

THE "GREAT TURNAROUND" IN BRITAIN'S FINANCIAL AFFAIRS

1964-1970

A research study and brief presented by

the ECONOMIC RESEARCH COUNCIL

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FOREWORD

The Economic Research Council has undertaken to provide a series of Papers for all those who want information about current affairs most clearly rooted in the national economy, by providing impartial but comprehensive and meaningful presentations of information derived from the official statistics.

The first of these Papers deals with the vital question of Britain's balance of payments, and brings up to date the facts and figures already published in Research Report No. 3 by the National Recovery Programme in January, 1969.

Although this is a very controversial subject, we feel that the presentation of the facts extracted from statistical information provided by official sources is essential in present circumstances.

A handwritten signature in cursive script, appearing to read 'Beach', written in black ink.

President

June 1970

Great success has been claimed for the economic policies of the last $5\frac{1}{2}$ years because the "balance-of-payments" has swung :-

from:	a "basic deficit" in 1964 of £800 million -	(actually a monetary net OUTFLOW of £762 million)
to:	a "basic surplus" in 1970 of £606 million -	(actually a monetary net INFLOW of £1,017 million)

Secondly, it is claimed that the great increase of government overseas debt after October 1964 was incurred to pay off a "balance-of-payments" deficit inherited from the Tories. They point out that the Overseas debt was reduced by £1,010 million in the first quarter of 1970.

Thirdly, it is claimed that the present surplus on the "balance of payments" is proof that the British economy is now healthy and strong - "one of the strongest economies in the world".

This report shows that the first two claims are utterly false - therefore the third claim is merely absurd.

The case argued here is essentially the same as that in Research Paper No: 3 "The Balance of Payments and Invisible Earnings" published in January 1969 - one of a series published by The Committee of the National Recovery Programme.

We have brought the RP 3 figures up to date where necessary, and we compare the balance-of-payments over $12\frac{3}{4}$ of "Tory mismanagement" with $5\frac{1}{4}$ years of "Labour's achievements".

The central proposition in the three claims is that the swing from Deficit to Surplus on the "balance-of-payments" was due to the policies of severe restraint bravely applied by the Government for the last five years.

It should be noted that the policies were explicitly designed to correct a deficit on the "BALANCE OF TRADE" IN GOODS (the "disturbing export-import gap"). All along the cry has been that the country must export more and import less.

In fact (as was shown in RP3 - pp 11-21), if Government transactions are excluded and "invisible" services are included, the private sector overseas trade in GOODS and SERVICES, in aggregate, oscillates very narrowly between surplus and deficit but always remains in long-term equilibrium. Over the years it closely followed the cyclical rhythm of world trade. It is impossible to isolate the British economy from the powerful market forces which generate the regular cycles of world trade, therefore it is impossible for governments to control the natural cycles of Britain's external trade in goods and services so as to achieve a perennial surplus. (RP 3 p21)

So the swing from trade deficit in 1964 to surplus in 1969/70 was simply part of the normal world trade cycle. Table A shows the short term oscillations and the long-term equilibrium of private trade in goods and services over the 18 years 1952 to 1969 inclusive.

Table A also reinforces the point made in RP3 (table 4 and pp 12-16), that a visible deficit has been a constant feature of our external accounts for more than 175 years but that, in the course of world trade cycles, our external trade in GOODS and SERVICES (visible and invisible trade) together has always quickly recovered its balance.

This means that the restrictive measures imposed over the last five years (originally to correct the "disturbing export-import gap") were a theorist's attempt to control the tidal rhythm of world trade. Curiously enough, the restrictions were maintained throughout a whole trade cycle because there was a deficit at the beginning of the cycle which, in the natural course of the cycle became a surplus at the end of the cycle.

The world trade cycle is no new discovery. Nor is the fact that the foreign trade of some countries oscillates during a cycle between

surplus and deficit. The International Monetary Fund was created in 1944 specifically to provide temporary finance to countries in the deficit phase of the cycle. The U. K. has subscribed £1,017 million to the Fund (of which £254 million was in gold) which established the right to draw on the Fund for temporary finance up to a ceiling fixed by the rules. In September 1964, the ceiling was £870 million, and nothing had been drawn. At March 1970, the ceiling was £1,271 million but £1,000 million had been drawn.

