

# A Programme for **NATIONAL RECOVERY**

## **EXPANSION WITHOUT INFLATION**

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### **Research Paper No. 2**

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PRICE 7s. 6d. (*post free*)

**MAY 1968**

# A Programme for NATIONAL RECOVERY

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## FOREWORD

The theme of this second Research Paper to be issued under the auspices of the National Recovery Programme is **EXPANSION WITHOUT INFLATION**. The case argued here is that expansion of the British economy, carrying with it a rising standard of living, and free from the inflation which has long eroded the value of our money, is attainable in a state of full employment of our working population. In this paper it is demonstrated that inflation is due to the central government's mismanagement of the finances of the public sector. The argument is based on the finding in the Report of the Radcliffe Committee on the Working of the Monetary System (Cmd. 827, August 1959) that the factor which monetary policy should seek to influence or control is the state of liquidity of the whole economy. By showing that inflation today means an excessive expansion of liquidity, this paper reinforces the conclusion of Research Paper No. 1 that "the Government is not in a position effectively to control the level or the composition of aggregate effective demand, or to prevent inflation of the currency."

The Radcliffe Committee's inquiry into the working of the monetary and credit system, which was a most timely undertaking of great national importance, was not required specifically to identify the root cause of inflation. The important improvement in the official statistics, which is referred to on page 15 have remedied this deficiency by making it possible to identify the source of the very evident increase in liquidity of the economy in recent years. We have found that the accumulation of liquid purchasing power in the hands of the people at the end of September 1967 was greater than at the end of September 1964 by about £2,500 million. When it is realised that this is equivalent to roughly £50 of spending

money in hand for every man, woman and child in the entire population, the absurdity of the government's efforts to control domestic demand by "deflationary" measures is revealed.

The nation as a whole has performed the extraordinary feat of over-spending its income while at the same time managing to accumulate a large part of its income in the banking system. The way in which this seeming miracle has been achieved is clearly shown on page 20.

It is brought out that the main weakness lies in the fact that, whereas the banking system can and does control the provision of money as credit to the private sector, there is no limiting control of the money drawn from the banking system by central government borrowing.

All this leads us to the conclusion that a new inquiry into the working of the monetary system should be initiated as a matter of urgency, and that financial management in the public sector should be brought once more under strictest control by Parliament.

Our further researches will look into other questions raised in the original Programme for National Recovery. Report No. 3 will look at the potential resources of the nation as a result of technological progress; Report No. 4 at taxation policies for growth; and Report No. 5 at the balance of payments with particular reference to invisible earnings.

The members of the Committee responsible for the programme of research are Patrick de Laszlo, John Paxton, Antony Vickers and the undersigned. Once again we are greatly indebted to Mr. F. W. Tooby, the full-time economist whose skill and perseverance have made possible the research on which this Paper is based and who formulated the general theme. On this occasion, the Paper was circulated in draft form to a number of people for comment and criticism. The final text owes much to the comments and suggestions they provided.

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1st MAY, 1968.

## Private Affluence and Public Indebtedness

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The public has been led to believe that the economy of Britain is in a mess and that this mess is due to the fact that we have become a nation of spendthrifts. The implication has always been that the public as a whole—each individual—has developed spendthrift habits and that for years we have not paid our way either at home or overseas with the result that we are now deep in debt to foreign bankers.

It is not surprising that a common belief holds the minds of so many. For more than three years it has been obsessively cultivated by political leaders of all parties, and sedulously promulgated by commentators and other publicists through all the ways of informing public opinion.

The world takes a nation at its own valuation. Speaking to the country on television on 19th March, 1968, Mr. Roy Jenkins said of his "tough" Budget: "No doubt there will be a lot of complaints. But I would deserve to receive many more if I had failed to do what was necessary and encourage the country to live in a fool's paradise."

"Jenkins had no need to spell out to his countrymen," said the American magazine "Newsweek", "what was likely to happen if they failed to face up to the challenge before them. Unless Britain can improve its competitive position in world trade and break a seemingly endless series of balance-of-payments deficits, it will be doomed, sooner or later, to

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• 1 April, 1968.

devalue the pound yet again. And another devaluation of sterling, should it occur before the U.S. has put its own international economic position in order, could prove a major, perhaps deadly, blow to the dollar and the entire world monetary system. All of which meant that the impact of Roy Jenkins's budget on the British economy was of direct concern not only to Englishmen, but also to Americans—and, indeed, to all the inhabitants of the non-Communist world."

If, in fact, we are a nation of spendthrifts living in a fool's paradise, and if our improvidence is truly the cause of the series of deficits on the country's balance of payments, the British people must indeed accept much of the responsibility for the vulnerability of the world's trade financing system and the looming threat of a new Great Depression. But are we? Is it?

It is true that the most generally accepted explanation of our present economic troubles is that we have not been paying our way overseas, and have run into debt with foreign bankers, because we have been living beyond our means here at home. This is an explanation which is easily grasped by ordinary people, for we all have to manage to live within our means. To the great majority of us it is a matter of common sense that if our expenditure in any period has exceeded our current income in that period, the excess must have been financed either by drawing on our savings or by borrowing from others—or perhaps by both these means. It is a natural assumption that this self-evident principle must apply with equal truth to managing the finances of a nation. And because this explanation of the country's financial condition is easily grasped, and is therefore generally accepted, we, the British people, with 97½ per cent of our working population of 25 million in employment [and a major problem to find parking space for our 10 million private cars—of which one million are new registrations added last year]—nod comfortable agreement over well-filled glasses that "we're broke".

## OVER-SPENDING

What is the explanation of this seeming paradox? It is indisputable that the nation as a whole has been over-spending. The accounts of our national finances show that

because expenditure has exceeded income in our home economy, we have run down our resources of international money and borrowed from foreign bankers. But these accounts show also that the private sector of the economy—the people at large and the commercial and industrial companies—has lived well within its income and has built up its savings. In contrast, the public sector of the economy—which includes the central government and local authorities, the nationalized industries and other public corporations—has persistently overspent its income. What is more, the public sector's over-spending has, for a number of years past, exceeded the margin of income over expenditure which has been saved by the private sector. It is in this sense that in the economy as a whole, total expenditure has exceeded total income. While the private sector has lived within its income and saved, the public sector has overspent its income by more than the private sector has saved. The result is that the nation lives in a paradoxical state of private prosperity and public indebtedness. This may be living in a fool's paradise, but the folly is in mismanagement of our public finances and not in a general thriftlessness of the British people at large.

