FOR AGENDA

EBS/76/519

CONFIDENTIAL

December 16, 1976

To: Members of the Executive Board

From: The Secretary

Subject: United Kingdom - Request for Stand-By Arrangement

Attached for consideration by the Executive Directors is a request from the United Kingdom for a stand-by arrangement equivalent to SDR 3,360 million, together with the staff's analysis and recommendation.

This subject will be brought to the agenda for discussion at an Executive Board meeting on Monday, January 3, 1977.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

UNITED KINGDOM

Request for Stand-By Arrangement

Prepared by the European Department

(In consultation with the Exchange and Trade Relations, Legal, Research, and Treasurer's Departments)

Approved by L. A. Whittome

December 16, 1976

I. Introduction

In the attached letter dated December 15, 1976, from the Chancellor of the Exchequer to the Managing Director, the United Kingdom is requesting a stand-by arrangement for a period of two years for an amount equivalent to SDR 3,360 million. The letter also sets out the policies and intentions of the Government of the United Kingdom. A staff mission comprising Messrs. Whittome (EUR), Finch (ETR), Vittas (EUR), Brau (ETR), Manison (EUR), and Deppler (RES), with, as secretaries, Mrs. Stephens and Miss Ryan (EUR), discussed these policies and intentions with U.K. officials in London during the period November 1 to December 12, inclusive, 1976. Mr. Ryrie, Executive Director for the United Kingdom, also participated in the discussions.

The last Article VIII consultations with the United Kingdom were held in London in May 1976 and the Staff Report (SM/76/153, 7/27/76) 1/ was discussed by the Executive Board on July 30, 1976 (EBM/76/116).

The par value of the pound remained unchanged in terms of gold in the December 1971 currency realignmemt. On June 23, 1972, the Government of the United Kingdom notified the Fund that "for the time being the market rate for sterling would not necessarily be confined within announced limits." Since that date, the exchange rate has depreciated under pressure from market forces, and by December 13, 1976, it had fallen in effective trade-weighted terms by 44.4 per cent compared to its level on December 21, 1971. 2/

The United Kingdom has a quota of SDR 2,800 million. On December 31, 1975, the Executive Board approved a purchase under the Oil Facility for 1975 for an amount equivalent to SDR 1,000 million and on the same date approved a one-year stand-by arrangement for the United Kingdom authorizing purchases of currencies up to the equivalent of SDR 700 million. On January 16, 1976, the United Kingdom purchased the full amount of the gold tranche, on January 23, 1976, the equivalent of SDR 1,000 million under the Oil Facility, and on May 12, 1976, the

1/ Background information to that report was contained in SM/76/154 (7/12/76).
2/ According to estimates of the Bank of England, which uses an approach similar to that incorporated in the Fund's Multilateral Exchange Rate Model.

equivalent of SDR 700 million under the stand-by arrangement. On November 30, 1976, the Fund's holdings of pound sterling, excluding amounts purchased under the Oil Facility, amounted to the equivalent of SDR 3,500 million or 125.0 per cent of quota and, including the amount outstanding from the oil facility purchase, amounted to the equivalent of SDR 4,500 million or 160.7 per cent of quota. If the United Kingdom purchased the full amount available under the proposed stand-by arrangement (annexed), the Fund's holdings of pound sterling, excluding the amount outstanding under the oil facility purchase, would reach 245.0 per cent of quota. A waiver of the conditions under Article V, Section 3 (a)(iii) of the Fund's Articles of Agreement will be required. According to the phasing of the proposed stand-by arrangement, purchases may not exceed the equivalent of SDR 1,950 million over the first 12 months. The stand-by arrangement includes performance clauses with regard to domestic credit expansion, the public sector borrowing requirement (PSBR), and with respect to multiple currency practices, restrictions on payments, and transfers for current international transactions and restrictions on imports for balance of payments purposes. Performance clauses for purchases in the second year of the stand-by arrangement will be agreed in the light of the review with the Fund, which is to be completed before January 16, 1978 and which is referred to in paragraph 25 of the annexed letter. The United Kingdom will consult with the Managing Director regarding the currencies to be purchased under the stand-by arrangement.

On November 30, 1976, the United Kingdom's holdings of Special Drawing Rights amounted to SDR 629.5 million or 62.6 per cent of its net cumulative allocation.

This report is divided into three sections and an attached appendix. The first section summarizes, against a brief exposition of the historical background, the present economic situation of the United Kingdom, the second comments on the content and adequacy of the stabilization program adopted by the British authorities, and the last contains some concluding remarks. The appendix analyzes in greater detail actual developments in 1976 and discusses the prospects for the next two years as foreseen in October 1976.

II. The Present Economic Situation

As recently as last July, the U.K. authorities were anticipating a strong recovery in economic activity, against a background of a continued and steady deceleration in the rate of inflation. During the period to the second half of 1977, real GDP was expected to increase at an average annual rate of more than 4 per cent, on the basis of a steep rise in exports of goods and services, the resumption of stockbuilding, and a marked upturn of investment in the manufacturing sector. Unemployment was expected to level off in early 1977 and the current account of the balance of payments was projected to move into surplus from about the middle of that year.

By October the picture was very different. The upturn in demand, which appeared to be well under way in early 1976, has since tapered off. In the six months to September 1976, industrial output rose by less than 0.5 per cent, while total real GDP is estimated to have actually fallen somewhat between the first and third quarters of the year. The recovery of investment in manufacturing has been delayed and the performance of exports has been extremely disappointing. In volume terms, exports fell by 3 per cent in the third quarter of 1976, despite an estimated growth in U.K. export markets of nearly 4 per cent, while the growth in imports was exceptionally large, given the depressed state of total demand. In recent months, the deceleration in prices has ceased and there are instead clear signs of renewed acceleration, notwithstanding the successful implementation of the voluntary policy of pay restraint.

There has also been a distinct worsening in the short-term outlook for economic growth. Real GDP is now expected to grow by only 2 to 2.5 per cent in 1977 over 1976, after an estimated increase of only 1.2 per cent in 1976 (Table 1), and unemployment is likely to continue to rise. The maintenance of the pay policy, against the background of escalating price increases, is expected to lead to a sharp fall in real personal disposable income and a small decline in private consumption. The prospect of a marked upturn in private investment is becoming increasingly uncertain and the turnaround in the current account of the balance of payments into a surplus is not now expected to occur before 1978, despite the weakening of domestic demand.

This disappointing change in economic performance and in the immediate prospects is difficult to explain. The U.K. authorities attach importance to the slowdown in the rate of recovery of the world economy. They also stress that the hoped-for continuing improvement in domestic price trends has been hampered both by rises in the world prices of imported goods and by sharp and unforeseen weaknesses in sterling, resulting in part from large withdrawals of sterling balances. The staff accepts that these factors have hampered progress but would put more stress on what they regard as other weaknesses. First among these has been the failure to establish effective control over financial policies.

For a number of years now, the growth in public expenditure has been very rapid and has led to a very sharp increase in the public sector borrowing requirement (PSBR) which, in 1975/76, reached a level equivalent to some 10 per cent of GDP at market prices. In the course of 1976, the financing of the PSBR by nonmonetary means has become increasingly difficult and, there has also been a recovery in the demand for private credit to finance stockpiling of imported goods and speculative outflows of capital, mainly in the form of adverse shifts in leads and lags. As a result, the growth in the monetary aggregates has accelerated markedly and has contributed to repeated instability in the exchange market. This, in turn, has led to increases in long-term interest rates to levels that must be about prohibitive to industrial borrowers, unless the latter are content to assume that the rate of inflation will not fall in the future. Moreover, in the view of the staff, these developments in financial markets have created an atmosphere of uncertainty, which has further damaged business confidence. In these circumstances, it is hardly surprising that the responsiveness of business to favorable export prospects or to the numerous and generous investment incentive schemes has been sluggish and often scarcely perceptible. Part of the blame for this snail-like response must also be attributed to the disincentive effects of very high marginal rates of taxation, the continuing control of prices and dividends, the tendency of successive governments to support or nationalize faltering private enterprises, and a variety of other factors of a similar nature.

It is instructive to consider these developments in a broader historical perspective. For many years, the British economy has been characterized by a low rate of growth, reflecting fundamentally a rate of productivity growth far below that in most other industrial countries. From time to time, the authorities have attempted to raise the rate of expansion by stimulating consumption mainly through relaxation in the stance of financial policies. These attempts have been unsuccessful and have invariably led quickly to balance of payments difficulties. The laxity of financial policies has added to such difficulties by provoking capital outflows and increasing domestic inflationary pressures. The result has been an unhappy historical pattern of "stop-go" cycles and recurrent external crises, which have greatly weakened business confidence.

The need for a fundamental change in the policy approach came to be accepted in the late 1960s. The devaluation of sterling in 1967 and the subsequent introduction of a sharp, if slightly tardy, constraint on domestic demand led briefly to a distinct improvement. But it required more time and patience than was forthcoming to correct the weaknesses that had become structural and to overcome the lack of social consensus manifested in industrial attitudes. Indeed, the improvement in competitiveness obtained by the devaluation of 1967 was allowed to be eroded all too rapidly as U.K. relative cost and price performance deteriorated again, while the exchange rate remained unchanged, with the result that the incentive to shift resources to exports and import substitutes weakened (Chart A). In consequence, the follow-through to investment and employment did not materialize. In the early 1970s, a renewed massive impetus was given to consumption and public sector expenditure, in order to increase the rate of growth, while the pound was allowed to float in the hope that this would remove the external constraint. Once again, control of monetary developments was neglected and the fiscal position was allowed to deteriorate sharply. In the event, the floating of the pound in the absence of adequate supporting action did little more than contribute to an acceleration of inflation and to increasingly rapid rises in wages. Moreover, the recourse to external borrowing, which became very large after the advent of the oil crisis in 1974 (Table 2), prevented the exchange rate from falling to a level where British exports would be competitive even in the face of such well publicized weaknesses of British exporters, as failures to meet delivery dates, lack of quality control, and less than efficient sales organizations. As a result, the United Kingdom continued to lose shares in world markets and suffer a rate of penetration by imports of manufactured goods well in excess of that recorded by most other industrial countries (Table 3).

By the summer of 1975, the multiplication of the danger signals had compelled a re-examination of policy. Wages were rising at an annual rate of about 30 per cent and prices at about 25 per cent. Profits and investment had fallen off sharply and output was being maintained only by a continuous but unsustainable expansion in private and public consumption. A new strategy was therefore adopted. It sought to reverse the secular decline in the manufacturing sector by relying on exports and investment to provide the impetus to growth. The staff has no doubt that this change in strategy was right and indeed long overdue.

The authorities realized that an essential preliminary for the success of the new policy approach was the control of wage and price inflation and that a second precondition, of equal importance, was the maintenance of a sufficient degree of slack to facilitate the switch of real resources toward net exports and investment.

Substantial progress has been made in each of these areas. As a result of the policy of voluntary wage restraint, the rise in average wage earnings was halved in the year to July 1976, to 13.9 per cent, compared with an increase of 27.6 per cent in the previous 12 months, and a further decline to about 9 per cent is now expected in the year to July 1977. There has also been a very marked improvement in industrial relations with the number of days lost in strikes falling from 14.7 million in 1974, to 6.0 million in 1975, and 2.5 million in the first nine months of 1976.

Discernible progress has also been made in establishing more effective control over government spending. A system of cash limits, affecting some 60 per cent of total public sector expenditure, was introduced in the current financial year and has been vigorously enforced. This has been accompanied by greater efforts to prevent overspending by the local authorities.

Despite these achievements, progress in attaining the basic objectives of the new strategy has been very slow. The PSBR has remained at a very high level and contributed to a high rate of growth in the money supply. Action to tighten credit conditions and allow interest rates to rise was taken only reluctantly in the wake of pressures in the exchange market, induced at least partly by the acceleration in the growth of domestic credit. This further reduced confidence in the authorities' determination to carry through their strategy. The climate of uncertainty, and indeed the external trade returns, have also not been helped by repeated and well publicized calls on the Government to adopt a strategy of generalized import restrictions.

The staff also has strong doubts as to whether the exchange rate policy that has been followed by the authorities has been properly geared to the success of the new economic strategy. The rate has been held stable for long periods of time despite sharply adverse movements in relative costs and prices (Chart A) with the result that it has had to fall very rapidly subsequently, often despite heavy official support. It is difficult to substantiate, as is sometimes argued, that sterling is undervalued at the present exchange rate given that the balance of payments will remain in substantial deficit in 1977 despite high and rising unemployment. Moreover, according to official forecasts the United Kingdom is likely to continue to lose export market shares and experience a very high rate of import penetration. If the present rate can be regarded as approximately appropriate, it follows that sterling has been consistently overvalued except for rare and brief occasions ever since the adoption of the policy of export-led growth in mid-1975. These factors help to explain why the response of exports and imports has been much less favorable than could have been expected.

To take this view of past exchange rate policy is far from denying the obvious advantages that can stem from a much greater stability in the rate. But stability in the exchange rate can only be realized if there is also as much success in achieving stability of costs as in competing countries.

III. Program

It is against the background of recent developments that the British Government has just concluded a reassessment of policies. In summary, the strategy of switching resources to secure an export and investment-led growth has been reaffirmed, and measures have also been announced to correct the weaknesses that have delayed, and threatened to abort, the realization of the gains that could be expected from this economic strategy. The reassessment has also had to take into account forecasts which suggest that the economy would continue to be weak over 1977 and that, if no action were to be taken, the financial developments that were implicit threatened an unsustainable situation. Given the immediate prospects, the U.K. authorities have decided upon a program which would build up over a two-year period and which should around early 1978 bring about a very marked improvement in underlying trends. To this end, a financial program has been formulated for the first year and financial targets have been specified for the second year. The measures already announced are geared to the achievement of the targets set through the second year and will be supplemented by further measures, provided that the review around the end of 1977 confirms the hoped-for improvement in prospects and the need for making additional room to sustain the shift of resources to net exports and investment.

If the program is continuously adhered to and successfully implemented, then, in the staff's view, it promises to lead to a shift of resources that will result in a significant improvement in the current account of the balance of payments by 1978/79, helped by the exploitation of North Sea oil and gas and achieved in conditions of relative financial stability. In the staff's view, an essential element in such a policy has to be the determination that U.K. production should not again be allowed to become insufficiently competitive but that the desired switch in resources will be encouraged by the continued maintenance of the improvement in relative costs, compared with recent years, that has now been created.

1. Incomes policy

Overall wage settlements in the second year of the policy of voluntary wage restraint have so far been in accordance with the agreement which is consistent with the achievement of a growth of average labor earnings of not more than 9 per cent in the 12 months ending July 1977. It is obvious that a satisfactory agreement on the pay policy for a third year beginning August 1977 is of vital importance for the success of the Government's overall strategy. It is also plain that industrial and external confidence would be helped if this could be achieved and announced just as soon as is practicable. Discussions on the third stage of the pay policy between the Government, the Trades Union Congress (TUC), and the Confederation of British Industries (CBI) have been brought forward to very early in 1977, and it is hoped that they will be completed before the budget strategy is finally decided. It is sometimes claimed that an incomes policy can only be effective over a short period of time; moreover, the decline in real personal disposable income foreseen during 1977 and the projected high and rising level of unemployment in that year hardly constitute a favorable background for the attainment of a satisfactory agreement for a third year. However, the preliminary signs are that both the TUC and the CBI are determined that the progress achieved to date by voluntary wage restraint--in particular, the sharp reduction in the rate of inflation--must not be jeopardized and that all are conscious of the dangers inherent in any other course of behavior. The new agreement will need to include provision for some flexibility as the erosion of differentials has begun to arouse mounting pressures and to create disincentives for the development of needed skills. This flexibility will undoubtedly have to be circumscribed. Lastly, if the rate of inflation is to be rapidly reduced to levels approximating to those expected in the other major industrial countries, then the rate of growth of earnings for the 12 months ending July 1978 will need to be significantly lower than that inherent in the present agreement.

2. Industrial strategy

The Government will continue to give a very high priority to its effort, through a broad range of measures, to encourage a regeneration of the U.K. industrial sector and to lead in particular to an improvement in the trend growth of productivity in manufacturing industry. The success of this policy depends upon changes in attitudes and work practices and progress can, therefore, at best only be slow. Yet, the success of this policy is vital to the achievement of a more rapid and sustainable rate of growth in the future.

3. Fiscal policy

The sharp rise in public sector expenditures during recent years has been a striking feature of the U.K. economy (Chart B). The Government has already made noticeable progress in containing public expenditures which, in the current fiscal year (1976/77), have been largely kept within the original budget estimates. The need to ensure continued room for a switch in resources and to avoid new uncertainties in financial markets caused the authorities to decide to limit further the real volume of public expenditures; in July 1976, they announced cuts in total programmed expenditures for 1977/78, including investment by nationalized industries but excluding debt interest payments, amounting to about £1 billion in terms of constant prices. 1/ At the same time, an increase of 2 percentage points in employers' contributions to the National Insurance Fund, which should reduce the PSBR by about £600 million in 1977/78, was also announced.

However, pressures on financial markets continued and showed up in repeated instability in the foreign exchange market, sharply rising interest rates, and a further erosion of business confidence. For this reason, the authorities have now decided on a further reduction in the volume of public sector expenditures of £1.0 billion in 1977/78 and £1.5 billion in 1978/79 (in 1976 Survey prices). In current prices these cuts would be equivalent to about £1.3 billion in 1977/78 and a little over £2.0 billion in 1978/79. In 1977/78 the U.K. authorities will also sell shares in the British Petroleum Company presently belonging to the Government by an amount sufficient to raise £500 million. In 1978/79 additional fiscal action totaling £500 million at 1976 prices will be taken to reduce the PSBR further. In the view of the staff, it would be preferable if, given the need to emphasize incentives, this last amount also were primarily concentrated on further expenditure cuts rather than on increases in taxes.

1/ Defined as 1976 Survey prices, namely for goods and services the prices ruling in August-October of 1975 and for transfers and other expenditure average estimated prices in the financial year 1976/77.

The Chancellor has also announced a 10 per cent increase in the excise duties on tobacco and alcoholic beverages. This increase is estimated to yield sufficient revenue to permit an extension of the scheme under which interest rate relief may be given for industrial investments and to finance further measures to reduce unemployment. In the circumstances, these measures seem very appropriate and do not in any way prevent a switch from direct to indirect taxation at a later date. In the view of the staff such a switch would be desirable in order to reduce the burden of income taxes especially at the lower and higher earnings levels. The staff agrees with the Chancellor that present levels of direct taxation have proved discouraging to effort and efficiency. The Chancellor has also stated that if, in planning his Budget for 1977/78, he judged that there would be scope for tax reliefs without increasing the PSBR above the level presently foreseen (£8.7 billion) and if a satisfactory agreement had been reached with the TUC and the CBI on pay arrangements for the period after July 1977, then he would plan to use the available margin to reduce the present burden of direct taxation.

If the national income forecasts undertaken in late 1977 or in early 1978 suggest that GDP will grow at a rate in excess of 3.5 per cent per annum in the period from the beginning of 1978 to the end of 1979, further steps to reduce the PSBR will be taken in fiscal 1978/79 of between £500 million and £1.0 billion at 1976 prices. The exact magnitude of the adjustment will depend on the buoyancy of demand that is then foreseen while the nature of the measures taken will depend both on the timing of the decision and on the economic prospects. The staff regards this contingent undertaking as an important safeguard against the danger that a higher than presently expected rate of growth of private demand could be aborted at an early stage by a scarcity of financial or real resources.

Summarizing the effect of the cuts in aggregate public expenditure is complicated by recent changes in definition. Henceforth, public expenditure totals include only the government financing of the nationalized industries, not their total investment expenditure as before. Thus, the July cuts which included reductions in nationalized industries' investment appear smaller in the new presentation. Some of the July cuts have also been offset, in comparison with the White Paper of February 1976, by increases in expenditure for unemployment relief due to upward revisions in the unemployment forecasts. Interest payments are excluded from both the old and the new presentation. The staff has been assured, however, that the cuts announced on December 15 will not be offset by increases in other programs--and, in particular, that the contingency reserve to be included in the coming public expenditure White Paper for both 1977/78 and 1978/79 will be fixed so that the announced reductions are not eroded.

Apart from the amount of government financing provided to the nationalized industries which is not expected to rise over the period, the profile of public expenditure, in 1976 Survey prices, after the cuts announced on December 15 will be, in round terms, £50.5 billion in 1975/76, about £51.0 billion in 1976/77, somewhat less than £50.0 billion in 1977/78, and approximately the same figure in 1978/79.

To the extent that the additional £ 500 million adjustment in 1978/79 takes the form of expenditure cuts, public sector expenditure in 1978/79 will fall, in constant prices, below the level which will be recorded in 1977/78, so that, for two years in succession, such expenditures will have fallen in real terms (Chart B). In these calculations no allowance is made either for the sale of the British Petroleum shares or for the contingent additional fiscal action of between £500 million to £1 billion.

In appraising the recent decisions on public expenditures, one has to start out from the premise that no program of action can be devised to reverse the extremely difficult position in which the United Kingdom finds itself at the present time that would not contain certain aspects that are far from satisfactory if considered by themselves. Thus, it must be anticipated that these decisions will have some adverse short-term effects on employment in certain sectors at a time when unemployment is already high. On the other hand, without such measures continued financial instabilities would further impede the desired recovery of investment and would thus threaten a larger adverse effect on employment. There is, moreover, a large question mark overhanging discussion of the amount of spare resources currently available.

The immediate application of deeper cuts in public expenditure might induce a more rapid shift of resources but would not be acceptable to the authorities in the prevailing employment situation. It is difficult to assess the precise amount of cuts necessary to achieve the objectives of the program but the staff believes that the measures taken by the authorities strike an appropriate balance. However, it is unfortunate that the new measures include substantial cuts in construction at a time when this sector is already suffering from a lack of demand and also when it seems likely that these cuts are likely to be offset, at least in part, by renewed expenditures in the short to medium term. The balance of the cuts is being applied by way of a series of relatively small reductions of a large number of programs, regrettably including a small cut in overseas aid.

As a result of the measures just described, the PSBR in 1977/78 will fall to £8.7 billion or 6 per cent of GDP (at market prices) and to £8.6 billion or 5 1/4 per cent of GDP in 1978/79 (Table 4); the quarterly path of the PSBR to end-1977/78, used as a performance clause, is recorded in Table 5. These figures contrast with an expected outcome for 1976/77 of £11.2 billion or 9 per cent of GDP. By international comparisons, the projected ratio of the PSBR to GDP in 1978/79 is reasonable, especially considering that the PSBR in the United Kingdom has a wider coverage than the concepts used in most industrialized countries. Such comparisons, however, are not the most meaningful, as judgment has to be made on the basis of the individual country's financial and economic situation. In the staff's view, the announced cuts in public sector expenditure and the resultant reductions in the PSBR will have a dampening effect on interest rates and induce a more buoyant business climate which can be expected to lead to the bringing forward of investment decisions as there would be assurance that a new recovery would be sustained.

It should be emphasized that the U.K. authorities find it extremely difficult to forecast precisely the outturn of the PSBR. For some years, there was a tendency for this figure to be underestimated, especially when, as in 1974/75, wages were rising more rapidly in the public than in the private sector.

More recently, this tendency has been reversed. The present estimates of the U.K. authorities suggest that the PSBR will reach £11.2 billion in 1976/77 but, as explained in the Appendix, the staff believes that this estimate may be too high.

4. Monetary policy

In the past six months, increasing attention has been paid to monetary policy. Monetary aggregates have been featured in policy statements, the most important of which was the Chancellor's reference to a target for the growth of the broadly defined money stock (M3) 1/ of 12 per cent for the fiscal year 1976/77. At the time this target was formulated, it was still thought that the recovery of demand for credit by the private sector would be slow. In the event, it rose much more rapidly than was expected and a series of tightening measures have been taken which raised interest rates sharply. As these measures proved slow in restraining the growth of M3, the extreme action was taken in November of reintroducing the supplementary special deposits scheme in a form which will virtually halt the growth of interest-bearing bank deposits.

The consequences will be important. It is now virtually assured that M3 will grow at a very much lower rate than in the immediate past. Because of the growth that has already taken place, the continued increase of M1, which is unaffected by the new deposit requirement, and also the inclusion of foreign currency deposits in the definition of M3, whose value has increased as the exchange rate has fallen, the actual growth of M3 in the fiscal year 1976/77 is very likely to exceed the target of 12 per cent. But, for the next six months, the growth of the sterling component of M3 is now certain to be at an annual rate well below the 12 per cent and it will continue at a low rate, while the supplementary special deposits scheme is maintained at its present degree of restrictiveness.

In the program for the next two years, the authorities have adopted a firm policy of managing the banking system to ensure that the domestic credit expansion will be suitably restrained to limit pressures on the exchange market and on domestic inflation. In this effort, a major part will be played by the reduction of the PSBR, whose size, in recent years, has greatly complicated the task of monetary management. However, it is now also clearly recognized that private demands for credit have reached the point where they too have to be restrained. Currently, this restraint is to be primarily achieved by the new supplementary special deposits but, in the medium term, it is hoped that the task will be eased by a more restrained growth of the monetary base stemming from lower PSBR and that more orderly financial prospects will lead to increased sales of public sector debt. Indeed, the staff would hope that the supplementary special deposits scheme, which inevitably causes distorting effects resulting from the impetus which it gives to ~~dis~~intermediation, can be relaxed or dropped during the course of 1977. However, this can only happen provided that alternative instruments of monetary policy are available and are used effectively.

1/ M3 includes notes and coins in circulation plus all bank deposits, whether denominated in sterling or other currencies, held by U.K. residents less 60 per cent of the net value of transit items. The sterling component of M3 excludes bank deposits denominated in foreign currencies.

To give precision to their monetary policy, the authorities have focused on domestic credit expansion as being the most significant indicator in times of foreign exchange pressure. Consequently, they have specified a path for domestic credit which will limit its growth from the £9 billion intended for 1976/77 to £7.7 billion in 1977/78 and £6 billion in 1978/79 (Table 6). These rates of credit expansion are equivalent to 24 per cent of sterling M3 at the beginning of 1976/77, 18 per cent of sterling M3 at the beginning of 1977/78 and 13 per cent of sterling M3 at the beginning of 1978/79, respectively.

There has been one modification of the definition of DCE. Henceforth, it will include only sterling credit. Foreign exchange credit to the private sector other than for the financing of investment overseas (Table 6), which previously was included to the extent that it came from U.K. banks, is now excluded, as the provision of such credit by U.K. banks is subject to strict rules relating to their overall foreign exchange position and no net pressure on foreign exchange reserves is possible from this source. Moreover, it was arbitrary to include only foreign currency loans from U.K. banks, while excluding those from foreign banks.

The provision for private credit estimated to be available within the overall DCE target has been looked at in the light of the projected financial flows, including the recovery of investment by the corporate sector. While these results must be treated with caution, as past forecasts in this area have proved particularly unreliable, it appears that the financing for the needed investment recovery is reasonably assured for both 1977/78 and 1978/79. The recovery of corporate finances is expected to be particularly marked in 1978/79, notably in the export sector, and it should be possible to finance investment well in excess of present projections. If this proved not to be so, there is the latitude provided by the possibility of drawing on external bank sources if expansion prospects were sufficiently attractive. In addition, the ban on the use of sterling in third country trade will provide room for the extension of credit in sterling to residents of some £500 million.

Some problems arise in projecting monetary aggregates while the special supplementary deposits scheme is in existence. Undoubtedly, the scheme tends to reduce the degree of intermediation of banks and so changes the relationship of M3 to the overall demand and liquidity situation. The effect of this should not be exaggerated--it arises with any device which relies in part on the rationing of bank credit and it certainly occurred when ceilings on bank advances were used in past programs. In determining the annual credit program for 1977/78 and 1978/79, it has been necessary to proceed on the assumption that the supplementary deposits scheme will not be an effective source of limitation at the time the final figures are available. In effect, this means that the scheme, if it does continue formally, will stop having any restrictive effect well before April 19, 1978. However, the distorting effect of the first stage of tight application has been taken into account in the first two ceilings for the quarterly path recorded in the Table 5 and used as performance clauses. The figures for the remaining two quarters of 1977/78 will be agreed before July 31 in the light of the experience with the scheme and the plans then made for its extension and the prospective financial requirements of industry for investment and expansion.

In the view of the staff, it is particularly important, while the supplementary deposit scheme is in effect, that the course of the interest rates be carefully controlled, lest they fall at a rate that would be inappropriate on external considerations. The scheme, through its distorting effects, can lead to a tendency for interest rates to decline temporarily. It is reassuring that the authorities have taken special note of the distorting effects of the measure and plan to reduce DCE appropriately. It is also helpful that they have stressed their desire to finance the major share of the PSBR outside the banking system. It will require careful attention to the growth of the monetary base to allow interest rates to follow an appropriately restrained path and to permit the supplementary special deposits scheme to stop having any restrictive effect before the end of the next fiscal year.

