A Programme for NATIONAL RECOVERY

THE BALANCE OF PAYMENTS AND INVISIBLE EARNINGS

Research Paper No. 3

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A Programme for NATIONAL RECOVERY

FOREWORD

The original Programme for National Recovery, signed by 19 industrialists, economists and writers was published in July 1967. Since then, two Research Papers have appeared, one in January 1968 and the second in May 1968. Both these studies concentrated on Britain's basic weakness—inflation—and we are glad to observe that there is now an increasing recognition that adequate regulation of the money supply is a vital factor in containing inflation.

In this third study we have concentrated on the equally important issue of our balance of payments, with particular reference to invisible earnings. As we showed in Paper No. 1, "the underlying disequilibrium of the balance of payments is not due to a persistent imbalance of the private sector's trade with the rest of the world, but to the fact that the net government expenditure overseas has persistently exceeded the surpluses earned by the private sector." This theme is considerably expanded and illuminated by up-to-date official statistics. We also go very thoroughly into the official records covering private foreign investment. The results reveal a situation very different to the generally accepted view. A summary of the findings will be found on pages 1 to 4.

Once again we are indebted to Mr. F. W. Tooby who has been fully engaged for several months in research into the official statistics and who formulated the general theme on which this Paper is based. It was circulated in draft form to a number of people in banking, industrial and commercial circles and the final text owes much to the valuable criticisms and suggestions made.

The members of the Committee responsible for the programme of research are Patrick de Laszlo, W. A. P. Manser, John Paxton and the undersigned. Two further research projects are planned for 1969, No. 4 on taxation and policies for growth and No. 5 on potential resources.

Edward Holloway.

24th JANUARY, 1969

Summary

The over-riding problem confronting Britain in 1969 is the need to correct a persistent deficit on the balance of payments. For four years the Government have rigorously imposed orthodox policies on the country, but there is little sign that these are proving effective. The primary aim of these policies has been to reduce imports, increase exports, and restrict private foreign investment, because, in the Government's judgment, the problem arises from a "disturbing export-import gap" in the private sector's overseas merchandise (visible) trade, and from an outflow of capital into private overseas investment which the country cannot afford. This study challenges both these basic assumptions.

The official statistics demonstrate that the country is not faced with an abnormal deficit on visible trade account, and it is unrealistic to base economic policy on the expectation that external trade balances can be permanently tilted in this country's favour. The only reliable source of a large and growing surplus on the balance of payments is the net cash inflow from private foreign investment.

A visible deficit has been a natural feature of our external accounts for some 175 years at least, but there is a wholly reliable balance between payments and receipts in our trade in goods and services taken together. The basic laws of supply and demand in the national context on the one hand, and the constant balance between world exports and imports on the other, bring our overseas commercial transactions into equilibrium again and again, in a regular rhythm which is shown to be characteristic of all world trade. Since it is impossible to isolate the British economy from the powerful influences which generate these regular cycles of world trade, it is not possible to distort the cycle of Britain's

external trade in goods and services so as to achieve a perennial surplus.

The private investment sector has in fact produced a substantial and growing net cash inflow into this country. As against this, Government expenditure overseas, by its nature not subject to the market forces which hold trade in oscillating balance, has persistently exceeded the net cash inflow from private foreign investment; it is this which has led to the deficit in our balance of payments.

From the official record of private foreign investment over the ten years 1958-1967, there was a net cash *inflow* of £4,172 million in capital and interest combined, from outward and inward investment taken together, and for all classes of investment. This net cash inflow grew steadily from 1958 to 1967 at an average rate of 7·2 per cent; the net direct benefit to the balance of payments in the year 1967 was £554 million. Financially, this, the only steadily rising cash inflow in the balance of payments, is entirely self-supporting. Yet it is being throttled by present policies on the grounds that the country cannot afford it!

Examination of Government expenditure overseas over the ten years 1958-1967, shows that the total at £6,026 million exceeded the net inflow of capital and interest from foreign private investment at £4,172 million, by £1,854 million. It is not suggested, on this account, that Government spending overseas should be drastically reduced, though no doubt economies could be made. Rather, it is argued that our national policy should be to raise the level of what it is possible to spend in support of vital British interests around the world, including the merchant fleet. Only thus can we safeguard and strengthen our important role in the world economy, and maintain and improve the standard of living of the British people.

This excess of expenditure on Government account is very largely due to the grants and loans made to help developing countries. It is not suggested that these grants and loans should not have been made; rather that Britain could not afford to finance them in the way we did, by reducing our reserves of gold and foreign currencies. The International Bank for Reconstruction and Development exists for the purpose of giving financial assistance of this kind. Such transactions should be financed by raising long-term capital on the international market through the World Bank: With our record of growing income from private overseas investment,

now in the region of £800 million a year, increasing at 4 per cent per annum, Britain would have no difficulty in underwriting such loans by the World Bank, if she wished to help less fortunate countries.

In concentrating on efforts designed in theory to increase the private sector's capacity to earn income from foreign trading, the Government have disregarded the accounts which showed that their official spending was persistently outpacing the private sector's growing net earnings overseas, which came from foreign investment and not from trading. Partly in order to finance this Government deficit spending, and partly to replenish the reserves after withdrawals of private funds from sterling from 1 October 1964 to 30 June 1968, Government overseas debt was increased by some £2,000 million, all repayable within the next four years.

A review of the country's resources of international liquidity out of which to repay this £2,000 million of official debt when due shows that the second-line reserves—the dollar portfolio and our credits with the I.M.F.—have been used to the full, and the first-line reserves of gold and convertible currencies now stand alone at about £1,000 million, a figure which is already precariously low. While Government spending overseas continues to exceed what the private sector earns overseas, there is no reason to hope that a continuation or intensification of present policies will add sufficiently to our resources of international liquidity to cover the repayment of £2,000 million of official debt within the next four years.

This does not mean, however, that the British economy and the sterling monetary system are on the rocks. Comparing our overseas assets with our liabilities it is shown that the external monetary system in its role as international banker is basically sound. Assets exceeded liabilities by £1,915 million at the end of 1967. Our balance sheet is unsatisfactory, however, because, in the present fluid condition of the world monetary system, our resources of international liquidity are inadequate in relation to the sterling cash flows, in and out, across the foreign exchange markets.

Competent financial management could quickly remedy this element of weakness in an otherwise strong balance sheet. The problem is simply that while our overseas enterprises have grown enormously and continue to expand, the banking side has run short of working capital. Some £3,000 million of additional working capital is needed and should be raised in foreign convertible currencies on the international market, in an operation which could be spread over four years. Given the immense strength of our private foreign investments, and the large and growing cash inflow which they generate, the raising of loan-capital on this scale would be well within Britain's financial capacity.

The solution to the problem of Britain's balance of payments is to be found, therefore, in sound financial management by the Government of the whole sterling monetary system. Above all, it is vitally necessary to view this British problem in the full perspective of the world economy.

TABLE 1

U.K. BALANCE OF PAYMENTS
The Standard Presentation

£ million

	1963	1964	1965	1966	1967
Current account					
Imports (f.o.b.)	4,362	5,003	5,049	5,244	5,660
Exports and re-exports (f.o.b.)	4,282	4,466	4,777	5,108	5,023
Visible trade (net)	− 80	−537	−272	−136	−637
Invisibles (net) including government	+ 191	+ 138	+ 181	+ 151	+ 233
Current balance	+ 111	−399	− 91	+ 15	−404
Long-term capital account[1]					
Inter-government loans (net)	− 97	−101	− 66	− 61	− 39
Other U.K. official long-term capital (net)	− 8	− 15	− 20	− 20	− 18
Private investment:					
Abroad	−320	−396	−353	−303	−424
In the United Kingdom	+ 277	+ 142	+ 236	+ 280	+ 395
Balance of long-term capital	−148	−370	−203	−104	− 86
BALANCE OF CURRENT AND LONG-TERM CAPITAL TRANSACTIONS	− 37	−769	−294	− 89	−490
Balancing item	− 73	+ 41	+ 67	− 10	+ 175
Monetary movements					
Miscellaneous capital (net)[2]	− 57	+ 191	− 97	−264	+ 229
Changes in external liabilities in sterling and overseas sterling area currencies (net)[3]	+ 109	+ 56	+ 71	+ 83	+ 317
Transfer from dollar portfolio to reserves	—	—	—	+ 316	+ 204
Exchange adjustments	—	—	—	—	−101
Account with I.M.F.[4]	+ 5	+ 359	+ 499	− 2	−318
Gold and convertible currency reserves	+ 53	+ 122	−246	− 34	− 16
Balance of monetary movements	+ 110	+ 728	+ 227	+ 99	+ 315

Notes: 1. A decrease in liabilities or an increase in assets is shown −, an increase in liabilities or a decrease in assets is shown +.
2. Including changes in liabilities in non-sterling currencies (net).
3. Excluding liabilities to the International Monetary Fund.
4. Comprising changes in the United Kingdom's subscription to the I.M.F. and in sterling liabilities to the Fund.

Source: Layout—Bank of England Quarterly Bulletin, December 1964.
Data—U.K. Balance of Payments 1968.

What went wrong?

For four years now the Government have rigorously imposed orthodox policies in an effort to correct a persistent deficit on the balance of payments. But success is still a hope for the future. Since the cure has not worked after four years, a re-examination of the original diagnosis of the trouble is necessary.

The economic policies in force since October 1964 were based entirely on the Government's judgment that the national economy was in a "gigantic mess" because there was a "disturbing export-import gap" in the private sector's overseas trading, and because (in Lord Balogh's words) of a "tendency to generate overseas investment far beyond the country's capacity to maintain it".[1] Consequently, the primary aim has been to reduce imports, increase exports and restrict overseas investment.

The economic judgment which underlies this policy was based on a forecast, made at the time of the General Election in October 1964, of a deficit of unprecedented size on the balance of current and long-term capital transactions for that year. On 3 November 1964, in his first address to the Commons as Prime Minister, Mr. Harold Wilson said: "It is to the economic crisis that I now finally turn. Just over a week ago the Government issued our first statement on the measures immediately necessary to deal with the disturbing export-import gap . . . The House and the country are entitled to know the situation which forced the Government to take this action and the reasons for it. The best available estimate for 1964, with no change in policy, was an overall balance of payments deficit of at least £700 million, possibly up to £800 million, with a continuing overall, if reduced, deficit for 1965. This clearly could not be allowed to go on. It meant that we could get through this year and next only by running down our reserves and by prodigious borrowing."

There was no dissent by publicists from the Government's opinion, set out in the White Paper of 26 October 1964, that the situation called for: "a wholly new approach to the problem of balance of payments difficulties both on the import side and on the side of exports."

