencies for price increases in important industrial materials and in the cost of living are symptoms of the growth in internal demand.

Externally, Britain's economic position has deteriorated rapidly since the budget was presented to Parliament on April 17. Recent declines in sterling exchange rates and in the price of government securities in the gilt-edged market reflect a general uneasiness in world foreign exchange markets about the par value of the pound. These adverse developments in the foreign exchange and gilt-edged markets are in response to unfavorable trade returns, and in particular the 4-1/2 per cent decline in seasonally adjusted exports from March to May (1961) below shipments in the preceding three months. This reversal of what had looked like an improvement in exports is unquestionably the most disturbing aspect of Britain's current position.

The extent to which the anti-inflationary budget can directly assist the current account depends wholly on the effects of home demand on the volume of exports and imports. These effects seem to have been generally small in recent years and, at most, only of minor importance. The major cause of the increase in British imports and the decline in her exports and net earnings from invisible transactions is actually a complex range of questions such as salesmanship, quality, delivery dates, repair services and, in some cases, price. These problems have impaired the competitiveness of British goods. Britain's long-term trade problems -- (a) increasing imports, due to declining competitiveness of British goods in the home market, (b) exports of manufactured goods failing to hold their share in world export markets and (c) a sharply declining level of invisible exports -- can not be adequately resolved merely by further efforts at controlling domestic demand.

Because Britain's current economic difficulties are deep-rooted, they cannot be expected to be corrected by means of a few fiscal measures. It is evident that the Chancellor of the Exchequer did not expect, when he introduced the budget, that he would so soon find the pound under such selling pressures as now are evident in world foreign exchange markets. That he will find it necessary to call into effect one of the economic regulators is commonly expected in Britain's financial press; in fact, the main point under discussion has not been whether the measures are needed but the fact that neither of these can be put into effect until sometime in July when the Finance Bill becomes effective. The authorities may decide that restrictive measures may be required before July. These measures, and the budget as well, can only be considered as short-term defenses against a long-term problem of deterioration in the current account and can be thought of only as interim steps while far-reaching structural changes are inaugurated to improve the competitiveness of the British economy in the present world situation.