As has been stated, the special emphasis placed in the program on DCE rather than M3, is appropriate in present conditions when exchange market management is so important. But, in view of the current employment situation, if the net foreign exchange reserves should recover more rapidly than is presently expected, it would be appropriate to allow some of the increase to be reflected in money growth. However, the authorities are fully conscious of the need to limit the growth of money and they intend to ensure that it does not endanger their overall policy. In 1977/78, a growth in sterling M3 of around 12 per cent is foreseen, compared with an expected rise of 10.6 per cent in 1976/77. This latter figure is, however, heavily affected by the imposition of the supplementary special deposits scheme. In 1978/79, a more difficult problem may emerge as the balance of payments runs into large surplus. The authorities agree with the staff that, at that time, the rate of monetary growth will have to be particularly closely watched and controlled to ensure that the changed balance of payments position does not result in a rate of growth of the monetary aggregates that will again lead to loss of control.

5. External policies

Economic policies will be consistent with the achievement of a considerable surplus in the current account of the balance of payments in 1978/79. The forecasts suggest that the deficit in 1976/77 will be over £2.0 billion, and that it will improve in 1977/78 to about £1.0 billion and then show a surplus of the order of £2.0 billion to £3.0 billion in 1978/79. This sharp turnaround in 1978/79 is attributable to the lagged effects of the depreciation of sterling during 1976 especially on the services account, and a substantial positive net contribution from North Sea oil and gas operations.

The impact of the North Sea operations and the determination not to allow U.K. exports again to become uncompetitive should lead to a substantial rise in net exports which would contribute most of the growth in 1977/78 and particularly so in 1978/79. The magnitude of the improvement in the balance of payments will be dependent upon a satisfactory rate of growth of world trade in both 1977/78 and 1978/79.

The sharp decline in the trade deficit between 1976/77 and 1978/79 is more than fully accounted for by the estimated net saving in oil imports. The deficit for trade in crude oil and oil products alone, which is estimated at £3.8 billion in 1976/77, is projected to decline to £1.3 billion in 1978/79 and is expected to change into surplus in the early 1980s. This improvement is due to rising production from the North Sea oil fields from an estimated 12 million tons in 1976 to 62 million tons in 1978, which more than offsets the effects of increasing consumption of oil and higher oil prices. Currently, the United Kingdom's annual domestic consumption of oil is about 82 million tons. Production from the North Sea oil fields is expected to continue to increase after 1978, reaching a peak of about 130 million tons per annum by 1982-85. The United Kingdom also benefits from inflows of capital for investment in the North Sea oil fields, which, in 1976/77, are estimated at about £1.0 billion; these inflows are expected to decline over the next two years but will be associated with more or less equal falls in the imports of capital equipment, materials, and services connected with the development of and production from the North Sea oil fields. The gains on the trade and direct investment accounts from the North Sea oil operations will in part be offset by a large rise in private remittances, dividends, and interest payments resulting from the operations of oil companies in the North Sea oil fields. These invisibles payments are projected to rise by nearly £0.9 billion in 1977/78 and by a further £0.6 billion in 1978/79.

The external capital account is expected to remain in deficit in 1977/78 as inflows due to North Sea oil operations decline, and export credits rise. However, the series of measures recently announced by the U.K. authorities, the additional financial support being promoted by Germany and the United States, and the possibility of a satisfactory arrangement for the sterling balances as well as the repayment of sterling credits to third countries can be expected to result in a turnaround in the remainder of the capital accounts. As the external position moves into overall surplus, the opportunity will be taken to reduce the very large external debts accumulated in recent years and to reconstitute gross official reserves. Over the two-year period, foreign currency borrowing by public sector entities will continue but, it is hoped, on a declining scale.

exchange rate?

The authorities will continue to pursue a flexible exchange rate policy with intervention in the exchange market aimed at minimizing short-term disruptive fluctuations and at maintaining stability in the exchange markets consistently with a continued maintenance of the competitive position of U.K. manufactures both at home and overseas. In their management of the exchange rate, the authorities will seek to avoid a situation in which the rate became fixed at an unsustainable level since the inevitable subsequent fall would do serious damage to confidence both at home and abroad. The staff believes that such a policy will go far to avoid the uncertainties which have hampered investment decision making. Exchange rate policy will be supported by the tight control to be kept over the growth of money and credit aggregates over the two years of the stand-by program. In the staff's view, it is crucial that the exchange rate not be allowed again to become uncompetitive.

In the attached letter, the Chancellor affirms that it is the intention of the Government not to introduce any multiple currency practices or impose new or intensify existing restrictions on payments and transfers for current international transactions or import restrictions for balance of payments reasons. However, it is stated that the imposition of selective restrictions on imports may continue to be necessary to protect domestic industries which are viable in the longer run but which have suffered or are threatened with serious injury as a result of steep and disruptive increases in imports. There has been a growth of such restrictions. The staff regards this as a matter of concern and, in particular, is worried both at the risk that the criterion of "industries which are viable in the longer run" might come to be too loosely interpreted and that these restrictions tend to inflict damage on the exports of countries with relatively low per capita incomes. The staff understands that any such restrictions would only be imposed within GATT rules and procedures.

IV. Staff Appraisal and Recommendation

At this time, given that the hopes of early economic growth have been so dampened, an intensive debate has been taking place in the United Kingdom about the orientation of economic policies. There are those who argue that demand policies should be designed to maintain an immediately higher level of employment, despite the evident failure of such policies in the past. These advocates of expansion have increasingly been driven, in the face of evident external financing problems, to embrace a willingness to meet balance of payments problems by direct controls on imports.

After a long debate the authorities, in undertaking the program described above, have rejected these views. They have decided, rightly in the view of the staff, that, in the medium term, such a strategy is not viable and is, indeed, likely only to foster inefficiencies and weaknesses in the economy. The long history of responding to weakness in demand through greater stimulus to public and private consumption has so reduced incentives for productive investment that recourse to consumption-led growth is doomed to an early check through a lack of capacity to compete with the rest of the world. Attempts to shelter from such competition will only worsen the trend in productivity. Moreover, it is clear that the future growth of an industrial economy is critically dependent on the control of inflation. Serious setbacks in this battle would go far toward ensuring continuing stagnation of the economy and a low level of job creation.

The staff strongly endorses the decision of the authorities to place their faith in the future growth of U.K. exports, given the right domestic conditions. These conditions necessarily involve continuity of policies. Even establishing sales outlets abroad on the needed scale will only take place when it is reasonably clear that conditions will remain as profitable as they are now. The two-year program undertaken by the authorities is intended to give just that assurance.

There are examples in other countries of a quick and impressive response to conditions similar to those being created in the United Kingdom. The staff is confident that the United Kingdom could achieve such a turning point in the next 18 months, if business can be convinced that the recent uncertainties are past and that export profitability can be maintained. The measures now being taken go far toward giving such assurance, both with the programmed release of resources from the public sector over the next two years and also with the steadiness of financial markets which should result from more realistic monetary and fiscal policies.

However, success will be dependent also on the continued cooperation of the trade unions, who have the power to make or break the strategy. If they remain convinced that the strategy will deliver more jobs over time and also a return to a sustainable path of real wage gains, then the major hurdle will have been passed.

Moreover, the regeneration of an industrial economy which has been debilitated by years of slow growth and an exchange rate which has been perennially overvalued, will need to be sustained over an extended period. It will take courage to maintain a steady incentive to foster production for exports and import substitution and it may be difficult to persevere during a period that includes an election. In addition, the siren voice of North Sea oil, with its power to limit temporarily external constraints, could weaken the will to persist in the longer-term task of job creation through growth in manufacturing output based on a competitive exchange rate.

Inevitably, the road is full of pitfalls but the staff believes that the program now undertaken can provide a firm basis for the urgently needed change in past economic trends of the United Kingdom. The staff is convinced that the program, far from being deflationary and destructive of job opportunities, is the only way out of the weak economic position and low employment now arising from the failures of the past.

In view of the above, the following decision is submitted for consideration by the Executive Board:

> "The Government of the United Kingdom has requested a stand-by arrangement for a period of two years and for the equivalent of SDR 3,360 million. The Fund approves the stand-by arrangement attached to EBS/76/519 and grants any necessary waiver of the conditions of Article V, Section 3 (a)(iii) of the Articles of Agreement."

Table 1. United Kingdom: Selected Economic Indicators, 1975-78

	1970 to 1974	1975	1976	1977	1978	1976 1/ 1st half	2nd half
	Percentage change from preceding year or half-year, at annual rate						
Expenditure (at constant 1970 prices)							
Private consumption	3.0	-0.7	--	-0.7	0.2	1.4	0.7
Public consumption	3.2	4.7	3.0	1.2	0.6	1.0	3.0
Fixed investment	1.6	-1.2	-2.1	-2.1	1.0	-6.1	4.9
Of which:							
Public	0.3	1.1	0.3	-6.5	-5.2	6.0	-6.1
Manufacturing	-1.3	-17.0	-8.5	16.5	16.0	-7.5	11.1
Other private	5.0	3.6	-2.1	-4.0	1.0	-16.3	14.9
Final domestic demand	2.8	0.2	0.2	-0.6	0.4	--	1.9
Stockbuilding 2/ 3/	0.1	-2.8	1.2	1.5	0.5	1.5	1.3
Foreign balance 3/	-0.1	0.8	-0.2	1.2	1.7	1.4	-1.3
Exports	7.0	-3.4	5.7	8.3	6.8	11.8	4.4
Imports	7.3	-6.6	6.7	3.9	0.8	6.3	9.8
GDP (at market prices) 4/	2.8	-1.8	1.2	2.1	2.6	2.9	1.9
Prices and incomes							
GDP deflator	9.5	19.0	15.5	12.5	10.5	12.5	12.2
Consumer prices (unadjusted)	10.4	24.2	16.5	15.3	10.0	15.2	13.5
Real personal disposable income	3.9	-0.5	--	-3.0	0.5	-0.2	4.6
Real disposable average wages and salaries	...	1.8	-2.5	-6.5	-0.8	-9.3	8.6
Gross company profits (net stock appreciation) in per cent of GDP	10.7	6.8	7.2	9.9	12.9	7.2	7.1

Sources: Central Statistical Office, Economic Trends; and data provided by the U.K. authorities.

Note: The estimates and forecasts shown for the years 1976 to 1978 are based on policies obtaining in October 1976.

1/ Seasonally adjusted, unless otherwise indicated.

2/ Including residual errors.

3/ Contribution to GDP growth.

4/ Average estimate based on expenditure, output, and income data.

Table 2. United Kingdom: Official Reserves, Official Financing Liabilities, and External Sterling Liabilities

(In millions of pounds) 1/

End of period	Gross official reserves (1)	Official financing liabilities 2/: Total (2=3+4+5)	Official financing liabilities 2/: IMF (3)	Official financing liabilities 2/: Borrowing from other monetary authorities (4)	Official financing liabilities 2/: Other foreign currency borrowing 3/ (5)	External sterling liabilities: Total (6=7+9)	External sterling liabilities: Official: Total (7)	External sterling liabilities: Official: Of which: oil-exporting countries 4/ (8)	External sterling liabilities: Private (9)
1970	1,178	1,419	970	399	50	4,220	2,547	...	1,673
1971	2,526	555	415	--	140	5,622	3,240	...	2,382
1972	2,404	155	--	--	155	5,909	3,618	...	2,291
1973	2,787	1,283	--	--	1,283	5,973	3,689	959	2,284
1974	2,890	3,018	--	--	3,018	7,134	4,634	3,101	2,500
1975 1st qtr.	2,962	3,413	--	--	3,413	7,381	4,862	3,449	2,519
2nd qtr.	2,837	3,922	--	--	3,922	7,543	4,559	3,239	2,984
3rd qtr.	2,867	4,237	--	--	4,237	7,164	4,179	2,943	2,985
4th qtr.	2,683	4,409	--	--	4,409	7,331	4,102	2,839	3,229
1976 1st qtr.	3,082	5,589	630	--	4,959	7,254	4,016	2,622	3,238
2nd qtr.	2,976	7,642	1,232	577	5,916	6,335	3,111	1,964	3,224
3rd qtr.	3,075					6,190	2,756		3,434

Source: Central Statistical Office, Economic Trends.

1/ From 1972, foreign currencies converted at end-period middle-market closing rates.

2/ Excluding official long-term borrowing.

3/ By Her Majesty's Government and by public sector entities under official exchange cover schemes.

4/ Algeria, Bahrain, Brunei, Ecuador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Oman, Qatar, Saudi Arabia, Trinidad and Tobago, United Arab Emirates, and Venezuela.

Table 3a. Growth of Export Markets and Relative Export Performance of Major Industrial Countries

(Changes, in per cent, at average annual rates)

	1958-68	1968-72	1973	1974	1975	1976 1/
Export market growth						
United Kingdom	7.9	9.2	13.5	9.1	-2.3	9.0
United States	7.7	9.0	13.6	8.7	-2.6	5.0
Japan	7.8	9.4	10.1	10.5	-1.8	8.0
France	7.9	10.8	13.1	6.8	-2.7	8.0
Germany	9.1	10.1	14.2	7.1	-5.0	11.0
Italy	9.0	11.2	12.0	6.0	-1.3	11.0
Relative export performance 2/						
United Kingdom	-2.9	-1.7	0.8	-2.3	-1.2	-1.0
United States	-1.9	-2.7	10.6	-0.8	--	-1.0
Japan	9.6	7.3	-4.3	5.2	4.1	12.0
France	2.1	2.6	-2.6	3.3	-0.7	2.0
Germany	0.5	--	1.5	5.4	-5.6	2.0
Italy	6.3	--	-9.9	2.1	3.6	1.0

Source: IMF, World Economic Outlook, December 1975, and World Economic Outlook-Statistical Summary, July 1976.

1/ Projections.

2/ Relative export performance is here defined as the percentage by which the index of a country's actual or projected export volume exceeds (falls short of) the index of its export market growth.

Table 3b. Import Penetration and Export Performance in Manufactured Goods in Selected Industrial Countries

	Manufactured imports as a percentage of the domestic market		Manufactured exports from selected countries as a percentage of total manufactured exports 1/	
	1969	1974	1969	1975
United Kingdom	10.2	16.7	11.3	9.3
United States	3.7	4.7	19.3	17.7
Japan	3.1	3.7	11.2	13.6
France	12.1	14.3	8.2	10.2
Germany	13.4	11.8	19.5	20.3
Italy	15.2	20.1	7.3	7.5

Sources: University of Cambridge--Department of Applied Economics, Economic Policy Review, March 1976, No. 2; and National Institute of Economic Review, August 1976.

1/ Total manufacturing exports of the 11 largest industrial countries of the western world.

Table 4. United Kingdom: Public Sector Accounts

(In billions of pounds)

	1975/76	1976/77	1977/78	1978/79
Total receipts	46.2	52.8	62.6	70.8
Total expenditure	56.8	64.0	71.3	79.4
Of which:				
Current expenditure	43.9	51.5	58.5	65.0
Capital expenditure	10.8	10.8	12.0	12.5
Net lending	2.0	1.7	0.8	1.9
Public Sector Borrowing Requirement (PSBR)	-10.6	-11.2	-8.7	-8.6
PSBR, in per cent of GDP:				
At factor cost	11.0	10.1	6.9	6.0
At market prices	9.9	9.1	6.0	5.3

Sources: Central Statistical Office, Financial Statistics; and data provided by the U.K. authorities.

Table 5. United Kingdom: Quantitative Performance Criteria Under the Stand-By Arrangement

(In millions of pounds; not seasonally adjusted)

	Limit during:				
	6 months to end-March 1977	3 months to end-June 1977	6 months to end-September 1977	9 months to end-December 1977	12 months to end-March 1978
1. Public sector borrowing requirement (PSBR) 1/ 2/	5,900	3,100	5,200	7,700	9,200
	Limit during:				
	6 months to April 20, 1977	9 months to July 20, 1977			
2. Domestic credit expansion (DCE) 3/	4,500	7,100			

Source: Annex to Letter of December 15, 1976 to the Managing Director from the Chancellor of the Exchequer.

1/ The public sector borrowing requirement is defined as the sum of the borrowing requirements of the Central Government, local authorities, and public corporations excluding borrowing by local authorities and public corporations from the Central Government less net acquisition of other public sector debt by local authorities and public corporations.

2/ Excludes proceeds from the sale of British Petroleum shares estimated at £500 million in fiscal year 1977/78.

3/ Domestic credit expansion is defined as all lending in sterling by the banking sector (including the Bank of England Banking Department, and Issue Department transactions in commercial bills) to the public sector, private sector, and to nonresidents, plus the change in domestic nonbank holdings of notes and coin, plus overseas lending to the public sector.

The dates chosen are the nearest banking month dates after the end of calendar quarters; banking month data are used for operational purposes by the authorities and are available more quickly than data for the end of calendar quarters.

Table 6. United Kingdom: Monetary Developments and Prospects

(In millions of pounds)

		Projections		
	1975/76	1976/77	1977/78	1978/79
1. Public sector borrowing requirement (PSBR) (borrowing +)	10.6	11.2	8.7	8.6
2. Sales (-) of public sector debt to nonbank private sector	-5.6	-6.1	-4.9	-6.7
3. Bank lending (+) in sterling to private and overseas sectors 1/	-0.3	3.9	3.9	4.1
4. Domestic credit expansion (DCE) (1+2+3) 1/	4.7	9.0	7.7	6.0
5. External finance (-) of public sector and of banking sector	-1.4	-4.0	-1.8	1.2 ...
6. Increase (-) in banks' nondeposit liabilities	-0.8	-1.0	-1.0	-1.0 ...
7. Increase (+) in sterling money supply (M3) (4+5+6)	2.5	4.0	4.9	... 62
Percentage increase in sterling M3	(7.0)	(10.6)	(11.9)	(...)
Memorandum items:				
8. Increase (+) in residents' foreign currency deposits (transactions and valuation changes)	0.5			
9. Increase (+) in money stock (M3) (7+8)	3.0			
Percentage increase in M3	(8.1)			
10. Banks' lending in foreign currencies to private sector for domestic use (transactions only)	0.7			
11. Domestic credit expansion (old definition) (4+10)	5.4			

Source: Information provided by United Kingdom authorities.

1/ For purposes of the stand-by arrangement, the U.K. authorities have proposed, and the staff has accepted, that domestic credit expansion should be defined to exclude bank lending in foreign currencies to the private sector for domestic use (item 10). Such lending to the private sector is subject to strict exchange control and mainly limited to North Sea oil operations; repayment of the foreign currency loans is not normally allowed in less than two years, and exchange losses on such loans are not tax-deductible. The exclusion of this item from DCE means that reliable data on DCE will be available monthly rather than quarterly.

Table 7. United Kingdom: Summary Balance of Payments, 1974-78

(In millions of pounds)

	1974	1975	1976 1/	1977	1978
Exports	15,899	18,768	24,600	33,500	40,600
Imports	-21,119	-21,972	-28,200	-37,000	-42,300
Trade balance	-5,220	-3,204	-3,600	-3,500	-1,700
Of which:					
Crude oil and oil products	-3,422	-3,114	-3,865	-3,175	-1,808
Services (net)	892	1,049	1,450	1,950	3,600
Interest, profits, and dividends (net)	1,412	967	1,150	800	550
Transfers	-407	-468	-750	-800	-1,200
Invisibles balance	1,897	1,548	1,850	1,950	2,950
Current balance	-3,323	-1,656	-1,750	-1,550	1,250
External sterling liabilities					
Official	1,410	-615	(-1,346)		
Private	148	550	(205)		
Other capital flows (net)	93	242	(-1,023)		
Capital account balance	1,651	177	(-2,164)		
Balance for official financing	-1,672	-1,479	(-3,414)		
Official borrowing 2/	1,751	810	(3,251)		
Change in gross reserves (- increase)	-79	669	(163)		

Sources: Central Statistical Office, Economic Trends; and data provided by the U.K. authorities.

Note: The estimates and forecasts for the years 1976 to 1978 are based on policies obtaining in October 1976.

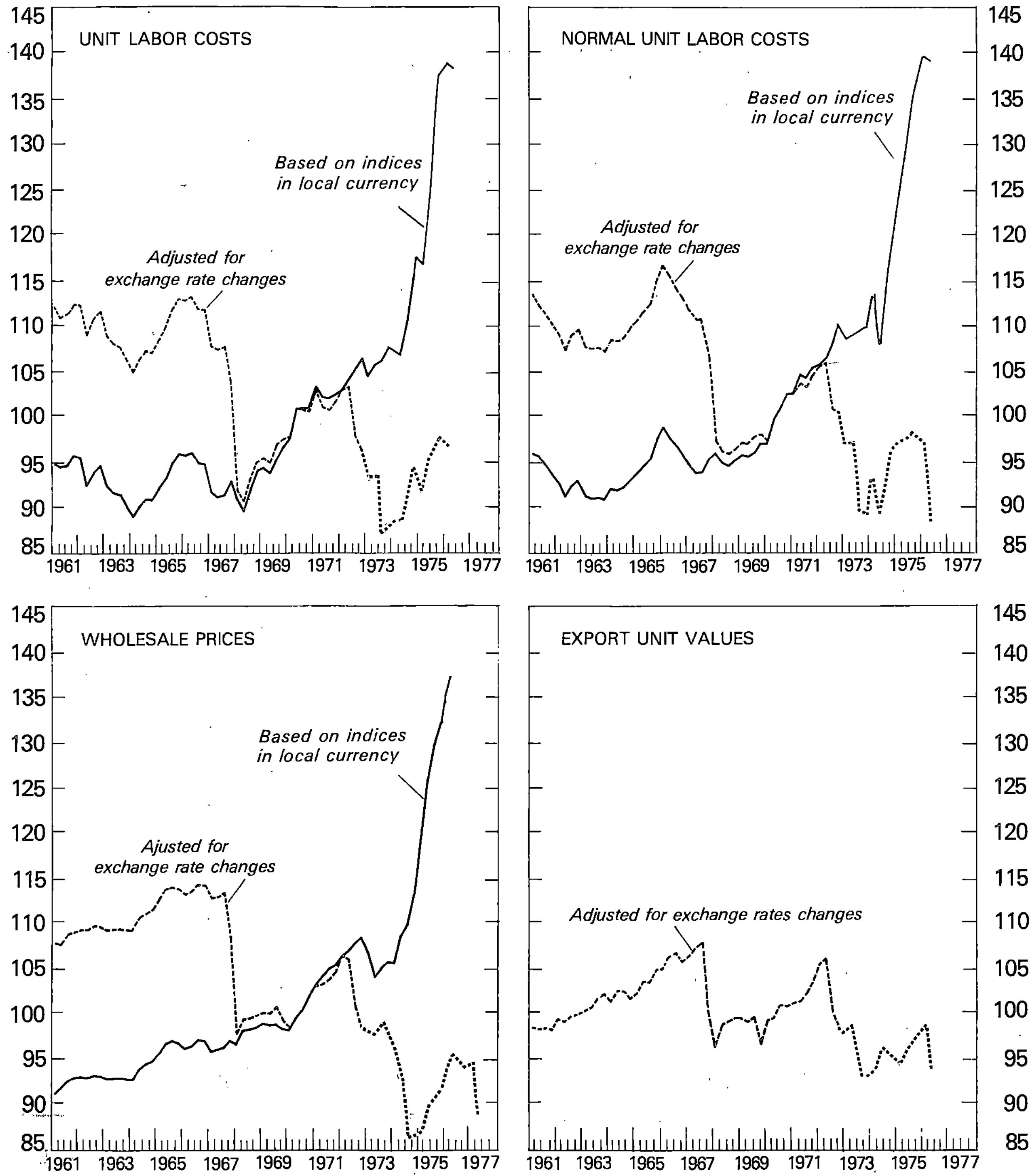
1/ Bracketed figures refer to the first three quarters of the year only.
2/ Including foreign currency borrowing by the public sector under the exchange cover scheme.

CHART A

UNITED KINGDOM

COSTS, PRICES AND COMPETITIVENESS IN MANUFACTURING[1]

(1970=100)



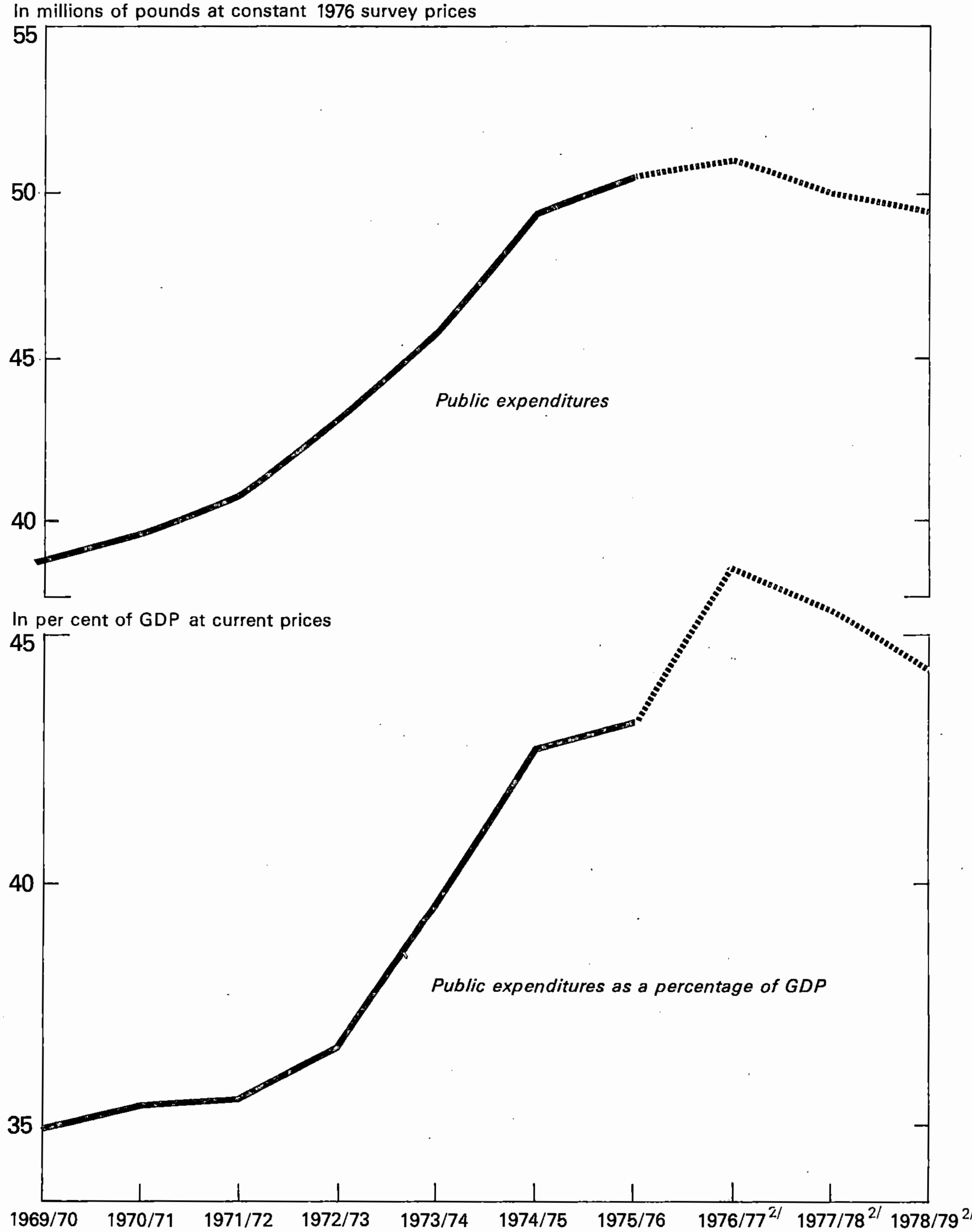
Source: IMF, Research Department.

1/ Ratios of United Kingdom indices to competitors indices.

CHART B

UNITED KINGDOM

TOTAL PUBLIC SECTOR EXPENDITURES[1]



Source: Central Statistical Office, *Economic Trends;* HMSO Public Expenditure to 1979-80; estimates of HM Treasury; and staff estimates.