Since then the consensus of opinion expressed by all who have spoken and written about economic policy has been that

[1] Maiden speech in the House of Lords, 17 July 1968.

Britain staggers from crisis to crisis on the foreign exchange market because of a persistent deficit on the balance of her external trade. We consider that this is overdue for reappraisal.

FOLLOW COMMERCIAL PRACTICE

By unanimous agreement, both diagnosis and prescription have stemmed from readings of a single indicator, the balance of current and long-term capital transactions, now commonly referred to as the "basic" balance. In assessing the country's financial position in its transactions with the rest of the world, we do not follow commercial practice by looking first at the current transactions in the profit and loss account, and then at the corresponding changes in the inventory of assets and liabilities in the balance-sheet. Instead, we base our judgments on an eccentric balance which is a combination of the profit and loss account and some selected items from the balance sheet.

The reason for this peculiar practice was explained by the Treasury in a Memorandum of Evidence, dated January 1958, to the Radcliffe Committee on the Working of the Monetary System:

> "As a precondition for the maintenance of external and internal confidence, and in order to meet both contractual and other commitments, it is essential that the United Kingdom should earn an adequate balance of payments surplus on current account. The current account, as defined in White Papers on the United Kingdom Balance of Payments, includes payments in respect of net Government military and civil expenditure overseas, and the interest on Government overseas debt (mainly the United States and Canadian loans). Other transactions in the current account must therefore yield a sufficient net receipt to cover these payments. But for them to do no more than this, i.e. *for the current account to be merely in balance, would be wholly insufficient.* To prevent a call on reserves—other things being equal—a surplus is needed to cover:
>
> (a) Private and net long-term capital outflow, and
>
> (b) The capital repayments of Government overseas debt, as well as
>
> (c) Net Government long-term lending overseas.
>
> The sum of the above factors may be described as the *balance of current and long-term capital transactions,* a concept which distinguishes our trading and investing roles from our role as an international banker. This balance must itself be in surplus if our overseas monetary position, i.e. the balance of our overseas monetary assets and liabilities, is to be strengthened."

It should be noted at once that the Treasury's explanation provides no justification for the assumption that a "basic" deficit (of current and long-term capital transactions) implies that imports are too high and exports too low.

A great deal of what has gone wrong with the management of our economy springs from the over-simplification which promotes the "basic" balance to be the principal indicator of how the country is faring in its combined roles of overseas trader and investor. All the facts of the country's complex transactions with the rest of the world have come to be distilled into this one figure. Widely approved policies and opinions are based on this alone, without the discomfort of thought, by *applying a prefabricated* set of interpretations. There was no dissent by the publicists when the Government declared that a prospective "overall" deficit of over £700 million in 1964 was evidence of a disturbing export-import gap. Yet we will show that the trade-gap was of small consequence.

A NEW ANALYSIS

Re-appraisal of the diagnosis of our economic troubles must therefore start with analysis of the "basic" balance for 1964, separating out its main components as named by the Treasury in its evidence to the Radcliffe Committee; particular care must be taken to show separately Government expenditure on overseas services, and also the official interest on Government overseas debt. This is done in Table 2. There was a basic deficit of £769 million in 1964, to which net government spending overseas contributed a deficit of £657 million, and the private sector's trading and investing a deficit of £112 million. These are the salient facts of a situation which the Government declared to be one which called for a new attack on both imports and exports. For four years since then, the Government's economic policy has been confined to the alleged overriding object of influencing the balance of merchandise trade, in order to tilt it permanently in Britain's favour.

From Table 2 it is clear that in 1964 Government expenditure overseas far exceeded the private sector's net income from trading and investment. But this is well known to have been an abnormal

TABLE 2

U.K. BALANCE OF PAYMENTS, 1964

Balance of Current and Long-term Capital Transactions Analysis by Component Balances

£ million

	First Quarter	Second Quarter	Third Quarter	*Total* 1 Jan. to 30 Sept.	Fourth Quarter	*TOTAL* Year 1964
Trade in goods (visibles):						
Imports	1,247	1,253	1,214	3,714	1,287	5,001
Exports	1,125	1,152	1,029	3,306	1,160	4,466
Balance of trade in goods	—122	—101	—185	—408	—127	—535
Trade in services (invisibles):						
Imports	334	390	463	1,187	364	1,551
Exports	386	426	470	1,282	426	1,708
Balance of trade in services	+ 52	+ 36	+ 7	+ 95	+ 62	+ 157
Balance of trade in goods and services	— 70	— 65	—178	—313	— 65	—378
Private investment overseas:						
Capital outflow, net	— 68	— 98	— 22	—188	— 66	—254
Interest, profits and dividends	+ 137	+ 105	+ 92	+ 334	+ 79	+ 413
Add back official interest[1]	+ 26	+ 27	+ 27	+ 80	+ 27	+ 107
Balance from investing role	+ 95	+ 34	+ 97	+ 226	+ 40	+ 266
BALANCE FROM TRADING AND INVESTING ROLES	+ 25	— 31	— 81	— 87	— 25	—112
Government expenditure overseas:						
Services; military, diplomatic etc.	— 73	— 67	— 65	—205	— 64	—269
Official interest (from above)[1]	— 26	— 27	— 27	— 80	— 27	—107
Payments for U.S. aircraft	—	—	— 2	— 2	—	— 2
Current transfers	— 49	— 40	— 35	—124	— 39	—163
Sub-total, current account	—148	—134	—129	—411	—130	—541
Inter-governmental loans	— 24	— 17	— 27	— 68	— 33	—101
Other long-term capital	— 1	— 3	— 1	— 5	— 10	— 15
Sub-total, capital account	— 25	— 20	— 28	— 73	— 43	—116
BALANCE, ALL GOVERNMENT EXPENDITURE	—173	—154	—157	—484	—173	—657
Recapitulation of component balances:						
Private sector: trading	— 70	— 65	—178	—313	— 65	—378
Private sector: investing	+ 95	+ 34	+ 97	+ 226	+ 40	+ 266
Net balance, private sector	+ 25	— 31	— 81	— 87	— 25	—112
Government expenditure overseas	—173	—154	—157	—484	—173	—657
BALANCE OF CURRENT AND LONG-TERM CAPITAL TRANSACTIONS	—148	—185	—238	—571	—198	—769

Source: Economic Trends, September 1968.
Note: 1. Total for the year taken from Red Book 1968, table 15. Breakdown by quarters made arbitrarily by authors.

year. Let us then analyse the basic balance for the ten years 1958 to 1967. This is done in Table 3, which shows that the balance of total current and long-term capital transactions, over the period of ten years, was composed as follows:—

	£ million
Balance of trade in goods and services	— 168
Net flow of capital & interest, private sector	+4,172
Net Government expenditure overseas	—6,026
Basic balance, period of 10 years (58-67)	—2,022

TABLE 3

U.K. BALANCE OF PAYMENTS, 1958 to 1967

Balance of Current and Long-term Capital Transactions—Components

£ million

	Private Sector			Government				
	Trading	Investing						
	Balance of trade in goods and services	Net flow of capital and interest	Net overseas earnings	Current expenditure on services and transfers (net)	Inter-govt. loans and other official capital (net)	Official interest (net)	Net govt. expenditure overseas	U.K. Basic Balance
1958	+ 270	+ 288	+ 558	— 219	— 50	— 141	— 410	+ 148
59	+ 110	+ 257	+ 367	— 227	— 124	— 128	— 479	— 112
1960	— 214	+ 290	+ 76	— 282	— 103	— 148	— 533	— 457
61	+ 76	+ 527	+ 603	— 332	— 45	— 162	— 539	+ 64
62	+ 139	+ 482	+ 621	— 360	— 104	— 143	— 607	+ 14
63	+ 99	+ 474	+ 573	— 382	— 105	— 123	— 610	— 37
64	— 378	+ 266	— 112	— 434	— 116	— 107	— 657	— 769
65	— 102	+ 481	+ 379	— 459	— 86	— 128	— 673	— 294
66	+ 95	+ 553	+ 648	— 602	— 81	— 154	— 737	— 89
67	— 263	+ 554	+ 291	— 551	— 57	— 173	— 781	— 490
Totals for 10 years 1958-1967	— 168	+4,172	+4,004	—3,748	— 871	—1,407	—6,026	—2,022

Source: U.K. Balance of Payments 1968.

This suggests that our 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.

In this situation there are three possible courses of action which might be taken to establish and maintain a basic surplus.

They are:—

1. Continuation of the Government's policy of high taxation and restricted credit, the object of which is to swing the balance of visible trade permanently into surplus.
2. Encouragement by all means of private foreign investment, both outward and inward, so as to maximise the net inflow of capital and income combined.
3. Reduction of government spending abroad, or, alternatively, the financing of essential deficit spending overseas by long-term borrowing overseas.

We will now examine the possibility of these three courses.

The feasibility of achieving a perennial surplus on Britain's balance of external trade

We begin by noting the conclusions drawn by the Report of the Committee on Invisible Exports from the figures of Britain's visible and invisible trading accounts from 1825 to 1965:—

"1. Britain, as far back as the statistical records go and probably even farther, has had a continuing deficit on visible trading account. Only seven out of the past 175 years have shown a trading surplus.

2. Over the same extended period, Britain has had a continuous surplus on her invisible trading accounts. If Government spending abroad is excluded from the figures, this invisible surplus has always been big enough to offset the deficit on visible trade.

3. It is clear, therefore, that Britain is and has been for well over a century and a half as much a commercial and financial nation as a manufacturing nation".[1]

This summary review of the historical facts of our overseas trade calls into question the official doctrine which diagnoses our economic malady as being seated in the balance of visible trade. Why is it assumed that a visible gap which has existed naturally and unharmfully for nearly two centuries, at least, is at the root of difficulties which have developed only since 1948? It is the obviously doubtful validity of this assumption which prompts our re-evaluation of the logic and factual basis of the present policies of restraint, deflation, and "export-led recovery."

Table 4 shows the figures for external trade in *goods and services* for the sixteen years 1952 to 1967. Over this period as a whole there was a net deficit of £3,273 million on *visible* trade, offset by a net surplus of £3,148 million on trade in *services.* First, it should be noticed that there were eight deficits and eight

[1] "Britain's Invisible Earnings", Report of the Committee on Invisible Exports, published for the Financial Advisory Panel on Exports by the British National Export Council, 1967.

surpluses in the sixteen years; the largest surplus was in 1958 when exports exceeded imports by £270 million or by 6·02 per cent, and the largest deficit was in 1964, when imports exceeded exports by £378 million, or by 6·12 per cent. Next, it is clear that both exports and imports of goods and services have generally increased in value from year to year, though there were a few years in which the reverse was the case. Finally, it is seen that over the 16-year period as a whole, exports of goods and services totalled £83,670 million, and imports £83,795 million, so that imports exceeded exports by the relatively tiny margin of £125 million, or by 0·151 per cent.