Clearly, there is something very wrong with the way in which the financial affairs of the public sector are run. And it is not difficult to identify the main weakness. Management of the economy, as now practised in Britain, presupposes that increased taxation has the effect of reducing the total flow of demand in the economy. But all expenditure constitutes demand, whether on current or on capital account, and whether by the private or the public sector. **Since public expenditure has consistently exceeded the public revenues, despite the escalation of taxes, the "deflationary" measures which governments have applied in their supposed management of the economy have not, in fact, caused any reduction of total demand. Their only effect has been to increase public sector demand at the expense of private sector demand, and thereby to distort the pattern and depress the level of industrial production.**

## DEFLATION

Nor is this the only weakness in the methodology of fiscal management in this country. Deflation should mean the

opposite of inflation. As a general principle of economic policy-making, deflationary measures should be called into play only when total demand in the economy has expanded to the point where the country's productive resources are fully employed in the sense that the utilisation of industrial capacity approaches the limits of its extensibility. When the economy is thus close to full stretch, but not until then, any further expansion of total expenditure places unsustainable pressure on product and labour markets alike, with the result that the levels of prices and wages move upwards, producing the symptoms of inflation. The basic purposes of deflationary measures, therefore, is to prevent inflation by reducing the pressure of demand when a rising level of production stretches existing industrial capacity almost to the limit of practical feasibility.

But this has not been the purpose of the deflationary measures now imposed by the present Government. To quote from the main editorial comment by "The Financial Times" of 20th March, 1968: "The main object of Mr. Jenkins's first Budget is indisputable—to divert productive resources into the improvement of the balance of payments on a scale adequate to produce an annual surplus of around £500m. by 1969. This means imposing drastic curbs on consumer demand at home by one means or another, through price increases, wages restraint, higher taxation or credit restrictions. Just how drastic the curbs should be is arguable; the amount to be taken out of the economy is the difference between its forecast rate of growth and the maximum rate compatible with the balance of payments objective, and both these figures are unsure. Most commentators at home and abroad, however, have come down in favour of increased taxation (or its equivalent) in the range of £400—£700m."

In Research Paper No. 1\*, we explained that the policy of deflation, in its earlier version, was based largely on a belief that the way to correct a deficit on our external trade balance is to force down total demand in the domestic economy because this, it is held, causes exports to rise and imports to fall. The official statistics of the balance of payments, together with the statistics of supply and demand, prove the unreality

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\* Published January, 1968.

of this fable, for all that it has a firm hold on the minds of Whitehall and most commentators. On the contrary, the way to bring about a more favourable balance of trade is to allow total demand, and particularly consumer expenditure in the private sector, to rise. It cannot be repeated too often that the underlying cause of the persistent disequilibrium of our balance of payments is to be found, not in any imbalance of the private sector's trade with the rest of the world, but in the fact that Government expenditures overseas have persistently exceeded the growing net surpluses earned from private current and capital transactions. Here again, it is clear that the central cause of our economic troubles—the recurrent deficits on the balance of payments—is due to heedless over-spending by the Government and not to any failure by the private sector to pay its way overseas. **The policy of deflation is, therefore, both misconceived and mis-directed.**

Yet the wrong-headed doctrine of deflation still flourishes. Indeed, it has lately devoped a new variant. Now the pundits declare in chorus that "to make devaluation work" the imperative need is to reduce the excessive pressure of private consumption on our "resources" which, thus freed, must then be switched to the production of exports and of import replacements.

The tough measures imposed by Mr. Jenkins in his Budget of March 1968 can be justified only in terms of this newer version of deflationary dogma. His policy is founded on the assumption that the economy is now at full stretch. He and his supporting literati take for proof of this the fact that the number of unemployed in the country is only 2½ per cent of the number in employment. From this single datum, seen in the light of orthodox doctrine, it is argued that there is excessive pressure of demand on the labour market, and that this is confirmed by the fact of continuing inflation. Guided by this fetishistic interpretation of a single abstract indicator, economic policy is then based on a belief that our industrial capacity is stretched to the limit and fully employed in meeting the present level of demand. The final non-sequitur in the argument is that since room must be found for the diversion of resources into exports and import substitutions, there must be a reduction of the expenditure on consumption by the people at large, to be enforced by increased taxation.

## DEFLATIONARY DOGMA

The latest version of deflationary dogma thus rests on two suppositions. The first of these is that the inflation which continues to erode the purchasing-power of our money is a consequence of over-full employment of the working population, and that this is both the source and the result of excessive expenditure on private consumption. Although there was a time when this theory was valid in some degree, in present-day labour conditions there is no statistical relationship between the levels of unemployment and the levels of wages and prices. There is no longer any threshold point in the level of unemployment, short of 100 per cent full employment, beyond which a further decrease in unemployment causes excessive rises in wage rates, leading to cost inflation. It is our view, based on statistical analysis of the factual figures in the official record, that the rise in wage rates has not been the cause of the inflationary spiral, but that, on the contrary, wage rates have been forced upward ineluctably by normal market forces as the result of inflation caused by mismanagement of the public sector's finances. A policy which pretends to institute an autocratic control of prices and incomes amounts, therefore, to a gross deception of the people of this country.

The second supposition underlying the policy of deflation is that our existing industrial capacity is strained to the limit by the present pressure of total demand. Statistical evidence on this question is surprisingly sparse. The Tenth Industrial Inquiry by the National Institute of Economic and Social Research, made in December 1967, elicited an estimate by the mechanical engineering industry that in 1967 only 78 per cent of its current capacity had been utilised. The value of this estimate is limited, however; it is derived, not from a comparison of the movement of capacity and output, but from the statements of firms about their potential increase in output, and shows the aggregate experience and expectations of a number of firms in one industry only, and not in the economy as a whole. Nevertheless, there is no reason to suppose that the experience and expectations of firms in the mechanical engineering industry differed in any large degree in 1967 from those of the general run of firms engaged in

production of manufactures for export. We believe that most managements would agree, speaking of industry generally, that the present level of output could be raised by something over 10 per cent without doing more than take up the slack in present utilisation of existing capacity.

In 1967, our gross domestic product of goods and services (at current factor cost) was valued at some £33,300 million, and included goods and services exported to the estimated value of £7,012 million. The most optimistic hopes for our export performance in 1968 foresee an increase of 20 per cent over 1967. If this were to be realised, it alone would demand an increase in our production of goods and services by £1,400 million. That is to say, in order to leave room for increased production of exports in 1968 on the maximum scale foreseen, we needed to start 1968 with sufficient slack in the utilisation of our industrial capacity to be able to increase our total production of goods and services, on that account alone, by 4½ per cent during the year. As we see it, therefore, there is ample slack at present in our industrial capacity to take care of the largest probable increase of export demand in 1968.

Our makers of economic policy see the situation differently—as one of strain rather than of slack. They speak of the need to make better use of our resources, and of having to decide among competing claims on our resources. It is clear that what they mean by resources in this context is the national output of goods and services, the level of which is—according to the theory on which the latest Budget was based—precisely and very strictly controlled by the Chancellor of the Exchequer. With the yearly rate of expansion of output in 1968/69 controlled at 3 per cent, they say, the economy would be at full stretch but safe. We have Mr. Jenkins' word for it that if he were to allow the yearly rate of growth of output to rise to 6 per cent, as advocated by the T.U.C., the gamble would involve appalling risks which could have a catastrophic effect on world trade. This ominous vision of world disaster, hanging fatefully on whether Mr. Jenkins' 3 per cent is more accurate than Mr. Woodcock's 6 per cent, can be grasped only by those who are schooled in the peculiar arithmetic of the mythology of economic management by

deflation. For only they can truly believe that by raising or lowering the level of taxation by a few hundred million pounds, the Chancellor can actually control from the centre, with an accuracy of within 2 or 3 per cent of annual variation, the total volume of goods and services produced in the whole economy, which is valued in tens of thousands of millions.