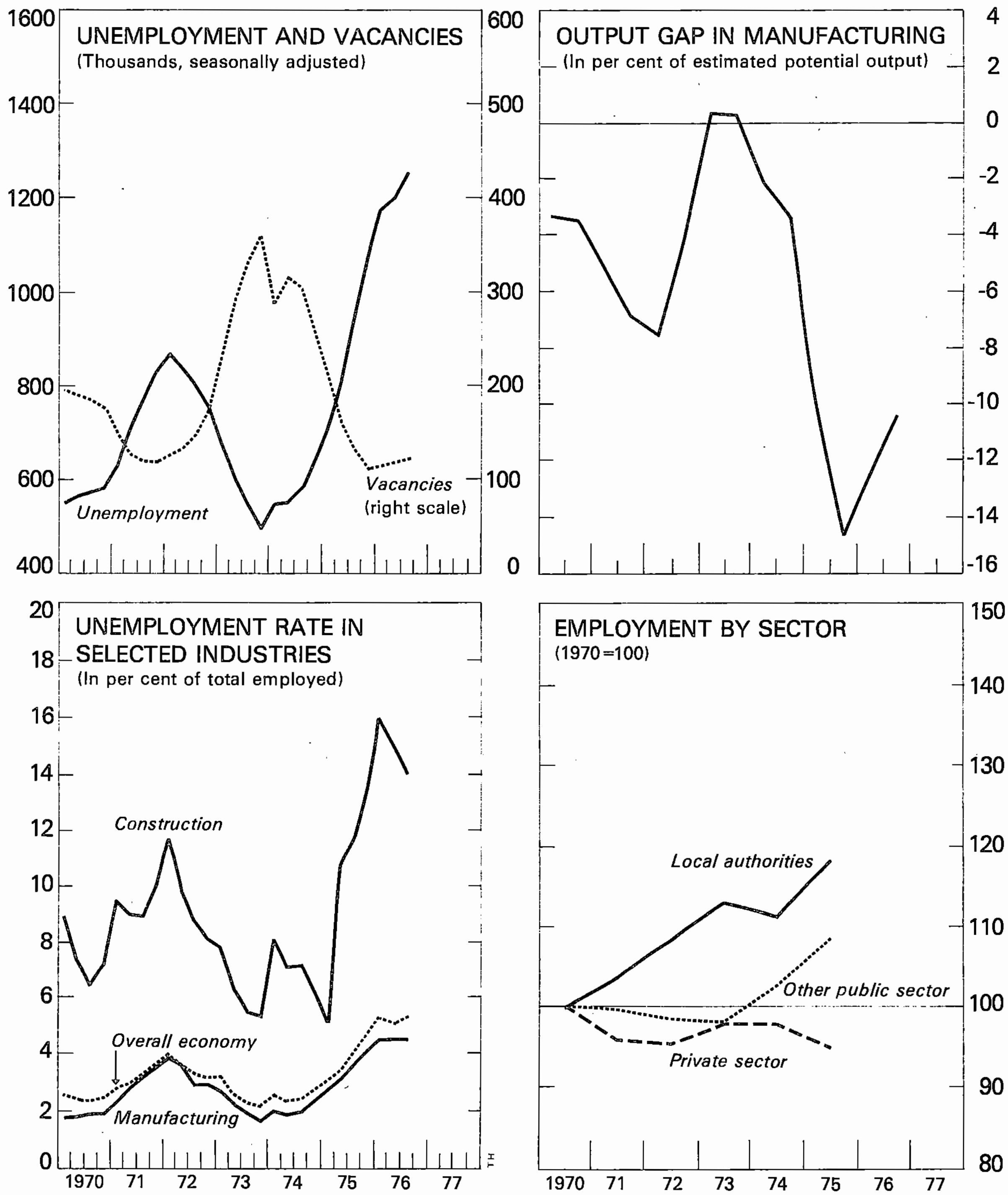
1 Excludes debt interest and nationalized industries capital expenditures.

2 Forecast. In the forecast for 1978/79 it is assumed that the pound sterling 0.5 billion of fiscal action mentioned in the text takes the form of expenditures cuts.

CHART C

UNITED KINGDOM

EMPLOYMENT, UNEMPLOYMENT AND CAPACITY UTILIZATION



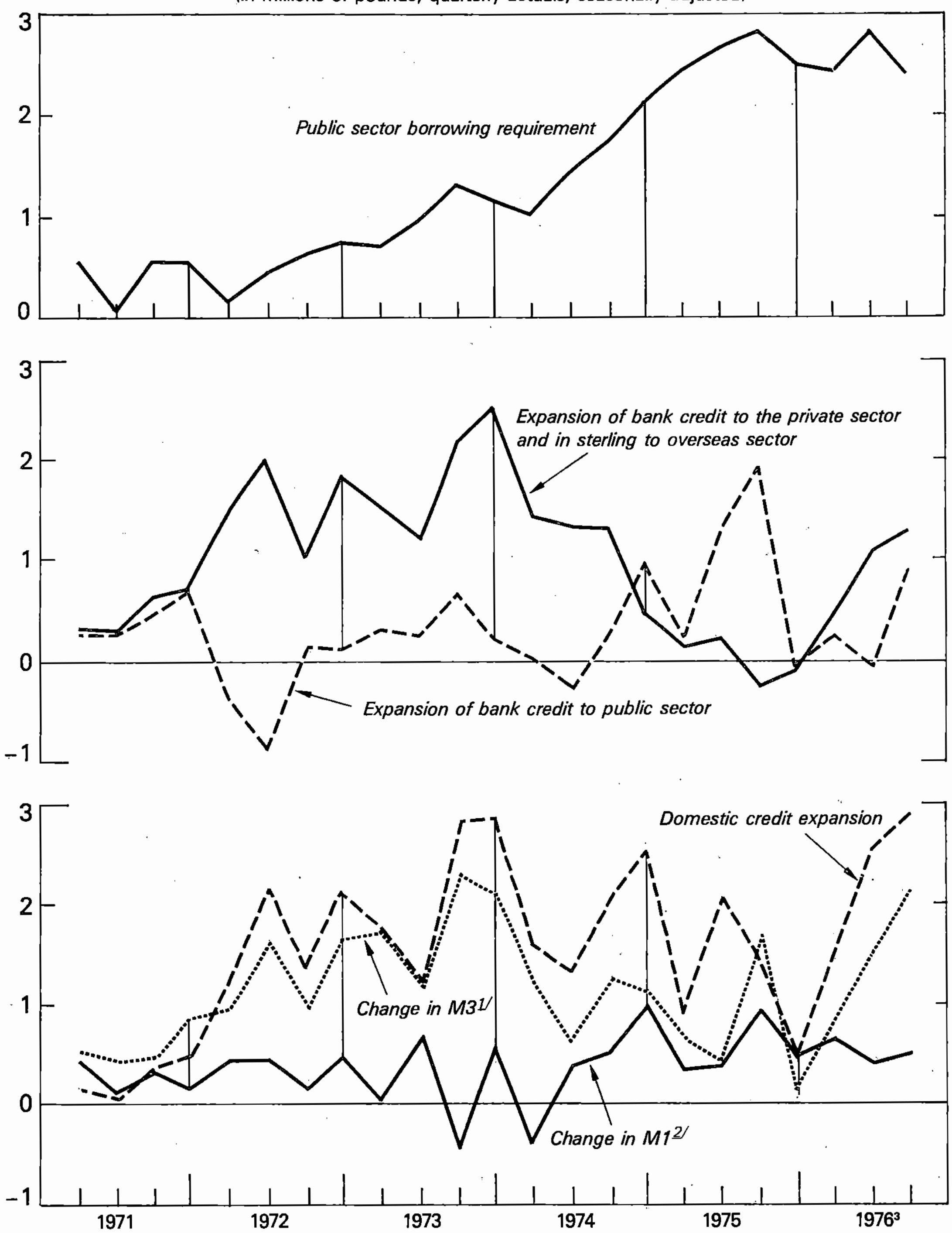
Sources: Central Statistical Office, *Economic Trends;* HMSO, Department of Employment, *Gazette* and IMF staff estimates.

CHART D

UNITED KINGDOM

MONETARY DEVELOPMENTS

(in millions of pounds, quarterly actuals, seasonally adjusted)



Source: Bank of England, *Quarterly Bulletin,* and staff estimates.

1/ Money supply, broadly defined i.e. notes and coin circulation with the public together with all deposits, whether denominated in sterling or other currencies held by U.K. residents in both the public and private sectors less 60 per cent of the net value of transit items.

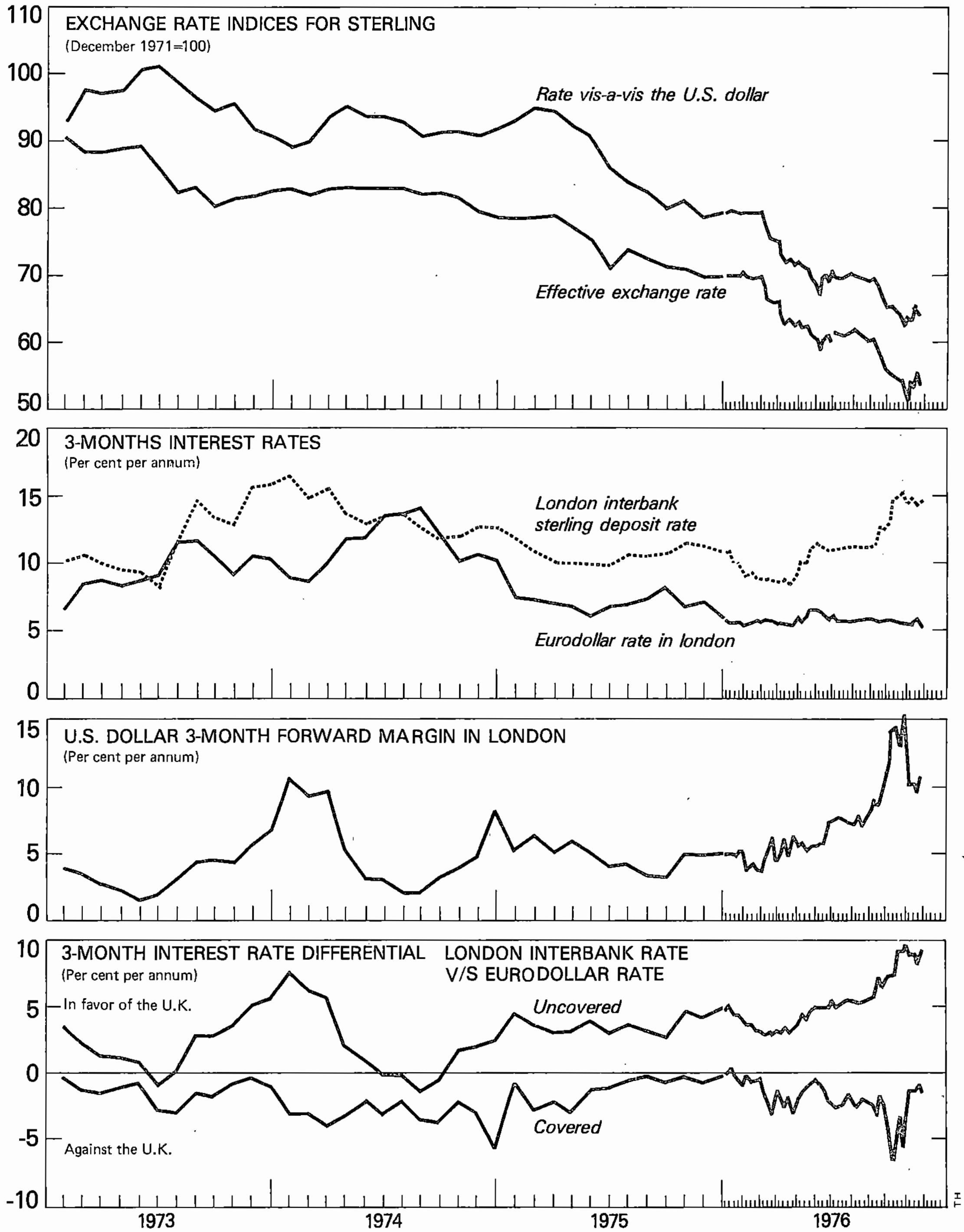
2/ Money supply, narrowly defined--i.e. notes and coins in circulation with the public plus sterling current accounts held by the private sector, less 60 per cent of the net value of transit items.

3/ Third quarter data are staff estimates.

CHART E

UNITED KINGDOM

INTEREST RATE AND EXCHANGE RATE DEVELOPMENTS

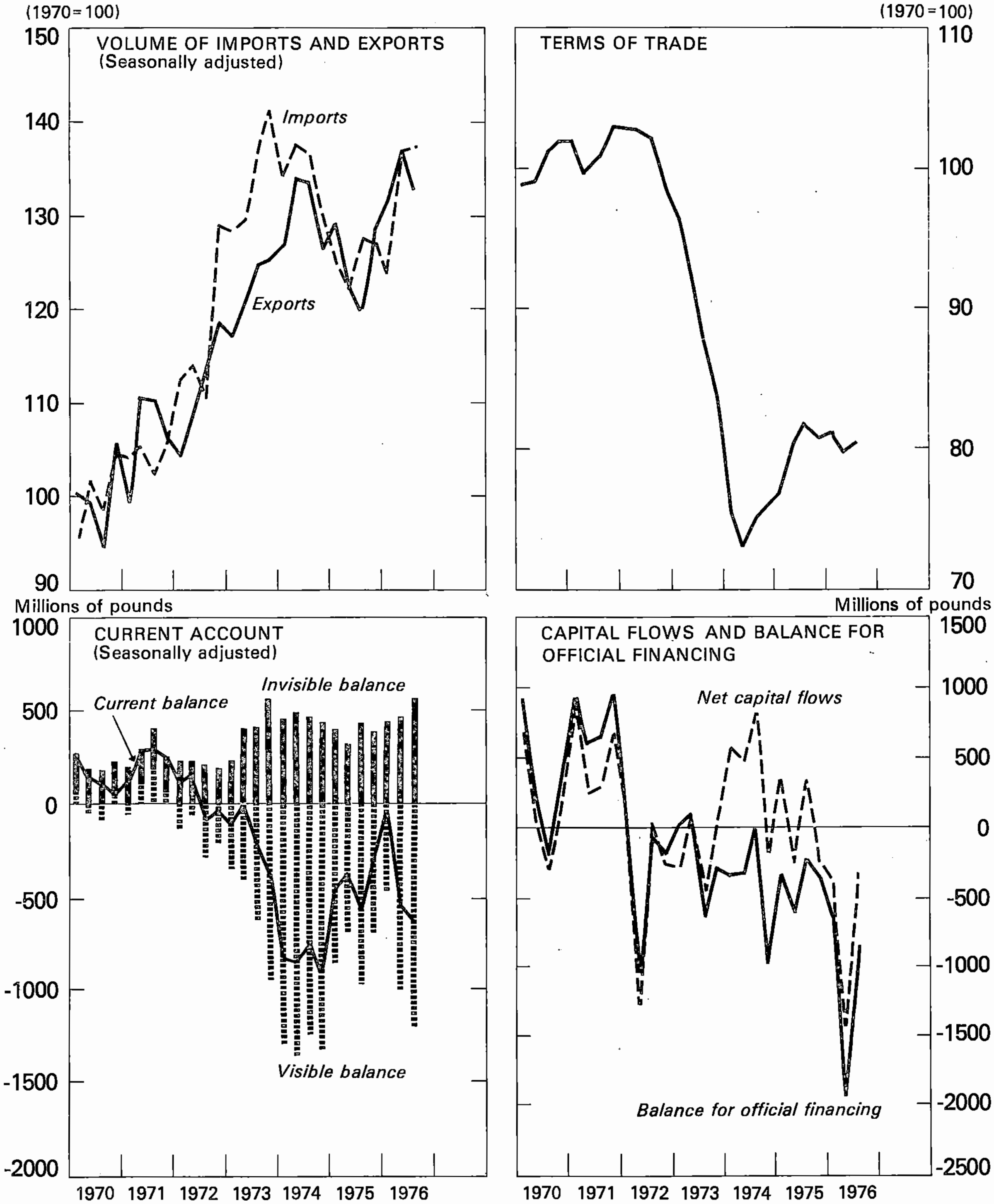


Source: Bank of England, *Quarterly Bulletin.*

CHART F

UNITED KINGDOM

BALANCE OF PAYMENTS DEVELOPMENTS



Source: Central Statistical Office, Economic Trends.

UNITED KINGDOM

Recent Developments and Short-Term Prospects

I. Recent Developments

At the time of the Article VIII consultation last May, the U.K. authorities were anticipating a rapid rate of economic growth (about 4 per cent per annum in the 18 months to the first half of 1977) in an environment of steadily decelerating price increases. Unemployment was expected to continue to rise for a number of months but a leveling out and, indeed a reversal was in prospect for the period up to mid-1977. The staff had generally concurred with this assessment and suggested that, to the extent that the speed of recovery in other countries was any guide, the possibility of an even stronger rebound could not be ruled out. In the event, even as the predictions were being made the economy showed a weaker development. The current and prospective underlying rate of growth has been cut back to about 2 1/2 per cent per annum; unemployment has continued to rise, particularly if the effects of several emergency employment measures are abstracted; the rate of inflation has stalled at around 13 per cent to 14 per cent and threatens to rise; the exchange rate has fallen sharply; and, a distinct lack of confidence permeates both the financial markets and British industry. This brief outline of the most recent developments is expanded on in the following paragraphs.

1. Aggregate demand (at constant prices)

The outlook for personal consumption expenditures in 1976 was, in any case, weak essentially because of the slight fall in real personal disposable income implied by the policy of wage restraint. However, even the quite modest increase in consumption projected last spring (0.7 per cent for the year as a whole), now appears optimistic. Consumer expenditures declined by 1 per cent (actual rate) between the first two quarters of 1976, a movement which was only partially reversed in the third quarter under the impetus of tax rebates equivalent to six months of the tax relief given in the 1976/77 Budget to obtain the consent of the Trade Union Congress (TUC) to the pay agreement. However, as in other countries, an unexpectedly large fraction of this one time boost to disposable income has been saved. As a result, the savings ratio is now estimated to decline by only 0.3 percentage point between 1975 and 1976 (which is 0.6 percentage point less than earlier expected). It is mainly for this reason that consumption is now estimated to remain flat both on a year-on-year and also a through the year basis (Table 1).

Except for some shift from the first to the second half of 1976, the increase in public consumption is still estimated to be about 3 per cent. Public investment, however, is now expected to decline by 6 per cent between the two halves of the year so that, despite a year-on-year increase of 2 per cent, the path of total public expenditures on goods and services is essentially flat. Most of the unexpected weakness of private investment in the first half of the year is likely to be made up in the second half when manufacturing investment is expected to begin to rise in response to favorable prospects for net exports and a much improved cash flow. Part of the expected strength of private nonmanufacturing investment in the second half of 1976 reflects such special factors as North Sea oil-related investments which distort the short-run movements of total fixed investment (Table 1), but do not influence the annual changes. While total final domestic demand is still estimated to increase at an annual rate of 2 per cent in the second half of 1976 virtually no increase is expected for the year as a whole.

The prospects for a prompt recovery were further weakened by renewed inventory disinvestment in the second quarter, after an opposite movement in the first, as well as by a weakening of the foreign balance. Inventory investment has been subject to quite large variations and revisions in the past, but the less favorable foreign trade outturn may be much more serious as it has taken, as it were, the wind out of the economy's sails. Substantial increases in exports of goods and services were expected broadly to offset the effects on incomes and production arising from the squeeze on real wages. In fact, after a good performance in the early months of the year, exports dropped sharply in early summer and are only now returning to the levels reached in late spring. Exports of goods fell by 3 per cent in the third quarter in spite of an estimated growth in U.K. export markets of perhaps 3.5 per cent to 4 per cent in that quarter and maintenance of price competitiveness. The reasons for this disappointing performance are not yet fully understood. Meanwhile, due partly to precautionary purchases in reaction to the recurring talk of import controls and expectations of further depreciation of the pound sterling, large increases in imports were again recorded despite the depressed state of demand. Given these unexpected leakages (higher personal saving and imports) and the lack of stimulus from exports, it is not surprising that aggregate demand has been on a considerably flatter path than expected earlier.

2. Output and employment

The weakness of demand has been coupled with a corresponding sluggishness on the supply side. The index of industrial production for the third quarter was 1/2 per cent below its level in the previous three months and is now at the level recorded in 1972. The drought contributed to the slowdown in production, as the output of utilities declined by 5 1/2 per cent between the first quarter and August. Overall, GDP is likely to increase by about 1 1/4 per cent in 1976 with the underlying rate of growth during the course of the year being in the 2-2 1/2 per cent range.

The weak development of output has engendered a considerable amount of slack both in the use of plant and equipment and of the labor force. As a very rough order of magnitude, GDP is thought to be some 10 per cent below "potential" in the second half of 1976 though the definition of "potential" output is beset with difficulties. In manufacturing, capacity utilization is well below peak levels, particularly in the export-intensive industries, although some improvement from the situation at the turn of the year is apparent (Chart C). The unemployment rate (excluding school leavers and adult students), which averaged 2.6 per cent during 1974, has increased from 5.1 per cent to 5.6 per cent between January and October 1976. The latter figure implies some 1.3 million unemployed, twice as many as two years previously. The increase has been apparent among all demographic and industrial groupings (except mining and quarrying which includes North Sea oil), though in absolute terms the unemployment rate differs markedly from sector to sector, being very high in construction and below average in the manufacturing industries (Chart C). Moreover, even though married women have no incentive to register, in terms of obtaining unemployment benefits, the number of unemployed women more than tripled over this period. Against this condition of generally deteriorating labor market conditions, however, there have been some more hopeful developments as unfilled vacancies showed a slight but discernible increase in 1976, overtime hours tended to firm, and the number of employees working short-time fell off. Further, the rate of incrase in unemployment is slower than at the turn of the year, though this may be due to the various employment measures taken by the Government over the past 18 months; these are estimated to have kept some 150,000 persons off the unemployment rolls. The most important of these measures is the Temporary Employment Subsidy program which offers employers a £ 20 a week subsidy for keeping on those workers who are viable long-term prospects. The costs of the program to the government budget are substantially offset by the corresponding savings on unemployment benefit payments.

3. Prices and wages

Despite the considerable dampening of inflationary pressures over the last year, the current rate of increase of domestic prices in the United Kingdom is still well above that in most other major industrial countries. From a peak of 27 per cent in August 1975, the 12-monthly rate of increase of retail prices declined continually until July 1976, when it reached a rate of around 14 per cent. In the 12 months to October 1976 the retail price index rose by 14.7 per cent. The reduction in inflationary pressures in the year to mid-1976 reflected in part the relatively successful implementation of the first stage of the policy of voluntary wage restraint agreed to by the Government and the Trade Union Congress. As a result of this agreement and after taking into account estimated wage drift and other adjustments, average labor earnings were originally estimated to rise by 12 per cent over the year ending July 1976 compared with a 27.6 per cent increase in the previous year. The actual rate of increase was 13.9 per cent, with the excess over the original estimate due to the effect of certain long-term settlements (mostly tied to the retail price index), a rise in piecework payments, and, also, a change in the composition of the workforce. Agreement was reached in May 1976 on the details of the second stage of the incomes policy, which is expected to result in pay increases averaging 5 per cent during the year beginning August 1, 1976. After allowing for estimated wage drift, average labor earnings are expected to rise by about 9 per cent in the 12 months to mid-1977. Currently, average earnings are rising at an annual rate of about 12 per cent (as measured by the change in the latest three months over the preceding three months).

Notwithstanding the expected moderation of wage settlements, the immediate outlook for prices is clouded by rapidly rising import costs stemming from the depreciation of the pound sterling, the effects of the drought on food prices, and rising profit margins. Indeed, the wholesale price index for materials and fuels used in manufactured goods has risen at an annual rate of nearly 30 per cent in the six months to November 1976.

4. Financial policies

It now appears that the public sector borrowing requirement (PSBR) for the current fiscal year (ending March 31, 1977) will be somewhat lower than the original budget estimate of £12 billion. The latest official estimate of the PSBR for the full year is £11.2 billion or some 9 per cent of estimated GDP at market prices. The fact that the rate of inflation was higher than previously foreseen has raised government revenues above original estimates while the strict implementation of the system of cash limits on the bulk of central government outlays has contributed to containing the increase in the volume of public expenditures below the original plans. At the same time the improvement in the trading profits of some nationalized industries has reduced their needs for external funds. In the view of the staff there is a distinct possibility that even the revised PSBR estimates for 1976/77 may be on the pessimistic side. In the first half of the fiscal year, the PSBR was running at an annual rate of £10.3 billion. Although the recent uprating of social security benefits would tend to increase the PSBR in the remainder of the fiscal year, some other factors, including the strict implementation of the pay guidelines in the public sector and the continuing efforts to limit the amount of overspending by local authorities would probably work in the opposite direction.

Although the PSBR was large in 1975/76 (£10.6 billion equivalent to nearly 10 per cent of GDP at market prices), the expansion of the money supply was relatively slow due to the large sales of public sector debt to the nonbank private sector and the very low demand for bank credit by the private sector (Chart D). The situation changed in the first part of the current fiscal year, however, with the increase in the money supply (M3) accelerating as the extension of bank loans to the private sector rose appreciably and as the demand for gilt-edged stocks weakened. The seasonally adjusted rate of increase of M3 rose from 9.8 per cent in the 12 months ending mid-April 1976, to an annual rate of about 17 per cent in the six months to mid-October 1976; the actual increase in the three months to mid-October was 5.3 per cent. These rates of increase compare with an official guideline of 12 per cent for the growth rate of M3 during 1976/77. The expansion of bank credit, especially credit to the private sector, has been even more rapid. At the time of the last staff consultation discussions in May 1976 the authorities projected an expansion in domestic credit of £9.1 billion during 1976/77, in line with the target indicated in the Chancellor's letter of December 18, 1975, requesting a stand-by arrangement in the first credit tranche and a purchase under the Oil Facility. However, in the first six months of the current fiscal year the seasonally adjusted increase in domestic bank credit was £5.5 billion. Of this £2.4 billion was accounted for by bank credit to the private sector and in sterling to nonresidents which for the full year had been projected to rise by £2.6 billion. The authorities attribute some of this rapid expansion to a desire on the part of industry to speed up payments for imports and build up stocks of imported raw materials, as well as to anticipatory borrowing. The rapid credit expansion in the first part of 1976/77 also owed to the Government's difficulties in selling gilt-edged stocks to the nonbank private sector at a time when interest rates were expected to rise.

It was against the background of concern about the rapid growth of monetary aggregates and the associated weakening of the external payments position that the authorities took steps in the past few months to curb the expansion of the money supply. The Bank of England's minimum lending rate was raised from 11.5 per cent to 13 per cent on September 10 and then to the record high level of 15 per cent on October 7. Concurrently, the Bank of England called up an additional £1 billion of special deposits (£350 million and £700 million on September 16 and October 7, respectively) from the banking system. These deposits are equivalent to 3 per cent of the Bank's eligible liabilities against which reserve assets are required to be kept. These measures led to a rise in both market and administered interest rates, including an increase in yields on longer-term government securities to over 16 per cent, a rise in the clearing banks' base lending rates to 13 1/2-14 per cent, and an increase in the mortgage rate of building societies to 12 1/4 per cent. The three-month interbank rate for sterling rose by nearly 3 percentage points in the three weeks to October 27 and helped to reduce the covered differential between U.S. and U.K. money market rates which had risen to over 4 percentage points against London by October 6 (Chart E).

The calls for special deposits impinged sharply on the liquidity of the banks and caused them to compete aggressively for funds in the wholesale market, especially through the offer of high interest rates on certificates of deposit. To ease the pressures the Bank of England in early November announced that the second call for special deposits (equivalent to 1 per cent of eligible liabilities) due on November 15, 1976 would be postponed until December 14, 1976. Subsequently, on December 10, 1976, it was announced that this call would be further postponed until January 28, 1977. But as bank credit and the money supply continued to rise rapidly in the month to mid-October, the Bank of England on November 18 announced the reintroduction of the scheme of supplementary special deposits--the so-called "corset." Under this scheme guidelines are applied to the growth of the bank's eligible interest-bearing liabilities (IBELs). If IBELs exceed these guidelines, a certain portion of the excess has to be placed in supplementary special deposits at a progressively penal rate. 1/ With the imposition of the "corset" the authorities expected that there would be a moderation in the growth of domestic credit and M3, which would be offset in part by accelerated growth of wider liquidity components such as building society deposits and holdings of Treasury bills and local authority temporary debt by the nonbank private sector. On the following day, November 19, the Bank of England's minimum lending rate was reduced from 15 per cent to 14.75 per cent in response to an easing in the average rates tendered for Treasury bills. The reintroduction of the scheme of supplementary special deposits has been an important factor contributing to the buoyancy in the market for gilt-edged securities in recent weeks.

1/ The guidelines are such that the three-month moving average of IBELs for the period to April 1977 is not permitted to be more than 3 per cent above the average level of IBELs in the three months to October 1976. The implied average permissible growth rate of IBELs of one half of 1 per cent per month will be rolled forward until June 1977. Penalties on the excess of IBELs above guidelines are assessed monthly with the first assessment taking place once the April banking data are reported. If actual IBELs are in excess of guidelines by less than 3 per cent, then 5 per cent of the excess will be placed in noninterest-bearing special supplementary deposits with the Bank of England; such deposits would be 25 per cent if the excess is between 3 per cent and 5 per cent; and 50 per cent if the excess is 5 per cent or more.