EQUILIBRIUM

This set of inter-related observations can have only one explanation, that in our trade in goods and services with the rest of the world, *exports* grow from year to year at a different rate from *imports*, and that the yearly growth-rates of both exports and imports vary in cycles over periods of years; in one phase of each cycle, exports grow faster than imports, producing surpluses, and in the reverse phase, imports grow faster than exports, producing deficits which

TABLE 4

U.K. BALANCE OF PAYMENTS, 1952 to 1967

Balance of Trade in Goods and Services, excluding Government

£ million

	Trade in goods (visibles)			Trade in services (invisibles): includes private transfers, shipping, civil aviation, travel and other services			Trade in goods and services		
	Imports	Exports	Balance	Imports	Exports	Balance	Imports	Exports	Balance
1952	3,048	2,769	— 279	793	1,044	+ 251	3,841	3,813	— 28
53	2,927	2,683	— 244	810	1,036	+ 226	3,737	3,719	— 18
54	2,989	2,785	— 204	872	1,074	+ 202	3,861	3,859	— 2
55	3,386	3,073	— 313	1,004	1,126	+ 122	4,390	4,199	—191
56	3,324	3,377	+ 53	1,145	1,246	+ 101	4,469	4,623	+ 154
57	3,538	3,509	— 29	1,175	1,332	+ 157	4,713	4,841	+ 128
58	3,377	3,406	+ 29	1,109	1,350	+ 241	4,486	4,756	+ 270
59	3,639	3,522	— 117	1,158	1,385	+ 227	4,797	4,907	+ 110
1960	4,138	3,732	— 406	1,284	1,476	+ 192	5,422	5,208	—214
61	4,043	3,891	— 152	1,314	1,542	+ 228	5,357	5,433	+ 76
62	4,095	3,993	— 102	1,342	1,583	+ 241	5,437	5,576	+ 139
63	4,362	4,282	— 80	1,426	1,605	+ 179	5,788	5,887	+ 99
64	5,001	4,466	— 535	1,551	1,708	+ 157	6,552	6,174	—378
65	5,037	4,777	— 260	1,645	1,803	+ 158	6,682	6,580	—102
66	5,203	5,108	— 95	1,698	1,888	+ 190	6,901	6,996	+ 95
67	5,562	5,023	— 539	1,800	2,076	+ 276	7,362	7,099	—263
Total 16 years to 31.12.67	63,669	60,396	—3,273	20,126	23,274	+3,148	83,795	83,670	—125

Source: U.K. Balance of Payments 1968.

CHART A **CYCLICAL VARIATION IN GROWTH-RATES**

Percentage changes from previous year

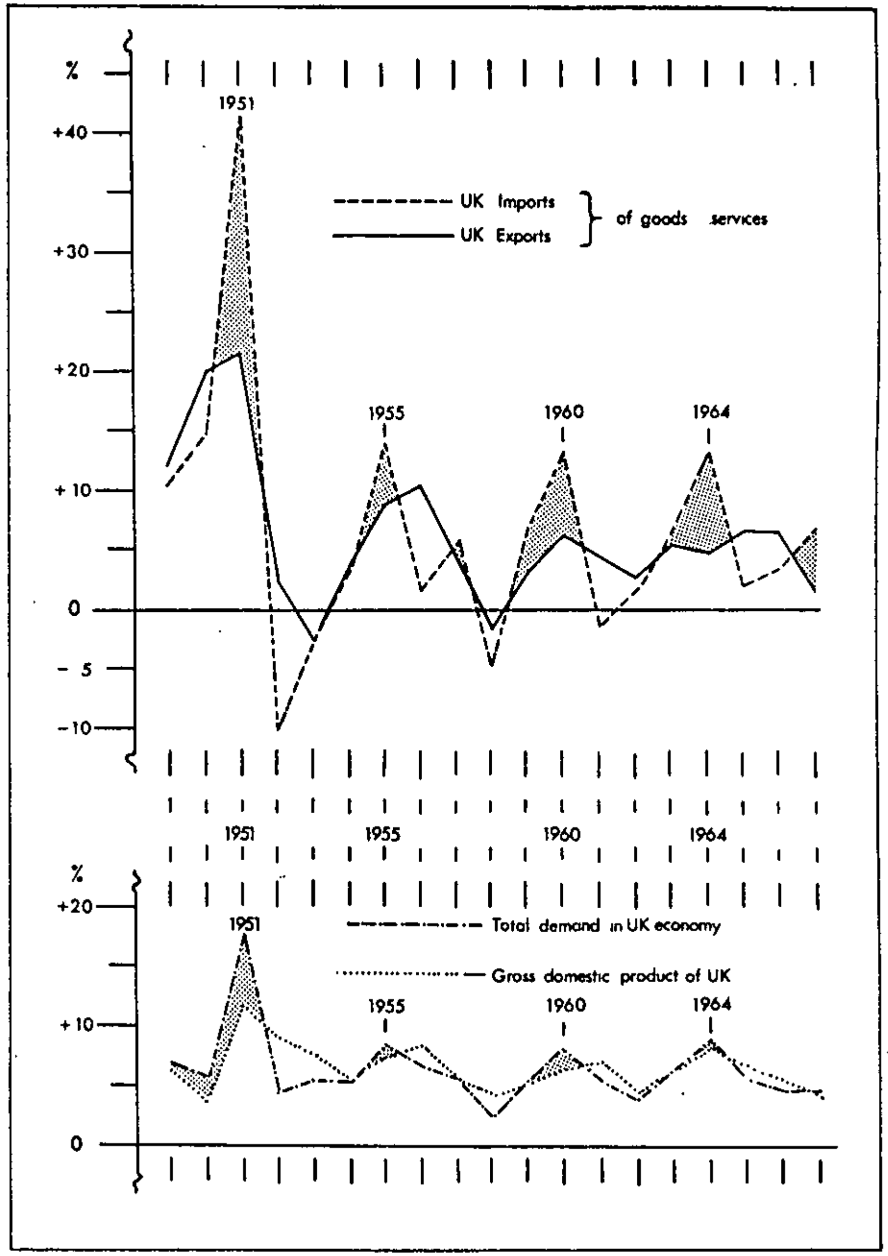
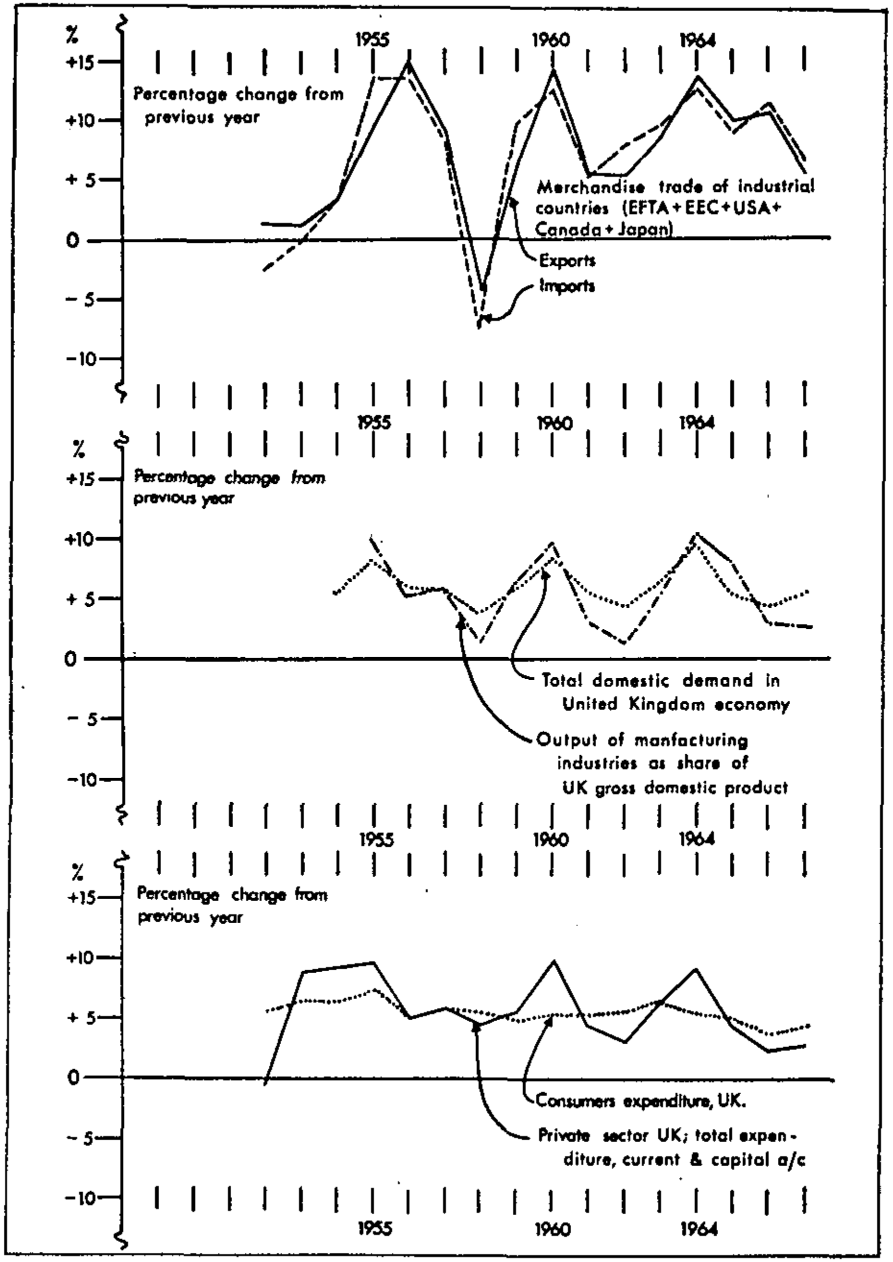


CHART B CYCLICAL VARIATION IN GROWTH-RATES



counter-balance the surpluses. This balanced oscillation between surpluses and deficits produces the long-term equilibrium of total exports and imports which is clearly shown in Table 4.

The real existence of these cycles can be shown graphically by tracing the variations of the yearly percentage growth-rates of both exports and imports. This is done in Chart A, covering the period 1949 to 1967. In the case of imports, the cyclical variation over periods of four to five years has been, and continues to be, quite strongly marked. The year-to-year variation in the growth of exports, on the other hand, has diminished progressively, and although it followed much the same periodicity as that of imports up to 1962-63, has been notably out of phase since 1964.