The limits of our industrial capacity are in reality much more elastic than is imagined in this economics-fiction. In the normal variations of the business cycle since 1947, yearly rates of increase in output of up to 10 per cent have been recorded. To a very large extent these increases in output have been obtained from existing plant and equipment by changes in overtime arrangements and in shift-working. The statistical record shows that total income from employment remains a remarkably constant percentage of the varying value of the gross domestic product at current factor cost. This means simply that when production moves up, earnings move up by much the same percentage, and vice-versa. Since there is now very little unemployment, the periodical increases in total earnings benefit almost entirely the labour-force now in employment, who work longer hours at overtime rates of pay. The orthodox notion that the absolute limits of our industrial capacity are reached when the average level of unemployment throughout the country falls to 1 per cent, takes no account of the current reality of these large variations in output and earnings which relate to overtime working and not to any significant changes in the numbers in employment. It ignores the fact that over the last decade the average number of hours in the normal working week has dropped from 44·6 to 40·5, not so much to increase the manual workers' hours of leisure as to enlarge the opportunities to earn more overtime pay.

Moreover, given the incentive of rising demand, managements can and do increase output by redeployment and re-training of their existing work-force. The continuing introduction of technological innovations also results in greater output from existing resources. **Another important consideration bearing on this is that, if workers generally had abiding confidence in the Government's ability to maintain healthy conditions for the nation's economic activity and so were freed from their chronic fear of being out of a job, many of the restrictive**

**practices and much of the hidden over-manning which are prevalent today would disappear. The result would be an improvement in productivity which could add substantially to our potential output.** We shall be examining the potentialities of these hidden resources in Research Paper No. 3.

In the foregoing pages we have argued that the current policies of deflation are misconceived, mis-directed and ineffective. Oddly, we find the case against these policies most cogently summed up in the following statement:—

*"... we have learned the hard way that deflation and contraction, so far from making us more efficient and competitive, have the opposite effect—costs rise; essential investment is discouraged; restrictive attitudes on both sides of industry are encouraged; a policy which relates incomes to expanding production is made infinitely harder to achieve."*

The oddity of the opinion quoted above is that it was stated by Mr. Harold Wilson in his first policy speech as Prime Minister, in the House of Commons on 3rd November 1964. (Hansard, col. 79.)

## **PUBLIC FINANCIAL MANAGEMENT**

The purpose of this paper is to put forward reasoned proposals to improve the management of our public finances. For it is clear that Britain's economic problem lies in the field of public financial management; not in a want of thrift among the people at large, not in any widespread weakness of management in industry, not in over-spending by the private sector overseas, but in uncontrolled over-spending by the public sector both at home and overseas. It is this which is the primary source of inflation, and it is this which causes the persistent deficits on our balance of payments.

Radical changes are necessary in the ideas which at present inform the making of fiscal and monetary policy. Rather than attempt to unravel these mistaken notions, however, we have preferred to start afresh by re-stating our concepts of the economy, its monetary system and the balance of payments, building up to a new analysis of the financial state of the national economy, on which to base our suggestions for the revision of policies for management of the economy.



## The National Economy

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The national economy is the total activity of all our people in their daily business of life, earning their living by contributing to the nation's production of goods and services, while enjoying life in consuming a share of those same goods and services. It is a self-contained and balanced system for the multiple exchange of demand and supply of goods and services. It is balanced because all production anticipates an equal demand; and because supply and demand are held in constant equality of value by the dual participation of a buyer and a seller, and their mutual agreement on a price, in every one of the myriad exchanges in the daily economic life of the country.

This pervasive balancing influence derives from the familiar constraints of natural market forces which are not, and cannot be, centrally controlled, but which constitute an automatic adjustment mechanism which holds supply and demand in constant equality of value at current market prices. This is as true of the economy as a whole as it is of any of the manifold markets of which it is composed.

The sum of the nation's production of goods and services is an entirely fortuitous aggregate. The decisions on what shall be produced where, and how, and by whom, and the decisions on where and how the product or service shall be marketed, are made severally by a host of autonomous managements. It follows that the size, shape, dynamism and growth of the national economy—the jobs and material prosperity of every one of us—are determined, not by the fiscal and monetary policies of any government, but by the practical enterprise and efficiency of the nation's business managements in organising the employment of the nation's resources of capital, know-how and workers, and in competitive marketing at home and overseas.

## The Monetary System

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In our modern exchange economy, nobody lives by bartering his production of goods and services for that of others. The livelihood of all the people is earned by the production of goods and services, but it is received in money. This money-income is expended on a selection of these same goods and services by each individual according to his means and needs, and thus, in the economy as a whole, the total supply of goods and services is exchanged for total demand through the medium of a co-extensive monetary system.

Britain being no longer on the gold standard, the currency of our modern monetary system has neither substance nor intrinsic value. Value in pounds, shillings and pence appears only on paper, as ciphers either inscribed in ledgers or printed on banknotes. The value derives from the principle that every such inscription records both a debtor and a creditor position. To the holder of a banknote the inscription represents a financial asset, while to the Bank of England it represents a liability of the Government. In a bank, a credit balance inscribed in a customer's account represents a financial asset to the customer and a liability to the bank. In the myriad daily exchanges of the nation's economic life there is a continuous, multiple interchange of these financial assets and liabilities, that is to say, of these debtor and creditor positions.

Our monetary system today is therefore a vast system, co-extensive with the economy, for the multiple interchange of a complex set of financial assets and liabilities which, being represented by recorded ciphers, can be inventoried as at successive points in time. It is also a balanced system, because each inscription records both a debtor and a creditor position, so that the total of financial assets in the system is always exactly balanced by the total liabilities. Thus the economic life of the country is carried on by an infinity of exchanges of creditor and debtor positions, involving every part of the organic structure of the monetary system. And these flows of funds—this constant state of flux in the monetary system—is, in the words of the Radcliffe Committee on the Working of the Monetary System (1959): "... nothing less than the state of liquidity in the whole economy."

## The Circular Flow of Income

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The livelihood of all the people in the country is earned by the production of goods and services, but is received in money; and this money is expended on a selection of these same goods and services by each individual according to his needs.

In the economy as a whole, therefore, total income is a perpetual, circular flow, generated as the aggregate of remuneration paid to the people for their individual services contributing to the national production of goods and services, which is a continuous process. The flow of income into the hands of individual persons is in small part retained as savings, but by far the greater part flows out again as expenditure on to the numberless markets of which the total economy is composed. So aggregate expenditure becomes total demand, and this stimulus motivates an equal production. Thus, by the continuous production and sale of goods and services, the flow of expenditure in the total economy is reconverted to a flow of income, and by this perpetual regeneration of purchasing-power the economic life of the nation is carried forward through time.