5. The balance of payments

The current account of the balance of payments, after a fairly steady improvement from a £900 million deficit in the fourth quarter of 1974 to almost balance in the first quarter of this year, registered a marked deterioration in the months thereafter (Chart F). The trade deficit during 1976 rose from £ 478 million in the first quarter, to £1,004 million in the second quarter, and further to £1,206 million in the third quarter. And in the first two months of the final quarter of 1976, the trade deficit amounted to £666 million. The deterioration in the trade account has been due to a substantial decline in the volume of exports in the third quarter combined with continuing increases in import volume; there has not been any significant adverse shift in the terms of trade. Although the Bank of England's trade-weighted effective exchange rate depreciated by 20.9 per cent during the first nine months of 1976, the external terms of trade have hardly changed; in the first three quarters of 1976 both export and import unit values rose by 18 per cent. Exporters, who apparently have continued to invoice their contracts mainly in sterling, have tended to raise the sterling price of their exports in step with the depreciation of the pound. The deficit on trade account would have been much greater if it had not been for the increase in crude oil production from the North Sea which is estimated to result in savings of net oil imports of £650 million in 1976. The current account has also been supported by a substantial increase in receipts from tourism. For 1976 as a whole, the authorities are now projecting a current account deficit of about £1.8 billion, compared to a deficit of £1.7 billion in 1975 (Table 6).

A substantial weakening in the capital account, particularly in the second quarter, has also placed pressure on the external financing position. In fact, it is estimated that external transactions other than those recorded on current account were responsible for about two thirds of the official financing need in the first three quarters of 1976. A net outflow on capital account of £1.8 billion was recorded in the six months ending September 1976, compared to a net outflow of £0.4 billion in the first quarter of 1976 and a net inflow of £0.2 billion in 1975. A large fall of £1.3 billion in official sterling balances in the second and third quarters of 1976 was the primary reason for the deterioration in the capital account; holdings of oil-exporting countries accounted for more than £1 billion of this decline.

The overall balance requiring official financing increased from £1.5 billion in 1975 to an estimated £3.4 billion (US$6.3 billion) in the first three quarters of 1976. To meet this requirement, the authorities have relied mainly on compensatory borrowing in the form of drawings on the Fund totaling US$2.1 billion; foreign currency borrowings by public sector entities amounting to US$2.4 billion; and use of US$1.5 billion of the G-10 stand-by credit arrangement. 1/ Further foreign currency borrowing by the public sector totaling nearly US$1 billion is estimated to take place in the final quarter of 1976, including a US$500 million loan from the euro-currency market by the National Electricity Council. Gross official reserves fell by US$0.3 billion in the first 11 months of 1976 and reached a level of US$5.2 billion at end-November 1976, equivalent to about one-month's imports of goods and services.

1/ This amount was repaid on December 9, 1976.

Despite the very substantial official intervention the pound sterling has been repeatedly under pressure. The official index of the effective (average trade-weighted) exchange rate of sterling, which fell by 11 per cent during 1975, declined by a further 26 per cent in the period to October 27, 1976; on this date the index was 48 per cent below the level at end-1971. Between end-1975 and October 27, 1976 the US dollar/sterling spot rate fell from US$2.0234 per pound to US$1.5763 per pound. Since then, sterling has strengthened, on balance, and on December 13, 1976 its rate to the U.S. dollar was US$1.6820, while the official index of the average effective depreciation was 44.5 per cent.

6. Exchange and trade policies

As stated by the Chancellor in his letter of December 18, 1975 to the Managing Director, the U.K. Government remained opposed to generalized restrictions on imports. However, the Government considered that selective import controls may be justified in cases where industries, which would be viable and valuable once economic recovery had been established, are damaged or threatened with damage by an excessive level of imports. The Chancellor indicated that the Government would consult with the Fund if measures of this nature were proposed.

In 1976, the Government has consulted the Fund on several occasions (EBD/76/50, March 11, 1976 and Sup. 1, July 23, 1976; EBD/76/88, May 5, 1976; and EBD/76/174, August 20, 1976) concerning the introduction of import quotas on men's woolen suits from Romania, Czechoslovakia, and the German Democratic Republic; spun cotton yarn from Spain; men's and boys' woolen jackets from Czechoslovakia; synthetic shirts and synthetic undergarments from the People's Republic of China; shirts from Romania, cotton fabrics from Yugoslavia, cotton yarn and man-made fibre fabrics from Portugal under the terms of EEC agreements established under the GATT Multi-Fibre Agreement, and portable monochrome television sets from the Republic of China. Voluntary restraint on exports to the United Kingdom in 1976 of leather footwear was agreed to by Romania, Poland, and Czechoslovakia, and of woolen suits by Hungary and Poland. The import quotas established since mid-1975 cover approximately 1 1/2 per cent of total 1975 U.K. imports of textiles, 1 1/2 per cent of total 1975 U.K. imports of clothing, and 1/2 per cent of total 1975 U.K. imports of consumer electronic products (13 per cent of 1975 imports of monochrome TV sets). Together, the quotas limit imports of affected products to approximately £18 million annually against total imports in 1975 of some £22 billion. The voluntary restraint agreements on leather footwear cover 7 per cent of total imports of leather footwear in 1975.

With effect from November 19, 1976, the Government required U.K. banks to cease providing sterling finance for trade transactions involving two Overseas Sterling Area (OAS) countries, or OAS countries and other non-Scheduled Territories 1/ (EBS/76/228, 11/18/76). (Previously from August 24, 1976, the rules governing sterling finance for third country trade had been tightened so as to allow such financing only against original documents relating to a specific current movement of goods and within a period of credit not exceeding 180 days.) This measure is designed to terminate the use by U.K. merchants

1/ Non-Scheduled Territories comprise all countries other than the United Kingdom, including the Channel Islands and the Isle of Man, the Republic of Ireland, and Gibraltar.

of official exchange to finance trade between any of the non-Scheduled Territories. No change is made to the arrangement for trading by participants in Exchange Control Commodities Schemes. The measure is expected to produce a substantial once-for-all inflow of foreign currency in coming months as drawings under the facilities are repaid.

A similar facility for sterling finance for third country trade between non-Sterling Area countries was withdrawn in 1968. The Fund agreed in 1971 that this measure would no longer be subject to the Fund's approval under Article VIII, Section 2(a).

Sterling credit provided by U.K. banks for foreign trade will in future be restricted to the financing of trade between the rest of the world and the Scheduled Territories. In line with this restriction, U.K. merchants will in future be allowed to pay nonresidents for goods onsold to other nonresidents only with foreign currency borrowed for this purpose. Banks will remain free to replace the sterling facilities hitherto made available by offering appropriate finance in foreign currency to overseas customers or to U.K. merchants.

II. Economic Prospects on the Basis of the Policies Obtaining in Early Fall 1976

1. The real economy

The forecasts, which are summarized below, had been prepared in October 1976 on the basis of policies then obtaining. Accordingly, they do not take into account the likely economic effects of the policy measures announced by the Chancellor on December 15, 1976. These forecasts are also based on the assumption that the present pay policy would be continued into a third year, that the competitiveness of U.K. exports of manufactures would be kept constant at the level observed at the beginning of the fourth quarter of 1976, that the volume of world trade, weighted by the geographic distribution of U.K. exports, would increase by 10 per cent and 8 per cent in 1977 and 1978, respectively; and that the acute domestic and external financial difficulties besetting the U.K. economy during most of 1976 would be satisfactorily resolved. On these assumptions, which were admittedly not entirely consistent with each other, it was expected that the rate of growth of GDP would accelerate though gradually from an estimated 1.5 per cent in 1976 (Table 1) to a rate somewhat greater than the presumed potential rate of growth during 1978.

A significant acceleration in the rate of price increase between the third quarter of 1976 and mid-1977 was also foreseen. This would result from a combination of several factors the most important of which were the effects of exchange rate changes on the prices of imported goods and the effect of the drought on food prices. The more rapid increase in prices would occur despite an assumed slowdown in average earnings from annual rates of increase of some 14 per cent in the second half of 1976 to 8 per cent to 9 per cent during 1977. It was expected that thereafter price performance would improve reasonably rapidly. After mid-1977, exchange rate and drought effects would be dissipated and the rate of inflation would return to single digits by 1978, helped in part by an assumed cyclically weak increase in world commodity prices.

Such a development in prices, given the starting assumption as regards earnings, would imply a substantial decline in real wages in 1977, which would not turn around until some time in 1978. In consequence the immediate prospects for aggregate demand and employment were seen to be weak. But there was also a cumulative process at work as the weak employment prospects were bound to depress further the growth of aggregate employee compensation, while the support to personal incomes provided by public sector transfers would be offset by the rapid rise in taxes. The end result was that real personal disposable income could fall quite substantially in 1977, and rise only very modestly the following year. A partial offset was likely to come from the company sector where net income was expected to increase very markedly (company profits net of stock appreciation were expected to more than double between 1976 and 1978) as a result both of the increasingly important and large profits obtained from the North Sea oil operations and the much improved profitability of the export- and import-competing sectors.

Private consumption would probably decline in 1977, but not commensurately with real disposable income since a fairly substantial decline in the savings ratio was thought probable. Because of the projected decline in public investment, total public expenditure on goods and services was expected to drop in real terms both in 1977 and in 1978. Similarly, nonmanufacturing private investment was likely to decline again in 1977 on account of weak demand conditions. By contrast, the outlook for manufacturing investment was encouraging, with increases of the order of 16 per cent to 17 per cent expected in both 1977 and 1978 because of the favorable demand and profitability prospects in the export- and import-competing sectors. But since manufacturing investment accounts for only about a fifth of total investment, the latter was nevertheless expected to decline in 1977 and to recover slowly in 1978. Overall, final domestic demand was forecast to be unchanged between 1976 and 1978, the dip in 1977 being made up in the following year.

Between 1976 and 1978, it was expected that growth would mainly emanate from stockbuilding and an increase in net exports. Stockbuilding was expected to account for about half of the growth of GDP in 1977 and considerably less than that in 1978, with 80 per cent of the increase in stocks taking place in the manufacturing sector. The foreign balance was expected to account for about half the growth of GDP in 1977, and to do so again in 1978, despite an assumed slowdown in world trade in that year. In both years, net exports were expected to benefit from the price effects of the depreciation of 1976 and the reduction in net oil imports owing to North Sea oil. Nevertheless, because of the subdued pace of the recovery of aggregate output, a further increase in the number of unemployed was thought likely.

The financing picture derived from these projections suggested--always given the starting assumptions--that the public sector borrowing requirement (PSBR) for 1977/78 would be some £10.4 billion, as compared with the £9 billion estimate announced at the time the July 1976 policy package was introduced. This upward revision in the PSBR was attributable mainly to two factors: (a) the marked deterioration, between July and October 1976, in the outlook for activity and employment in 1977/78, which had reduced the expected revenue from income taxes and national security contributions and had increased the estimated expenditure on unemployment benefits; and (b) the higher than previously anticipated rate of inflation, which had raised the estimated cost of expenditure programs planned for 1977/78, especially programs involving a high import content, and the cost of uprating social security benefits which are linked to the cost of living. Projections of debt interest payments had also been revised upward, both because of the higher PSBR and because of the rise in interest rates which had occurred since July 1976 and which, in the absence of any policy changes, was expected to persist. A rate of inflation higher than expected in July 1976 had also led to some compensating increase in the projected revenue from taxes on expenditure but had not affected the forecasts of the yield from income taxes because the assumptions regarding average wage increases had not been revised.

Domestic credit expansion during the financial year 1976/77 was expected to be in excess of £10 billion, i.e., well above the target of £9.1 billion described in the Chancellor's letter of December 1975, requesting a stand-by arrangement in the first credit tranche. The larger than foreseen credit expansion reflected primarily the sharp increase of bank lending to the private sector and in sterling to nonresidents, which had taken place in the first half of 1976/77 and, which in the absence of policy changes, was expected to continue in the remainder of the year. Notwithstanding, the larger than originally foreseen balance of payments deficit, the change in the outstanding money stock (M3) seemed likely to exceed 15 per cent in 1976/77 (of which 1.5 per cent to 2 per cent would reflect valuation changes in the foreign currency deposits included in M3).

Given the PSBR projection for 1977/78, the above trends were likely to continue during 1977/78 leading to a rate of domestic credit expansion of between £ 9 billion to £10 billion and an increase in the money supply (M3) not appreciably different from that which would have occurred in 1976/77.

2. Balance of payments

A deficit of £1.6 billion was projected for the current account of the balance of payments in 1977, compared with one of some £1.8 billion in 1976, followed by a forecast surplus of about £1.3 billion in 1978 (Table 2). The projections showed a significant shift of real resources into the balance of payments both in 1977 and 1978. It was anticipated that the capital account would remain adverse in 1977, but would probably strengthen thereafter for confidence reasons, as the current account improved.

The projected halving of the trade deficit between 1976 and 1978 to about £ 1.7 billion was more than fully accounted for by the estimated net saving in oil imports. Production from the North Sea oil fields was expected to rise from an estimated 12 million tonnes in 1976 to 42 million tonnes in 1977, 62 million tonnes in 1978, and a peak of about 130 million tonnes per annum in the mid-1980s. On the basis of these production forecasts and certain working asssumptions regarding oil price and exchange rate movements, the net contribution of North Sea oil exported and substituted for imports (c.i.f.) was estimated to reach about £3 billion in 1977 and £5 billion in 1978, compared to £0.6 billion in

1976. On the assumption that just over one half of North Sea oil production would be used for import substitution, and that the substantially improved price competitiveness would mitigate the increasing trend penetration of imported manufactures, the growth rate of total import volume was expected to be very low in both 1977 and 1978. With respect to exports, the sharp increase in oil exports and the benefits of high relative profitability, 1/ favorable price competitiveness, and relative absence of capacity constraints was expected to lead to a better export performance in relation to world trade than has normally been achieved in the past. However, some decline in world market shares was still projected.

In the next two years, the depreciation of the pound sterling was projected to have its most pronounced effects on the invisibles account. The surplus on services account was projected to more than double, with exports of services, especially those relating to the travel account, expected to rise at a particularly rapid rate. However, a large rise in profit remittances, dividends, and interest payments stemming from the profits of overseas companies involved in the North Sea oil operations and the increased cost of official debt servicing, would limit the overall improvement in the balance on invisibles between 1976 and 1978 to about £1 billion.

1/ The profitability of exports relative to home market sales is estimated currently to be unusually favorable, due to exporters raising substantially their sterling prices following the depreciation of the pound during 1976.

December 16, 1976

Stand-By Arrangement--United Kingdom

1. Annexed hereto is a letter dated December 15, 1976, from the Chancellor of the Exchequer setting forth the objectives and policies which the authorities of the United Kingdom will pursue.

2. The International Monetary Fund grants this stand-by arrangement to support these objectives and policies.

3. The United Kingdom will remain in close consultation with the Fund during the period of the stand-by arrangement and, in particular, will consult with the Fund in accordance with paragraph 25 of the annexed letter and paragraph 6 below. These consultations may include correspondence and visits of officials of the Fund to the United Kingdom or of representatives of the United Kingdom to Washington, D.C. For the purposes of these consultations, the United Kingdom will keep the Fund informed of developments in the exchange, trade, credit and fiscal situation through reports at intervals or dates requested by the Fund.

4. For a period of two years from January , 1977, the United Kingdom will have the right, after making full use of any gold tranche that it may have, to purchase from the Fund the currencies of other members in exchange for its own currency in an amount equivalent to SDR 3,360 million provided that:

(i) Purchases under the stand-by arrangement shall not, without the consent of the Fund, exceed
the equivalent of SDR 1,000 million until May 25, 1977,
the equivalent of SDR 1,320 million until August 25, 1977,
the equivalent of SDR 1,640 million until November 25, 1977,
the equivalent of SDR 1,950 million until February 25, 1978,
the equivalent of SDR 2,310 million until May 25, 1978
the equivalent of SDR 2,660 million until August 25, 1978, and
the equivalent of SDR 3,010 million until November 25, 1978.

(ii) The right of the United Kingdom to make purchases under the stand-by arrangement shall be subject to paragraph 5 below to the extent that such purchases would increase the Fund's holdings of sterling beyond the first credit tranche.

If at any time any limit in (i) above would prevent a purchase under the stand-by arrangement that would not increase the Fund's holdings of sterling beyond the first credit tranche, the limit will not apply to that purchase. The amounts available in accordance with this paragraph 4 shall be augmented by the amounts equivalent to repurchases in respect of purchases under the stand-by arrangement, unless when any such repurchase is made the United Kingdom informs the Fund that it does not wish the stand-by arrangement to be augmented by the amount of that repurchase.

5. During any period of the stand-by arrangement in which the limits specified in paragrpahs 1 and 2 of the annex to the attached letter are not observed, or the intentions in the first and the last sentence of paragraph 24 of the attached letter are not being observed, or understandings on the limits specified in

paragraph 1 of the annex to the attached letter for the period of the stand-by arrangement after July 31, 1977, and paragraph 2 of the annex to the attached letter for the period of the stand-by arrangement after January 16, 1978, are not reached, the United Kingdom will not request any purchases under the stand-by arrangement which would raise the Fund's holdings of its currency beyond the first credit tranche, except after reaching understandings with the Fund regarding the circumstances in which such purchases may be made.

6. During the period of the stand-by arrangement, the United Kingdom will consult the Fund on the adoption of any measures that may be appropriate at the initiative of the United Kingdom or whenever the Managing Director requests consultation because any of the criteria referred to in paragraph 5 above are not being observed or because he considers that consultation on the program is desirable. In addition, after the period of the stand-by arrangement and while the Fund's holdings of sterling above the first credit tranche include currency resulting from purchases under the stand-by arrangement, the Government of the United Kingdom will consult the Fund from time to time, at the initiative of the Government or at the request of the Managing Director, concerning the United Kingdom's balance of payments policies.

7. The United Kingdom will pay charges for this stand-by arrangement in accordance with the decisions of the Fund on charges for stand-by arrangements.

8. Subject to paragraph 4 above, the United Kingdom will have the right to engage in the transactions covered by this stand-by arrangement without further review by the Fund. This right can be suspended only with respect to requests received by the Fund after (a) a formal ineligibility, or (b) a decision of the Executive Board to suspend transactions, either generally (under Article XVI, Section 1(a)(ii)) or in order to consider a proposal made by an Executive Director or the Managing Director, formally to suppress or to limit the eligibility of the United Kingdom. When notice of a decision of formal ineligibility or of a decision to consider a proposal is given pursuant to this paragraph 8, purchases under this stand-by arrangement will be resumed only after consultation has taken place between the Fund and the United Kingdom and understandings have been reached regarding the circumstances in which such purchases can be resumed.

9. Not later than three years after each purchase of exchange by the United Kingdom under this arrangement, the United Kingdom shall repurchase an equivalent amount of sterling from the Fund, provided that, if sterling held by the Fund as a result of transactions under this arrangement is reduced by repurchases under Article V, Section 7, or otherwise, such reductions shall be credited against the earliest amounts that become payable under this paragraph 9. Repurchases shall be made with the assets specified by the Fund at the time of the repurchase in accordance with the Fund's policies and practices at the time of the repurchase.

10. The rate of exchange at which the United Kingdom will purchase currencies from the Fund in exchange for sterling and at which the Fund will return sterling in repurchase operations and make all other computations involving sterling will be such rate as the Fund may from time to time determine under Article IV, Section 8, of the Fund Agreement.

CONFIDENTIAL

Treasury Chambers
Parliament Street
London, SW1P 3AG

15 December 1976

Dear Mr. Witteveen:

1. The Government of the United Kingdom hereby requests of the International Monetary Fund a stand-by arrangement under which for a period of two years the Government of the United Kingdom will have the right to purchase from the Fund currencies of other members in exchange for sterling up to an amount equivalent to SDR 3,360 million. Before making purchases under the stand-by arrangement, the Government will consult with the Managing Director on the particular currencies to be purchased from the Fund.

2. The purpose of this request is to support the policies that have been adopted by the Government of the United Kingdom to strengthen the balance of payments and create the conditions in which it will be possible to get both unemployment and domestic inflation down from their present unacceptable levels and keep them down. The stand-by arrangement will also help to repay external debt now falling due and assist in maintaining orderly conditions in the exchange market for sterling. The Government's objectives and policies, which I shall summarize below, have been set out in detail in recent policy pronouncements, including particularly the Prime Minister's speech to the House of Commons on 11 October 1976, my speeches to the House on 11 October and 30 November, and my statement in the House this afternoon.

3. Since the summer of 1975, the Government, with the support of both sides of industry, has pursued a medium-term strategy whose objectives are to reduce the rate of inflation and to achieve a sustainable growth in output, employment, and living standards based on a strong expansion in net exports and productive investment. In order to secure this strategy, the White Paper on public expenditure published in February 1976 (Cmnd. 6393) indicated the Government's intention in the years ahead to reduce the share of resources taken by public expenditure. It is also part of this strategy to reduce the public sector borrowing requirement so as to establish monetary conditions which will help the growth of output and the control of inflation. The Government sees this strategy as the basis for a three-year programme which will firmly establish the recovery of the nation's economy and will also allow the United Kingdom to make its proper contribution to the stability and prosperity of the world.

4. The two pillars on which this strategy is based are the social contract with the trades union movement, which has already allowed us to achieve a substantial reduction in the rate of price and wage inflation and has brought about a dramatic improvement in industrial relations; and the industrial strategy, through which the Government, the trade unions, and the employers are seeking to improve the performance of our manufacturing industry and, in particular, its

productivity and its ability to compete successfully in world markets. It is our firm intention to continue the policy of securing a progressive deceleration of inflation through voluntary agreement between the Government and the Trades Union Congress. Under the first stage of this policy, the increase in average earnings was reduced to 13.9 per cent in the year ending July 1976 from 27.6 per cent in the corresponding period a year earlier. Under the second stage, the TUC and the Government are applying the present pay agreement strictly; average earnings resulting from this second stage policy in the period July 1976 to July 1977 will at least rise by something like half of the amount of increase in the preceding 12 months. Largely because of this restraint in earnings the rate of price increase has fallen sharply from a rate of 25.9 per cent in the 12 months to October 1975 to one of 14.7 per cent in the 12 months to October 1976. In recent months this progress has been interrupted because of the sharp rise in commodity prices, the effects of the drought, and the depreciation of the exchange rate of sterling. Nevertheless, the Government is determined to ensure that the rate of inflation continues to fall. Accordingly, it will begin early next year to consider, in consultation with the TUC and the CBI, how this objective can best be pursued in the period beyond July 1977. I would aim at reaching agreement through these consultations in the early spring of next year, in time for the Budget. This will ensure that the gains achieved by the sacrifices already made are further improved and that there is continued progress in bringing the rate of inflation in the United Kingdom down to that obtaining in the other main industrial countries.

5. Work to develop an industrial strategy can produce major results only in the medium term, but significant progress has been made in the last 12 months. The current phase of the work is directed to increasing market shares at home and abroad, through improvements in industrial productivity and non-price competitiveness. It is the Government's policy to create the conditions in which a strong British manufacturing industry can contribute to the improvement of our balance of trade and payments.

6. I have repeatedly stressed that the Government aims to strengthen the balance of payments progressively over the coming years as one essential condition for sustained growth and a high level of employment. On the basis of our present projections for the growth of world trade and prices, the Government expects that the deficit on current account will fall from over £ 2 billion in 1976/77 to about £ 1 billion in 1977/78, and then move into a surplus of some £ 2 billion to £ 3 billion in 1978/79. In the coming years the current account will increasingly benefit from production of North Sea oil and gas. This prospect together with continued progress in improving the non-oil component of our external accounts will allow us to reduce the large outstanding amount of foreign debt that has been accumulated and at the same time to reconstitute our foreign exchange reserves. However, I must emphasize that an improvement of this magnitude must depend on a satisfactory rate of expansion in world trade. It is not possible for deficit countries to improve their position unless countries with a strong balance of payments ensure a satisfactory rate of growth in their economies and are prepared to accept a deterioration in their own external position.

7. The Government is determined to carry through a stabilization programme which will bring the economy into balance and which, if it is not to produce unacceptable social tensions and levels of unemployment, will need to extend over two to three years. The changes required by this programme must proceed at a pace which will not overstrain the consensus on which our policies for regenerating industry and reducing inflation must depend. The Government is deeply conscious that the present state of the economy has brought a waste of human and material resources. The Government's objective is to break decisively away from the constricting pattern of present circumstances and post-war disappointments. It will, therefore, keep a close watch on the development of the economy, so that if any further action is needed, it can be taken in good time to ensure that conditions are favorable for the necessary shift of resources into exports and productive investment. For this purpose, an essential element of the Government's strategy will be a continuing and substantial reduction over the next few years in the share of resources required for the public sector. It is also essential to reduce the public sector borrowing requirement (PSBR) in order to create monetary conditions which will encourage investment and support sustained growth and the control of inflation. In the following paragraphs of this letter I will describe the policies which the Government will therefore follow over the next two years: the policies for the second year--the financial year 1978-79--will be reviewed before the end of 1977, in the light of economic developments and prospects.

8. Our most recent forecast shows the PSBR in 1976/77 to be £11.2 billion. This is less than the figure of £12 billion forecast when I requested a stand-by arrangement in the first credit tranche in December 1975. This improvement in the expected outcome reflects higher revenues because of the higher rate of inflation referred to in paragraph 4 above and the improved financial position of the public corporations; and it has also been assisted by the progress that has recently been made in establishing firm control over large areas of public expenditures by the use of cash limits and our refusal to sanction expenditure beyond the total set in last February's White Paper for programmes and the contingency reserve.

9. In the White Paper of February this year (Cmnd. 6393) the Government introduced policies to move resources into the balance of payments and investment by reducing public expenditure in both 1977/78 and 1978/79. In July 1976, it made further reductions in public expenditure programmes for the year 1977/78, of the order of £1 billion at 1976 Survey prices. It also announced a surcharge on employers' national insurance contributions, to become effective on April 6, 1977, which will yield some £1 billion in additional revenue in 1977/78.

10. Since these measures were announced, there have been periods of instability in the exchange market and pressures on monetary aggregates, which have led to a steep increase in interest rates; these, if sustained, would damage our economic performance in several areas. I am therefore convinced that a further reduction in public expenditure and in the public sector borrowing requirement is unavoidable.

11. To remove this instability, therefore, the Government has decided to reduce public expenditure programmes in 1977/78 by a further £1 billion and in 1978/79 by £1 1/2 billion, at 1976 Survey prices, in both cases. Details are set

out in my statement to the House of Commons today. At the same time I wish to give the maximum possible help to industry and to avoid unnecessary unemployment. I therefore intend to increase expenditure on incentives for industrial investment and expansion and on measures to reduce unemployment in each of the two years 1977/78 and 1978/79 by £200 million. This expenditure will be financed by an increase of 10 per cent in the duties on alcohol and tobacco.

12. As a result of these measures and of a sale during 1977/78 of British Petroleum shares calculated to yield £500 million, the aim is to hold the PSBR to £ 8.7 billion in that year. As a proportion of GDP at market prices, the PSBR will therefore, fall from about 9 per cent in 1976/77 to about 6 per cent in 1977/78. If, at the time I plan my Budget for 1977/78, I judge that without increasing the PSBR above £ 8.7 billion there is scope for tax reliefs and if, as I hope, a satisfactory agreement has been reached with the TUC and the CBI on pay arrangements for the period after July 1977, then I would plan to use the available margin to reduce the present burden of direct taxation. My own belief is that present levels of direct taxation have proved discouraging to effort and efficiency, and if they were to continue unchanged they could threaten the improvement in our economic performance which is an essential objective of the Government's strategy.

13. The profile of public expenditure after these reductions and those mentioned earlier in this letter can therefore be stated as follows. The total of public expenditure programmes for the financial year 1976/77 (excluding debt interest and capital finance for nationalized industries) is now expected to be about 1 per cent more in volume than in 1975/76, when it was approximately £ 50 1/2 billion at 1976 Survey prices. This latest 1976/77 estimate is within the corresponding provision for these programmes and the contingency reserve in the last public expenditure White Paper (Cmnd. 6393). The level in 1977/78, after the measures announced in July and the further reductions now decided is planned to fall to about 1 per cent below that of 1975/76 at 1976 Survey prices without taking account of the proceeds of the planned sale of British Petroleum shares. The planned level for 1978/79 will also be about 1 per cent below that for 1975/76. That part of total expenditure which is due to provision for social security benefits for the unemployed is, however, subject to a margin of fluctuation according to the actual level of unemployment. The revised expenditure programmes incorporating the changes which I described will be published in the next public expenditure White Paper. The implication of the figures which I have given is that the published total for programmes plus the contingency reserve, but excluding on the one hand receipts from the sale of the British Petroleum shares and on the other hand debt interest and capital finance for the nationalized industries, will be around £ 50 billion or somewhat less in 1977-78 and around £ 50 billion again in 1978-79, at 1976 Survey prices in both cases. Capital finance for the nationalized industries mobilized by the Government is estimated to be broadly stable over this period.