It was obviously in the years when imports expanded at a faster rate than exports—indicated by the shaded areas in Chart A—that the largest deficits appeared in the balance of trade in goods and services (see Table 4). There were exceptionally large deficits in 1955 (—£191 million), 1960 (—£214 million) and 1964 (—£378 million).

NO CRITICAL INSTABILITY

These periodic large deficits on the trade balance should not be interpreted, however, as evidence of critical instability of the national economy. The historical record provides assurance that the balance of exports and imports levels out in the course of each trade cycle, provided the natural forces of the market are left free. Financially, the periodic deficits are and have been amply covered by Britain's drawing-rights as a principal subscriber to the International Monetary Fund. The observed oscillations between surplus and deficit are therefore quite safe, and should be accepted with equanimity as a normal rhythm in the nation's economic life.

It is equally a mistake to assume that a large surplus on trade account is only brought about by a healthy expansion of exports. Note in Chart A that the large surplus in 1958 was not the result of any surge in exports. On the contrary, exports that year fell below the previous year; the large surplus arose because imports fell even further.

Now the yearly totals of exports and imports are fortuitous aggregates of numberless transactions made individually, independently and endlessly. Yet, manifestly, there are pervasive influences at work that hold these aggregates in long-term equilibrium by continuously levelling out the differences which develop naturally between them. These influences can be none other than the free market forces which hold supply and demand in constant equality of value. The balance of trade in goods and services is, in other words, a pair of aggregates forming integral components of the constant equation of supply and demand in the national accounts of income, expenditure and production.

CYCLICAL VARIATIONS

This abstract conception, however, portrays the balance of trade as being normally static, resembling a pair of beam-scales, or a see-saw, its ends free to swing alternately up and down, but tending always to come to rest in equilibrium. But Chart A shows a continuous swing up and down through an infinite succession of trade cycles. Strong factors must be at work to maintain the impetus of this rhythmical movement, and there is clear empirical evidence that these factors are at work, not only in our own economy, but also throughout world trade. For the cyclical variation in growth-rates apparent in Chart A is not peculiar to the British economy; the upper graph in Chart B shows a precisely similar periodicity in the varying growth-rate of the merchandise trade of all the industrialised countries collectively. (Rates of change plotted here are calculated from trade data in NIESR Reviews.) But though we have this empirical evidence that some pervasive influence produces a world-wide effect, we cannot yet describe or explain it; for the time being we can only observe the fact that there is, so to speak, "a tide in the affairs of men."

It is no surprise that the variation of growth-rate in U.K. exports of goods and services (in Chart A) has traced a very similar course to that in imports of goods by all the industrialised countries collectively (in Chart B). But it is surely unexpected that precisely the same periodicity occurs in the varying growth-rates of domestic sectors of the U.K. economy, as is shown in the middle graph in Chart B. Total domestic demand, which is generally thought to be under fiscal and/or monetary control by our central government, is seen to have varied in close accordance with the seemingly universal cycle; and the output of our manufacturing industries has followed suit.

CONSUMERS' EXPENDITURE

There is, however, a very notable exception to this general

accord. The lower graph in Chart B shows the rate of year-to-year expansion in consumers' expenditure to have varied very narrowly, without any apparent relation to the ups and downs of the cycle so apparent in all the other graphs. There is no close relationship, therefore, between changes in the level of consumers' expenditure and changes in the level of imports. What, then, of the Government's conviction that by controlling consumption it is "managing" the level of demand, and thereby swinging the balance of external trade into permanent surplus?

The integration of the balance of trade in goods and services into the constant equation of supply and demand in the national economy is shown in Table 5. The natural forces of our free market economy are seen to hold the total supply of goods and services in constant equality of value with the total amount of money expended in exchange for that supply. On the supply side of the

TABLE 5

RESOURCES AND USE OF RESOURCES IN THE U.K. ECONOMY 1948 to 1967

£ million

	RESOURCES			USE OF RESOURCES			
	Supply of goods and services		← TOTAL SUPPLY	Expenditure on goods and services			
	Domestic production (G.D.P. at current factor cost)	Imports (incl. govt.)	equals	Domestic demand			Foreign demand
			TOTAL DEMAND →	Public sector	*Private sector	Total	Exports (incl. govt.)
1948	10,282	2,434	12,716	2,349	8,171	10,520	2,196
1949	10,914	2,697	13,611	2,722	8,394	11,116	2,495
1950	11,341	3,076	14,417	2,655	8,767	11,422	2,995
1951	12,616	4,331	16,947	3,490	9,809	13,299	3,648
1952	13,757	3,933	17,690	4,178	9,752	13,930	3,760
1953	14,833	3,835	18,668	4,365	10,616	14,981	3,687
1954	15,674	3,961	19,635	4,217	11,581	15,798	3,837
1955	16,804	4,481	21,285	4,404	12,704	17,108	4,177
1956	18,195	4,554	22,749	4,797	13,354	18,151	4,598
1957	19,284	4,778	24,062	5,076	14,150	19,226	4,836
1958	20,103	4,586	24,689	5,183	14,799	19,982	4,707
1959	21,138	4,885	26,023	5,512	15,661	21,173	4,850
1960	22,559	5,554	28,113	5,769	17,195	22,964	5,149
1961	24,140	5,515	29,655	6,325	17,960	24,285	5,370
1962	25,217	5,604	30,821	6,795	18,522	25,317	5,504
1963	26,769	5,950	32,719	7,182	19,723	26,905	5,814
1964	28,900	6,714	35,614	7,996	21,530	29,526	6,088
1965	30,840	6,843	37,683	8,741	22,451	31,192	6,492
1966	32,436	7,083	39,519	9,635	22,980	32,615	6,904
1967	33,882	7,568	41,450	10,814	23,636	34,450	7,000

Source: Years 1948-56, Blue Book 1967. Years 1957-67, Blue Book 1968.
Note: *Excludes taxes on expenditure and subsidies.

equation is the domestic production of goods and services *plus* those that are imported; and on the demand side is total domestic expenditure, *plus* foreign expenditure on our exports of goods and services. (Note that in Table 5, Government transactions are not excluded from exports and imports, as they are in Table 4).

In Table 5, the two sides of the equation are headed "Supply" and "Demand", and also "Resources" and "Use of Resources." These latter terms are merely another way of describing the balanced set of aggregates in the historical record of the country's economy. They are used here to draw attention to the fallacy of the doctrine which holds that by forcibly reducing domestic demand for goods and services, we can divert part of our "resources" to increase foreign expenditure on our exports.

In 1967, for example, imports exceeded exports by £568 million, and, because the two sides of the equation balance, domestic demand exceeded domestic production by precisely the same amount. Therefore, it is argued, the deficit on the balance of external trade was caused by the excess of domestic demand over domestic production. But the simplicity of the arithmetic is deceiving. The fallacy derives perhaps from the presentation of the national accounts of income and expenditure as series of annual aggregates; this may suggest that our total resources in any year amount to a sum of money received regularly by the managers of the economy, as a sort of pay-packet, to be allocated to expenditure with careful deliberation. Hence, it would seem, the notion that a deliberate reduction of expenditure under one head must automatically "free resources" to make possible an increase of expenditure elsewhere. What is obviously wrong with this conception is that our "resources" do not come to us as a nation in annual packets of money from some external Providence.

PRODUCTION OF GOODS & SERVICES

The reality is quite otherwise. The source of the nation's income and wealth is in the production of goods and services. Income, expenditure, production, imports and exports are all continuous flows of funds in the perpetual stream of the nation's economic life. All of these component flows, with the sole exception of public expenditure, are fortuitous aggregates not susceptible to central, overall control. Periodical measurements of the component flows of supply and demand, as recorded in Table 5, reveal that all of them are continuously expanding, at rates of growth which vary from component to component and from year to year. Yet, despite the differential growth-rates of their components, Supply and Demand are held in constant equality of money-value by the price-adjustment mechanism of a free-market economy.

Further examination of Table 5 also reveals that a surprising number of the different growth-rates have varied from year to year in the same cycles as those already observed in the case of our imports of goods and services. In the lower part of Chart A are plotted the cyclical variations in the growth-rates of total demand (or total supply) and the gross domestic product. Comparison with the upper graph shows that in those years when total demand expanded at a faster rate than domestic production—indicated by the shaded areas in the lower graph—imports expanded at a markedly higher rate than exports.

There is, of course, a causal relationship between the movements recorded in these two graphs, deriving from the fact (apparent in Table 5) that domestic production and imports are complementary to each other in balancing total demand for goods and services. Their relationship is such that when production expands less rapidly than total demand, imports must of necessity expand more rapidly; and, arithmetically, these differences of rates of change (in opposite senses) are inversely proportional to the current money-values of production and imports respectively.[1]

Notice from Chart A, however, that the variations and differences in growth rates are counterbalanced automatically in the course of each cycle, whether or not the central government takes action intended to reduce domestic demand.