## The Balance of Payments

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In this case our re-thinking can best start by noting that the balance of payments is no more than a statement of account, in peculiar form, of all the country's financial transactions with the rest of the world. Although peculiar in the way the figures are presented, this accounting is based on the principles of double-entry book-keeping. As in commercial accounting, so in the balance of payments, every external transaction involves both a debit and a credit entry, and the recording of every current account transaction leads to a corresponding change in the balance between external assets and external liabilities.

These principles also form the basis of the relationship between the financial accounts of the national economy and the accounts of the country's financial transactions overseas. If these basic equations are kept in mind, it can be seen that if a country has run a deficit in its balance of payments, investment must have exceeded saving in the economy. Or, to state the same relationship in other terms, a deficit on a country's balance of external trade in goods and services is always the result of the country's total expenditure on consumption and fixed investment exceeding its produced income.

The key to the solution of our balance of payments problem, therefore, lies in ensuring that total expenditure in the national economy on consumption and fixed investment does not exceed the country's total income from domestic production of goods and services and from trading and investing overseas.

It is therefore clear that what is needed to hold our balance of payments in equilibrium is effective financial management of the public sector of our domestic economy, to ensure that in the economy as a whole, total expenditure can never exceed total income.

# Scheme of Analysis

We now set down the reasoning which has guided our study:—

By the continuous process of producing and selling goods and services, expenditure is reconverted to income in a perpetual circular flow. Income being a personal thing, the total income earned from the nation's domestic production of goods and services flows directly and almost entirely to the private sector. (With the exception of the trading profits of the public corporations, the public sector earns no income.) By taxes, rates and other levies, a part of the nation's income from production is transferred from the private sector to be at the disposal of the public sector. In recent years, expenditure by the public sector has persistently exceeded the transferred income at its disposal, and the deficits have been met by some form of borrowing.

Subject to adjustment for changes in inventories, the value of total income flowing from production at any one time is equal to the value of total expenditure flowing into the stimulation of production at the same time. The total flow of expenditure has two components—expenditure by the private sector and expenditure by the public sector. But these two components, passing through the process of production, are reconverted to a single flow of income which goes initially to the private sector. So, at any one time, the initial inflow of income into the hands of the private sector is greater than the outflow of expenditure by the private sector alone at that same time, the difference being equal to the concurrent flow of expenditure by the public sector.

The effect of rates, taxes and other levies is to divert part of the private sector's income into the coffers of the public sector. If the concurrent outflow of public sector expenditure is larger than the flow of income so diverted, a residual flow of income accumulates as liquidity at the disposal of the private sector.

In recent years public expenditure on current and capital account has persistently exceeded the income transferred from the private sector by taxation and other levies. Such deficitary

expenditure must be financed by borrowing. If it were financed entirely and solely by borrowing from the private sector, this further diversion would reduce the total flow of income into the hands of the private sector to an exact equality with the private sector's expenditure. There would then be no accumulation of liquidity at the disposal of the private sector.

However, we know, from the official analysis of changes in holdings of public sector debt, that the deficitary expenditure by the public sector has not, in fact, been financed in full by borrowing from the private sector in ways which would reduce its disposable income. To some extent, therefore, there must have been an accumulation of liquidity at the disposal of the private sector. Two consequences flow from this:—

- (a) The tendency for liquidity to accumulate in the hands of the private sector is offset to some extent by an outflow of liquidity as an expansion of demand. Thus, the monetary demand flowing on to the markets becomes a larger volume of currency than the concurrent flow from production into income, and results in inflation of the currency.
- (b) Although some of the accumulating liquidity flows out as expanded demand, the rest forms an expansion of the total reserves of financial assets in the ownership of the private sector. Since the private sector has complete freedom of choice as to the forms in which its financial reserves are held, and the range of choice has widened greatly in recent years, this expansion of reserves has far-reaching and highly variable effects on the state of liquidity of the whole economy.

We have therefore framed our analysis of the financial accounts of the economy so as to establish in detail:—

- (a) how the known excess of public spending over public revenues has in fact been financed;
- (b) what expansion there has been in the private sector's total holdings of financial assets; and
- (c) what variations there have been in the private sector's holdings of each of the several forms of financial assets now obtaining.

# New Financial Statistics

A most important improvement in the official statistics of the national economy was introduced in 1963 with the production by the Bank of England of quarterly accounts of aggregate flows of funds in the total monetary system. That is to say, economic management in this country has since December 1963 been aided by a new form of management accounting which shows the quarterly changes in the state of liquidity in the whole economy.

These accounts now appear regularly both in the Bank of England's Quarterly Bulletin and in the monthly "Financial Statistics" published by the Central Statistical Office. They divide and re-divide the economy into eight sectors, as shown in the schematic "Summary of Inter-sector Flows of Funds in the Monetary System, 1 October 1964 to 30 September 1967", on page 17.

The figures of sector balances which appear in this schematic summary are taken from our analytical summary of the new financial accounts for the period of three years up to the end of September 1967, which is in Appendix I to this paper, supported by similar summaries for each of the three years separately.

These are accounts of the total monetary system, which is a self-contained and balanced system in the sense that the flows of funds within it are constituted by an infinity of exchanges of creditor and debtor positions among all sectors of the economy, while the total of financial assets in the system remains always exactly balanced by total liabilities.

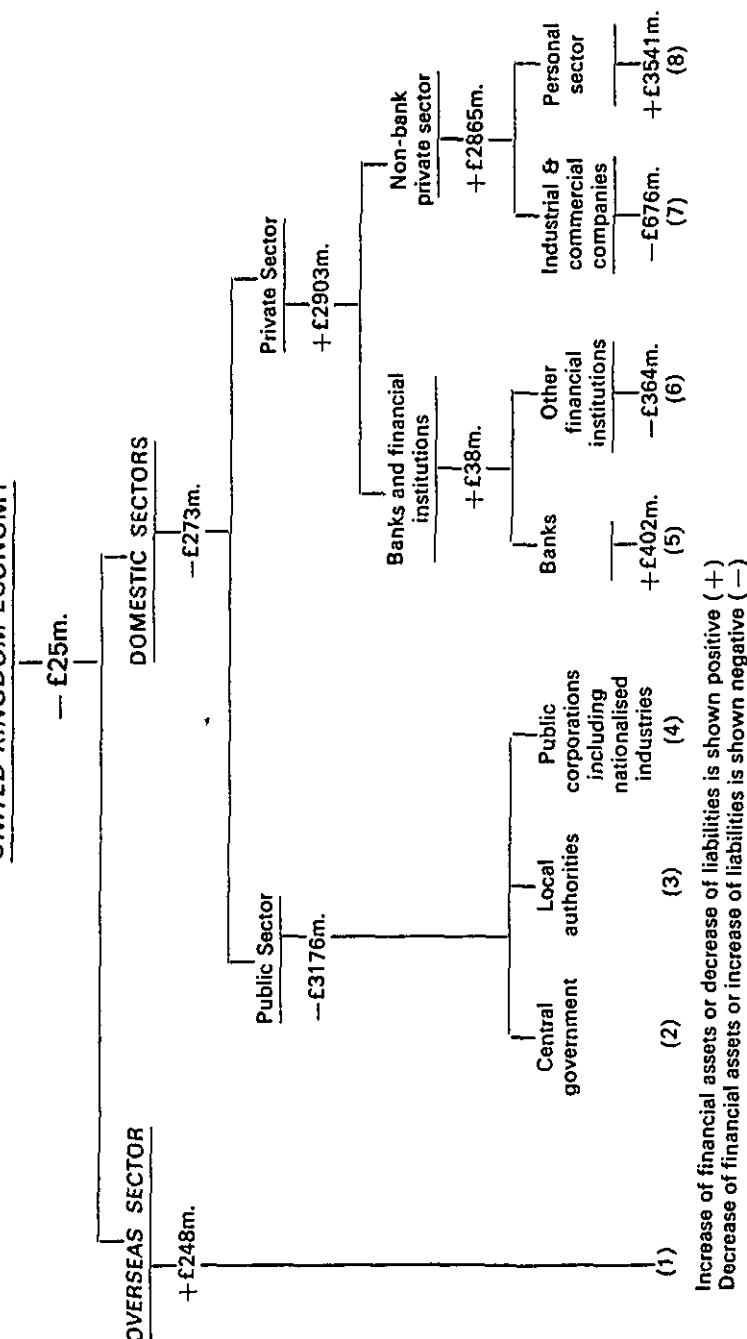
It follows from this that the financial balance of the economy as a whole—the net balance of changes in total financial assets and total liabilities—is, in principle, always zero. By dividing and sub-dividing the economy into sectors, or branches, the accounts show not only the change in each sector's holding of financial assets, but also the contributory relationships of the balances in the branches to the zero balance in the "tree" of the economy as a whole.