14. I also intend to take further fiscal action totaling £ 0.5 billion at 1976 prices affecting 1978/79 in order to bring the PSBR for that year down to £ 8.6 billion in nominal terms; this would represent a fall in the level of the PSBR to some 5 1/4 per cent of GDP at market prices in that year.

15. The Government has determined these objectives for the PSBR on the basis of a forecast that the gross domestic product will show an increase of about 2 per cent in 1977/78 compared with 1976/77, followed by a somewhat larger increase of 2 1/2-3 per cent between 1977/78 and 1978/79.

16. In carrying out the annual survey of public expenditure programmes in 1977 and in preparing my 1978 Budget, I shall continue to be guided by the need, which is an essential element in our strategy, to shift resources into the export and investment sectors and I shall, therefore, take full account of the prospective growth of output and ensure that nothing stands in the way of this shift of resources. In particular, if the forecast rate of growth from the beginning of 1978 to the end of 1979 is in excess of 3.5 per cent per annum, I shall--in order to allow for it--make an additional fiscal adjustment in 1978/79 of between £ 500 million and £ 1,000 million at 1976 prices. The exact figure would depend on the buoyancy of aggregate demand.

17. A reduction in the PSBR will go a long way to improve our ability to control the rate of growth of the monetary aggregates, and will help to reduce the level of interest rates which might otherwise be an impediment to increased industrial investment. I have repeatedly stressed that our policies should not be undermined by an excessive expansion of credit. In the first half of 1976/77, the growth of bank lending rose much more rapidly than expected, and this contributed to pressures on the pound. To counter these developments, a series of measures have been taken. In September and October 1976, the Bank of England increased their minimum lending rate substantially and called for special deposits from the banking system amounting in all to 3 per cent of eligible liabilities. In November 1976, the Bank of England reintroduced the system of supplementary special deposits which should ensure that the growth of credit and the money aggregates is brought under control quickly. The Government is determined that bank credit expansion will not undermine the stability of the exchange market.

18. I accordingly intend that domestic credit expansion should be kept to £ 9 billion in the 12 months ending 20 April 1977 and to £ 7.7 billion in the 12 months ending 19 April 1978. I intend, however, to review the latter figure early in the financial year and to take account of the prospective financial requirements of industry for investment and expansion. It is the Government's intention that the course during each year of Domestic Credit Expansion (DCE), and of the public sector borrowing requirement within it, should be consistent with the intended results for the year as a whole and to take action as appropriate to this end.

19. In the year ending 18 April 1979, I expect the expansion of domestic credit to be further reduced to £ 6 billion. This, however, will have to be reviewed late in 1977 in the light of the prospects for 1978/79. In that review an appropriate downward adjustment will be made in the intended rate of domestic credit expansion for any reduction in the public sector borrowing requirement for 1978/79 that may result from the review described in paragraph 16.

20. I intend to fund the major part of the PSBR outside the banking system, so that there can be room within these levels of domestic credit expansion for bank credit to facilitate the shift of resources into exports and productive

investment. I envisage that the measures which I have now taken, especially those to reduce the PSBR, will make it possible to reduce interest rates progressively from their present exceptional levels, while maintaining effective control of the monetary aggregates.

21. For at least the immediate future, the supplementary special deposits scheme, involving guidelines for the growth of banks' interest-bearing liabilities, will be a key instrument for controlling the growth of bank credit to the private sector. It may also cause some shift of holdings of short-term public sector debt away from the banking system, distorting the DCE and money supply statistics, without affecting the underlying state of liquidity in the economy: if this happens, I intend to keep DCE correspondingly lower than the targets set out above.

22. While the exact implications of the targets for DCE for the growth of the money supply and, in particular, for sterling M3 will depend on the speed of progress in achieving our balance of payments objectives, I am satisfied that the resultant course of sterling M3 will be consistent with a reduction in inflation.

23. During the past year the problems of financing our external and internal deficits have seriously hampered progress in achieving our goals. The exchange market, in particular, has been a conspicuous cause of uncertainty, thereby undoubtedly delaying the recovery of the economy. The measures now taken by the Government give assurance that private business decisions can be taken against the background of a clearly defined policy. Intervention will be designed to minimize disruptive short-term fluctuations in the rate and to maintain stability in the exchange markets consistently with the continued maintenance of the competitive position of U.K. manufactures both at home and overseas. It is my belief that this, in conjunction with the continued restraint of domestic demand, a steady improvement in non-price competitiveness and progress in aligning our cost and price inflation to those of our major partners, will alter the long-standing trend for the U.K. share of world markets to diminish, and limit more effectively the continuing penetration of the domestic market by imported manufactures, thereby promoting industrial growth in the United Kingdom. It should also help to secure us a much needed improvement in our reserves position. The U.K. authorities stress their support of the Executive Board Decision of January 23, 1974, on Consultations on Members' Policies in Present Circumstances, and reiterate their intentions to collaborate with the Fund in accordance with the provisions of Article IV, Section 4(a).

24. The Government remains firmly opposed to generalized restrictions on trade and does not intend to introduce restrictions for balance of payments purposes. It continues to believe, however, that in current economic circumstances there may be cases where particular industries which are viable in the long-term are suffering serious injury as a result of increased imports. The Government has introduced certain temporary selective measures in a number of such cases and has stated that it is prepared to consider the further use of such measures where they may be justified in similar cases which may arise. It will be the Government's policy to reduce such protective measures as soon as

circumstances permit. During the period of the stand-by arrangement, the Government does not intend to introduce any multiple currency practices or impose new or intensify existing restrictions on payments and transfers for current international transactions.

25. The Government believes that the policies set out in this letter are adequate to achieve the objectives of its programmes, but will take any further measures that may become appropriate for this purpose. The United Kingdom Government will consult the Fund in accordance with the policies of the Fund on such consultations on the adoption of any measure that may be appropriate. In any case, the United Kingdom authorities will reach understandings with the Fund before 16 January 1978, on their policy intentions for the remaining period of the stand-by arrangement.

Yours sincerely,

/s/

Denis Healey
Chancellor of the Exchequer

ANNEX

15 December 1976

Memorandum of Understanding

1. With reference to paragraph 18 of the letter dated 15 December 1976 from the Chancellor of the Exchequer to the Managing Director of the International Monetary Fund, requesting a stand-by arrangement equivalent to SDR 3,360 million, it is understood that domestic credit expansion, consistent with the intended result for the financial years 1976/77 and 1977/78 as a whole, will not exceed the following amounts during the periods indicated below.

(In millions of pounds; not seasonally adjusted)

	Limit
6 months to 20 April 1977	4,500
9 months to 20 July 1977	7,100

The cumulative amounts for the 12 months to 19 October 1977 and 15 months to 18 January 1978 will be established during a review with the Fund before 31 July 1977.

2. With reference to paragraph 8 and paragraph 12 of the above letter, it is understood that the public sector borrowing requirement (PSBR)(excluding the receipt of £500 million from the sale of British Petroleum shares referred to in paragraph 12 of the letter dated December 15, 1976 from the Chancellor of the Exchequer to the Managing Director) consistent with the intended result for the financial years 1976/77 and 1977/78 as a whole will not exceed the following amounts during the periods indicated below.

(In millions of pounds; not seasonally adjusted)

Financial year		Limit
1976/77:	6 months to end-March 1977	5,900
1977/78:	3 months to end-June 1977	3,100
	6 months to end-September 1977	5,200
	9 months to end-December 1977	7,700
	12 months to end-March 1978	9,200

Tuesday,
November 11, 1975

MEMORANDUM FOR FILES

1. Mr. Finch and I called on Mr. Littler at the Treasury this afternoon. He handed us the attached timetable on which he made the following remarks: (a) that they may need to reverse the order on Wednesday morning taking the balance of payments then and the U.K. economy in the afternoon; (b) that they hoped to take energy policy on Thursday afternoon, leaving Friday afternoon free for a visit to the Bank of England.

2. Mr. Cassell had invited Mr. Finch and I to lunch on Thursday. On Friday, the whole mission were invited to lunch at the Bank of England. On Friday evening, Mr. Littler is inviting Mr. Finch and myself to dinner. On Tuesday, the whole mission were invited to lunch by Sir Derek Mitchell.

3. The coverage of the various letters and statements was discussed in an informal way. On the U.K. side, they agreed to produce as early as possible drafts of passages which were likely to prove contentious. For our part, we said that we would endeavor to leave with them by Friday evening or sometime during the course of Saturday a draft of the documents which they would have to submit.

It was agreed that if by Tuesday some passages were still contentious then they could probably be left aside and picked up toward the end of the month or December. In any case, some questions such as those pertinent to import controls and public sector expenditures could not be finalized until later in November. As Mr. Littler saw it, the final touches could be agreed either through Mr. Ryrie in Washington or by means of a visit to Washington either by himself or by Sir Derek Mitchell.

4. We added to the list of contentious subjects that pertaining to the exchange rate. However, Mr. Littler said that Ministers had already decided to reject the advice of those counselling a deliberate depreciation of the exchange rate by more than was required to maintain the present level of competitivity over the next few months. In broad terms, this seems to imply on present forecasts that they contemplate a depreciation in effective terms of 3 per cent between now and Easter 1976. When this point was further discussed, Mr. Littler stated that money drawn from the Fund would not be used to prevent any further depreciation should market pressures be stronger than was expected. It is not clear what this phrase should be intended to mean, though it seems likely that he was saying that a depreciation in excess of 3 per cent would not be deliberately sought but that it would not on the other hand be resisted if it occurred through market pressures.

5. It was agreed that there should be no formal minutes. That each/side would keep an informal record and that contentious topics would have to be put in writing to the satisfaction of both sides.

6. We pointed out that the material given to us in Paris had been very useful, but that we did not know ourselves what part of it should be regarded as confidential. Mr. Littler undertook to bear this in mind in all meetings and to make it clear what material had to be regarded a secret and what could be put in the mouths of the staff, but not directly attributed to U.K. officials.

7. Mr. Littler emphasized that the words "Letter of Intent" were an anathema in Whitehall and that they would talk throughout in terms of "Letter of Application."

L. A. Whittome

cc: Mr. Finch
Mr. Vittas
Mr. Brau
Mr. Hyndman

Office Memorandum

TO : Mr. Whittome

DATE: November 7, 1975

FROM : H. Vittas

SUBJECT : United Kingdom

The following is a list of subjects that would have to be covered during the formal discussions. A few of the subjects involve both technical and policy aspects and may require two different sets of meetings. The subject matters are listed in the order which appears to be most convenient from our point of view.

1. Domestic economic prospects
2. Balance of payments - short-term and medium-term prospects
3. Balance of payments "need"
4. Energy: information and description of policy
5. Incomes policy
6. PSBR and public expenditure
7. Monetary targets and projections
8. Import restrictions
9. Exchange rate policy

cc: Mr. Finch
Mr. Brau
Mr. Hyndman

Restrictions (very inclusive list)

(1) In the staff papers, the April 15, 1975 measures affecting gold and gold coins will be described as resulting in an incidental restriction on imports, while no payments restriction is involved.

(2) Please confirm that import licenses are issued on demand under: (a) the surveillance licensing system for imports of textiles and clothing from non-EEC sources; (b) the surveillance licensing system for imports of color TV tubes and sets from all sources.

(3) Please describe the more restrictive practice followed by the Department of Trade since early August 1975 in granting waivers of import duties on imports of materials from non-EEC sources to be used in industrial production.

(4) Please provide details of the following measures taken by the EEC as they affect the United Kingdom: (a) the re-imposition of import duties to 10.2 per cent from 6.3 per cent on certain textile goods manufactured in Portugal (July 15, 1975); (b) the agreements under the GATT Multi-Fibre Arrangements limiting the rate of growth of imports of certain textiles from India, Pakistan, Hong Kong, Macao, and Singapore; (c) the suspension of imports of cattle and beef from "third" countries (July 15, 1974).

(5) Please provide a description of the implementation of the scheme for partial insurance against cost inflation which affect fixed-price export contracts, introduced on February 20, 1975.

(6) Anti Dumping measures planned ?

List of Questions

Inflation

(a) What are the main exceptions from the £6-a-week pay limit?

(b) What is the permissible percentage increase in wage earnings for employees earning (1) minimum, and (2) average earnings? Also for male and female employees.

(c) What is the projected timepath of the index of average earnings through the end of 1976?

(d) Please provide information on the success of the pay limit to date.

(e) Please indicate whether there has been any modification in the policy stance with respect to the phasing out of subsidies to nationalized industries and the reduction of food and rent subsidies.

(f) Please discuss present official attitudes with respect to the price controls.

September 16, 1975

CONFIDENTIAL

Discussions in Washington in Early October

Suggested Agenda

The objectives of the discussions will be:

(a) to establish that there is balance of payments need in the sense in which this term is used for an Oil Facility drawing;

(b) to agree on the form (straight drawing or stand-by) of a first credit tranche transaction, if such a transaction is contemplated;

(c) to agree on the appropriate quantification and description of fiscal and credit policies for the period extending at least through the first half of 1976, and to understand the Government's quantitative aims in regard to public expenditure and the public sector borrowing requirement over the next two to three years;

(d) to make some quantitative estimate of the speed of the external adjustment in the next two to three years;

(e) to understand present policy as regards the exchange rate and agree on the terms in which it can be described in staff papers; and

(f) to complete as far as possible the documents related to an Oil Facility and a first credit tranche transaction.

Points to be discussed

1. For the purpose of establishing balance of payments need in the context of an oil drawing, we would need an updated version of the official balance of payments forecast for calendar 1975 in the standard format for an Oil Facility drawing and discuss the major individual items (indicating where the main uncertainties lie) in the light of actual developments so far this year. In cases where the forecasts for the year as a whole imply a significant change of recent trends, please explain the reasons why such a change is expected.

2. Please describe the Government's objectives for the current account of the balance of payments in the short and medium term. What are the Government's gross and net official reserve targets for 1975 and the first half of 1976?

3. Please discuss reserve and exchange rate policies so far this year and indicate the exchange rate policy to be followed over the coming months. What role do relative price developments--past and projected--play in determining the exchange rate movement, and which price indices are being used for such comparisons?

4. Please outline the Government's objectives with respect to foreign currency borrowing by the public sector in 1975 and 1976.

5. Please provide information to show what action has been taken to attract private capital flows and also that adequate use has been made of alternative sources of financing the balance of payments deficit. Also, please indicate what is the position with respect to the EEC Oil Facility and the OECD "Safety Net."

6. Please provide a concise statement of the new counter-inflationary measures, their objectives, and some assessment of their likely success.

7. Please provide your latest estimate of the PSBR in 1975/76 and indicate as precisely as possible what is meant by the Government's commitment to take whatever action is necessary to prevent it from rising further. Please describe action taken or currently under consideration to substantially reduce the PSBR in 1976/77 and, if possible, indicate the order of magnitude by which the PSBR is expected to decline in that year. Also, please confirm the Government's intention to continue progress in subsequent years toward reducing the PSBR to levels consistent with domestic and external stabilization--mainly, as we understand it, by means of effective control on public expenditure both in real and in nominal terms.

8. Please provide the Government's monetary projections for the 12-month period ending June 1976, including in particular a maximum target figure for DCE as that concept is defined in the Bank of England, Quarterly Bulletin. Indicate what is the implication of this target for the growth of M3 over the same period. (If preferred, we could work out a DCE estimate from U.K. projections of M3.)

9. Please confirm the Government's commitment to abstain from introducing or intensifying import and current payments restrictions.

10. Please provide a summary statement of the Government's energy policies.

September 16, 1975

CONFIDENTIAL

Technical Mission to London in Early October:
Suggested Agenda

The main purposes of a "technical" staff mission to London in early October 1975 would be to:

(a) ensure that our information on recent economic developments is as up to date as possible;

(b) complete certain gaps in our knowledge of recent measures and developments as well as official projections for the near future; and

(c) discuss the assumptions underlying the projections, notably those for the balance of payments (current and capital accounts), public sector borrowing requirement, and prices and wages.

Suggested specific questions and topics for discussion are outlined below. We have chosen to put these questions in great detail in the hope that they may prove helpful.

Balance of payments

1. What revisions, if any, have been made in the official balance of payments projections for 1975 recently supplied to the staff in "oil facility" format?

2. How do you envisage the current account balance developing during the remainder of 1975 and 1976 (first and second halves)?

3. Please specify the volume and unit value assumptions behind the export and import value projections for 1975 and first half 1976.

4. Please analyze recent developments in and prospects for the volume of imports. We are especially interested in your assessment of the demand for inventories and its relation to imports.

5. Please analyze U.K. export market performance (in volume terms) over the past few years and the prospects through mid-1976, and discuss the relationship between export performance and developments in U.K. export competitiveness (including the impact of exchange rate changes).

6. Please summarize the forecast for invisibles transactions in the second half of 1975 and, if possible, first half 1976. Explain the main underlying assumptions, identifying in particular the impact of interest paid on public sector borrowing from abroad.

7. Please outline and discuss the principal assumptions behind official projections for the capital account in 1975.

Fiscal developments

8. Please review the latest revised projections of the public sector accounts in FY 1975/76, explaining the main revisions and underlying assumptions (including projected expenditure deflators). As a basis for the discussion, the staff would appreciate a table showing for FY 1975/76 the original and revised projections of the public sector accounts, distinguishing between current and capital expenditure and revenue items (as in Table XXIII of SM/75/153, 6/12/75).

9. As regards the expenditure estimates, please outline the areas where significant slippage has occurred thus far in FY 1975/76 and where it could occur during the remainder of the fiscal year.

10. What progresss have the authorities made in devising and implementing a system of cash ceilings to supplement the existing technique of planning public expenditure programs in "real" terms? How would such ceilings be likely to operate and how extensive would their application be?

7. 11. Please explain why the July 1975 counter-inflation measures are officially estimated to have a "neutral" impact on the public sector borrowing requirement--identifying the expenditure saving, and the income tax and indirect tax losses.

Monetary developments

12. Please elaborate the assumptions underlying the recently revised official projections (shown to the staff during the informal discussion in August in Washington) of the main components of DCE and M3 in FY 1975/76. To what extent can developments to date be interpreted as confirming these projections?

13. The staff would like to discuss why sales of public sector debt to the nonbank private sector in FY 1975/76 are now thought likely to be much more buoyant than previously.

14. Please give some indication, however tentative, of prospective developments in DCE and M3 in the first half FY 1976/77 (or at least first half 1976).

Output and demand

15. Please elaborate the assumptions underlying the latest official forecasts of the national accounts through mid-1976, with special emphasis on those relating to the volume of consumers' expenditure and stockbuilding.

16. To what extent is industry currently operating at below full capacity? Are there any special and identificable problems likely to hinder U.K. industry from taking full advantage of a recovery in world demand (e.g., supply bottlenecks in certain sectors).

Prices and wages

17. Assess the prospects of reducing the rate of inflation down to 10 per cent by end-September 1976 and of producing a corresponding fall in average earnings growth.

Energy

18. Please provide official projections for 1975 of:

(a) domestic uses of primary energy sources; and

(b) exports, imports, and domestic production of crude and refined oil in metric tons (see Appendix A of EBS/75/276, 8/8/75).

List of Questions

Domestic economic prospects

1. Please elaborate the assumptions underlying the current official forecasts of the national account through 1977 (first quarter).

2. Please show the derivation of the personal disposable income projections, distinguishing between the three main components of personal income (income from employment, current transfers, and other earned income including rent and income for self-employment) and direct taxes).

3. Explain the assumption behind the personal savings ratio projections, especially why the ratio is expected to stand at the historically high level of around 11 1/2 per cent toward the end of the forecast period.

4. Elaborate assumptions underlying the real gross fixed investment forecasts, with particular emphasis on the reasons for the timepath and the breakdown between the following components of investment: investment and dwellings (distinguishing between private and public), other private investment (identifying manufacturing investment separately) and other public investment. The overall fixed investment forecasts for 1975 (~~first~~ second half) seems very high.

5. Explain the assumptions behind the stockbuilding forecasts, identifying prospective developments in stocks of finished manufacturers and materials and fuels. We would also appreciate your comments on the forecasts' implications for stock output ratio.

6. Why is the volume of exports, goods and services, expected to rise by 6.5 per cent between 1975 and 1976?

7. Please provide current price projections ~~and~~ of the expenditure ~~capacity~~ components of GDP through the forecast period.

8. To what extent is industry currently operating at below full capacity? Are there any specific and identifiable problems likely to hinder U.K. industries from taking full advantage in recovery in world demand next year (i.e., supply bottlenecks)?

Monetary policy

(1) With reference to the table "DCE and Money Supply 1974/75 to 1976/77" please elaborate the assumptions underlying:

(a) The projection of sales of public sector debt to the nonbank private sector in 1975/76, and the seasonal distribution between the first and second halves of the fiscal year.

-- The projection of sales of public sector debt of £5,500 million to the nonbank private sector in 1976/77 in the light of the projection of sectoral balances for 1976/77.

(b) The projection of bank lending to the private sector and in sterling to the overseas sector of £1,000 million for 1975/76; what accounts for the expected drop in such lending in the second half of 1975/76?

-- The projection of this item at £2,000 million for 1976/77.

(2) Please provide revised figures for the external finance of the public sector in 1975/76 which incorporate the recent seasonality adjustments of the trade balance.

(3) Please provide a breakdown of "other adjustments" as between the change in: (a) banks' non-resident sterling deposits, and (b) non-resident foreign currency deposits net of foreign currency claims of non-residents. What accounts for the particular pattern expected for this item as between the first and second halves of the fiscal year 1975/76? What explains the further reduction in this item expected for 1976/77?

(4) The projection of £6,000 million for the increase in M3 during 1975/76 implies a sharp acceleration in the growth rate as between the first and second halves of the fiscal year. To what extent do latest developments provide confirmation for this expectation? What would explain the implied substantial drop in the velocity of circulation?

(5) What are the implications for short-term and long-term interest rates arising out of the Government's monetary projections?

(6) How do you assess the liquidity position of the private sector?

WITHDRAWAL NOTICE

PROJECT

Project number	2008-012
Project name	PDR/EXR Front Office (AI)
Project tab number	319
Project box number	4

DOCUMENT

Series / File	United Kingdom-Stand-By (97063)
Original box / file No	80 / 1
Date	1975-11-03
Type	Notes on meeting
From	Chancellor of teh Exchequer & C.W. France & H.J. Witteveen & D. Green
To	Chambriere
Subject / Title	Note of a working dinner at No. 11 Downing Street on Monday, 3rd November, 1975
Number of pages	9
Classification	SECRET
Authority	Office of Executive Director for UK

COMMENTS

THIS DOCUMENT IS IN THE COURSE OF A SYSTEMATIC PUBLIC DISCLOSURE REVIEW PROCESS

Entered by bhooten Entered on 2008-11-10

WITHDRAWAL NOTICE

PROJECT

Project number	2008-012
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DOCUMENT

Series / File	United Kingdom-Stand-By (97063)
Original box / file No	80 / 1
Date	1975-11-03
Type	Notes on meeting
From	L.A. Whittome & C.D. Finch
To	MD
Subject / Title	U.K. - We met secretly with U.K. officials in Paris on Saturday and Sunday.
Number of pages	4
Classification	SECRET
Authority	European Department

COMMENTS

THIS DOCUMENT IS IN THE COURSE OF A SYSTEMATIC PUBLIC DISCLOSURE REVIEW PROCESS

Entered by bhooten Entered on 2008-11-10

Hans / Michael

BK
given time in London

Revised 2nd quarter GDP Figures

(Seasonally adjusted at 1970 prices)*

1. GDP

GDP(O) fell 2½% in the second quarter (previous estimate 2%). GDP(E) fell 3-3½% in the second quarter, thereby narrowing the difference between the GDP(O) and GDP(E) estimates.

2. Consumers Expenditure

Revised figures have reversed the recent pattern slightly with a small increase between the third and fourth quarter of 1974 (1% compared with 1½%), an increase of ¼% in the first quarter (compared with a fall of ½%), and a fall of 2% in the second quarter (compared with -1½%).

3. Stockbuilding

(£ mn., 1970 prices)

	Latest estimates	Previous estimates
1973	+960	+706
1974	+553	+288
1975 1st quarter	-104	- 79
2nd quarter	-309	(-100)

Latest estimates of aggregate destocking in the first half of 1975 have been revised to over £400 million at 1970 prices, but at the same time the build up of stocks in 1973 and 1974 has been revised up by a further £500 million to £1,500 million. Thus destocking has further to go than previously anticipated.

4. Exports and Imports

Both series have been revised upwards: imports by about £150 million a quarter in 1975, and exports by about £50 million a quarter. The quarter to quarter changes are little changed. It does, however, have the effect of reducing the difference between the GDP(O) and GDP(E) estimates.

Second quarter changes were:-

volume of exports of goods and services	-5-5½%
volume of imports of goods and services	-5%

* Except for 6 and 7 which are at current prices.

Oct

	Oct	III 9
CA	− 100	− 626
Cap	+ 23	− 492
Reg	− 77	− 120
Bal ~~sheet~~		+ 900

Some credit arrangement ~~made this~~ — ① Oil Meggs

② Oil import boosted before price increase

Two months delay in payments In arrangement.

Public ~~sector~~ ~~cap~~

Foreign borrowing in Oct was small !! Public sector as whole ; + 5 million

Mr Hyndman

August 13, 1975

MEMORANDUM FOR FILES

Subject: United Kingdom - Balance of Payments (Current Account) Projections

Given the marked improvement in the current account balance in the first half of 1975,[1] evidence of a deepening U.K. recession together with the further sizable depreciation in the value of sterling in recent weeks, suggests a prospective current account deficit of only some £1.2 billion for 1975 as a whole. This contrasts sharply with our projection in the WEO paper last May of a £2.6 billion deficit--in line with U.K. official thinking. Also, it implies a correspondingly reduced financing requirement in 1975, thereby raising some doubts about the likelihood that the United Kingdom could satisfy the "need" criteria for drawing upon the Fund's 1975 Oil Facility.

Details of the revised current account forecasts for 1975 and first half 1976 are shown in Table 1, with the main purpose of the note being to provide some further elaboration, including a brief summary of the main underlying assumptions.

In constructing the revised current account forecasts, the following assumptions were made:

1. Exchange rates. In 2nd half 1975 the exchange rate of sterling in effective (trade weighted) terms, and against the dollar, is assumed on average to be unchanged from the present level--i.e., an effective rate of about 28 per cent lower (according to the Bank of England's calculations) than at the time of the Smithsonian Agreements, with a U.S. dollar/sterling rate of about \$2.10. This represents an effective depreciation of some 7 per cent between the two halves of 1975. Some further depreciation in the value of sterling is assumed in 1st half 1976 in order to, at least in part, preserve U.K. export competitiveness.

2. Export prices. In 2nd half 1975 the rise in U.K. export prices (in sterling) are expected to be marginally higher than in 1st half 1975, assuming:

   (a) no significant slowdown in the present rate of increase in manufacturers' costs due to the sizable labor cost increases already in the pipeline and the lagged interaction of wages and prices; and

---

1/ For an analysis of this largely cyclical improvement in the U.K. current account balance in first half 1975, see Mr. Vittas' memorandum for files on that subject dated June 20, 1975.

(b) exporters take advantage of the substantial depreciation in sterling that has already occurred between the two halves of 1975 to slightly raise their profit margins.

In 1st half 1976, a significant slowdown in the rate of export price rises is envisaged, on the assumption that the incomes policy measures announced in July 1975, together with the deepened recession, will then be starting to exert a dampening influence on inflation.

3. Export volumes. In 2nd half 1975, U.K. exporters are again assumed to lose export market shares--despite the sharp depreciation of sterling--on the basis of lengthy past experience which suggests that they are "chronic underperformers." Given the likelihood of little if any growth in U.K. export markets between the two halves of 1975, this implies a fall in export volumes between these periods of perhaps 1.5 per cent. (The Research Dept. has initially projected a 0.7 per cent growth in U.K. export markets between the two halves of 1975, but this seems too high.)

In 1st half 1976, the Research Dept.'s projected U.K. markets' growth of 3.6 per cent (from 2nd half 1975), plus the assumption of some further depreciation of sterling, suggests a modest recovery in export volume growth--a rise of 1.5 per cent is projected.

4. Import prices. Between the two halves of 1975 import prices (in sterling) are expected to rise by about 12 per cent. This assumes:

(a) a rise of about 4 per cent in foreign currency terms--in line with current Research Dept. projections;

(b) most of the balance being due to the depreciation of sterling which has already occurred; and

(c) perhaps a 0.5-1.0 percentage point due to an assumed 5-10 per cent rise in the U.S. dollar price of OPEC countries' oil in the fall--although time lags in deliveries and existing stockpiles will probably render any such effect negligible in 1975.1/

1/ Oil imports constitute under 20 per cent of total U.K. imports in value terms.

In 1st half 1976, a further increase in import prices in foreign currency terms of about 4 per cent is expected to correspond to about a 6-6.5 per cent rise in sterling terms, assuming some further depreciation of sterling.