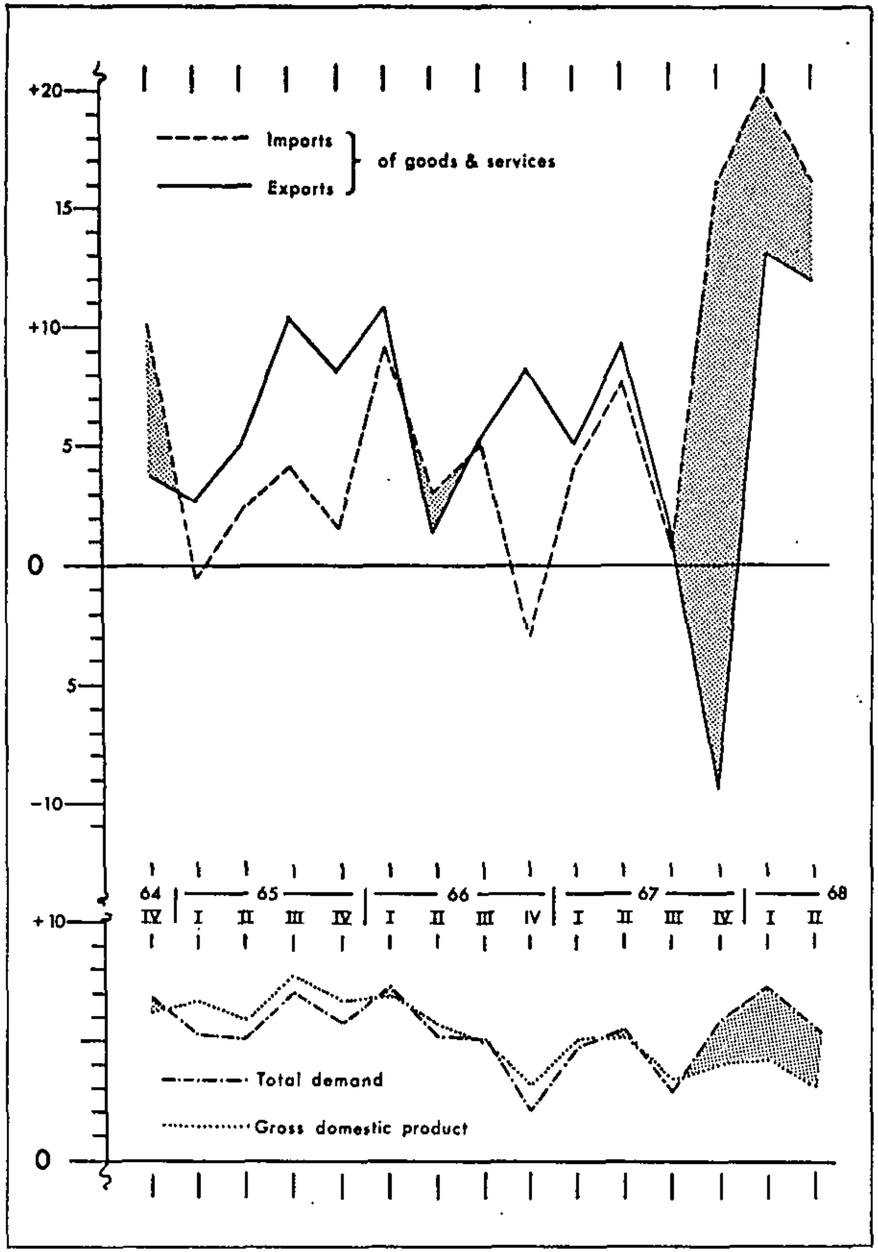
EXPANSION OF DOMESTIC PRODUCTION

Deficits arise on the balance of trade in goods and services, therefore, in those years of each cycle when total demand expands more rapidly than domestic production. Present policies are a delayed reaction to a deficit already in evidence, and seek to reverse the deficit by forcing a reduction of consumers' expenditure. The method has failed to work, as we see it, because it relies on a causal relationship between rising consumption and rising imports of which there is no evidence.

[1] This point was made also in Research Paper No. 1, page 41 and Chart 6.

CHART C VARIATION OF GROWTH-RATES —
1 OCTOBER 1964 - 30 JUNE 1968

Percentage change of quarter's figures from the same quarter of the previous year comparing exports and imports with demand and production



In our view, the most obvious way to reduce the magnitude of the periodical deficits in the trade cycle is to create those conditions of internal confidence in which expansion of domestic production will respond promptly to an expansion of total demand.

The great burden of taxation imposed by the present Government in pursuit of its misconceived policies of deflation has the precisely opposite effect of stultifying all enthusiasm for enterprise. As a result, the growth-rate of domestic production trails below that of total demand, and the growth-rate of imports of goods and services remains persistently above that of exports. These adverse trends over the period from 1 October 1964 to 30 June 1968 are shown graphically in Chart C.

The foregoing consideration of the empirical evidence in the official accounts of the national economy and its external trade in goods and services can lead to only one conclusion, that the differential growth-rates of the component sectors of the British economy cannot be isolated from the powerful influences which generate the regular cycles of world trade. Consequently, it is not possible to distort the cycle of Britain's external trade balance so as to achieve a perennial surplus. Moreover, there is the self-evident truth that in the permanent inter-relationships of international trade a continuous surplus for any one country is impossible.

The feasibility of increasing the net inflow of capital and income in private foreign investment

To recapitulate our enquiry so far: We have seen that in the full external accounts of the nation, the basic deficit arises, not from trading and capital transactions, but from the outflow of government funds. Looking further into the trading figures, we have noted a broad equation of supply and demand, itself only a part of the international economy to which this country belongs, and one in which the Government's efforts to contrive an artificial "surplus" were fated only to be ineffectual and distracting.

Can we then look to the private capital sector for the revenues needed to cover the foreign exchange loss on government overseas activity? In Table 3, we saw that over the ten years 1958 to 1967, the net cash inflow of private capital and income from the country's role of international investor amounted to £4,172 million. This figure is broken down in Table 6 to show the yearly flows of income and capital separately, for both U.K. investment overseas and foreign investment in the U.K. It should be noted particularly that this is an analysis of the aggregates of *all* classes of private foreign investment covered by the official Balance of Payments Year Book, including direct investment in overseas branches and subsidiaries, portfolio investment in foreign securities and, most importantly, "oil and miscellaneous".

The figures in Table 6 differ in two important respects from the official accounts. The first difference appeared also in Tables 2 and 3, in separating official interest from the account of private investment income overseas. The other departure from the official presentation concerns *direct* investment overseas. In the official accounts, the outward and inward flows of capital into direct investment other than in oil are "grossed up" to include that part of foreign earnings which is retained and re-invested overseas; a corresponding addition is made, as a contra item, to current income from direct investment. The net effect of this arrangement

on the basic balance of payments is, of course, nil; but it has the effect of overstating the actual cash flows, both the outflow of capital and the inflow of income. Because our analysis of the balance of payments is concerned above all with net cash flows,

TABLE 6

PRIVATE FOREIGN INVESTMENT FLOWS OF INCOME AND CAPITAL

£ million

Inflow + / Outflow —	Flow of interest,[2] profits and dividends from: Direct investment[1] (other than oil)	Portfolio and other investment: Portfolio	Portfolio and other investment: Other (principally oil)	Portfolio and other investment: Sub-total	Total flow	Flow of capital: Direct investment[1] (other than oil)	Flow of capital: Portfolio and other	Flow of capital: Total flow	Net inflow of interest and capital
BRITAIN'S INVESTMENT OVERSEAS: Inflow of Income and Outflow of Capital									
1958	+121	+107	+359	+466	+587	—70	—166	—236	+351
1959	+145	+113	+283	+396	+541	—103	—107	—210	+331
1960	+173	+125	+258	+383	+556	—165	—72	—237	+319
1961	+176	+126	+268	+394	+569	—152	—87	—239	+330
1962	+179	+134	+306	+440	+619	—114	—33	—147	+472
1963	+212	+137	+334	+471	+683	—118	—84	—202	+481
1964	+223	+143	+348	+491	+714	—116	—133	—249	+465
1965	+234	+157	+423	+580	+814	—142	—45	—187	+627
1966	+246	+153	+353	+506	+752	—93	—27	—120	+632
1967	+258	+145	+374	+519	+777	—87	—157	—244	+533
Totals for 10 years	+1,966	+1,340	+3,306	+4,646	+6,612	—1,160	—991	—2,071	+4,541
FOREIGN INVESTMENT IN BRITAIN: Outflow of Income and Inflow of Capital									
1958	—51	—55	—77	—132	—183	+43	+77	+120	—63
1959	—60	—49	—61	—110	—170	+70	+26	+96	—74
1960	—70	—56	—69	—125	—195	+68	+98	+166	—29
1961	—91	—51	—50	—101	—192	+199	+190	+389	+197
1962	—76	—51	—53	—104	—180	+72	+118	+190	+10
1963	—78	—63	—53	—116	—194	+70	+117	+187	—7
1964	—123	—65	—73	—138	—261	+82	—20	+62	—199
1965	—117	—69	—78	—147	—264	+79	+39	+118	—146
1966	—111	—68	—87	—155	—266	+102	+85	+187	—79
1967	—103	—71	—79	—150	—253	+68	+206	+274	+21
Totals for 10 years	—880	—598	—680	—1,278	—2,158	+853	+936	+1,789	—369
Net movements over 10-year period	+1,086	+742	+2,626	+3,368	+4,454	—307	+25	—282	+4,172

Notes: 1. In the official balance-of-payments accounts the figures for private direct investment overseas include the parent company's share of unremitted profits retained and re-invested overseas; this item is also entered additionally in "interest, profits and dividends" as a contra item. Since this table deals with cash flows into and out of the U.K., these entries have been excluded.

2. Official interest, which is included in the official estimates of "interest, profits and dividends", is excluded from this table of flows of private funds in the country's investor role.

Source: U.K. Balance of Payments, 1968.

we take no account of these contra items. In Table 6, therefore, the flows of income and capital exclude both official interest and unremitted earnings overseas.

In summary, there was, during the ten years, a net cash *inflow* of £4,541 million from private U.K. investment overseas, and a net cash *outflow* of £369 million from private foreign investment in the U.K., resulting in the net inflow of £4,172 million already noted. Dividing this figure the other way, we see that it was composed of a net cash inflow of income amounting to £4,458 million, and a net cash outflow of private capital amounting to only £282 million over the ten-year period.

It is on direct investment in particular that official concern has been concentrated. But in the official accounts, "direct investment" does not include the oil companies; it includes only those companies which are covered by the Board of Trade's annual survey of foreign direct investment, inward and outward. Notice, however, that the net inflow of income and capital combined from direct investment other than oil accounted for only £779 million, or less than one-fifth of the total net inflow of £4,172 million over the ten years 1958 to 1967 (see Table 6).

Present policy restricts private U.K. investment overseas on grounds which were stated in The National Plan as follows, and clearly relate to direct investment only:

> "The extent of the capital outflow has not been commensurate with what the United Kingdom can afford, and a change in policy towards overseas investment was essential. Much of the benefit of overseas investment accrues to the recipient countries, and the returns from investment overseas is on average considerably less, from the point of view of the national economy, than the return on home investment. Our tax system has tended to give too favourable a treatment to overseas compared with domestic investment. The benefits of overseas investment to the balance of payments—in the form of interest and dividend income, and of increased exports of goods and services—are of course recognised, but in many cases these benefits accrue only over a longer period. And in a time of acute strain on the balance of payments, short-term considerations must be given weight. It is, therefore, reasonable to employ a reduction in net overseas investment as one of the means to bring about the required improvement in our external accounts . . . "

REDDAWAY INVESTIGATION

The major change in policy towards overseas investment was made in the 1965 Corporation Tax, introduced by Mr. Callaghan who indicated that it was intended to rectify the bias in favour of overseas investment. It was for this reason that W. B. Reddaway of the Cambridge University department of Applied Economics undertook on behalf of the Confederation of British Industry and Her Majesty's Government an independent investigation into the effects of direct British investment overseas, other than oil, on the balance of payments.