Since the structure and purport of the new financial accounts which are summarised in Appendix I are as yet

## SUMMARY OF INTER-SECTOR FLOWS OF FUNDS IN THE MONETARY SYSTEM

1st October 1964 to 30th September 1967

### UNITED KINGDOM ECONOMY



unfamiliar to many, the schematic summary on page 17 is included to serve as an outline guide to the commentary which follows. It will be noted that the financial balance for the economy as a whole appears in the summaries as - £25m., whereas it should, in principle, be zero. An explanation of the discrepancy accompanies the tables in Appendix I.

## COMMENTARY ON THE FINANCIAL ACCOUNTS

The figures for the three years indicate two separate but related phenomena. Firstly, that in our dealings with the rest of the world the country over-spent on current account by £248m. Secondly, that some £3,000m. of new money or liquidity was created during the period.

The balance of payments situation is very clearly shown by the accounts in Appendix I. The deficit of £248m. on current account corresponded to a net increase of Government liabilities overseas by £773m., less a net increase of private assets overseas by £525m.

The means by which £3,000m. of additional money or liquidity came into being internally is more difficult to grasp, but can be understood by keeping in mind the reasoning which guided our scheme of analysis (pages 13-15). While considering the following explanation of the more significant figures in our summaries:—

Over the period of three years to the end of September 1967, there was a deficit in the domestic sectors of the economy amounting to £248m. This means that the combined expenditures of the public and private sectors, on consumption and fixed investment, exceeded by this amount the country's total income from domestic production and from trade and investment overseas.

However, when the accounts of the public and private sectors are considered separately, it is seen that the domestic deficit of £248m. resulted from the fact that expenditure by the public sector exceeded its revenues by £3,176m., while in the private sector there was a financial surplus of income over expenditure amounting to £2,903m. (residual error £25m.).

The surplus of £2,903m. in the private sector was the net product of the financial balances in the four component sectors of the private sector, as follows:—

	£ million	
Banking sector	+ 402	
Other financial institutions	— 364	
Sub-total: Banks and financial institutions		+ 38
Personal sector	+3,541	
Industrial and commercial companies	— 676	
Sub-total: Non-bank private sector		+2,865
Net financial surplus, private sector	+2,903	+2,903

From Appendix I it is seen that the surplus in the non-bank private sector, amounting to £2,865m., resulted in the following changes in that sector's holdings of financial assets:—

	£ million	
Increase of bank deposits (net of advances)		626
Increase of deposits with other financial institutions (net of loans)		4,159
Increase of trade, credit and other financial assets of companies		650
		5,435
Less:		
Sales of stocks and shares by personal sector	2,194	
Issue of stocks and shares by companies	88	
Decrease of holding of public sector debt	288	
		2,570
Net acquisition of financial assets by non-bank private sector		2,865

The figures above show that none of the public sector deficit of £3,176m. was financed by borrowing from the

non-bank private sector, which in fact *reduced* its holding of public sector debt by £288m. The result was that the entire surplus of £2,865m. in the non-bank private sector went to swell the sector's credit balances with banks and other financial institutions.

This means that, although the financial balance of the whole economy for the three-year period was a net increase of liabilities/decrease of financial assets, amounting to £248m., there was in fact an accumulation of earned income amounting to some £3,000m. As a nation, therefore, we accomplished during those three years what as individuals we would hold to be impossible—we over-spent our income, but at the same time managed to put aside part of our income to increase our bank balance.

The explanation of this feat is that, of the two components of expenditure in the economy as a whole, expenditure by the private sector was financed entirely out of the country's total flow of income, almost all of which flows to the non-bank private sector; but of the expenditure by the public sector, some £3,000m. was financed by borrowing from overseas (£800m.) and from banks and other financial institutions (£2,200m.). **This left about £3,000m. of the country's total flow of income free to accumulate in the hands of the non-bank private sector, who deposited it in the banks and other financial institutions.**

It may be thought that it makes no difference if the public sector chooses not to borrow direct from the non-bank private sector, but rather to borrow from the banks and financial institutions with whom the accumulation of income is deposited. In fact this is not so. We are here considering aggregate flows of funds among the main sectors of the economy. When there is an increase in the collective total of deposits by the non-bank private sector with the banks and other financial institutions, the latter are thereby enabled to *increase the total of their lending by an almost equal amount*. But this increase in total lending by the banks and financial institutions does not diminish or restrict in any way the right of individual depositors to dispose of their liquid funds as they please. When the public sector borrows direct from the non-bank sector, the collective effect of such borrowing is to reduce the total amount of liquid funds at the disposal of the

non-bank private sector as a group. But if the non-bank private sector's funds are deposited with the banks and financial institutions, who then have larger resources of liquidity to lend to the public sector, the aggregate of this borrowing by the public sector does not reduce at all the total of funds at the free disposal of the non-bank private sector.