Up to 1964 the Government used the drawing right on IMF to finance the peak deficits of the two trade cycles (1955 and 1960) during their 13 years of office. They intended to do so again in 1964. Thus the Government used the IMF drawing right as it was intended to be used by its founders - as a second-line reserve of international currency to finance temporary swings into deficit on the balance of payments and so avoid depleting first-line reserves of gold and international currency.

In contrast, since 1964 there has been much talk about "prodigious borrowing to finance the Tory deficits", about "living beyond our means", and the "shocking facts" that had been hidden from the public by the public. This outcry started a run on our reserves of international currency, because it shook world confidence in sterling as a reserve currency.

The country's first- and second-line reserves of international currency at 30 September 1964 stood at £2,224 million. (RP3 pp 33-4). We had drawn nothing from the IMF and only £59 million from other Central Banks. Thus the Government inherited reserves of international currency amounting to £2,165 million more than our outstanding shorter-term overseas debts.

At March 1970, the official reserves totalled £1,400 million, composed of first-line reserves of gold and currency totalling £1,129 million plus, in the second line, the unused balance of our IMF drawing right - £271 million.

Against our total reserve of £1,400 million our liabilities

stood at £1,654 million - £1,000 million drawn from the IMF and £654 million borrowed from Central Banks (see Bank of England Quarterly Bulletin, June 1970, p.121).

IN OCTOBER 1964 OUR RESERVES EXCEEDED OUR LIABILITIES BY £2,165 MILLION.

BY MARCH 1970 OUR LIABILITIES EXCEEDED OUR RESERVES BY £254 MILLION. In $5\frac{1}{2}$ years our external balance of liabilities has deteriorated by £2,419 million.

Official external reserves (first- and second-line) have been run down by £824 million, while official current overseas liabilities have increased by £1,595 million net. Our official deficit in June 1969 was :-

	<u>£million</u>
Proceeds of sale of the dollar portfolio provided	520
Increase in Government overseas debt	2,400
Reduction in gold and currency reserve	20
	<hr/>
	2,940
	<hr/> <hr/>

The claim that the increase in external government debt after October 1964 was required to pay off previous deficits

is nonsense. It is common sense that no-one can spend more than his income without simultaneously reducing his savings or borrowing from somebody else.

This principle is the basis of all business accounting, by which the balance of income and expenditure in any period is exactly counter-balanced by a change in the difference between assets and liabilities.

The same principle, in a slightly different form, is the basis of our national accounts. In the "balance-of-payments" account, the "basic balance" (i. e. the balance of current and long-term capital transactions) is always counter-balanced by an equal change in the "balance of monetary movements" (the change in the balance of external financial assets and liabilities).

Therefore, in the "balance-of-payments", a "basic deficit" must at the time be financed, either by reducing the country's external financial assets (drawing upon its reserves of international currency) or by increasing its external liabilities (borrowing overseas).

So it is obvious that any deficit spending during the first $12\frac{3}{4}$ years must have been financed at that time and was certainly not financed by accumulating subsequent debt.

We attach the official balance-of-payments accounts for the 18 years 1951 to 1969 inclusive separated into the $12\frac{3}{4}$ years up to 30 September 1964 and the subsequent $5\frac{1}{4}$ years up to 1970.

The only change from the official accounts has been to transfer "inter-government loans to the UK" from the "basic balance" to "the balance of monetary movements". This was done because "monetary movements" have been divided so as to show separately the balance of "Official settlements" (i. e. official borrowing overseas and reduction of reserves) and inter-government loans to the U. K. are obviously an important part of UK overseas borrowing. The "basic balance" and the "balance of monetary movements" are shown in Table B.

In Table C, the aggregates of the principal balances for the whole 18 years are divided between the two periods.