The Reddaway Reports (interim and final) were based on an analytical survey of the accounts and returns of companies overseas between 1955 and 1964, from which was calculated the effect on the balance of payments, in terms of profits after tax and appreciation plus additional net exports, of each £100 of capital outflow from the U.K. into direct investment overseas, assuming it to be matched by £67 (i.e. in the ratio of 60 to 40) of capital raised simultaneously overseas. Although the final Report does confirm the long-term beneficial effects of overseas investment, the central conclusion is that, although a steady rate of investment would eventually provide enough current account surplus to finance each year's new investment, in the short term each single act of investment has a large and immediate damaging effect on the balance of payments; hence restriction of British direct investment overseas benefits the balance of payments for a substantial number of years.

The Reddaway conclusions were based on hypothetical analysis of the effects of additions of £100 to direct investment overseas. Had they been based instead on the recorded aggregates of inflows of income and outflows of capital, as they appear in Table 6, the conclusions would necessarily have been different. For the inflow of remitted profits from British direct investment overseas, other than oil, increasing from £121 million in 1958 to £258 million in 1967, followed a rising straight-line trend equivalent to a "compound interest" rate of 8.0 per cent per annum; the outflow of capital from the U.K. into direct investment, on the other hand, followed a slightly downward trend, at an annual rate of decrease of —0.7 per cent. In none of the ten years 1958 to 1967 was the net income on current account from direct investment insufficient to cover the outflow on capital account. The strongly rising trend of income, contrasting with the fairly level trend of capital outflow, shows that the rate of outflow of British direct investment overseas prior to 1965 was in fact producing a benefit to the balance of payments by 1965, a benefit which was increasing then, and continues to increase.

The figures in Table 6 show that the net inflow of interest and capital combined, for outward direct investment other than oil, has grown as follows over the last ten years:

Outward Direct Investment, other than oil

	Inflow of income	*Outflow of capital*	*£ million Net inflow of income and capital combined*
1958	+ 121	— 70	+ 51
1959	+ 145	— 103	+ 42
1960	+ 173	— 165	+ 8
1961	+ 175	— 152	+ 23
1962	+ 179	— 114	+ 65
1963	+ 212	— 118	+ 94
1964	+ 223	— 116	+107
1965	+ 234	— 142	+ 92
1966	+ 246	— 93	+153
1967	+ 258	— 87	+171
Totals for 10 years	+1,966	—1,160	+806

The growing net benefit to the balance of payments which appears in the table above takes no account of secondary benefits by way of additional exports. Moreover, these figures relate only to direct investment other than oil, which produces less than one-fifth of our net cash inflow from foreign investment. They show that British direct overseas investment has been financially self-supporting for the past ten years at least, and has produced a direct, net cash inflow which increasingly benefits the balance of payments. **Even in respect of this small segment of foreign investment, therefore, it is not true that the private sector has shown a tendency to invest overseas beyond the country's capacity to maintain it. Much less is it true in respect of ALL classes of private British overseas investment, including oil, portfolio and miscellaneous.**

POLITICAL REASONS

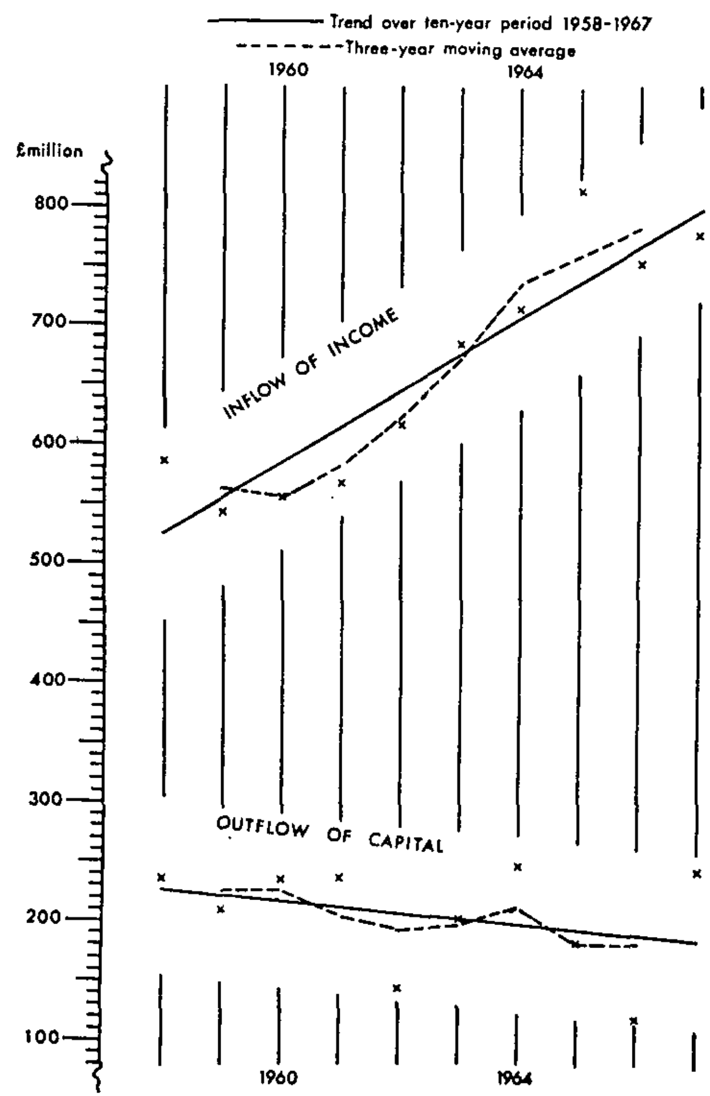
The numerical facts of the cash outflow of private capital, into all classes of overseas investment, and of the income resulting from the outflow to date, are recorded in the upper part of Table 6. The actual tendencies of these inward and outward cash flows, over the period from 1958 to 1967, are shown graphically in Chart D. Over the ten years, cash income received in the U.K. from private foreign investment has clearly been increasing rapidly; the slope of the straight-line trend, over the period as a whole, indicates an average annual rate of increase of 4.7 per cent. The cash outflow of capital, on the other hand, has shown a marked tendency to decrease; the average rate of reduction indicated by the trend-line in this case is 2.1 per cent per annum. Private outward investment is therefore fully self-supporting financially, yet the one reliable source of a large and growing surplus in the balance of payments has been wilfully throttled for political reasons which have no rational basis.

To return once more to the one dominant fact that over the ten years 1958 to 1967 there was a net cash inflow of £4,172 million in capital and interest combined, from outward and inward investment combined, and for all classes of private foreign investment. This total for ten years grew over the period as follows:—

Net inflow of capital and interest	*£ million*
1958	288
1959	257
1960	290
1961	527
1962	482
1963	474
1964	266
1965	481
1966	553
1967	554
Total for ten years	4,172

CHART D **PRIVATE INVESTMENT OVERSEAS**

Trends of Flows of Income and Capital



Ten-year straight line trend fitted by 'method of least squares'

The rising trend of this net cash inflow, calculated as a straight line, showed an average "compound interest" rate of increase of 7.2 per cent per annum. Financially, this increasing net inflow was entirely self-supporting. If its present rate of rise continues, the net inflow for the year 1977 will amount to £1,016 million. Yet the Labour Government has stated that this, the only steadily rising flow of income in our balance of payments, "has not been commensurate with what the United Kingdom can afford".

SCANT KNOWLEDGE

This brings us to the question: is it feasible to accelerate the rate of increase of the net inflow of capital and income from private foreign investment? It is evident that the present rate of increase is self-supporting because a high proportion of overseas earnings is not remitted to this country, but is ploughed back into investment overseas, yielding more and more income in succeeding years. Apart from direct investments other than in oil, however, our knowledge of earnings-yields and rates of plough-back is very scant indeed. Without comprehensive knowledge of these behavioural factors it would be quite unrealistic to attempt to prescribe measures which in theory would increase the net inflow of that portion of overseas earnings which is remitted to this country. Our answer to this question, therefore, is that here is one branch of the national economy which is evidently flourishing quite strongly, despite all that the present Government has done and is doing to wither it, and that the wisest course of action would be to remove all restraints and so encourage the inflow to continue its strong growth out of its own very adequate resources.

The feasibility of reducing government spending; or, alternatively of finding means to finance essential deficit spending overseas

Whether the central government's expenditure overseas could be reduced is a matter of political opinion. As such it may seem to fall outside the scope of a paper concerned with research into the current numerical facts of the U.K. balance of payments. But the aim of this paper is to make a fresh analysis of the external financial position of the United Kingdom so as to provide comprehensive accounting information for those who wish to re-appraise the management of the economy. A management accountant can properly express an opinion on whether a class of spending is dispensable or not.

The present Government talks of the need to reduce our spending on overseas naval bases to what a second-class power can afford, in the mistaken belief that when national flags of independence were raised all round the world, and the colonial services, civil and military, were brought home and disbanded, the wind of change swept away the British presence from all the corners of the earth. Nothing could be further from the present truth. The British flag was originally raised around the world to enlarge and protect this country's interests as a predominant world trader and investor. Under that flag, a world-wide network of industrial, commercial and banking interests was established. The banking connections, branch establishments, agencies and correspondents which spread outwards to all parts of the world with this development of British trade and investment provided the most widespread and convenient machinery of international payments, not only for the dominions and colonial territories of the British Empire, but also for third countries outside the immediate British connection. This installed equipment of banking facilities, commercial houses and industrial investment, backed by the City of London's unrivalled markets and credit facilities, is still functioning and flourishing under British ownership and management throughout the world today. Moreover, those British interests overseas form a major and essential part of the organic infra-structure of the world economy and the international monetary system, a responsibility shared only with the United States. And the further expansion of private investment overseas is essential if Britain is to continue to play this vital role.

MARITIME POWER

Britain cannot, as a responsible member of the world community, withdraw unilaterally from this role. Indeed, continuance is essential to maintain the living standard of the British people and to raise it in keeping with that of other industrial nations. It is inconceivable that this world role could be maintained without a merchant fleet to match, and it is therefore essential that Britain continues as a first-class maritime power in peace, no matter how diminished her military potential in war may be.

Without entering into detailed consideration of the present levels and purposes of government spending overseas, we would argue, therefore, that policy should be based on the best way of increasing what can be spent to support our merchant fleet and expand this country's vital role in the world economy.

We have seen that the trouble with our balance of payments has mainly arisen because government overseas spending has persistently exceeded the rising net inflow of capital and income from private foreign investment. Over the ten years 1958 to 1967 (Table 3), net government expenditure overseas, at £6,026 million, exceeded the net inflow of capital and interest, at £4,172 million, by £1,854 million. It is not for us to suggest that government spending could or should have been less. The question is whether some part of this expenditure could have been financed by other means which would relieve the overseas earnings of the private sector from an excessive burden.

GRANT AND LOANS ABROAD

Current overseas expenditure by the government on services and transfers amounted to £3,748 million over the ten years 1958-1967, rising from £219 million in 1958 to £551 million in 1967 (Table 3).