Borrowing by the public sector is not, however, limited by any consideration of the resources of liquidity of the banks and financial institutions. The great majority of public sector borrowing is now done through the central Exchequer. Whenever expenditure by the Exchequer on current and capital account exceeds its revenues, the Bank of England provides the cash automatically to cover the deficit to whatever extent it is not financed by other means. At all times the Exchequer seeks to maintain a minimum working balance on its account with the Bank of England, which provides cash as necessary by means of market operations, the end result being that the Exchequer's increased indebtedness is to the banking system and not to the Bank of England. **The practical consequence of this is that, whereas the banking system can and does control the provision of money as credit to the people at large and the commercial and industrial companies of the private sector, there is no limiting control of the money drawn from the banking system by central government borrowing. It was to this situation that Lord Cromer was no doubt referring in his speech on 18th May 1966, in which he said: "We unfortunately have a system under which Exchequer financing can and does lead to the creation of money quasi-automatically to the extent that the requirements of the Exchequer are not met by genuine savings or taxation . . ."**

Over the three years under review, it is clear that because total public expenditure was not financed entirely out of income transferred directly from the non-bank private sector, either by taxation or by borrowing, the total liquidity of the whole economy was expanded by some £3,000m. This, beyond question, is what is now meant by inflation of the currency in the context of our modern monetary system. Unfortunately, the new financial accounts do not yet provide information on the total amount of liquidity in the economy

at any one time, so one cannot calculate the rate of its expansion over the three-year period. An indication of the degree of expansion may be found, however, in the fact that net deposits by United Kingdom residents with the banking sector alone expanded from £9,238m. at the end of September 1964 to £11,310m. at the end of September 1967. This was an increase of 22.5 per cent over the three years, representing an average rate of expansion of 7.0 per cent. Over the same period the average yearly rate of real economic growth was only 1.9 per cent.

This increased liquidity in the economy is at the disposal of the non-bank private sector which, as shown in the schematic summary on page 17, is composed of the personal sector—the people at large—on the one hand, and the industrial and commercial companies on the other. Since we are examining the paradox of public indebtedness and private affluence, it is important to consider separately how much of the increased liquidity has accumulated in the hands of the personal sector alone.

The detailed figures are set out in Appendix II, from which **it is clear that at the end of September 1967, the mass of liquid purchasing-power in the hands of the people at large was greater than at the beginning of the three-year period by an amount of the order of £2,500m. (This sum, it should be noted, is equivalent to roughly £50 of spending-money in hand for every man, woman and child in the entire population.)** Both the fact of the accumulation during three years of “deflationary” policy, and the magnitude of the fund of liquidity built up by the end of the period, demonstrate the absurdity of the notion that fiscal measures can effect a reduction of demand in the economy under present methods of managing the finances of the National Exchequer.

There can be no doubt that, in the total economy, this growing volume of pent-up purchasing power has continuously intensified the pressure of total demand on the currently available supply of goods and services, and it is this, very certainly, which is the main factor forcing prices up and causing the continuous erosion of the purchasing-power of profits, wages, salaries and pensions.

## Policy Implications

In the making of economic policy, as in the management of a business, the first essential is to establish objectives which are clear-cut, which take full account of the facts and figures defining the economic environment and financial resources, and which the management is equipped and competent to achieve.

Today, the British people, in common with the rest of the world, demand that the country's economic goals shall be high employment, price stability, and a rising standard of living borne on an accelerated growth of output. The means at the disposal of the Government to “manage” the country's economy for the achievement of these objectives are the tools of monetary and fiscal policy.

The present Government have applied the tools of monetary and fiscal measures to serve deflationary policies which have proved to be misconceived, mis-directed and ineffective, while, at the same time, they have caused inflation of the currency by mis-management of our public finances.

In doing so, they have suspended the pursuit of the country's economic aims in the longer term. Long-established inflation continues to force prices and wage rates upwards, and the real growth-rate of the economy is less than the rate of erosion of the purchasing-power of money, with the result that the country's standard of living is falling in real terms.

In the light of our analysis of the financial condition of the national economy, we put forward the following proposals. Their purpose is to re-establish economic policies which, while pursuing the economic objectives demanded by an enlightened people, would maintain equilibrium in the medium and long-term in the balance of payments. The aim would be EXPANSION WITHOUT INFLATION.

### MONETARY POLICY

Prevention of inflation should be a function of monetary policy and not of fiscal policy. The aim of monetary policy should be to maintain the liquidity of the monetary system at such a volume that the general price level is held constant.

New financial accounts should be developed to provide at regular intervals the amount of liquidity in the whole economy.

We should cease to base economic policy on the level of unemployment used as the sole indicator of excessive demand in the economy. The pressure of demand should be measured directly as total final expenditure on consumption, investment and exports of goods and services; and the degree of industrial capacity utilization should be measured from more frequent and comprehensive reports from industry itself.

Less reliance should be placed on the control of interest rates in the banking system as the main instrument of monetary policy. The great expansion in recent years of liquidity on deposit in financial institutions outside the integrated banking system has made this instrument largely ineffective.

A new inquiry into the working of the monetary system should be undertaken as a matter of urgency.

## FISCAL POLICY

Fiscal measures can reduce total demand only to the extent that there is an excess of revenue over the central government's total expenditure on current and capital account. Unless that condition obtains, rates, taxes and other levies should be reduced to a minimum by being used to finance public expenditure on current account only. There should be a general application to all public finances of the principle that all expenditure on capital account should be financed by the sale of securities to the non-bank private sector. This principle should apply in particular to the National Loans Fund, newly created to be the vehicle for all central government lending to local authorities, nationalized industries and public corporations.

It is of vital importance that our fiscal administration should be thoroughly renovated, so as to bring the management of our public finances once more under strict control by Parliament. Just as the Commons receives from the Chancellor of the Exchequer, in advance of each fiscal year, an estimate of his revenue and expenditure in that year, so, too, the Commons should receive each year a budget on capital account—including a budget for the National Loans

Fund—which it can debate separately and approve. To the extent required to provide adequate time once more for a rigorous control of all public expenditures, Parliament should overhaul and modernise its procedures. It was established long ago as a first principle of our representative democracy that Parliament should have sovereign power over the finances of the State. **In recent years, the management of our public finances by the Executive has been lax and inefficient, with damaging consequences for the country's economy. It is our belief that the country's elected representatives in Parliament bear an even greater responsibility towards the constituencies than do the elected directors of a public company towards their shareholders.**

## BALANCE OF PAYMENTS POLICY

There is a remarkable long-term equilibrium in Britain's private sector trade in goods and services with the rest of the world, which we shall examine in a later report. The cumulative net balance shows a relatively tiny margin of difference between massive exports and equally large, but quite unrelated imports; and a regular oscillation over a period of four to five years between deficit and surplus. The International Monetary Fund was created to provide member countries with the means of financing these periodical swings into deficit while avoiding the necessity for deflationary measures and economic stagnation at home—or devaluation of the currency. Our subscription to the capital fund of the I.M.F.—a quarter of it in gold—is of such a size that our drawing-rights as paid-up members are amply sufficient to cover the cyclical swings into deficit of the private sector's balance of trade.

We are no longer required to support the strains on our small reserves which arise from the rôle of sterling as international money and a reserve currency. The co-operative action of other central banks since the provision of adequate liquidity for the world's trade financing system became a critical international problem assures us that, provided our balance of payments is otherwise soundly managed, Britain, as banker to the world and with large external resources, can always obtain any necessary cover.