Table D shows the main component of the UK "basic balances", and separates the transactions of the PRIVATE SECTOR from those of GOVERNMENT SECTOR. These figures confirm the main conclusion of RP3 (p 9): "... current economic policy is based on a mistaken diagnosis. Our trouble is not that we are running an abnormal deficit on our visible trade account, but that Government spending abroad persistently exceeds the net inflow of capital and income from private foreign investment."

Table E shows the main components of "monetary movements", separating out in particular the balances of "official settlements" and the net movements of foreign-owned short-term funds held in the UK banking system.

The essential facts of the UK balance-of-payments over the 18 years, are thus summarised in Tables B to E. The figures are re-grouped in Annexes 1 and 2 to show the principal outflow of the balance of payments, and the way in which the outflow was financed, under Conservative and Labour government respectively.

Stated briefly:-

Annex 1 shows that in the first $12\frac{3}{4}$ years, the total net OUTFLOW financed through the balance of payments was £754 million; but there was also a net INFLOW of £1,407 million, giving a net financial surplus of £653 million, which was used to reduce government overseas debt by £562 million and to add £91 million, to the reserves of gold and foreign currency.

Annex 2 shows that in the last $5\frac{1}{4}$ years the total net OUTFLOW financed through the balance of payments was £2,786 million. The largest items were a "basic deficit" of £1,054 million (government overseas spending which exceeded the private sector's overseas earnings) and a net OUTFLOW of £1,201 million of foreign-owned funds from the UK banking system. Against this there was a net INFLOW of funds totalling

£264 million, giving a net financial deficit of £2,522 million. This deficit was financed by selling the dollar portfolio for £520 million and increasing government overseas debt by £2,017 million. The net remainder of £15 million was added to the reserves.

These are the facts ! !

For the last five years, the Government has applied restrictive measures to the private economy of this country. These measures were unnecessary because their intended purpose was to reverse a "balance-of-trade" deficit which automatically reversed itself in the natural course of the five-year trade cycle. Thus, while the Government concentrated on tackling a NON-PROBLEM by measures that were both futile and unnecessary, it failed to tackle the real problem which was that the Government persistently spent more overseas than the Private Sector earned overseas. This increased the strain imposed on the balance-of-payments by the withdrawal of foreign-owned funds from the UK banking system which resulted directly from the proclamation of an economic crisis in October 1964, when there was in reality NO CRISIS.

The 12½ years from January, 1952 to September, 1964

	<u>£ million</u>
The net cash INFLOW to the U.K. from the Private Sector's overseas trade was	3,404
Government spending overseas	3,926
	<u>-----</u>
Resulting in a U.K. "basic deficit" of	522
In addition, the U.K. paid a quota subscription to the I.M.F.	<u>232</u>
So that the net TOTAL identified OUTFLOW to be financed was	<u>754</u>
During the period the net INFLOW of finance to cover the outflow was :-	
Net INFLOW of foreign-owned short-term funds to the U.K. banking system	597
Miscellaneous capital movements IN	47
Receipts unidentified (the "balancing item") amounted to	763
	<u>-----</u>
Available finance therefore totalled	1,407
	<u>-----</u>
Therefore the excess of finance over what was required to cover the net identified outflow was	<u>653</u>
The surplus was disposed of by :-	
-reducing Government overseas debt	562
-adding to the reserves of gold and currency.	<u>91</u>
	<u>653</u>

The 5½ years from October, 1964 to December, 1969£ million

The net cash INFLOW to the U.K. from the		
Private Sector's overseas trade was	.....	2,799
Government overseas spending	.....	<u>3,853</u>
Resulting in a "basic deficit" of	.....	1,054

In addition:

There was a net OUTFLOW of foreign-owned short-term funds from the U.K. banking system		1,201
The U.K. paid a further quota subscription to the I.M.F.	.....	175
On devaluation, the Exchange Equalisation Account incurred a loss on forwards of	.....	<u>356</u>
So that the net total identified OUTFLOW to be financed was	.....	<u>2,786</u>

During the period the net INFLOW of finance to cover the outflow was :-

Miscellaneous capital movements IN		62
Receipts unidentified (the "balancing item")		<u>202</u>
Available finance therefore totalled		264

Thus, the total OUTFLOW exceeded the total INFLOW by 2,522

The deficit was financed by :

- the sale (and transfer to the reserves of the proceeds) of the portfolio of dollar securities which were vested in the U.K. government during the 1939-45 War		520
- increase of Government overseas debt		<u>2,017</u>
sub-total		<u>2,537</u>
Less transfer to our reserves of gold and currency		<u>15</u>
		<u>2,522</u>

TABLE A.