5. Import volumes. After the very sharp decline in the volume of imports in 1st half 1975--which was largely due to substantial decumulation of stocks of industrial materials and fuels--a further, albeit much smaller, fall in the volume of imports is expected in 2nd half 1975. This assumes a continuing depressed level of total domestic demand, including a further (net) rundown in stocks but with the decumulation bottoming out by the end of this year. Certainly, the current level of stock output ratios suggest there is still considerable scope for stock decumulation, and there seems little immediate motive for deliberate stock accumulation other than perhaps sheer speculation in some commodities.

In 1st half 1976 a slight recovery in total domestic demand, including the assumed cessation of the dampening effect of stock decumulation, suggests a small increase in the volume of exports from the previous half year. Assuming a more sizable recovery in domestic demand in 2nd half 1976, import volumes could be expected to pick up rather sharply then.

6. Invisibles balance. The recent sizable depreciation of sterling--as in the past--is expected to boost the net invisibles balance, if only due to a "scale effect" stemming from the fact that the credit items remain significantly larger than the debit items in the invisibles accounts.

7. Financing requirement. With a prospective current account deficit of about £1.2 billion in 1975, and official financing of some £0.4 billion already undertaken (i.e., the final $1 billion drawing on the Government's $2.5 billion Euro-dollar facility), this leaves an outstanding financing requirement of only some £0.8 billion. Given the huge capital inflow last year it seems difficult at first sight to envisage any difficulty meeting the outstanding financing requirement from noninstitutional sources, except in the case of a massive capital outflow.

MH

Michael Hyndman

cc: Mr. Whittome
Mr. Woodley
Mr. Karlstroem

Table 1. United Kingdom: Balance of Payments
Projections - Current Account

	1974	1975	1975 1st half	1975 2nd half	1976 1st half
(In millions of pounds, seasonally adjusted balance of payments data)					
Exports (f.o.b.)	15,589	18,755	8,961	9,794	10,636
Imports (f.o.b.)	-20,848	-21,413	-10,153	-11,260	-12,048
Trade balance	-5,259	-2,658	-1,192	-1,466	-1,412
Invisibles balance	1,488	1,434	734	700	700
Current balance	-3,771	-1,224	-458	-766	-712
(Percentage changes from preceding period)					
Exports (f.o.b.)					
Volume	7.0	-1.5	-0.4	-1.5	1.5
Price (£)	26.5	22.1	10.0	11.0	7.0
Value (£)	35.4	20.3	9.6	9.3	8.6
Imports (f.o.b.)					
Volume	1.2	-10.0	-9.2	-1.0	0.5
Price (£)	49.1	14.4	4.7	12.0	6.5
Value (£)	50.9	3.0	-4.9	10.9	7.0
Terms of trade (£)	-15.2	6.7	15.2	-1.9	1.5

Sources: C.S.O., Economic Trends; D.O.T., Press Releases; and IMF staff (BCD) estimates.

Note 1. These projections are based on the assumption that in 1975 2nd half the average $/£ exchange rate will be unchanged from the present level of around $2.10, but will depreciate further (perhaps by as much as 4 per cent) in 1976 1st half to maintain U.K. export competitiveness.

United Kingdom: Changes in Export and Import Volumes

(Percentage change from previous period, seasonally adjusted)

	Export Volume		Import Volume	
	Balance of payments index	National accounts index	Balance of payments index	National accounts index
	Goods only	Goods and services	Goods only	Goods and services
1974				
I	5.9	4.9	-2.2	-1.8
II	2.1	2.2	-0.5	0.2
III	1.9	0.8	-0.2	-0.3
IV	-7.1	-4.9	-1.8	-2.7
1975				
I	7.7	4.4	-4.9	-4.6
II	-7.8	-5.0 1/	-7.3	-7-0 1/
1973				
1st half				
2nd half	1.9	1.9	5.4	4.2
1974				
1st half	6.4	5.2	-0.6	-0.5
2nd half	-0.8	-0.6	-1.4	-1.5
1975				
1st half	-0.4	-0.8 1/	-9.2	-9.2 1/

Sources: CSO, Economic Trends; DOT, Press Release; and IMF (BCD) staff estimates.

1/ Staff estimate.

M. B. Heyndema

August 1, 1975

MEMORANDUM FOR FILES

Subject: United Kingdom - Balance of Payments Projections

This note presents guesstimates (henceforth described as "projections") for the U.K. balance of payments in 1975 as a whole and spells out the main underlying assumptions. The projections, which were included in a summary form in a recent memo from Mr. Whittome to the MD, are shown in Table 1 in the format that was suggested to the U.K. authorities last May for use in case of an Oil Facility drawing. This format is an adaptation of the standard balance of payments table in Oil Facility papers. The current account figures (items 1 to 6) are the latest staff estimates and are under review in the present round of the short-term forecasting exercise. Item 7 covers payments under the Sterling Guarantee Agreements. These agreements have expired and no payments are due in 1975.

Item 8 is meant to include the so-called compensatory borrowing. This is defined here to include foreign currency borrowing by the U.K. public sector--other than the Central Government--under the exchange cover scheme. Such borrowing can take place either directly or through the intermediation of commercial banks. The relevant information is not shown separately in the standard presentation of balance of payments statistics in U.K. sources but is normally published monthly--together with the reserve figures--in terms of U.S. dollars. In the first half of this year such borrowing amounted to US$477 million or roughly SDR 380 million. The projection for 1975 as a whole (SDR 1,100 million) assumes that the remainder of the Iranian loan (i.e., SDR 640 million) will be fully drawn but that because of doubts about the United Kingdom's "creditworthiness" it will not prove possible to arrange for any substantial further borrowing of this nature. It is also assumed that no substantial repayments of earlier loans are due in 1975.

Item 9, i.e., the change in sterling holdings abroad includes exchange reserves of overseas countries (and international organizations, other than the Fund) held in sterling, either in the form of British Government stocks or banking and money market liabilities, as well as other (presumably private) external banking and money market liabilities in sterling. In the first quarter of the year, there was a net inflow on account of this item of £234 million but there have recently been some reports of withdrawals by oil-exporting countries which now account for the bulk of exchange reserves in sterling (71 per cent at the end of March 1975). The projection for this item in Table 1 implies no net change in 1975 as a whole, but this is obviously no more than a working assumption. What is interesting to note is that if the assumptions and figures relating to other capital flows are not way off the mark the United Kingdom may have an unambiguous balance of payments need even in the absence of any substantial withdrawals of sterling balances.

Item 10 is the net balance of "import credit," "export credit," and "other short-term capital flows." The tabulation below shows the development of each of these items in recent years and tentative projections for 1975, in millions of pounds.

	1972	1973	1974	1975 1/	
Import credit	207	223	27	--	(-37)
Export credit	-359,	-343	-453	-400	(-189)
Other short-term flows	-425	-275	-166	-200	(-107)
Total	-577	-395	-592	-600	(-333)

1/ Figures in brackets are provisional estimates for the first quarter of the year.

No change in import credit is assumed because imports are likely to remain depressed through the end of the year. New export credit is assumed to be much lower than the first quarter figures imply, mainly because the short-term outlook for exports is not very good. The projection for short-term flows is no more than a convenient round figure that is not out of line with the recent record.

Item 10, i.e., "Other capital, net" lumps together a heterogeneous set of capital flows which in standard U.K. sources are identified separately under the headings shown below plus a residual item which in principle includes inflows of foreign capital to the U.K. public sector other than those covered by the exchange cover scheme. Recent developments and projections for these items are as follows (in millions of pounds).

	1972	1973	1974	1975	
Official long-term capital	-255	-252	-274	-275	(-64)
Overseas investment in U.K. private sector	774	1,613	1,930	1,500	(283)
U.K. private investment overseas	-1,393	-1,623	-1,244	-1,700	(-539)
Overseas currency borrowing or lending by U.K. banks to finance:					
U.K. investment overseas	725	590	255	400	(-40)
Other (n.i.e.)	-254	-58	-554	-325	(-52)
Residual inflow to U.K. public sector 1/	113	72	138	--	(...)
Total	-290	342	251	-400	(...)

1/ This is calculated as the net balance of "Overseas investment in U.K. public sector" plus "Overseas currency borrowing by banks to finance lending to U.K. public sector" minus Item 8 in Table 1.

Official long-term capital is a fairly stable item. It is assumed that easier (than in 1974) liquidity conditions in the U.K. company sector, the lack of investment opportunities at home (other than in North Sea) and exchange rate uncertainties will combine to produce a clear shift in private nonbank investment flows in favor of the overseas sector. It seems reasonable to assume that this shift will be financed to some extent by banking capital raised overseas.

"Net errors and omissions" (Item 12 in Table 1) were very large and positive in 1974. It is believed that they reflected mainly unrecorded inflows to the U.K. company sector which was experiencing at the time severe liquidity constraints. For 1975 a small positive figure is assumed--even though in the first quarter of the year this item was still showing a very large (but partly seasonal) capital inflow--because liquidity conditions in the U.K. company sector are expected to be much easier than in 1974.

The table shows for 1975 an overall deficit of nearly SDR 3 billion. This should be compared with an actual deficit in the first half of 1975 of close to SDR 1.3 billion, financed by a decline in reserves which at constant exchange rates amounted to some SDR 500 million and the drawing in early 1975 of the remainder of the US$2.5 billion Euro-dollar loan (SDR 800 million). Thus, the "projections" in Table 1 do not appear to imply any marked change of trends between the first and the second halves of 1975.

H. Vittas

Suggested Oil Facility Format July 30, 1975

Table 1

United Kingdom: Summary Balance of Payments

(In millions of SDRs) 1/

	1972	1973	1974	1975 Projection
1. Exports, f.o.b.			29,930	35,615
Of which:				
Petroleum and petroleum products			1,336	
2. Imports, f.o.b.			40,028	40,350
Of which:				
Petroleum and petroleum products			-7,953	
3. Trade balance (1+2)			-10,097	-4,735
4. Services and transfers (net)			455)	2,475
5. Interest, profits, and dividends (net)			2,401)	
6. Current account balance (3+4+5)			-7,240	-2,260
7. Capital transfers 2/			-144	--
8. Foreign currency borrowing by public sector other than Central Government			2,342	1,100
9. Increase in sterling holdings abroad			2,991	...
10. Trade credit (net) and other short-term flows			-1,136	-1,135
11. Other capital (net)			482	-755
12. Net errors and omissions			1,620	190
13. Total (7+8+9+10+11+12)			-1,085	-2,860
14. Allocation of SDRs			--	--
15. Surplus or deficit (-) (6+13+14)			-1,085	-2,860
16. Financing				
Monetary authorities			1,085	2,860
Assets (- increase)			-163	160
(of which reserve position in the IMF)			(-89)	(232)
Liabilities (+ increase)			1,248	2,700
(of which use of Fund credit)			(--)	(1,900)
under--Oil Facility			(--)	(1,200)
Other			(--)	(700)
Euro-dollar loan			(1,248)	(800)

Memorandum items:

Maximum access to 1975 Oil Facility (SDR millions)				1,750

Source: Data provided by U.K. authorities and staff estimates.

1/ Sterling figures are converted into SDR by applying Rule 0-3 conversion factors at average quarterly values of (in SDR per £) 2.304 in 1972, 2.061 in 1973, and 1.92 in 1974, and in 1975 at the average monthly values prior to preparation of this table (1.894).

2/ Payments under the Sterling Agreements.

Extract from NIESR Economic Review, Aug. 1975.

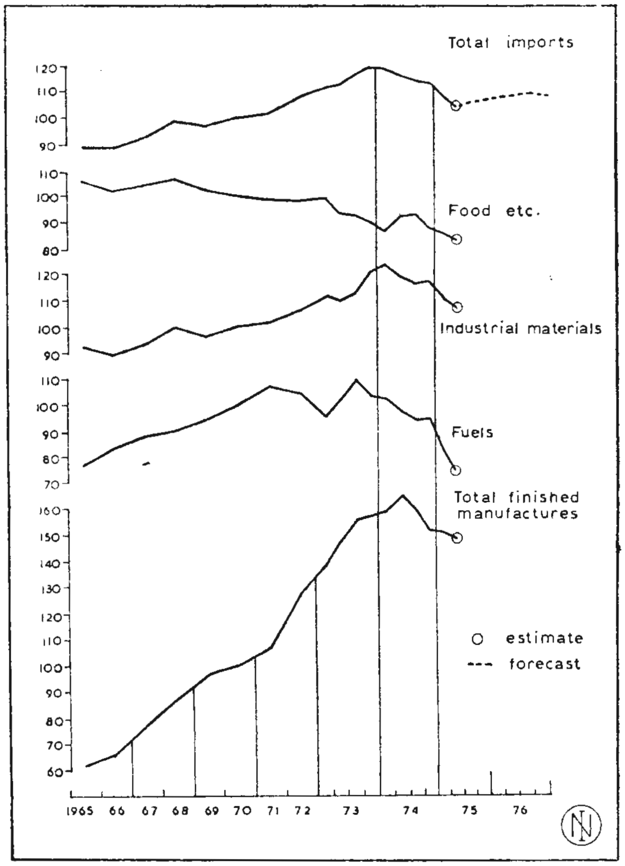
imports were totally price-inelastic.[1] However, there is some evidence that UK price competitiveness has, since the floating of the pound, been rather better than in 1968 and 1969. On the export side this is shown fairly clearly by the movement of prices of UK manufactured exports (in dollars) relative to world prices (table 2), and a similar picture is given by the (sterling) ratio of export to import prices of total manufactures (even though semi-manufactures have very different weights in exports and imports). The story is not corroborated by some other indices (for example the ratio of domestic wholesale to import prices of manufactures) but this may well be due to inadequacies in the indices used.

For the forecast it is fairly clear that we should continue to allow for at least the existing degree of 'saving' of food and fuel imports (the latter increasingly augmented by North Sea oil production).[2] Equally, the forecast for industrial materials imports should clearly follow the stockbuilding forecast. But, as usual, the big uncertainty lies with finished manufactures. The assumptions we make below about domestic inflation and the exchange rate imply some small loss of competitiveness through the forecast period; but against this the level of imported equipment for use in the North Sea may now be reaching a peak, and we are now assuming an even faster decline in shipping investment (where the import content has recently been very high).

The overall result (chart 4) is that we are forecasting that the import content of total demand will rise slowly from the second quarter of 1975 until the middle of next year when the build-up of domestic oil production will check it. But it has to be admitted that, once the forecasters' relationships begin to err by as much as our import equation has done this year, the element of 'judgement' or sheer guesswork in the forecast becomes very large.

Chart 4. Import ratios

Volume ratios, 1970=100[a]



Source: *Trade and Industry, National Income and Expenditure*, NIESR estimates.

(a) The curves indicate ratios of imports to the following categories of demand: total imports to total final expenditure; food-beverages-tobacco imports to total consumers' expenditure on food, drink and tobacco; industrial materials to manufacturing production; fuels to GDP (average estimate); and total finished manufactures to the sum of consumers' expenditure on durables and fixed investment in plant and machinery. 1975 II estimated by NIESR.

The forecast

The UK forecast is set out in tables 1–7. As usual our calculations assume no further changes in government policy beyond those already announced. This means that the forecasts are probably not a good guide to what will actually happen. If our unemployment forecast is anywhere near right, it seems to us quite likely that policies will be changed.

The exchange rate is assumed (as the most likely outcome) to fall further, though only slowly, reaching an effective devaluation of 30 per cent from the Smithsonian level by the end of next year. A small loss of price competitiveness is involved in this assumption.

We have also assumed that the £6 pay limit will generally be held, with only minor exceptions. In many cases the policy seems to be gaining acceptance by trade union members as well as by certain national leaders.

The general picture painted by the forecast is one of severe recession brought about basically by the rise in oil prices and the failure of governments to offset its recessionary consequences. For the UK the recession is coming late relative to the experience in other countries. The fall in real personal disposable income, which would otherwise have been brought about by the rise in oil and other world prices, was largely offset last year by a combination of (unannounced) increases in government expenditure on subsidies and wage inflation which soared ahead of price increases. Now that wage increases are to be

[1] However, our present forecasting equation for imports of goods does contain a relative price term with a long-run elasticity of 0.8. But this fails to capture the extent of the overall fall in imports so far this year even after allowing for the fuel effect and for destocking of raw materials.

[2] For convenience we are assuming that domestic oil production will replace imports; in fact it will probably be largely exported.

Table 2. UK price competitiveness in manufactures

Indices, 1970 = 100; percentages

	Other countries' export prices ($)	UK export prices ($)	Relative prices	UK share in world trade in manufactures (per cent)	Ratio of UK export to import prices: total manufactures
1965	89	92	103	13.9	101.2
1966	89	96	108	13.4	103.0
1967	90	95	106	12.3	103.6
1968	91	90	99	11.6	97.8
1969	92	93	101	11.3	97.9
1970	100	100	100	10.8	100.0
1971	105	107	102	10.9	104.0
1972	113	116	103	10.0	106.7
1973	134	127	95	9.4	98.4
1974	163	153	94	8.9	93.1
Forecast					
1975	*191*	*180*	*94*	*9.6*	*102*
1976	*200*	*193*	*97*	*9.7*	*107*
1974 I	146	134	92	8.7	91.6
II	162	153	95	8.8	91.6
III	168	159	95	9.1	93.6
IV	176	165	94	8.8	95.5
1975 I	188	178	95	9.8	97.8
Estimate					
II	192	182	95	9.5	100.0
Forecast					
III	*190*	*177*	*93*	*9.5*	*103*
IV	*193*	*184*	*95*	*9.7*	*106*
1976 I	*196*	*189*	*96*	*9.8*	*107*
II	*199*	*192*	*96*	*9.8*	*107*
III	*202*	*195*	*97*	*9.7*	*107*
IV	*204*	*197*	*97*	*9.6*	*106*

Source: Table 19, page 70, *Monthly Digest;* NIESR estimates.

controlled, and subsidies reduced, real incomes and expenditure are likely to fall for two years. Our forecast is that consumers' expenditure will fall by ½–1 per cent both this year and next.

The depression of personal spending this year is occurring at the same time as the fall in world trade has intensified. Private industrial investment, in both stocks and fixed assets, is also turning down sharply, so that real GDP may fall by about 2 per cent between the fourth quarters of 1974 and 1975.

Next year we are assuming that the rest of the world economy will be moving out of recession at a fairly moderate pace. After falling by around 9 per cent this year, the volume of world trade in manufactures is forecast to rise by 6–7 per cent through the twelve months from the end of this year. Over the same period the volume of total UK exports is forecast to rise by 4 per cent. At the same time, the violent stock adjustment at home should be coming to an end, private industrial investment may fall less steeply and North Sea oil should begin to arrive in significant quantities.

However, real personal disposable income and expenditure are forecast to be still declining, while the growth rate of public spending is forecast to slow down in 1976. Thus, although GDP may start rising again, it will do so more slowly than productive potential.

Unemployment is therefore forecast to continue rising throughout the forecast period, rapidly reaching 1¼ million during this winter (UK, seasonally adjusted excluding school leavers and adult students) and continuing to rise to between 1⅓ and 1½ million by the end of 1976.

Our expectation that the new pay policy will be observed means that we are forecasting a rapid deceleration in the rate of price inflation, though (with other policies unchanged) not quite to the single figures officially expected. In terms of the implicit deflator of consumers' expenditure, prices are forecast to rise by 22 per cent through this year and by just

Table 3. Leading indicators of fixed investment

	Public dwellings			Private dwellings			Mainly private industries				Mainly public industries
	Starts[a]	Contractors' new orders[b]	Improvement grants[c]	Starts[a]	Contractors' new orders[b]	Improvement grants[d]	New home engineering orders volume	Contractors' new orders[e]	CBI Intentions Survey[f] Building	CBI Intentions Survey[f] Plant and machinery	Contractors' new orders[g]
1970 ..	154.1	100	59.5	165.1	100	120.5	99	100	−20	− 5	100
1971 ..	136.1	85	89.0	207.3	117	143.5	98	74	−31	−22	121
1972 ..	123.0	87	136.8	227.4	142	231.2	108	83	− 9	+11	119
1973 ..	112.8	80	188.1	214.9	131	265.4	136	104	+12	+36	102
1974 ..	146.8	87	121.4	105.0	63	179.1	106	87	−22	−10	81
1973 I..	31.2	78	41.8	63.5	173	62.9	134	94	+ 4	+30	115
II..	26.9	78	41.7	55.6	129	70.7	134	98	+11	+35	112
III..	27.2	84	58.4	52.8	121	66.6	143	111	+18	+39	106
IV..	27.5	78	46.2	43.0	102	65.2	132	117	+16	+38	74
1974 I..	35.7	78	37.8	34.1	65	68.5	109	83	−15	− 3	62
II..	38.9	82	30.0	26.1	62	47.5	114	83	−10	+ 2	64
III..	36.7	98	22.7	22.5	63	33.7	107	104	−22	− 6	91
IV..	35.5	89	30.9	22.3	63	29.4	93	83	−39	−33	105
1975 I..	44.4	104	22.0	34.4	69	23.0	87	77	−47	−41	71
II..	36.5	104[i]	15.5	35.7	71[i]	27.0	83[h]	55[i]	−42	−27	73[i]
III..									−39	−24	

Source: *Economic Trends, Trade and Industry, Housing and Construction Statistics,* Department of the Environment Press Notices.

(a) Thousands of dwellings, seasonally adjusted, GB.
(b) Indices of new orders received by contractors for new housing, 1970 prices, seasonally adjusted, GB.
(c) Number of house improvement grants approved for local authorities, thousands, GB.
(d) Number of house improvement grants approved for private owners and housing associations, thousands.
(e) Indices of new orders received by contractors for private industrial work, 1970 prices, seasonally adjusted, GB.
(f) Twelve-month forecast of investment authorisation—percentage balance of those indicating up or more over down or less.
(g) Indices of contractors' new orders for public works, 1970 prices, seasonally adjusted, GB.
(h) April.
(i) Average of April and May.

over 11 per cent through next. In terms of the retail price index, the rate may be about 2 (or more) per cent per annum greater. However, by the end of next year the quarter-to-quarter movement of retail prices may be down to 11–12 per cent at an annual rate.

The balance of payments forecast has been changed substantially; for this year the deficit in the current account is put as low as £¾ billion, an improvement of £3 billion on last year's outcome. The forecast for next year shows a further but much smaller improvement. However, in the light of our recent errors, we put little weight on the actual number. The major influences next year (which work in opposite directions on the balance) are expected to be an end to the destocking of raw materials and an upturn in the world economy which will be ahead of the movement of domestic (UK) demand.

Uncertainties in the forecast

With the exception of the balance of payments, the outlook has been presented above as though we felt our usual degree of confidence in the forecasts. In fact this is not so; there are several areas in which major uncertainties are present and it may assist the reader to make his own assessment of our forecasts if the important ones are pointed out.

At root the problem is that in what is generally agreed to be an 'unprecedented' situation the experience of the past (on which both econometric and less sophisticated forecasting methods rely) is a poor guide to the future. The behaviour of economic decision-makers in response to changes in various economic variables may be different from the average of past experience. In addition the levels or rates of change of some variables (e.g. unemployment and world trade respectively) are well outside anything experienced over the sample period of the data used to estimate the forecasting relationships. It is a standard result in econometric theory that, when this is the case, the statistical error band surrounding any forecasts increases quite sharply.

To begin with the world economy, the OECD as

Table XX. Central Government Accounts

(In millions of pounds)

	1972/73	1973/74	1974/75		1975/76 estimates	
	Outturn		March budget estimates	Provisional outturn 1/	Before budget changes	After budget changes
Current receipts						
Taxes on income	8,257	9,595	13,033	13,146	15,856	16,074
National insurance contributions, etc.	3,483	4,099	5,221	5,435	6,635	6,635
Taxes on expenditure	7,053	7,489	9,012	8,619	9,392	10,520
Other	1,651	1,918	2,154	2,117	2,501	2,496
Capital receipts (net)	1,070	1,177	365	1,242	251	156
Total receipts	21,514	24,278	29,785	30,559	34,635	35,881 (17.4)
Current expenditure						
Goods and services	7,062	7,980	9,441	10,517	13,022	13,029
Grants and subsidies	10,489	12,527	15,072	17,115	21,836	21,849
Debt interest	1,628	1,915	2,116	2,197	2,987	2,987
Capital expenditure						
Gross domestic capital formation (including stocks)	696	882	1,049	991	1,256	1,256
Grants (including capital transfers abroad)	986	1,050	1,273	1,271	1,488	1,488
Net lending, etc.	2,477	1,797	2,359	3,577	3,074	3,099
Total expenditure	23,338	26,151	31,310	35,668	43,663	43,708 (22.5)
Borrowing requirement (-)	-1,824	-1,873	-1,525	-5,109	-9,028	-7,827

Sources: Bank of England, Quarterly Bulletin; and Her Majesty's Stationery Office, Financial Statement and Budget Reports, 1974/75, 1975/76.

1/ Includes the effects of policy changes incorporated in the July and November 1974 budgetary measures.

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1/ Includes the effects of policy changes incorporated in the July and November 1974 budgetary measures.

Mr. Whittome July 25, 1975

Michael Hyndman

United Kingdom: Impact of July 1975 Counter-Inflation Measures on PSBR

In recent weeks there has been renewed speculation in the U.K. press about the probable size of the public sector's borrowing requirement (PSBR) in 1975/76. Some unofficial estimates now put this as high as £12 billion, compared with £9.1 billion projected in last April's Budget. This note is concerned with one[1/] of two main reasons for the sudden revival of interest in reassessing the prospective size of the 1975/76 PSBR—the publication on July 11 of a White Paper outlining proposed new counter-inflation measures due to take effect for 12 months from August 1.

According to Whitehall sources the new measures—which center on a £6-per-week limit on pay rises during the next 12 months—will tend to reduce the PSBR in 1975/76. These sources argue that the beneficial impact of the new pay limit on public sector wage/salary increases should outweigh the effect of lower revenue due to the weaker outlook for demand. To check the validity of this conclusion, we have made an independent assessment of the probable impact of the new measures on the PSBR in 1975/76 using—wherever possible—actual or implicit official data projections.

Our calculations (which are set out in detail in the attached appendix) suggest that the July 1975 measures may well add some £0.5 billion to the PSBR in 1975/76 rather than reduce it slightly—assuming strict compliance with the pay limit. This net impact is made up as follows:

£ million	
-800	expenditure saving (-)
1,140	income tax loss (+)
195	indirect tax loss (+)
534	

As yet there is insufficient information to make a reliable estimate of the measures' likely impact on the PSBR in 1976/77. However, it is clear that any savings then arising from the pay limit will be partially offset by the extra £70 million in food subsidies in 1976/77 and an (officially estimated) £80 million revenue loss in 1976/77 due to the 60 pence per week limit on council-rent increases.

Also, as a by-product of this assessment, we estimate that the first-round direct demand impact of these measures in 1975/76 is likely to be of the order of -£900 million, in current prices, compared with a little under

1/ The other was the almost simultaneous revelation of supplementary estimates for public expenditure in 1975/76 totaling some £2 billion, although probably only some £200 million of this was not accounted for in the April 1975 Budget.

-£550 million according to Whitehall sources. To the extent that our data and assumptions provide a reasonably accurate picture of the official prognosis prior to the measures, this discrepancy suggests that the authorities are not expecting the new pay limit to be adhered to rigidly. Instead, they may be envisaging slippage amounting to a 12-months rate of increase in wages and salaries of some 14-15 per cent (not the 10 per cent implied by the £6-per-week limit).

One final note of caution is necessary regarding the foregoing calculations, insofar as they depend heavily on the assumption that there will be no significant reduction in prices attributable to the new measures during the second half of fiscal year 1975/76 (i.e., October 1, 1975 through March 31, 1976). This may be unduly pessimistic, although it seemed defensible at the time of calculation, in view of the normal lag before wage rate changes are passed on. Nevertheless, this assumption could perhaps be weakened and this would tend to lower the net increase in the PSBR due to the July 1975 measures.

cc: Mr. Karlstroem
Mr. Vittas

APPENDIX

UNITED KINGDOM

Impact of July 1975 Counter-Inflation Measures on PSBR

The net impact on the PSBR of the United Kingdom's new counter-inflation measures--which center on a £6-per-week limit to pay rises during the next 12 months--is essentially equal to: the saving in public expenditure arising from a lower public sector wage bill, less the reduction in both direct and indirect taxes due to lower money incomes in the economy as a whole.

Impact on public expenditure

In estimating the reduction in public expenditure likely to result in 1975/76 from the new counter-inflation measures, the following simplifying assumptions were made:

(1) The July 1975 measures' impact on public expenditure in the first half 1975/76 will be negligible, since no further major pay settlements are likely in either the public or private sectors until the second half of 1975/76.

(2) During second half 1975/76, the 12-months rate of increase in public sector wages and salaries will now be held to exactly £6 a week, which--according to official calculations--is equivalent to an average rate of increase of about 10 per cent.