The remaining basic problem on our balance of payments is that the net cash inflow of private capital and interest, though large and growing, is not yet large enough to cover the Government's net expenditures overseas. Two things are necessary—to encourage by all possible means the expansion of the net cash inflow from private foreign investment, and to find means of reducing the burden on that inflow which is imposed by the Government's actual expenditures overseas. As regards the latter, we suggest that the central government should be required to adhere in its external transactions also to the general principle that all expenditures on capital account should be financed by formal borrowing. In this case, having regard to the general purpose of the Government's capital expenditure overseas, it would be appropriate to finance it by long-term borrowing from, say, the World Bank. If this were done, the Government's expenditure overseas on current account, at the present rates, would be well covered by the net inflow of private capital and interest.

## FINANCIAL ACCOUNTS

Totals for three-year period

1 October 1964 to 30 September 1967

## Inter-sector Flows of Funds in the Monetary System

Classification by Sector of Twin Changes of Financial Assets and Liabilities

Increase of financial assets or decrease of liabilities is shown positive (+)

Decrease of financial assets or increase of liabilities is shown negative (—)

£ million

Debtors \ Creditors	Overseas sector	Public sector	Private sector			Residual error in classification
			Total	Banks and financial institutions	Non-bank private sector	
UNITED KINGDOM	+ 248	-3176	+2903	+ 38	+2865	- 25
PUBLIC SECTOR	+ 773	-3073	+1894	+2182	- 288	- 406
Central government	+ 886	-1779	+ 839	+1064	- 225	- 54
Local authorities	- 42	-1330	+ 968	+ 892	+ 76	- 404
Other public sector	- 71	+ 36	+ 87	+ 226	- 139	+ 52
PRIVATE SECTOR	- 525	- 103	+1009	-2144	+3153	+ 381
Banking sector	- 300	+ 69	+ 530	- 96	+ 626	+ 299
Other financial institutions	+ 23	-	- 278	-4437	+4159	- 255
Stocks and shares	+ 221	+ 64	- 77	+2205	-2282	+ 208
Trade and hire purchase debt	- 39	- 236	+ 181	- 10	+ 191	- 94
Other private sector	- 430	-	+ 653	+ 194	+ 459	+ 223

## Further Analysis of Private Sector

£ million

Debtors	Creditors	Totals	Banks and financial institutions			Non-bank private sector		
			Banks	Other financial inst's	Total	Ind. and comm. coys.	Personal	Total
UNITED KINGDOM			+ 402	- 364	+ 38	- 676	+3541	+2865
PUBLIC SECTOR			+ 512	+1670	+2182	- 175	- 113	- 288
Central government			+ 839	+ 339	+ 725	+ 88	- 313	- 225
Local authorities			+ 968	+ 173	+ 719	- 124	+ 200	+ 76
Other public sector			+ 87	—	+ 226	- 139	—	- 139
PRIVATE SECTOR			- 110	-2034	-2144	- 501	+3654	+3153
Banking sector			- 295	+ 199	- 96	- 771	+1397	+ 626
Other financial institutions			—	-4437	-4437	- 299	+4458	+4159
Stocks and shares			+ 78	+2127	+2205	- 88	-2194	-2282
Trade and hire purchase debt			+ 107	- 117	- 10	+ 188	- 7	+ 191
Other private sector			—	+ 194	+ 194	+ 459	—	+ 459

# **FINANCIAL ACCOUNTS** **Year to 30 September 1965**

## **Inter-sector Flows of Funds in the Monetary System**

Classification by Sector of Twin Changes of Financial Assets and Liabilities  
Increase of financial assets or decrease of liabilities is shown positive (+)  
Decrease of financial assets or increase of liabilities is shown negative (—)

£ million

Creditors Debtors	Overseas sector	Public sector	Private sector			Residual error in classification
			Total	Banks and financial institutions	Non-bank private sector	
UNITED KINGDOM	+ 202	— 869	+ 685	+ 65	+ 620	+ 18
PUBLIC SECTOR	+ 548	— 850	+ 353	+ 346	+ 7	+ 51
Central government	+ 601	— 505	— 96	— 35	— 61	—
Local authorities	— 34	— 343	+ 423	+ 314	+ 109	+ 46
Other public sector	— 19	— 2	+ 26	+ 67	— 41	+ 5
PRIVATE SECTOR	— 346	— 19	+ 332	— 281	+ 613	— 33
Banking sector	— 175	+ 10	+ 101	+ 227	— 126	— 64
Other financial institutions	+ 75	—	— 119	— 1300	+ 1181	— 44
Stocks and shares	+ 75	— 15	— 25	+ 614	— 639	+ 35
Trade and hire purchase debt	— 73	— 14	— 14	+ 107	— 121	— 101
Other private sector	— 248	—	+ 389	+ 71	+ 318	+ 141

## **Further Analysis of Private Sector**

£ million

Creditors Debtors	Totals	Banks and financial institutions			Non-bank private sector		
		Banks	Other financial inst's	Total	Ind. and comm. coys.	Personal	Total
UNITED KINGDOM	+ 685	+ 200	— 135	+ 65	— 434	+ 1054	+ 620
PUBLIC SECTOR	+ 353	— 177	+ 523	+ 346	— 80	+ 87	+ 7
Central government	— 96	— 216	+ 181	— 35	— 29	— 32	— 61
Local authorities	+ 423	+ 39	+ 275	+ 314	— 10	+ 119	+ 109
Other public sector	+ 26	—	+ 67	+ 67	— 41	—	— 41
PRIVATE SECTOR	+ 332	+ 377	— 658	— 281	— 354	+ 967	+ 613
Banking sector	+ 101	+ 246	— 19	+ 227	— 649	+ 523	— 126
Other financial institutions	— 119	—	— 1300	— 1300	— 129	+ 1310	+ 1181
Stocks and shares	— 25	+ 24	+ 590	+ 614	+ 114	— 753	— 639
Trade and hire purchase debt	— 14	+ 107	—	+ 107	— 8	— 113	— 121
Other private sector	+ 389	—	+ 71	+ 71	+ 318	—	+ 318

# **FINANCIAL ACCOUNTS** **Year to 30 September 1966**

## **Inter-sector Flows of Funds in the Monetary System**

Classification by Sector of Twin Changes of Financial Assets and Liabilities  
Increase of financial assets or decrease of liabilities is shown positive (+)  
Decrease of financial assets or increase of liabilities is shown negative (—)

£ million

Creditors Debtors	Overseas sector	Public sector	Private sector			Residual error in classification
			Total	Banks and financial institutions	Non-bank private sector	
UNITED KINGDOM	+ 91	— 800	+ 825	— 5	+ 830	+ 116
PUBLIC SECTOR	+ 327	— 871	+ 381	+ 580	— 199	— 163
Central government	+ 382	— 521	+ 84	+ 208	— 124	— 55
Local authorities	— 24	— 355	+ 244	+ 286	— 42	— 135
Other public sector	— 31	+ 5	+ 53	+ 86	— 33	+ 27
PRIVATE SECTOR	— 236	+ 71	+ 444	— 585	+ 1029	+ 279
Banking sector	— 195	+ 95	+ 372	— 38	+ 410	+ 272
Other financial institutions	+ 37	—	— 150	— 1473	+ 1323	— 113
Stocks and shares	+ 37	+ 53	+ 11	+ 886	— 875	+ 101
Trade and hire purchase debt	— 3	— 77	+ 33	— 18	+ 51	— 47
Other private sector	— 112	—	+ 178	+ 58	+ 120	+ 66