This included economic grants in aid totalling £739 million, and military grants totalling £150 million. Expenditure on capital account included loans to other governments by the United Kingdom which amounted to £658 million, of which £582 million went to countries in the sterling area. No doubt these grants and loans, amounting to £1,547 million, resulted in some secondary benefit to the balance of payments by way of an increase in Britain's exports; but this aid to other countries accounts for a very large part of the excess of government spending over private sector earnings in the ten years under study, and therefore had to be financed by drawing on our first and second-line reserves of international liquidity.

It is not suggested that these grants and loans should not have been made; but Britain could not afford to finance them in the way she did by reducing her external reserves of gold and currencies

The International Bank for Reconstruction and Development exists for the purpose of giving assistance of the kind which Britain has found it desirable to provide selectively herself. These loans and grants, which are now depleting our reserves at a rate of about £200 million a year, should, in our view, be financed by raising long-term loan capital on the international market through the World Bank. With our record of growing income from outward private overseas investment, now approaching £800 million a year and increasing at a steady rate above 4 per cent per annum (Table 6), Britain would have no difficulty in underwriting loans to those less fortunate countries which we desired to help.

Distinguishing our trading and investing role from our role as an international banker

We have suggested that certain changes in financial management would help us to increase our basic surplus. But our immediate overseas monetary position will not be restored to health by these simple steps alone. The external financial balance-sheet of this country, in its role of an international banker, is in the sorry state of being desperately short of liquidity despite the country's immense overseas investment and the large and growing cash inflow from those investments.

We now suggest that this has come about through bad financial management of the sterling monetary system. Both political parties are to blame, but the Labour Government must accept full responsibility for aggravation of the position in October 1964, when they chose, for political purposes, to proclaim an economic crisis and to deal with what was merely a large but transient deficit on the balance of payments as if it were a national emergency of overwhelming proportions. It is equivalent to a bank manager proclaiming that his bank is broke, and then being surprised that there was a run on it. This irresponsible conduct by what may be regarded as the new board of directors of the "International Bank of the Sterling Monetary System" had a near-disastrous effect on foreign confidence in the value of sterling, a loss of confidence which has not yet been restored.

RESERVES OF INTERNATIONAL LIQUIDITY

In October 1964, rather than proclaim a national emergency, the Labour Government should have assured foreign holders of sterling that, although we had a basic deficit that year of unprecedented size, possibly as large as £800 million, our resources of liquidity were amply sufficient to cover it, since they were then valued at £2,224 million. They comprised the reserves of gold and convertible currencies, £907 million; the entire dollar portfolio, then valued at £446 million (it has more recently been liquidated, realising £520 million); and our drawing-rights with the I.M.F., which were then limited to £871 million and were entirely untouched when the government changed hands.

Since that time, the dollar portfolio has been sold and transferred to the first-line reserves, and our drawing-rights with the I.M.F. have been exercised to the full, though the limit has been raised to £1,270 million. Our first-line reserves of gold and convertible currencies now have no second-line support; at 30 November 1968 they stood alone at £1,046 million. In four years, therefore, the country's total resources of international liquidity have been reduced from £2,224 million to less than half that figure.

But this is not the full measure of the damage to the sterling monetary system. To comprehend the full situation it is necessary to distinguish between the overseas transactions of the private sector and those of the public sector. The numberless independent transactions of the private sector are not under central control, so that their aggregates are entirely fortuitous, but the transactions of the public sector are—or most certainly should be—under the accountable control of the central government. And it is financial management by the government which is in question.

For the purposes of our further analysis we shall abandon the eccentric concept of the "basic" balance—the balance of current and long-term capital transactions—and rely upon normal accounting, which says that the balance of income and expenditure on current account for any period is always equal to the change in the balance between assets and liabilities. The period from 1 October 1964 to 30 June 1968 has been selected as being under one continuous management.

Transactions on current account are shown in Table 7, and the equivalent changes in external assets and liabilities in Table 8. The broad summary is as follows:—

International Transactions of the United Kingdom

1 October 1964 to 30 June 1968

— *financial deficit* *£ million*

+ *financial surplus*

	Balance on current a/c	*Change in balance of external assets and liabilities*
Public sector	—2,485	—1,934
Private sector	+1,615	+1,240
United Kingdom	— 870	— 694
"Balancing item"	+ 177	
	— 693	— 694

The net outcome of the total international transactions of the United Kingdom for the period was a financial deficit of £694 million. This was recorded on the one hand (subject to statistical discrepancies) as an excess of official spending on current account over private sector income, and, on the other hand, as the difference between a net increase of official external liabilities (£1,934 million) and a net increase of private financial assets (£1,240 million).

We must assume that the official overseas spending on current account could not have been reduced. There is no evidence, however, that the central government were conscious of the fact that the rate of their official overseas spending exceeded private overseas earning, or that, as a natural consequence, their deficit overseas spending must inevitably be financed by adding to the country's official overseas debt.

GOVERNMENT'S MANAGERIAL RESPONSIBILITY

It is precisely here that the central government's handling of the balance of payments problem has been at fault. They have concentrated on efforts designed to increase the private sector's capacity to earn income from foreign trade, while disregarding the evidence that government spending persistently outpaced the private sector's earnings. They neglected their managerial responsibility to finance their overseas deficit spending by orderly and prudent overseas fund-raising, judiciously balanced between long-term and short-term. In consequence, the government are responsible for the depletion of the country's reserves of international liquidity.

TABLE 7

UNITED KINGDOM BALANCE OF PAYMENTS, 1 OCTOBER 64 to 30 JUNE 68

Transactions on current account divided between private and public sectors

£ million

	Quarter 64-IV	Year 1965	Year 1966	Year 1967	Quarter 68-I	Quarter 68-II	TOTAL 1.10.64 to 30.6.68
PRIVATE SECTOR							
Balance of trade in goods and services, incl. private transfers:							
Imports	1,651	6,682	6,901	7,362	2,172	2,168	26,938
Exports	1,586	6,580	6,996	7,099	2,037	2,061	26,359
Balance of trade in goods and services	− 65	−102	+ 95	−263	−135	−107	−577
Interest, profits and dividends:							
As in official accounts	+ 79	+ 470	+ 422	+ 410	+ 100	+ 129	+1,610
Add back official interest deducted	+ 27*	+ 128	+ 154	+ 173	+ 50*	+ 50*	+ 582
Balance, private income from overseas investment (net)	+ 106	+ 598	+ 576	+ 583	+ 150	+ 179	+2,192
Current balance, private sector	+ 41	+ 496	+ 671	+ 320	+ 15	+ 72	+1,615
PUBLIC SECTOR							
Government spending overseas, current account:							
Services: defence and diplomatic	− 64	−270	−282	−269	− 67	− 70	−1,022
Current transfers, grants	− 39	−177	−179	−184	− 53	− 44	−676
Payments for U.S. aircraft	—	− 12	− 41	− 98	− 23	− 31	−205
Official interest (net) as above	− 27*	−128	−154	−173	− 50*	− 50*	−582
Current balance, public sector	−130	−587	−656	−724	−193	−195	−2,485
CURRENT BALANCE, UNITED KINGDOM	− 89	− 91	+ 15	−404	−178	−123	−870
"Balancing item"	− 34	+ 67	− 10	+ 175	− 47	+ 26	+ 177
Net change in external assets/liabilities	+ 123	+ 24	− 5	+ 229	+ 225	+ 97	+ 693
Balance of all international transactions	0	0	0	0	0	0	0

Notes: *Estimates—the Red Book 1968, table 15, shows that "Interest, profits and dividends (net)" includes official interest (net) as follows:—
1964: £107m. 1965: £128m. 1966: £154m. 1967: £173m.
Source: Economic Trends, September 1968, and Red Book 1968.

TABLE 8

EXTERNAL LIABILITIES AND FINANCIAL ASSETS OF THE UNITED KINGDOM

Changes over period 1 October 1964 to 30 September 1968

£ million

	Footnotes	Quarter 64-IV	Year 1965	Year 1966	Year 1967	Quarter 68-I	Quarter 68-II	TOTAL 1.10.64 to 30.6.68
Long-term capital	1							
Public sector		− 43	− 86	− 81	− 57	− 15	+ 40	−242
Private sector		− 66	−117	− 23	− 29	− 91	− 43	−369
Net balance		−109	−203	−104	− 86	−106	− 3	−611
Net liabilities in sterling	2							
Public sector		+ 370	+ 421	+ 320	+ 401	+ 458	+ 207	+2,177
Private sector		−227	+ 139	− 31	−207	−108	−267	−701
Net balance		+ 143	+ 560	+ 289	+ 194	+ 350	− 60	+1,476
Net liabilities in non-sterling currencies	3							
Public sector		+ 13	− 72	+ 14	+ 179	+ 127	+ 82	+ 343
Private sector		+ 10	− 65	−162	+ 10	− 14	+ 34	−187
Net balance		+ 23	−137	−148	+ 189	+ 113	+ 116	+ 156
Subscription to I.M.F.	4							
Increased quota		—	—	−175	—	—	—	−175
Revaluation		—	—	—	−220	—	—	−220
I.M.F. gold deposits in U.K.		—	+ 3	+ 12	+ 1	—	—	+ 16
Net change		—	+ 3	−163	−219	—	—	−379
Miscellaneous capital	5							
Public sector		− 7	+ 44	− 34	+ 5	+ 21	+ 5	+ 34
Private sector		− 12	− 4	− 82	+ 35	− 19	+ 10	− 72
Net balance		− 19	+ 40	−116	+ 40	+ 2	+ 15	− 38
Other transactions on capital account								
Public sector:								
Gold and currency reserves	6	+ 80	−246	− 34	− 16	− 11	+ 16	−211
From dollar portfolio	7	—	—	+ 316	+ 204	—	—	+ 520
Exchange adjustments	8	—	—	—	−101	−124	− 83	−308
Sub-total, public sector		+ 80	−246	+ 282	+ 87	−135	− 67	+ 1
Private sector:								
Net liabilities in overseas sterling area currencies	9	+ 5	+ 7	− 45	+ 24	+ 1	+ 97	+ 89
Net total change in external financial assets and liabilities of the U.K.	10	+ 123	+ 24	− 5	+ 229	+ 225	+ 98	+ 694
of which—Public sector		+ 413	+ 64	+ 338	+ 396	+ 456	+ 267	+1,934
—Private sector		−290	− 40	−343	−167	−231	−169	−1,240

Footnotes:
1-3 From Economic Trends, September 1968, table 9.
4 From Central Statistical Office, personal communication.
5-9 From Economic Trends, September 1968, table 9.
10 For reconciliation with balance on current account in the balance of payments, see foot of table 7.
N.B. Assets: increase—/decrease+. Liabilities: increase+/decrease —.