BALANCE OF PRIVATE SECTOR OVERSEAS TRADE IN GOODS AND SERVICES SHOWING SMALL OSCILLATIONS WITH A BASIC EQUILIBRIUM OVER 18 YEARS 1952 to 1969

£ million

	BALANCE OF PRIVATE TRADE IN GOODS AND SERVICES			GOODS	SERVICES
	TOTAL IMPORTS	TOTAL EXPORTS	BALANCE		
1952	3,776	3,750	- 26	- 279	+ 253
53	3,676	3,647	- 29	- 244	+ 215
54	3,795	3,783	- 12	- 204	+ 192
55	4,308	4,119	- 189	- 313	+ 124
56	4,360	4,532	+ 172	● 53	+ 119
57	4,603	4,751	+ 148	- 29	+ 177
58	4,387	4,653	+ 266	● 29	+ 237
59	4,697	4,807	+ 110	- 117	+ 227
60	5,321	5,104	- 217	- 406	+ 189
61	5,255	5,324	+ 69	- 152	● 221
62	5,326	5,465	● 139	- 102	+ 241
63	5,656	5,775	+ 119	- 80	+ 199
64	6,395	6,064	- 331	- 517	+ 186
65	6,526	6,486	- 40	- 237	+ 197
66	6,763	6,941	● 178	- 73	+ 251
67	7,267	7,102	- 165	- 552	+ 387
68	8,719	8,628	- 91	- 643	● 552
69	9,164	9,602	● 438	- 158	+ 596
TOTALS FOR 18 YEARS	99,994	100,533	+ 539	-4,024	+ 4,563
<u>BALANCES for period</u>					
12½ years 1952-64			+ 269	- 2,241	+ 2,510
5½ years 1964-69			+ 270	- 1,783	+ 2,053

U.K. BALANCE OF PAYMENTS
Principal balances for 18 years 1952 to 1969 inclusive

£ million

	"BASIC BALANCE"			"MONETARY MOVEMENTS"			Net total of all identified trans- actions	Balanc- -ing item"
	As in official accts.	Deduct: trfd. to monetary movements	Adjusted balance	As in official accts.	Add: trfd. frm basic balance	Adjusted balance		
	1	2	3 (1-2)	4	5	6 (4+5)			7 (1+4) = (3+6)	8 (+7=0)
1952	+ 29	- 16	+ 45	- 95	- 16	- 111	- 66	+ 66
53	- 49	- 57	+ 8	+ 17	- 57	- 40	- 32	+ 32
54	- 74	- 54	- 20	+ 17	- 54	- 37	- 57	• 57
55	- 277	- 48	- 229	+ 156	- 48	• 108	- 121	+ 121
56	+ 21	- 70	+ 91	- 63	- 70	- 133	- 42	+ 42
57	+ 127	+ 59	+ 68	- 207	+ 59	- 148	- 80	+ 80
58	+ 148	- 60	+ 208	- 215	- 60	- 275	- 67	+ 67
59	- 112	- 146	+ 34	+ 134	- 146	- 12	+ 22	- 22
60	- 457	- 72	- 385	+ 158	- 72	+ 86	- 299	+ 299
61	+ 64	- 64	+ 128	- 39	- 64	- 103	+ 25	- 25
62	+ 14	- 44	+ 58	- 89	- 44	- 133	- 75	+ 75
63	- 35	- 45	+ 10	+ 107	- 45	+ 62	+ 72	- 72
64	- 744	- 36	- 708	+ 757	- 36	+ 721	+ 13	- 13
65	- 278	- 16	- 262	+ 247	- 16	+ 231	- 31	+ 31
66	- 67	+ 3	- 70	+ 104	+ 3	• 107	+ 37	- 37
67	- 461	+ 22	- 483	+ 234	+ 22	+ 256	- 227	+ 227
68	- 398	+ 54	- 452	+ 543	+ 54	+ 597	+ 145	- 145
69	+ 387	+ 4	+ 383	- 569	+ 4	- 565	- 182	• 182
TOTALS for 18 YEARS:	-2,162	- 586	-1,576	+1,197	- 586	+ 611	- 965	+ 965