## **Further Analysis of Private Sector**

£ million

Creditors Debtors	Totals	Banks and financial institutions			Non-bank private sector		
		Banks	Other financial inst's	Total	Ind. and comm. coys.	Personal	Total
UNITED KINGDOM	+ 825	+ 111	— 116	— 5	— 345	+ 1175	+ 830
PUBLIC SECTOR	+ 381	+ 192	+ 388	+ 580	— 87	— 112	— 199
Central government	+ 84	+ 114	+ 94	+ 208	+ 52	— 178	— 124
Local authorities	+ 244	+ 78	+ 208	+ 286	— 106	+ 64	— 42
Other public sector	+ 53	—	+ 86	+ 86	— 33	—	— 33
PRIVATE SECTOR	+ 444	— 81	— 504	— 585	— 258	+ 1287	+ 1029
Banking sector	+ 372	— 87	+ 49	— 38	— 99	+ 509	+ 410
Other financial institutions	— 150	—	— 1473	— 1473	— 131	+ 1454	+ 1323
Stocks and shares	+ 11	+ 6	+ 880	+ 886	— 190	— 685	— 875
Trade and hire purchase debt	+ 33	—	— 18	— 18	+ 42	+ 9	+ 51
Other private sector	+ 178	—	+ 58	+ 58	+ 120	—	+ 120

**FINANCIAL ACCOUNTS****Year to 30 September 1967****Inter-sector Flows of Funds in the Monetary System**

Classification by Sector of Twin Changes of Financial Assets and Liabilities

Increase of financial assets or decrease of liabilities is shown positive (+)

Decrease of financial assets or increase of liabilities is shown negative (—)

£ million

Debtors \ Creditors	Overseas sector	Public sector	Private sector			Residual error in classification
			Total	Banks and financial institutions	Non-bank private sector	
UNITED KINGDOM	— 45	—1507	+1393	— 22	+1415	— 159
PUBLIC SECTOR	— 102	—1352	+1160	+1256	— 96	— 294
Central government	— 97	— 753	+ 851	+ 891	— 40	+ 1
Local authorities	+ 16	— 632	+ 301	+ 292	+ 9	— 315
Other public sector	— 21	+ 33	+ 8	+ 73	— 65	+ 20
PRIVATE SECTOR	+ 57	— 155	+ 233	—1278	+1511	+ 135
Banking sector	+ 70	— 36	+ 57	— 285	+ 342	+ 91
Other financial institutions	— 89	—	— 9	—1664	+1655	— 98
Stocks and shares	+ 109	+ 26	— 63	+ 705	— 768	+ 72
Trade and hire purchase debt	+ 37	— 145	+ 162	— 99	+ 261	+ 54
Other private sector	— 70	—	+ 86	+ 65	+ 21	+ 18

**Further Analysis of Private Sector**

£ million

Debtors \ Creditors	Totals	Banks and financial institutions			Non-bank private sector		
		Banks	Other financial inst's	Total	Ind. and comm. coys.	Personal	Total
UNITED KINGDOM	+1393	+ 91	— 113	— 22	+ 103	+1312	+1415
PUBLIC SECTOR	+1160	+ 497	+ 759	+1256	— 8	— 88	— 96
Central government	+ 851	+ 441	+ 450	+ 891	+ 65	— 105	— 40
Local authorities	+ 301	+ 56	+ 236	+ 292	— 8	+ 17	+ 9
Other public sector	+ 8	—	+ 73	+ 73	— 65	—	— 65
PRIVATE SECTOR	+ 233	— 406	— 872	—1278	+ 111	+1400	+1511
Banking sector	+ 57	— 454	+ 169	— 285	— 23	+ 365	+ 342
Other financial institutions	— 9	—	—1664	—1664	— 39	+1694	+1655
Stocks and shares	— 63	+ 48	+ 657	+ 705	— 12	— 756	— 788
Trade and hire purchase debt	+ 162	—	— 99	— 99	+ 164	+ 97	+ 261
Other private sector	+ 88	—	+ 65	+ 65	+ 21	—	+ 21

**FINANCIAL ACCOUNTS***Note on residual errors shown in the tables:*

From the official accounts we have taken only the recorded changes in identified assets and liabilities. In principle, since every pair of twin changes is shown both positive (+) and negative (—), the sum of all inter-sector changes should be zero. But it would be unrealistic to imagine that the twin changes are recorded in an integrated set of accounts covering the entire monetary system; given the way in which the several sector accounts must be compiled in practice, it cannot be expected that the sum of all changes will in fact be zero. Moreover, it must in practice be extremely difficult, in respect of all creditor positions in every sector, to identify with unfailing precision the sector classification of the twin debtor positions. Our scheme of analysis is based on the assumption that all changes show up as pairs of identified twins which are accurately classified by sector. In practice, however, this high degree of cross-classification cannot be arrived at, and our analysis thus throws up discrepancies which are described as residual errors in classification.

## APPENDIX II

### Personal Sector

Detail of acquisition and disposal of financial assets  
1 October 1964 to 30 September 1967

The financial accounts show that over the three years under review there was an accumulation of income remaining at the disposal of the personal sector amounting to £3,541m., which was disposed of as follows:—

	£ million
Increase of bank deposits (net of advances)	1,397
Increase of deposits with other financial institutions (net of loans) ... ..	4,458
Sub-total, net increase of deposits ...	5,855
Less: Reduction of holdings of public sector debt ... ..	113
Reduction of holdings of stocks and shares ... ..	2,194
Increase of trade and hire purchase debt ... ..	7
	<u>2,314</u>
Net acquisition of financial assets by personal sector	<u>3,541</u>

Of these large additions to the funds at the disposal of the people at large, much of the accumulation was placed in life assurance and superannuation funds as savings which are proof against the temptation to spend. Nevertheless, there was also a very substantial increase in the liquid funds at the disposal of the personal sector, as can be seen in the following

breakdown of the £5,855m. net increase in personal deposits with banks and other financial institutions:—

Changes in £ million			
	Deposits	Loans	net of loans
Investment departments of trustee savings banks ... +	440	—	+ 440
Life assurance and super-annuation funds ... ..	+3,564	— 197	+3,367
Building societies ... ..	+2,308	—1,830	+ 478
Hire purchase finance coys.... +	46	—	+ 46
Unit trusts ... ..	+ 237	—	+ 237
Less: Other loans unclassified	—	— 110	— 110
Sub-totals, financial institutions other than banks ... +	6,595	—2,137	+4,458
Banking sector ... ..	+1,385	+ 12	+1,397
Total, change in personal net deposits with banks and other financial institutions	+7,980	—2,125	+5,855

Of the £5,855m. net increase of personal deposits, only the funds deposited in life assurance and superannuation funds can be regarded as relatively frozen, though the possibility of raising loans against the security of these funds represents also a substantial source of liquid purchasing-power.

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*Published by*

The Sponsoring Committee of the National Recovery Programme  
10 Upper Berkeley Street, London, W.1

*Printed by*

Maxwell, Love & Co. Ltd., London, S.E.1