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(3) The public sector's wage/salary bill also will now rise at a 12-months rate of exactly 10 per cent in second half 1975/76 (i.e., the rate of growth of average earnings and wage rates are assumed to be identical).

23

(4) The April 1975 Budget estimate of the PSBR in 1975/76 was derived on the basis of an implicit 12-months deflator for current public expenditure in second half 1975/76 of some 17.5 per cent--this was interpolated from calendar half-year data provided to the staff during the last mission to London. Accordingly, it is assumed that the public sector's wage/salary bill in second half 1975/76 was officially expected, prior to the July 1975 measures, to rise at a 12-months rate of 17.5 per cent.

(5) Wages and salaries comprised 31 per cent of the April 1975 Budget projection of current public expenditure in 1975/76--in accordance with Public Expenditure to 1978/79 (Cmnd. 5879).

(6) Prior to the July 1975 measures, some 53 per cent of the foregoing 1975/76 wage/salary bill estimate probably would have been incurred in the second half of the financial year--based on recent trends.

(7) Because of normal time lags in price adjustment, there will be no significant reduction in prices in 1975/76--and thus public expenditure--as a result of the lower wages and salaries implied by the new measures.

Given the foregoing assumptions, the reduction in public expenditure in 1975/76 attributable to the new counter-inflation measures is equivalent to the difference between the pre- and post-measures estimates of the public sector wage/salary bill in second half 1975/76. The pre-measure estimate is calculated as

(total current public expenditure in 1975/76)(0.31)(0.53)
= (£42,587 million)(0.31)(0.53)
= <u>£7,000 million</u>

The post-measures estimate is simply the pre-measures estimate reduced by a factor equal to the ratio of the pre- to post-measures assumed rate of growth in the public sector wage/salary bill. Thus, the post-measures estimate equals

(£7,000 million)(1.10/1.175)
= (£7,000 million)(0.936)
= <u>£6,550 million</u>

Thus, the July 1975 measures are estimated to reduce public expenditure in 1975/76 by some <u>£450 million</u> (£7,000 million - £6,550 million).

The above estimate, however, will underestimate the public expenditure-saving impact of the measures to the extent that:

(1) the wages and salaries component of the implicit official deflator for current public expenditure in second half 1975/76 is higher than the goods and other items components--this seems likely since from mid-1974 the rise in wage rates has continued to outpace that of prices by a substantial margin (currently some 6 percentage points); and

(2) average earnings and wage rates in the public sector are higher on average than in the economy as a whole and, therefore, the £6-per-week pay limit--which is officially estimated as being equivalent to an average 12-months rise of about 10 per cent for the economy as a whole--would be equivalent to a lower percentage rise in the public sector.

With these two considerations in mind, the likely reduction in public expenditure as a result of the July 1975 measures was re-estimated on the revised assumptions that:

(1) the implicit deflator (w) for the wage and salaries component of current public expenditure in second half 1975/76 was 22.5-25 per cent; and

(2) the £6-per-week pay limit (w') is equivalent on average in the public sector in second half 1975/76 to a 12-months rise of 8-9 per cent.

Depending on the values assigned to w and w', the revised estimate of the expenditure saving ranged from about £750 million to £950 million, with the best estimate judged to be that corresponding to w = 9 per cent, and w' = 23 per cent, i.e.,

$$£7{,}000 \text{ million} - (£7{,}000 \text{ million})\left(\frac{1.09}{1.23}\right)$$
= <u>£800 million</u>

Impact on income tax receipts

To the extent that the new counter-inflation measures cause money incomes in the economy to be lower than they otherwise would have been, there will be a corresponding reduction in income tax receipts.1/

In estimating the extent of this revenue loss in 1975/76, the following assumptions were made:

(1) The income tax revenue loss in 1975/76 due to the July 1975 measures will be confined to the latter half of that fiscal year.

(2) Only the income from employment component of total personal income in second half 1975/76 will be directly affected by the new measures.

(3) The pre-measures employment income in second half 1975/76 is interpolated from (confidential) official calendar six-monthly projections to be £34,430 million.

(4) The pre-measures implicit official estimate of the 12-months rate of growth in employment income in second half 1975/76 was 19 per cent.

(5) The post-measures rate of growth of employment income in second half 1975/76 will be held to 10 per cent.

(6) The pre-measures employment income in second half 1975/76 will comprise 69.5 per cent of the pre-measures total personal income in that period--i.e., the same proportion as in 1974.

(7) Income tax in second half 1974/75 is deduced to be £10,862 million.

(8) The fiscal drag coefficient is 1.7.

In addition, the following notation is used to show the method of calculation:

T_i = total personal income tax (including National Insurance, etc. contributions)

EY_i = income from employment

PY_i = total personal income

f = fiscal drag coefficient

i = 0,1; where 0 = second half 1974/75, and
1 = second half 1975/76

an asterisk (as in T_i^*) indicates the post-measures value of a variable

Using the above notation, the income tax revenue loss in 1975/76 due to the July 1975 measures (i.e., $T_1^* - T_1$) was derived as follows:

(1) Pre-measures values

$$EY_1 = (1.19)(EY_0) = £34,430 \text{ million}$$

$$\therefore\ EY_0 = 34430/1.19 = £28,933 \text{ million}$$

1/ Including National Insurance, etc., contributions.

$$EY_1/PY_1 = 0.695 = EY_0/PY_0$$
$$\therefore\ PY_1 = 34430/0.695 = £49,540 \text{ million}$$
$$\text{and } PY_0 = 28933/0.695 = £41,630 \text{ million}$$

$$T_0 = £10,682$$
$$f = 1.7$$
$$\Delta T_1 = T_1 - T_0$$
$$\Delta PY_1 = PY_1 - PY_0 = 49540 - 41630 = £7,910 \text{ million}$$

$$\Delta T_1/T_0 = (f)(\Delta PY_1/PY_0)$$
$$\therefore\ \Delta T_1 = (T_0)(f)(\Delta PY_1/PY_0)$$
$$= (10682)(1.7)(7910/41630)$$
$$= (10682)(0.323) = £3,450 \text{ million}$$
$$\text{and } T_1 = T_0 + \Delta T_1 = 10682 + 3450 = \underline{£14,130 \text{ million}}$$

(2) Post-measures values

$$EY_1^* = (1.10)(EY_0) = (1.10)(28933) = £31,825 \text{ million}$$

$$PY_1^* = EY_1^* + (PY_1 - EY_1)$$
$$= 31825 + 49540 - 34430 = £46,935 \text{ million}$$

$$\Delta PY_1^* = PY_1^* - PY_0 = 46935 - 41630 = £5,305$$

$$\Delta T_1^*/T_0 = (f)(\Delta PY_1^*/PY_0) = (1.7)(5305/41630) = 0.216$$

$$T_1^* = (1 + \Delta T_1^*/T_0)(T_0)$$
$$= (1.216)(10682) = \underline{£12,990 \text{ million}}$$

(3) Income tax revenue loss

The income tax revenue loss due to the new measures is given by

$$T_1^* - T_1 = 12990 - 14130$$
$$= \underline{-£1,140 \text{ million}}$$

Impact on indirect tax receipts

Indirect tax revenue in 1975/76 will be reduced as a result of the new measures insofar as they (directly) cause a fall in consumers' expenditure and/or (indirectly) any reduction in the prices of goods and services upon which ad valorem taxes are levied. But this loss conceivably could be partially offset to the extent that any reduction in prices attributable to the measures, induced a fall in the average propensity to save[1] and thus an increase in consumption.

The loss in indirect tax revenue in 1975/76 resulting from the July 1975 measures is calculated on the basis of the same assumptions used in estimating their impact on public expenditure and income tax revenue. In addition, it is assumed that:

(1) The ratio of indirect tax to consumers' expenditure in second half 1975/76 will be 22 per cent--i.e., unchanged from 1974.

? (2) The pre-measures official estimate of the average propensity to save in second half 1975/76 was 8.8 per cent--this was interpolated from calendar half-yearly data.

(3) The post-measures average propensity to save in second half 1975/76 will be only 7.5 per cent--some reduction is expected insofar as people probably will tend to maintain their past level of consumption for a while.

Likewise, the same notation is used, with the following additions:

IT_i = indirect taxes

C_i = consumers' expenditure

APC_i = average propensity to consume

APS_i = average propensity to save.

The indirect tax revenue loss in 1975/76 due to the new counter-inflation measures (i.e., $IT_1^* - IT_1$) was derived as follows:

(1) Pre-measures values

$$APC_1 = 1 - APS_1 = 0.912$$

$$IT_1/C_1 = 0.22$$

$$C_1 = (APC_1)(PY_1 - T_1)$$
$$= (0.912)(49540 - 14130) = (0.912)(35410)$$
$$= £32,295$$

$$IT_1 = (0.22)(C_1) = (0.22)(32295) = \underline{£7,105 \text{ million}}$$

(2) Post-measures values

$$APC_1^* = 1 - APS_1^* = 0.925$$
$$IT_1^*/C_1^* = 0.22$$
$$C_1 = (APC_1^*)(PY_1^* - T_1^*)$$
$$= (0.925)(46935 - 12990) = (0.925)(33945)$$
$$= £31,400 \text{ million}$$
$$IT_1^* = (0.22)(C_1) = (0.22)(31,400) = \underline{£6,910 \text{ million}}$$

(3) Indirect tax revenue loss

The indirect tax revenue loss due to the new measures is given by

$$IT_1^* - IT_1 = 6910 - 7105$$
$$= \underline{-£195 \text{ million}}$$

Direct impact on demand

The first-round direct demand impact of the new measures in 1975/76, on the foregoing assumptions, is given by

$$C_1^* - C_1 = 31400 - 32295$$
$$= \underline{-£895 \text{ million}}$$

This compares with a Whitehall estimate of -£300 million (presemably) in constant 1970 prices, or about -£540 million in current prices.

Net impact on PSBR

The net impact of the new counter-inflation measures on the PSBR in 1975/76 is given by

£ million	
-800	expenditure saving (-)
1,140	income tax reduction (+)
195	indirect tax loss (+)
534	

Thus, some £0.5 billion is likely to be added to the PSBR in 1975/76 as a result of the new measures, assuming they have no significant price effect during this period.

INTERNATIONAL MONETARY FUND

TO :

FROM:

Times 12/22/75

MONEY SUPPLY

The following are the figures released for the monthly amount of the money stock, seasonally adjusted, at the month-end make-up date.

	M1 £000m	M3 £000m	Percentage change over 3 months at Annual rate M1	M3
1974				
Nov	13.0	35.6	10.0	7.7
Dec	13.2	35.8	17.0	10.0
1975				
Jan	13.7	36.0	28.3	9.7
Feb	13.7	36.3	19.1	8.1
March	13.9	36.9	20.5	12.8
April	14.3	36.9	17.0	10.4
May	14.4	37.5	22.0	13.9
June	15.1	37.4	12.8	5.8
July	15.5	37.6	12.8	8.0
Aug	15.7	38.4	18.1	10.0
Sept	16.1	38.6	28.9	14.3
Oct	16.1	39.0	17.6	15.1
Nov	15.9	38.7	3.9	3.6

Banks in the United Kingdom: summary

£ millions

Liabilities

	Notes outstanding	Sterling deposits: Total	Sight deposits: Total sight deposits	Sight deposits: UK banking sector	Sight deposits: Other UK	Sight deposits: Overseas	Time deposits: Total time deposits	Time deposits: UK banking sector	Time deposits: Other UK	Time deposits: Overseas	Certificates of deposit
1975 May 21	294	44,235	13,645	1,124	11,050	1,470	26,703	6,954	17,940	1,810	3,887
June 18	297	44,307	13,600	1,224	10,863	1,513	26,827	6,918	18,093	1,817	3,881
July 16	309	44,623	13,882	1,251	11,124	1,506	26,941	6,638	18,424	1,879	3,801
Aug. 20	298	44,811	14,181	1,174	11,511	1,496	27,131	6,829	18,395	1,907	3,500
Sept. 17	299	44,112	13,924	1,229	11,271	1,425	26,981	6,513	18,560	1,909	3,207

Liabilities *continued*

	Other currency deposits: Total	Sight and time deposits: UK banking sector	Sight and time deposits: Other UK	Sight and time deposits: Overseas	Certificates of deposit	Sterling and other currencies: Items in suspense and transmission	Capital and other funds	Total liabilities and assets	Eligible liabilities: Total	Eligible liabilities: Interest-bearing	Reserve ratio
1975 May 21	70,321	15,368	1,928	48,065	4,960	2,064	7,685	124,598	32,603	22,575	13·7
June 18	71,728	15,786	2,014	48,718	5,210	1,946	7,700	125,979	32,382	22,333	14·6
July 16	76,257	17,210	1,982	51,657	5,407	2,132	8,167	131,489	33,211	23,003	15·0
Aug. 20	77,799	17,106	2,049	53,129	5,514	1,985	8,199	133,092	33,049	22,635	15·1
Sept. 17	79,783	17,741	2,277	54,104	5,661	1,838	8,187	134,220	32,978	22,705	15·9

Sterling assets

	Notes and coin	Reserve assets: Total	Balances with Bank of England	Money at call: Discount market	Money at call: Other	UK and NI Treasury bills	Other bills: Local authority	Other bills: Commercial	British government stocks 0–1 year	Special and supplementary deposits
1975 May 21	1,082	4,479[a]	314	2,055	258	735	143	613	356	950
June 18	1,088	4,733[a]	299	1,988	253	1,075	150	604	359	959
July 16	1,121	4,996	250	1,946	262	1,425	156	601	356	953
Aug. 20	1,098	4,993	227	1,723	234	1,583	131	577	518	978
Sept. 17	1,079	5,260	305	1,589	221	1,965	135	542	503	973

Sterling assets *continued*

	Market loans (other than Reserve Assets): Banks in UK	Loans to discount market	Certificates of deposit	UK local authorities	Other UK	Overseas	Bills (other than Reserve Assets): Other public sector	Other
1975 May 21	7,652	229	2,341	2,044	365	449	10	549
June 18	7,820	579	2,392	2,084	431	491	11	581
July 16	7,571	445	2,420	2,066	387	523	9	615
Aug. 20	7,565	729	2,208	2,148	383	562	6	643
Sept. 17	7,327	811	1,970	2,170	418	513	4	642

Sterling assets *concluded*

	Advances: Total	UK public sector	UK private sector	Overseas	Investments: British government stocks: Over 1 year to 5 years	Over 5 years and undated	Other: Public sector	Other: Other	Sterling and other currencies: Miscellaneous assets: Items in suspense and collections	Assets leased	Other
1975 May 21	24,606	458	22,047	2,101	1,240	313	87	1,613	3,250	91	2,251
June 18	24,082	310	21,692	2,080	1,305	277	76	1,623	2,956	85	2,180
July 16	24,855	364	22,382	2,109	1,382	304	84	1,616	3,245	87	2,186
Aug. 20	24,630	369	22,115	2,146	1,250	306	98	1,628	3,112	88	2,262
Sept. 17	24,316	333	21,829	2,155	1,332	302	101	1,575	2,716	84	2,232

Other currency assets

	Market loans and advances[b]: Total	Banks in UK and discount market	Certificates of deposit	UK public sector	UK private sector	Overseas	Bills	Investments: Total	Investments: UK	Investments: Overseas	Acceptances: Sterling	Acceptances: Other currencies
1975 May 21	70,057	15,687	1,452	2,351	4,563	46,005	329	616	28	588	2,250	232
June 18	71,224	16,003	1,505	2,388	4,821	46,507	360	648	32	616	2,241	217
July 16	75,648	17,376	1,530	2,489	4,932	49,321	332	643	42	601	2,178	220
Aug. 20	77,459	17,287	1,560	2,542	5,108	50,962	308	640	43	597	2,140	212
Sept. 17	79,424	17,861	1,688	2,592	5,177	52,105	328	644	45	599	2,091	188

[a] Also includes £5 million other reserve assets. See 'Competition and credit control; further developments' in the March 1973 *Quarterly Bulletin* page 51. The transitional period was extended to June 1975.

[b] Of which, advances: May, £19,505 million; June, £20,326 million; July, £20,871 million; August £21,390 million, September, £21,862 million.

Banks in the United Kingdom: detail

£ millions

Liabilities

Reporting dates: Aug. 20, Sept. 17		Notes outstanding	Sterling deposits: Total	Sterling deposits: UK banking sector	Sterling deposits: Other UK	Sterling deposits: Overseas	Sterling deposits: Certificates of deposit	Other currency deposits: Total	Other currency deposits: UK banking sector	Other currency deposits: Other UK	Other currency deposits: Overseas	Other currency deposits: Certificates of deposit	Total (including capital & other liabilities)	Eligible liabilities	Reserve ratio
London clearing banks	Aug.	–	22,808	835	20,182	981	810	4,053	913	335	2,489	316	31,805	18,772	13·6
	Sept.	–	22,338	698	19,927	984	729	4,069	915	332	2,488	334	31,155	18,523	13·7
Scottish clearing banks	Aug.	264	2,413	40	2,185	38	150	339	173	32	77	57	3,577	1,927	14·5
	Sept.	265	2,401	44	2,190	37	130	345	180	33	73	59	3,579	1,904	15·6
Northern Ireland banks	Aug.	34	731	125	416	190	–	16	15	–	–	–	894	454	15·5
	Sept.	34	728	121	418	190	–	17	16	1	1	–	902	449	20·9
Accepting houses	Aug.	–	2,178	455	1,409	162	152	2,671	775	223	1,582	92	5,528	1,332	16·5
	Sept.	–	2,203	430	1,446	171	156	2,747	826	232	1,595	94	5,637	1,400	20·3
Other UK banks	Aug.	–	9,402	4,035	3,406	890	1,071	8,363	2,133	250	5,290	691	20,169	5,988	19·6
	Sept.	–	9,303	3,952	3,444	915	992	8,593	2,202	297	5,372	723	20,302	6,104	21·3
American banks	Aug.	–	4,053	1,350	1,329	419	954	29,878	4,995	809	20,996	3,079	34,296	2,621	14·2
	Sept.	–	3,961	1,358	1,375	374	854	30,412	5,301	869	21,145	3,097	34,748	2,649	14·7
Japanese banks	Aug.	–	235	159	59	16	1	10,823	3,035	46	7,519	223	11,235	198	14·2
	Sept.	–	241	151	69	20	1	11,311	3,150	62	7,855	244	11,729	194	14·6
Other overseas banks	Aug.	–	2,483	769	780	664	269	17,043	3,402	315	12,382	944	20,038	1,568	17·0
	Sept.	–	2,445	762	818	603	262	17,646	3,467	398	12,791	991	20,591	1,564	17·7
Consortium banks	Aug.	–	509	232	141	44	92	4,612	1,665	39	2,796	113	5,549	189	20·0
	Sept.	–	492	226	144	39	83	4,642	1,685	54	2,785	119	5,577	191	26·4
Total	Aug.	298	44,811	8,002	29,906	3,403	3,500	77,799	17,106	2,049	53,129	5,514	133,092	33,049	15·1
	Sept.	299	44,112	7,742	29,830	3,333	3,207	79,783	17,741	2,277	54,104	5,661	134,220	32,978	15·9

Sterling assets

Reporting dates: Aug. 20, Sept. 17		Notes & coin	Reserve assets: Total	Reserve assets: Balances with Bank of England	Reserve assets: Money at call	Reserve assets: UK & NI Treasury bills	Reserve assets: Other bills	Reserve assets: British government stocks up to 1 year	Special & supplementary deposits	Market loans (other than reserve assets): Banks in UK and discount market	Market loans: Certificates of deposit	Market loans: UK local authorities	Market loans: Other	Bills (other than reserve assets)
London clearing banks	Aug.	759	2,548	222	781	763	392	390	566	2,836	387	283	116	259
	Sept.	743	2,538	300	661	827	378	372	563	2,887	278	299	110	223
Scottish clearing banks	Aug.	299	279	1	101	87	46	44	58	305	112	40	2	6
	Sept.	297	298	1	102	116	35	44	58	312	115	44	2	15
Northern Ireland banks	Aug.	17	70	–	19	27	12	11	–	83	34	21	128	7
	Sept.	16	94	–	18	58	9	9	–	84	33	20	142	4
Accepting houses	Aug.	1	220	1	152	37	29	1	42	506	299	312	88	86
	Sept.	1	284	1	208	43	29	3	40	504	269	320	80	90
Other UK banks	Aug.	18	1,173	3	461	497	154	58	174	2,583	688	934	239	183
	Sept.	18	1,300	2	373	714	154	57	174	2,427	635	920	264	201
American banks	Aug.	1	371	1	224	91	50	5	79	893	486	268	123	34
	Sept.	1	391	1	215	116	49	10	78	852	447	274	117	37
Japanese banks	Aug.	–	28	–	24	3	1	–	6	42	–	–	11	9
	Sept.	–	28	–	24	4	–	–	6	50	–	–	11	9
Other overseas banks	Aug.	3	266	1	181	57	21	6	46	788	132	214	218	60
	Sept.	2	277	1	189	62	19	6	47	778	125	217	194	64
Consortium banks	Aug.	–	38	–	14	18	4	2	7	260	69	76	17	4
	Sept.	–	51	–	19	26	4	2	7	245	69	77	11	3
Total	Aug.	1,098	4,993	227	1,957	1,583	708	518	978	8,294	2,208	2,148	945	649
	Sept.	1,079	5,260	305	1,810	1,965	677	503	973	8,137	1,970	2,170	931	645

Reporting dates: Aug. 20, Sept. 17		Sterling assets *continued*: Advances: UK	Advances: Overseas	Investments: British government stocks over 1 year & undated	Investments: Other	Other currency assets: Market loans and advances: UK banks & discount market	Market loans and advances: Certificates of deposit	Market loans and advances: UK public sector	Market loans and advances: UK private sector	Market loans and advances: Overseas	Bills	Investments	Sterling & other currencies: Miscellaneous assets	Sterling & other currencies: Acceptances
London clearing banks	Aug.	12,372	1,726	1,080	906	1,192	33	504	370	1,933	7	128	3,801	142
	Sept.	12,121	1,754	1,155	875	1,219	34	512	380	1,890	8	128	3,441	138
Scottish clearing banks	Aug.	1,469	110	84	47	78	3	64	126	70	–	10	415	34
	Sept.	1,439	103	87	47	78	3	65	129	73	–	10	407	37
Northern Ireland banks	Aug.	318	6	43	29	13	–	–	–	11	6	14	93	16
	Sept.	316	6	46	5	13	–	–	1	11	6	14	92	16
Accepting houses	Aug.	874	33	8	170	536	189	14	381	1,465	60	50	197	1,060
	Sept.	867	36	9	171	519	184	14	383	1,560	79	49	175	1,054
Other UK banks	Aug.	4,263	124	229	504	1,841	193	340	1,149	4,833	45	261	394	253
	Sept.	4,227	121	231	506	1,960	234	346	1,172	4,890	46	268	361	239
American banks	Aug.	1,904	39	63	9	6,809	391	811	1,577	20,155	49	37	197	224
	Sept.	1,887	37	62	10	7,099	404	823	1,570	20,356	51	35	218	204
Japanese banks	Aug.	132	41	–	–	924	8	216	266	9,350	10	66	126	163
	Sept.	131	37	–	–	1,043	8	220	288	9,694	10	67	127	155
Other overseas banks	Aug.	928	55	33	26	5,158	505	440	1,034	9,749	114	46	223	432
	Sept.	946	49	33	26	5,229	570	453	1,050	10,181	109	48	195	409
Consortium banks	Aug.	225	12	15	34	737	238	154	206	3,398	18	28	14	27
	Sept.	228	12	14	34	702	250	159	205	3,451	19	25	15	27
Total	Aug.	22,484	2,146	1,555	1,726	17,287	1,560	2,542	5,108	50,962	308	640	5,461	2,352
	Sept.	22,162	2,155	1,636	1,674	17,861	1,688	2,592	5,177	52,105	328	644	5,032	2,279

UK banking sector: changes in liabilities and assets[a]

£ millions

Liabilities

	Total	Domestic deposits: Total: Unadjusted	Domestic deposits: Total: Seasonally adjusted	Domestic deposits: Public sector	Domestic deposits: UK private sector deposits: Sterling: Unadjusted	Domestic deposits: UK private sector deposits: Sterling: Seasonally adjusted	Domestic deposits: UK private sector deposits: Other currencies	Overseas deposits: Sterling	Overseas deposits: Other currencies	Non-deposit liabilities (net)
Month ending										
1975 Mar. 19	+ 590	+191	+288	– 15	– 41	+ 56	+247	+ 91	+ 391	– 83
Apr. 16	+1,750	+110	+ 27	– 76	+539	+456	–353	– 91	+1,607	+124
May 21[b]	+1,521	+191	+462	+352	–247	+ 24	+ 86	– 33	+1,567	–204
June 18	+1,245	+167	–120	–269	+363	+ 76	+ 73	+104	+ 981	– 7
July 16	+4,141	+468	+196	+ 29	+484	+212	– 45	+ 44	+3,174	+455
Aug. 20	+1,953	+390	+624	+238	+101	+335	+ 51	– 7	+1,560	+ 10
Sept. 17	+1,326	+298	+334	–302	+374	+410	+226	– 35	+1,050	+ 13

Assets

	Total	Lending to public sector: Sterling: Total: Unadjusted	Lending to public sector: Sterling: Total: Seasonally adjusted	Lending to public sector: Sterling: Central government	Lending to public sector: Sterling: Other	Lending to public sector: Other currencies	Lending to private sector: Sterling: Unadjusted	Lending to private sector: Sterling: Seasonally adjusted	Lending to private sector: Other currencies	Lending to overseas sector: Sterling	Lending to overseas sector: Other currencies
Month ending											
1975 Mar. 19	+ 590	+151	+297	+ 55	+ 96	+ 22	–170	–217	– 69	+52	+ 604
Apr. 16	+1,750	+425	+137	+ 31	+394	+ 61	– 47	+128	+ 36	+87	+1,188
May 21[b]	+1,521	+187	+499	+ 7	+180	+ 63	+ 9	+ 61	+208	–54	+1,108
June 18	+1,245	+654	+331	+768	–114	+ 38	–309	–220	+270	+68	+ 524
July 16	+4,141	+441	+441	+468	– 27	+102	+659	+ 74	+111	+43	+2,785
Aug. 20	+1,953	+303	+465	+366	– 63	+ 52	–256	– 27	+182	+47	+1,625
Sept. 17	+1,326	+674	+427	+622	+ 52	+ 52	–515	–174	+110	–85	+1,090

[a] The banking sector comprises all banks in the United Kingdom together with the National Giro, the discount market, and the Bank of England, Banking Department. Inter-bank items are excluded and adjustments made to allow for transit items (see additional notes to Table 11 in the September 1975 Bank of England *Quarterly Bulletin*). The figures for liabilities and assets in foreign currencies are in some cases substantially affected by changes in exchange rates.

[b] Partly estimated.

Money stock: amounts outstanding

£ millions

	Notes and coin in circulation with public	UK private sector sterling sight deposits	*less* 60% of transit items [a]	Money stock M_1[b]: Unadjusted	Money stock M_1[b]: Seasonally adjusted	UK private sector sterling time deposits [c]	UK public sector: Sterling sight deposits	UK public sector: Sterling time deposits	UK residents' deposits in other currencies [c] [d]	Money stock M_3[e]: Unadjusted	Money stock M_3[e]: Seasonally adjusted
	1	2	3	4		5	6	7	8	9	
Month ending											
1975 Mar. 19	5,064	9,413	739	13,738	13,940	19,582	759		2,423	36,502	36,850
Apr. 16	5,123	9,845	703	14,265	14,250	19,653	683		2,070	36,671	36,920
May 21[f]	5,255	9,878	853	14,280	14,360	19,523	1,035		2,156	36,994	37,480
	5,259	10,540	786	15,013	15,090	18,762	883	139	2,186	36,983	37,470
June 18	5,270	10,644	658	15,256	15,120	18,893	602	152	2,258	37,161	37,360
July 16	5,465	10,866	708	15,623	15,500	19,205	637	145	2,214	37,824	37,630
Aug. 20	5,494	11,065	761	15,798	15,730	19,160	881	126	2,278	38,243	38,370
Sept. 17	5,460	11,110	578	15,992	16,100	19,306	552	155	2,502	38,507	38,730

[a] See additional notes to Tables 11 and 12 in the September 1975 Bank of England *Quarterly Bulletin*.

[b] M_1 equals columns 1+2–3.

[c] Including UK residents' holdings of certificates of deposit.

[d] The sterling value of deposits in other currencies. The figures are in some cases substantially affected by changes in exchange rates.

[e] M_3 equals M_1 + columns 5+6+7+8.

[f] The first line of figures is partly estimated.