TABLE C.

U.K. BALANCE OF PAYMENTS: 1952 to 1969 inclusive

Division of the aggregates of principal balances
for the total period of 18 years between periods

12 $\frac{3}{4}$ years - Jan. 1952 to Sept. 1964
5 $\frac{1}{4}$ years - Oct. 1964 to Dec. 1969

£ million

	Net totals for period of 18yrs. 1952 - 1969 inclusive	Net totals for period 1952 to 1964	Net totals for period 1964 to 1969
<u>"Basic balance":</u> balance of current and long-term capital trans- actions	- 1,576	- 522	- 1,054
<u>"Balance of monetary move- ments"</u>	+ 611	- 241	+ 852
<u>Net totals:</u> "identified external transactions"	- 965	- 763	- 202
"Balancing item"	+ 965	+ 762	+ 203
NET TOTAL (in principle) of all external transactions	0	0	0

TABLE D.

£ million

	Net totals 1952 to 1964	Net totals 1964 to 1969
<u>BASIC BALANCE:</u> balance of current and long-term capital transactions:		
<u>Private Sector:</u>		
- Foreign trade; balance of trade in		
- goods	-2,241	-1,783
- services	+2,510	+2,053
- goods and services	+ 269	+ 270
- Foreign investment:		
- net inflow of interest, profits and dividends	+4,421	+3,122
- net outflow (-) of capital	-1,248	- 278
- net inflow, income and capital combined	+3,173	+2,844
- Private transfers	- 38	- 315
<u>Basic balance, private sector</u>	+3,404	+2,799
<u>Government:</u>		
- Current services and transfers	-2,848	-2,403
- Official interest	- 947	-1,063
- Inter-govt. loans by U.K., net of repayments	+ 31	- 301
- Other official long-term capital	- 162	- 86
<u>Basic balance, government</u>	-3,926	-3,853
<u>"BASIC BALANCE": UNITED KINGDOM</u>	- 522	-1,054

TABLE E.

£ million

<u>MONETARY MOVEMENTS</u>	Net totals 1952-1964	Net totals 1964-1969
<u>Movements of foreign-owned short-term funds held in the U.K. banking system (net outflow -, net inflow +):</u>		
- held in sterling and sterling-area currencies	+ 380	-1,020
- held in non-sterling currencies	+ 217	- 181
Net movements of short-term funds	● 597	-1,201
<u>Official settlements: Government borrowing overseas (+), reduction of reserves of gold and currencies (+):</u>		
- overseas borrowing:		
- changes in overseas holdings of:		
- Treasury bills	+ 31	+ 447
- Government securities	- 64	+ 214
- direct borrowing:		
- International Monetary Fund	+ 46	+1,223
- Inter-govt. loans to U.K., net of repayments	- 634	+ 48
- other	+ 59	+ 85
Net borrowing overseas	- 562	+2,017
- Reduction of reserves	- 91	- 15
Net balance of official settlements	- 653	+2,002
Miscellaneous capital movements	+ 47	+ 62
U.K. quota subscriptions to I.M.F.	- 232	- 175
Financial adjustments:		
- transferred from dollar portfolio		+ 520
- loss on forwards incurred by Exchange Equalisation Account on devaluation		- 356
<u><u>BALANCE OF MONETARY MOVEMENTS</u></u>	- 241	+ 852

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