As seen in Table 8, the outstanding elements of the £1,934 million raised so haphazardly abroad were increases of net official liabilities in sterling (£2,177 million) and in non-sterling currencies (£343 million), partially offset by an increase of official assets in inter-government loans (£242 million) and an addition to the U.K. subscription to the I.M.F. (£379 million). Of these, the major item was obviously the net increase by £2,177 million in official liabilities in sterling; this was composed principally of an increase of £829 million in Treasury bills held abroad, and £1,269 million of sterling non-interest-bearing notes held by the I.M.F. against official drawings repayable in foreign currencies. In four years, our central government have incurred additional short- and medium-term official overseas debt of some £2,000 million, all of which is due for repayment within the next four years.

PROSPECTIVE RESOURCES

What resources of international liquidity will be available to the United Kingdom, assuming no change of policy in financial management by the central government, out of which to repay this £2,000 million on due date? Our present resources total little more than £1,000 million, which is already precariously low, as has been harshly revealed by the parity crisis of the French franc and the German mark. Certainly, nothing further can be drawn from present resources to repay accumulated official debt. Our credits with the I.M.F. are exhausted. The Treasury's dollar portfolio has been sold and the proceeds spent. Government overseas spending still exceeds the net cash inflow earned from trading and investing overseas by the private sector, adding further to the official short-term debt to be repaid abroad. Therefore, not only is our external balance-sheet in a precarious state of illiquidity, but it continues to deteriorate, and so long as the sterling monetary system, as international banker and world reserve centre, continues to operate on this critically narrow margin of liquidity, short-term funds will tend to fly out of sterling at the slightest hint of new pressure. There are no reasonable grounds for anticipating that present policies will result in any significant increase of our resources of international liquidity, not to speak of restoring them sufficiently to pay off £2,000 million of official debt within the next four years.

Yet it would be wrong to regard this state of affairs as evidence that the British economy and the sterling monetary system are on the rocks! Look again at our external balance-sheet Inventories of the estimated external assets and liabilities of the United Kingdom, as at the end of 1962, 1964, 1966 and 1967, were published in the official Red Book "United Kingdom Balance of Payments 1968". At the end of 1967, identified private long-term capital assets overseas owned by residents in Britain were valued at £11,550 million, while corresponding foreign-owned assets in this country were valued at £5,680 million. The net capital value to this country of private foreign investment was therefore estimated at £5,870 million; as we have seen, this produces an annual net cash inflow which exceeded £500 million in 1967 and is growing at a "compound interest" rate of 7.2 per cent per annum.

LIABILITIES

Against this, the country's total net liabilities overseas amounted to £3,955 million, composed of £1,110 million in long-term inter-governmental loans (net) plus the entire external liabilities of the sterling monetary system (the sterling balances, the debt to foreign central banks and the debt to the I.M.F.) which totalled £2,845 million (net after deducting the reserves and U.K. external claims).

The country's identified financial assets, therefore, exceeded total external liabilities by an estimated £1,915 million at the end of 1967. At the end of 1962, the net figure was estimated at £1,395 million; of 1964 at £1,605 million; and of 1966 at £1,465 million. **Not only do our external assets now exceed our liabilities but our net overseas worth has continued to expand, even during recent years in which, according to our economic overlords, the nation has failed to pay its way in the world.**

Given the immense strength of private overseas investments the external sector of the sterling monetary system (functioning as an international banker) is basically sound. The balance-sheet is unsatisfactory, however, because the magnitude of the sterling cash flows across the foreign exchange markets, arising out of the highly fluid condition of the international monetary system in the present phase of its evolution, cannot be accommodated by our limited reserves of international liquidity.

CORRECTING THE ILLIQUIDITY

Competent management would quickly remedy this weakness in an otherwise strong balance-sheet. The financial problem, though huge, is a familiar one in industry; our private overseas enterprises have grown enormously and continue to expand, but the banking side has run short of working capital. We need to raise some £3,000 million additional working capital in convertible currencies on the international market. Our total resources of international liquidity would then amount to some £4,000 million, which would give a cover of roughly 80 per cent to our total external liabilities in sterling (at 30 June 1968 our gross sterling liabilities totalled £5,629 million, but this figure includes £736 million for the sterling element of the U.K. subscription to the I.M.F., which is not a liability in the normal financial sense).

For any country to raise long-term capital of £3,000 million, or $7,200 million, is an operation of unprecedented magnitude. But it is clearly within Britain's present financial capacity. Provided the central government cease to finance overseas deficit spending out of reserves, the capital fund raised would add equally to the reserves of foreign currencies on the asset side and to the long-term capital on the liabilities side of our external balance-sheet. Ample security is provided by the country's large and growing private overseas investments; their hypothecation under treaty would not require them to be "nationalised", except in the remote contingency of default. Servicing of such loan-capital would be well covered by the present and prospective rates of cash inflow from private foreign investment.

It is not suggested that the £3,000 million should be raised in a single operation; a number of tranches, phased systematically over, say, four years, would doubtless be more convenient for the international market. The market can be expected to welcome the operation, since a capital-raising operation of this magnitude, deliberately undertaken by our central government by treaty in the framework of the Organisation for Economic Co-operation and Development, could not fail to strengthen the infra-structure of the international monetary system.

No doubt the prospect will daunt a government whose economic policy has hitherto been based on the homely principles of petty thrift. But the scale on which they would have to act is no larger than the scale of their "borrowing" over the last four years.

This is very clear when one sees the government's overseas deficit spending in the context of their total spending activities on both domestic and external accounts.

In three and three-quarter years, from 1 October 1964 to 30 June 1968, despite the escalation of taxes, the Government at home overspent their income by £2,709 million; there was a surplus of revenue over expenditure on current account amounting to £2,393 million, but loans were made to local authorities and public corporations to a total of £5,102 million.[1] The deficit spending of £2,709 million (now known euphemistically as "the central government's borrowing requirement") was financed by an equal increase of government debt, which was acquired by (and in that sense the finance was "borrowed" from) the following sectors of the economy:

Sector acquisitions of central government debt

		£ million
Overseas sector:		
Treasury bills	829	
Marketable securities	—18	
Direct borrowing from I.M.F.	1,262	
From gold and currency reserves	309	
Sub-total		2,382
Banking sector:		—214
Non-bank private sector:		
Increased issue of notes and coin	614	
Other government debt	—73	
Sub-total		541
Total acquisition of central government debt, all sectors, 1.10.64 to 30.6.68		2,709

As was explained in Research Paper No. 2, to the extent that the public sector's deficit spending in the domestic economy is not financed exclusively by the sale of long-term government securities to the personal sector, the deficit spending creates additional income which accumulates as liquid savings in the hands of the personal sector. The table above shows that over the period 1 October 1964 to 30 June 1968, the deficit spending at home by the central government, amounting to £2,709 million, was

[1] The figures in this paragraph and the following table are taken from FINANCIAL STATISTICS, November 1968.

not financed at all by the personal sector acquiring government securities.

CREATION OF MONEY

The manner in which the government deficit at home was in fact financed can also be seen in the table above. It happened that over this period central government debt overseas increased by £2,382 million; as the Exchange Equalisation Account (E.E.A.) has been operated since 1939, this resulted in the creation of near-money in the form of Treasury bills to provide the sterling collateral for the liability in foreign currencies, and consequently in a sterling credit of this amount to the E.E.A. Such credits are not held in the E.E.A., but transferred automatically to the credit of the Exchequer's account with the Bank of England. So their financial deficit *overseas* gave the central government £2,382 million of created money with which to help finance their financial deficit *at home* of £2,709 million. In addition, £614 million was added to the notes and coin in circulation, a further creation of money which also was credited automatically to the Exchequer's account with the Bank of England. These two lots of created money, together amounting to £2,996 million, exceeded the central government's "borrowing requirement" for the period (£2,709 million), by £287 million. Far from the private sector acquiring any government debt over the period, therefore, the banks sold off £214 million, and the non-bank part of the sector sold off £73 million.

Official statistics confirm that the central government's persistent deficit spending in recent years has resulted in a commensurate expansion of the liquid funds in the hands of potential private spenders. The facts were published by the Central Statistical Office in April 1967, and again in April 1968. It was shown that at the end of 1967, indentified liquid financial assets of the personal sector, on deposit in national savings, banks, building societies, etc., amounted, after deducting bank advances, to £22,034 million; and that this figure had grown from £17,725 million at the end of 1964. Since the personal sector is synonymous with the total population, these accounting figures mean that at the end of 1967 there was an average of £400 of liquid potential spending-money in the hands of every man, woman and child in the British Isles, an increase of £72 per head in only three years.

SOUND FINANCIAL MANAGEMENT OF STERLING

The monetary mechanism by which public deficit spending becomes expanded personal liquidity was explained in Research Paper No. 2. It is brought up again in this paper to emphasise the disastrous folly of continuing a system which provides windfall finance to the Exchequer whenever and to the extent that we add to our government overseas debts. The system is not immutable. It is vitally important that it be corrected before we embark on a major operation to raise long-term loan-capital on the international market.

The solution to the country's two main economic problems, which are inflation first and a basic deficit on the balance of payments second, is sound financial management of the sterling system by the government. Above all, our central governments must develop a new breadth of vision, and see these British problems in the full perspective of the world economy. For, in the last analysis, *what has been said in this paper on* the balance of payments could be summed up by repeating the words of the Radcliffe Committee on the Working of the Monetary System (1959), in the last of its main conclusions:

> "Fifthly, the external assets and liabilities of the United Kingdom are an integral part of its economy and its financial system. Their movements have a direct influence upon the state of its liquidity, and the problems they engender are not so much a separate set of problems as a different aspect of the total problem. There is no doubt that in one form or another the United Kingdom needs a greater amplitude of international reserves in order to secure for itself more freedom in the pursuit of one or more of its national objectives. But there are two important qualifications to the possible methods by which it can try to enlarge this freedom. One is that it is not so placed that it can by its own choice abdicate its responsibilities as the financial centre of the sterling area or determine the use of sterling as a means of international exchange. Even if it were differently placed, sterling is too valuable a constituent of the total volume of international liquidity for it to be an admissible objective of United Kingdom policy to bring about a limitation or reduction of its use. The second qualification is that we are under the obligation of acting as a responsible member of the society of nations: we cannot there-

fore look to a unilateral increase in our international reserves as the prime or indeed the main method of achieving greater *freedom. Our chief reliance must be upon increasing the* resources and through them the facilities of international organisations for the provision of credit."

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