Money stock: changes[a]

£ millions: *percentages in italics*

	Notes and coin in circulation with public	UK private sector sterling sight deposits [b]	Money stock M_1[c]		Domestic deposits: Sterling: UK private sector time deposits[d]	Domestic deposits: Sterling: UK public sector deposits	Domestic deposits: Other currencies [d]	Money stock M_3[e]	
	1	*2*	*3*		*4*	*5*	*6*	*7*	
Month ending (unadjusted)									
1975 Mar. 19	+ 96	+194	+290		−235	− 15	+247	+287	
Apr. 16	+ 59	+468	+527		+ 71	− 76	−353	+169	
May 21[f]	+132	−117	+ 15		−130	+352	+ 86	+323	
June 18	+ 11	+232	+243		+131	−268	+ 72	+178	
July 16	+195	+172	+367		+312	+ 28	− 44	+663	
Aug. 20	+ 29	+146	+175		− 45	+225	+ 64	+419	
Sept. 17	− 34	+228	+194		+146	−300	+224	+264	
Month ending (seasonally adjusted)									
1975 Mar. 19	+ 48	+219	+267	*+2·0*	−163	− 15	+247	+336	*+0·9*
Apr. 16	+ 42	+272	+314	*+2·3*	+184	− 76	−353	+ 69	*+0·2*
May 21[f]	+ 89	+ 14	+103	*+0·7*	+ 10	+352	+ 86	+551	*+1·5*
June 18	+ 15	+ 9	+ 24	*+0·2*	+ 67	−268	+ 72	−105	*−0·3*
July 16	+ 76	+310	+386	*+2·6*	− 98	+ 28	− 44	+272	*+0·7*
Aug. 20	+112	+113	+225	*+1·5*	+222	+225	+ 64	+736	*+2·0*
Sept. 17	+ 31	+334	+365	*+2·3*	+ 76	−300	+224	+365	*+1·0*

[a] Changes in the money stock may differ from those which can be calculated by reference to amounts outstanding; see additional notes to Table 12 of the September 1975 Bank of England *Quarterly Bulletin*.

[b] After deducting 60% of transit items; see additional notes to Table 11 of the September 1975 Bank of England *Quarterly Bulletin*.

[c] M_1 equals columns 1+2.

[d] Including certificates of deposit.

[e] M_3 equals M_1 + columns 4+5+6.

[f] Partly estimated.

Symbols and conventions

. . not available.

− nil or less than £½ million.

Owing to rounding of figures, the sum of the separate items will sometimes differ from the total shown.

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Table 2. Domestic Credit Expansi

(Changes in millions of pounds)

	1974/75	Projection 1975/76 M3 at 10.0	Projection 1975/76 M3 at 12.0	Comments
Money stock (M3)	3,432 (10.1)	3,730 (10.0)	4,470 (12.0)	... range of likely increase in M3 at targeted reduction in rate of increase of CPI to 10 per cent in second half of 1976.
Plus				
Adjustments	30	-100	-100	
Non-deposit liabilities	626	800	800	
External finance	2,863	1,500	1,500	... particularly undertain estimate dependent on assumption that capital account in 1975/76 (including sterling deposits by non-residents) is in approximate balance in 1976/76 (as against a surplus of E3 billion in 1974) after uptake of whatever foreign currency borrowing by public sector other than the Central Government is planned or possible.
Public sector	(1,550)	((...)	(...)	
Banking sector	(1,313)	(...)	(...)	
Corresponding to a current account deficit of	/3,828/	/1,500/	/1,500/	
Equals				
Desired domestic credit expansion	6,951	5,930*	6,670*	... for 1975/76, range of desired credit expansion consistent with price and balance of payments objectives.
= ex post		Excess: 2,470	Excess; 1,730	... to be eliminated by cuts in PSBR and increase in sale of public sector debt (through higher interest rates); the calculated excess is a minimum and would be raised by an expansion in bank lending to the private sector.
Domestic credit supply	6,951	8,400	8,400	
Public sector borrowing requirement (PSBR)	7,751 1/	11,000	11,000	... latest press estimate of PSBR at unchanged policies.
	3,657	8,500	8,500	
Net acquisition of public sector debt by nonbank public sector	-4,100	-2,500	-2,500	... H.M.G. estimate of May 1975.
Bank lending to private sector	3,264	--	--	... with improving liquidity situation of private company sector and continued weak investment demand, demand for bank credit by private sector is likely to remain very weak (actual decline in outstanding bank lending to private sector in first half of 1975).
Adjustments	30	-100	-100	

1/ Derived by difference; actual data not available; H.M.G. estimate in May 1975 was E7,600 million.

Reserve ratios, undefined assets multiple and special deposits

TABLE 37 — Banks (1) — £ million

	Total	*of which* Interest bearing (2)	London clearing banks	Scottish clearing banks	Northern Ireland banks (3)	Other deposit banks	Accepting houses	British overseas and Commonwealth banks	American banks	Foreign banks and affiliates	Other overseas banks	Other UK banks (3)
Eligible liabilities												
1974 September 18	30,752	*21,808*	18,087	1,749	450	364	1,218	1,576	2,279	632	343	4,053
1975 March 19	32,054	*22,341*	18,740	1,895	520	399	1,269	1,653	2,526	656	348	4,048
April 16	32,322	*22,135*	18,628	1,932	525	407	1,364	1,700	2,583	684	357	4,141
May 21	32,603	*22,234*	18,862	1,917	431	403	1,246	1,726	2,613	739	352	4,313
Reserve assets												
1974 September 18	4,187		2,414	233	64	53	173	229	311	98	65	547
1975 March 19	4,420		2,570	254	72	54	191	233	336	102	60	547
April 16	4,436		2,482	258	79	55	213	247	354	112	60	577
May 21	4,479		2,562	266	68	56	170	253	351	116	58	580
Reserve ratio (percentage)												
1974 September 18	*13.6*		*13.3*	*13.3*	*14.1*	*14.6*	*14.2*	*14.5*	*13.7*	*15.6*	*19.1*	*13.5*
1975 March 19	*13.2*		*13.7*	*13.4*	*13.9*	*13.6*	*15.0*	*14.1*	*13.3*	*15.6*	*17.2*	*13.5*
April 16	*13.7*		*13.3*	*13.4*	*15.0*	*13.4*	*15.6*	*14.5*	*13.7*	*16.3*	*16.9*	*13.9*
May 21	*13.7*		*13.6*	*13.9*	*15.9*	*13.9*	*13.7*	*14.6*	*13.4*	*15.7*	*16.6*	*13.4*

	Total	*of which* Interest bearing (2)	United Kingdom banks: London clearing banks	Scottish clearing banks	Northern Ireland banks	Accepting houses	Other	Overseas banks: American	Japanese	Other	Consortium banks
Eligible liabilities											
1975 June 18	32,382	*22,333*	18,393	1,870	429	1,356	5,775	2,648	206	1,475	230
July 16	33,211	*23,003*	18,882	1,917	439	1,387	5,967	2,668	203	1,545	204
August 20	33,049	*22,635*	18,772	1,927	454	1,332	5,988	2,621	198	1,568	189
September 17	32,978	*22,705*	18,523	1,904	449	1,400	6,104	2,649	194	1,564	191
Reserve assets											
1975 June 18	4,733		2,511	265	67	235	962	371	29	249	45
July 16	4,996		2,578	263	65	252	1,129	379	30	258	43
August 20	4,993		2,548	279	70	220	1,173	371	28	266	38
September 17	5,260		2,538	298	94	284	1,300	391	28	277	51
Reserve ratio (percentage)											
1975 June 18	*14.6*		*13.6*	*14.2*	*15.7*	*17.3*	*16.7*	*14.0*	*14.0*	*16.9*	*19.4*
July 16	*15.0*		*13.7*	*13.7*	*14.8*	*18.2*	*18.9*	*14.2*	*14.6*	*16.7*	*20.9*
August 20	*15.1*		*13.6*	*14.5*	*15.5*	*16.5*	*19.6*	*14.2*	*14.2*	*17.0*	*20.0*
September 17	*15.9*		*13.7*	*15.6*	*20.9*	*20.3*	*21.3*	*14.7*	*14.6*	*17.7*	*26.4*

	Constitution of total reserve assets: Total	Balances with Bank of England	Money at call: Discount market	Money at call: Other	Tax reserve certificates	UK and NI Treasury bills	Other bills: Local authority bills	Other bills: Commercial bills	British government stocks 0–1 yr.	Other (4)	British government stocks over 12 mths and under 18 mths
1974 September 18	4,187	288	2,267		3	330	142	571	584	4	198
October 16	4,169	231	2,228		–	407	154	573	572	5	207
November 20	4,262	285	2,361		–	378	139	585	508	7	210
December 11	4,297	298	2,389		–	387	142	590	487	3	206
1975 January 15	4,376	209	2,396		–	612	131	583	441	4	229
February 19	4,293	274	2,665		–	403	126	603	220	2	492
March 19	4,420	358	2,482		–	418	114	602	440	4	246
April 16	4,436	265	2,474		–	555	146	593	399	5	255
May 21	4,479	314	2,055	258	–	735	143	613	356	5	264
June 18	4,733	299	1,988	253	–	1,075	150	604	359	5	408
July 16	4,996	250	1,946	262	–	1,425	156	601	356		391
August 20	4,993	227	1,723	234	–	1,583	131	577	518		203
September 17	5,260	305	1,589 +	221 = 1810	–	1,965	135	542	503		488

See footnotes on page 43.

Source: Bank of England

Δ bet Dec 74 & Sep 75 +963 = +7 -579 +1578 -7 -48 +16 -3 +282

Reserve ratios, undefined assets multiple and special deposits

TABLE 37 *(continued)* | Discount market and finance houses | £ million

	Discount market		Finance houses		
	Undefined assets(5)	Undefined assets multiple(5)	Eligible liabilities(5)	Reserve assets(5)	Reserve ratio (percentage)
1974 August 21	1,795	18.6	282	30	10.7
September 18	1,828	19.0	251	29	11.4
October 16	1,864	19.4	241	26	10.6
November 20	1,874	19.5	236	25	10.6
December 11	1,872	19.4	221	23	10.6
1975 January 15	1,866	19.4	227	23	10.2
February 19	1,812	19.3	234	24	10.2
March 19	1,838	19.6	245	25	10.3
April 16	1,789	19.0	239	24	10.1
May 21	1,768	18.8	239	25	10.3
June 18	1,747	18.6	231	24	10.5
July 16	1,586	16.9	231	24	10.3
August 20	1,513	16.1	228	24	10.5
September 17	1,392	14.8	232	24	10.3

Special and supplementary deposits

	Special deposits		Supplementary deposits(7)							
	Banks	Finance houses	Total	Total no. of institutions	1st tranche	No. of institutions	2nd tranche	No. of institutions	3rd tranche	No. of institutions
1974 August 21	911	9	1	7	—	2	—	1	1	4
September 18	912	8	2	5	—	1	—	1	2	3
October 16	908	8	1	6	—	1	—	1	1	4
November 20	920	7	2	6	—	—	—	—	2	6
December 11	920	7	2	6	—	—	—	—	2	6
December 16(8)	924	7	1	5	—	3	—	—	1	2
1975 January 15	926	6	2	4	—	—	—	3	2	1
February 19	928	7	—	3	—	—	—	1	—	2
March 19	936	7								
April 16	942	7								
May 21	950	7								
June 18	959	7								
July 16	953	7								
August 20	978	7								
September 17	973	7								

Source: Bank of England

(1) Two sets of figures for May 1975 are shown, reflecting the change in composition of most groups. See supplement to Notes and Definitions on page 137.
(2) Banks in Northern Ireland were excluded up to the first set of figures for May 1975.
(3) Offices in Great Britain of Northern Ireland banks were transferred to other UK banks after April, 1975.
(4) See 'Competition and credit control: further developments' in *Bank of England Quarterly Bulletin,* March 1973. The transitional period was extended to June 1975.
(5) See *Notes and Definitions.* (6) Virtually all interest-bearing.
(7) Supplementary deposits were paid by banks and deposit-taking finance houses, according to the growth in their interest-bearing eligible liabilities in excess of the guide line. The rates of deposit were 5 per cent of excess liabilities in the first tranche, 25 per cent in the second, and 50 per cent in the third. Up to the August/October average the tranche's were: 1st, up to 1 per cent excess; 2nd, over 1 per cent up to 3 per cent, and 3rd, above 3 per cent. Thereafter they were: 1st, up to 3 per cent excess; 2nd over 3 per cent up to 5 per cent; 3rd, above 5 per cent. The same institution could therefore be penalised in one, two or all three tranches in any month. Although the table shows total amounts paid in each tranche, the numbers of institutions comprise only those banks and deposit-taking finance houses whose maximum rate of penalty fell within each tranche. On 28 February the supplementary deposits scheme was suspended for the time being.
(8) The adjustments to special and supplementary deposits arising from the mid-November figures were made on 16 December, 1974.

VII. MONEY STOCK AND DOMESTIC CREDIT EXPANSION

Money stock(1)

TABLE 57 — Amounts outstanding — £ million

	Notes and coin in circulation with public	UK private sector sterling sight deposits	*less* 60 per cent of transit items(2)	Money stock M_1: Un-adjusted(3)	Money stock M_1: Season-ally adjusted	Other UK deposits: Total	Other UK deposits: Sterling: Private sector time deposits(4)	Other UK deposits: Sterling: Public sector: Sight deposits	Other UK deposits: Sterling: Public sector: Time deposits	Other UK deposits: Other currencies (4)(5)	Money stock M_3(6): Un-adjusted	Money stock M_3(6): Season-ally adjusted
	1	2	3	4	5	6	7	8	9	10	11	12
Average amounts outstanding(7)												
1970	3,109	6,387	593	8,903		8,027	7,057	477		493	16,930	
1971	3,401	7,250	628	10,023		8,808	7,801	513		494	18,831	
1972	3,839	8,618	775	11,682		11,259	10,118	539		602	22,941	
1973	4,262	9,414	834	12,842		16,329	14,545	645		1,139	29,171	
1974	4,711	9,593	934	13,370		21,671	18,912	667		2,092	35,041	
End of period												
1971 1st quarter..	3,324	7,051	684	9,691	9,820	8,501	7,470	542		489	18,192	18,330
2nd quarter ..	3,373	6,996	538	9,831	9,890	8,831	7,819	505		507	18,662	18,740
3rd quarter(8)	3,454	7,428	672	10,210	10,230	8,902	7,909	481		512	19,112	19,180
4th quarter..	3,589	8,137	638	11,088	10,740	9,453	8,479	544		430	20,541	20,010
1972 1st quarter(8)	3,755	8,287	874	11,168	11,140	9,833	8,747	557		529	21,001	20,950
	3,755	8,341	871	11,225	11,190	10,186	9,099	558		529	21,411	21,360
2nd quarter .	3,860	8,611	742	11,729	11,590	11,376	10,239	525		612	23,105	23,010
3rd quarter..	3,905	8,803	778	11,930	11,790	12,130	10,989	490		651	24,060	23,990
4th quarter..	4,079	9,355	777	12,657	12,290	13,588	12,161	625		802	26,245	25,670
1973 1st quarter(8)	4,170	9,109	946	12,333	12,300	14,805	13,171	635		999	27,138	27,130
	4,170	9,109	946	12,333	12,300	14,813	13,079	635		1,099	27,146	27,140
2nd quarter..	4,349	9,623	797	13,175	12,970	15,499	13,762	665		1,072	28,674	28,560
3rd quarter..	4,301	9,401	820	12,882	12,540	18,126	16,203	603		1,320	31,008	30,790
4th quarter..	4,377	9,695	769	13,303	13,090	20,175	18,018	725		1,432	33,478	33,050
1974 1st quarter..	4,574	9,201	1,003	12,772	12,690	21,166	18,660	733		1,773	33,938	33,940
2nd quarter..	4,767	9,234	826	13,175	12,960	21,705	18,904	621		2,180	34,880	34,770
3rd quarter..	4,772	9,791	1,050	13,513	13,530	22,245	19,122	623		2,500	35,758	35,960
4th quarter..	5,085	10,598	944	14,739	14,530	22,959	19,905	656		2,398	37,698	37,260
1975 1st quarter..	5,448	10,474	1,187	14,735	14,840	22,687	19,482	686		2,519	37,422	37,600
2nd quarter(9)	5,369	11,025	1,219	15,175	15,130	23,000	19,797	872		2,331	38,175	38,230
	5,373	11,682	1,152	15,903	15,860	22,259	19,041	734	145	2,339	38,162	38,220
3rd quarter..												
4th quarter..												
1974 January 16..	4,264	8,781	600	12,445	12,410	20,406	18,221	664		1,521	32,851	32,610
February 20.	4,281	8,493	636	12,138	12,320	20,957	18,525	765		1,667	33,095	33,310
March 20 ...	4,337	8,499	703	12,133	12,320	20,964	18,561	719		1,684	33,097	33,440
April 17	4,450	8,908	722	12,636	12,640	20,597	18,232	696		1,669	33,233	33,530
May 15.....	4,439	8,658	623	12,474	12,560	20,829	18,415	670		1,744	33,303	33,850
June 19	4,504	8,698	677	12,525	12,400	21,013	18,448	677		1,888	33,538	33,770
July 17	4,657	8,779	664	12,772	12,680	25,055	18,990	695		2,370	34,827	34,710
August 21...	4,721	8,672	612	12,781	12,770	22,313	19,228	777		2,308	35,094	35,260
September 18	4,739	8,680	621	12,798	12,820	22,304	19,343	647		2,314	35,102	35,200
October 16..	4,767	9,051	676	13,142	13,080	22,199	19,245	630		2,324	35,341	35,350
Nobember 20	4,899	9,194	791	13,302	13,060	22,566	19,552	752		2,262	35,868	35,710
December 11	5,047	9,301	655	13,693	13,260	22,556	19,421	569		2,566	36,249	35,710
1975 January 15..	4,896	9,592	774	13,714	13,710	22,610	19,712	737		2,161	36,324	36,140
February 19.	4,968	9,196	716	13,448	13,670	22,767	19,817	774		2,176	36,215	36,510
March 19 ...	5,064	9,413	739	13,738	13,940	22,764	19,582	759		2,423	36,502	36,850
April 16	5,123	9,845	703	14,265	14,250	22,406	19,653	683		2,070	36,671	36,920
May 21(9) ..	5,255	9,878	853	14,280	14,360	22,714	19,523	1,035		2,156	36,994	37,480
	5,259	10,540	786	15,013	15,090	21,970	18,762	883	139	2,186	36,983	37,470
June 18	5,270	10,644	658	15,256	15,120	21,905	18,893	602	152	2,258	37,161	37,360
July 16.....	5,465	10,866	708	16,623	15,500	22,201	19,205	637	145	2,214	37,824	37,630
August 20...	5,494	11,065	761	15,798	15,730	22,445	19,160	881	126	2,278	38,243	38,370
September 17	5,460	11,110	578	15,992	16,100	22,515	19,306	552	155	2,502	38,507	38,730

(1) The quarterly seasonally adjusted figures have been revised to take account of later information. (2) See *Notes and Definitions* relating to the United Kingdom banking sector. (3) M_1 equals columns, 1 + 2 – 3. (4) Including UK residents' holdings of certificates of deposit. (5) The sterling value of deposits in other currencies. The figures are in some cases substantially affected by changes in exchange rates. (6) M_3 equals M_1 + column 6. (7) Average of the centred quarters of the year. (8) See *Notes and Definitions.* (9) See supplement to Notes and Definitions on page 137.

Sources: Bank of England
Central Statistical Office

X. PERSONAL SECTOR

Personal income, expenditure and saving

TABLE 86 £ million

	Personal income before tax: Total (1)	Wages and salaries	Forces' pay	Employers' contributions (2)	Current grants from public authorities (3)	Other personal income (4)(5)	Transfers abroad (net) and taxes paid abroad	UK taxes on income (payments) (6)	National insurance, etc. contributions	Total personal disposable income (7)(8)	Consumers' expenditure	Balance: personal saving (8)(9)	
1968	36,478	22,515	542	2,300	3,679	7,442	77	4,524	2,165	29,712	27,375	2,337	*7.9*
1969	39,066	24,110	539	2,433	3,937	8,047	71	5,139	2,244	31,612	29,033	2,579	*8.2*
1970	43,183	26,830	658	2,773	4,336	8,586	57	5,850	2,654	34,622	31,472	3,150	*9.1*
1971	47,785	29,685	758	3,057	4,784	9,501	35	6,424	2,835	38,491	35,075	3,416	*8.9*
1972	54,124	33,050	862	3,564	5,843	10,805	79	6,642	3,333	44,070	39,635	4,435	*10.1*
1973	62,720	37,970	928	4,263	6,403	13,156	115	7,807	3,930	50,868	45,141	5,727	*11.3*
1974	74,841	45,490	1,078	5,433	7,850	14,990	121	10,533	4,986	59,201	51,670	7,531	*12.7*
Unadjusted													
1972 1st quarter	12,700	7,690	199	841	1,399	2,571	15	1,871	794	10,020	8,914	1,106	*11.0*
2nd quarter	13,409	8,150	207	873	1,432	2,747	18	1,612	824	10,955	9,767	1,188	*10.8*
3rd quarter	13,598	8,345	231	899	1,394	2,729	22	1,608	835	11,133	10,122	1,011	*9.1*
4th quarter	14,417	8,865	225	951	1,618	2,758	24	1,551	880	11,962	10,832	1,130	*9.4*
1973 1st quarter	14,770	8,855	222	1,004	1,585	3,104	29	1,987	948	11,806	10,402	1,404	*11.9*
2nd quarter	15,441	9,380	215	1,028	1,553	3,265	43	1,966	944	12,488	11,020	1,468	*11.8*
3rd quarter	15,928	9,615	257	1,078	1,517	3,461	18	1,952	992	12,966	11,477	1,489	*11.5*
4th quarter	16,581	10,120	234	1,153	1,748	3,326	25	1,902	1,046	13,608	12,242	1,366	*10.0*
1974 1st quarter	16,879	9,905	234	1,223	1,773	3,744	28	2,294	1,118	13,439	11,373	2,066	*15.4*
2nd quarter	17,690	10,825	230	1,261	1,812	3,562	22	2,505	1,124	14,039	12,551	1,488	*10.6*
3rd quarter	19,445	11,755	320	1,414	2,006	3,950	29	2,771	1,308	15,337	13,269	2,068	*13.5*
4th quarter	20,827	13,005	294	1,535	2,259	3,734	42	2,963	1,436	16,386	14,477	1,909	*11.6*
1975 1st quarter	21,668	13,480	281	1,708	2,176	4,023	18	3,372	1,527	16,751	13,737	3,014	*18.0*
2nd quarter	22,726	14,185	311	1,774	2,572	3,884	34	3,517	1,622	17,553	15,456	2,097	*11.9*
3rd quarter													
4th quarter													
Seasonally adjusted													
1972 1st quarter	12,800	7,840	199	841	1,352	2,568	15	1,739	794	10,252	9,394	858	*8.4*
2nd quarter	13,431	8,150	207	873	1,434	2,767	18	1,587	824	11,002	9,748	1,254	*11.4*
3rd quarter	13,595	8,355	231	899	1,459	2,651	22	1,623	835	11,115	10,085	1,030	*9.3*
4th quarter	14,298	8,705	225	951	1,598	2,819	24	1,693	880	11,701	10,408	1,293	*11.0*
1973 1st quarter	14,882	9,050	222	1,004	1,538	3,068	29	1,843	948	12,062	10,985	1,077	*8.9*
2nd quarter	15,525	9,390	215	1,028	1,560	3,332	43	1,946	944	12,592	11,026	1,566	*12.1*
3rd quarter	15,888	9,610	257	1,078	1,597	3,346	18	1,964	992	12,914	11,413	1,501	*11.6*
4th quarter	16,425	9,920	234	1,153	1,708	3,410	25	2,054	1,046	13,300	11,717	1,583	*11.9*
1974 1st quarter	17,041	10,145	234	1,223	1,734	3,705	28	2,176	1,118	13,719	12,058	1,661	*12.1*
2nd quarter	17,827	10,840	230	1,261	1,817	3,679	22	2,480	1,124	14,201	12,566	1,635	*11.5*
3rd quarter	19,404	11,755	320	1,414	2,082	3,833	29	2,779	1,308	15,288	13,233	2,055	*13.4*
4th quarter	20,569	12,750	294	1,535	2,217	3,773	42	3,098	1,436	15,993	13,813	2,180	*13.6*
1975 1st quarter	21,841	13,795	281	1,708	2,106	3,951	18	3,351	1,527	16,945	14,545	2,400	*14.2*
2nd quarter	22,951	14,185	311	1,774	2,589	4,092	34	3,422	1,622	17,873	15,475	2,398	*13.4*
3rd quarter													
4th quarter													

Source: Central Statistical Office

(1) Before providing for depreciation and stock appreciation.
(2) Employers' contributions to national insurance, etc. and pension funds.
(3) National insurance benefits, family allowances, assistance grants, war pensions and service grants, etc.
(4) Income from rent and self-employment, before providing for depreciation and stock appreciation, dividend and net interest receipts, and transfers to charities from companies.
(5) From 2nd quarter 1973 includes tax credits on dividends.
(6) From 2nd quarter 1973 includes imputed tax payments set against tax credits on dividends *less* payments of these tax credits by the Inland Revenue.
(7) Equals total personal income before tax *less* payments of taxes on income, national insurance, etc. contributions and net transfers abroad.
(8) Before providing for depreciation, stock appreciation and additions to tax reserves.
(9) Personal saving as a percentage of Total personal disposable income is shown in italics.

Rates of change of gross national product at current market prices (seasonally adjusted)

TABLE D

Increase at annual rates

Initial quarters	Terminal quarters 1970		1971				1972				1973				1974				1975	
	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2
1970 2	8.1	12.2	8.0	10.8	12.1	11.5	10.3	11.1	10.5	11.4	13.2	11.8	12.1	11.9	10.7	11.9	13.3	13.2	14.0	14.5
3		16.4	7.9	11.8	13.1	12.1	10.7	11.5	10.9	11.8	13.7	12.1	12.4	12.2	10.9	12.2	13.6	13.5	14.3	14.9
4			—	9.5	12.0	11.1	9.6	10.7	10.1	11.2	13.4	11.7	12.1	11.8	10.5	11.9	13.5	13.3	14.2	14.8
1971 1				19.9	18.5	15.1	12.1	13.0	11.9	12.9	15.2	13.0	13.4	13.0	11.4	12.8	14.5	14.3	15.2	15.7
2					17.1	12.7	9.7	11.3	10.3	11.8	14.6	12.2	12.7	12.3	10.7	12.3	14.1	13.9	14.8	15.5
3						8.4	6.1	9.4	8.7	10.8	14.1	11.5	12.1	11.8	10.1	11.8	13.8	13.6	14.7	15.4
4							3.8	9.9	8.7	11.4	15.3	12.1	12.7	12.2	10.3	12.2	14.3	14.1	15.2	15.9
1972 1								16.5	11.3	14.0	18.4	13.8	14.2	13.5	11.1	13.2	15.4	15.0	16.2	16.9
2									6.4	12.8	19.0	13.1	13.8	13.0	10.4	12.7	15.3	14.9	16.2	16.9
3										19.6	25.9	15.5	15.7	14.4	11.0	13.7	16.5	15.9	17.2	17.9
4											32.6	13.5	14.4	13.1	9.4	12.7	16.1	15.4	16.9	17.7
1973 1												−2.9	6.3	7.3	4.3	9.1	13.5	13.2	15.1	16.2
2													16.3	12.7	6.8	12.4	17.1	16.1	17.9	18.8
3														9.3	2.3	11.1	17.3	16.1	18.2	19.2
4															4.2	12.0	20.1	17.8	20.1	20.9
1974 1																31.0	34.5	26.2	27.0	26.7
2																	38.2	23.9	25.8	25.7
3																		11.2	20.0	21.7
4																			29.5	27.4
1975 1																				25.4

Source: Central Statistical Office

Rates of change of money stock (M_3) outstanding (1) (seasonally adjusted)

TABLE E

Increase at annual rates

Initial quarters	Terminal quarters 1970		1971				1972				1973				1974				1975	
	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2
1970 2	13.0	11.5	11.5	11.4	11.0	11.5	12.6	14.3	15.6	16.4	17.4	17.9	18.7	19.8	19.9	18.9	17.7	16.7	15.7	14.9
3		10.0	10.8	10.8	10.5	11.2	12.5	14.5	15.9	16.8	17.9	18.4	19.2	20.3	20.4	19.7	18.9	17.7	16.7	15.7
4			11.6	11.2	10.6	11.5	13.0	15.3	16.8	17.7	18.8	19.3	20.1	21.2	21.2	20.4	19.9	18.9	17.7	16.7
1971 1				10.8	10.2	11.5	13.4	16.1	17.6	18.6	19.7	20.2	21.0	22.1	22.0	21.1	20.5	20.1	18.9	17.7
2					9.5	11.8	14.2	17.4	19.0	20.0	21.0	21.4	22.2	23.3	23.1	22.0	21.3	20.8	20.0	18.9
3						14.1	16.7	20.2	21.6	22.2	23.1	23.2	23.9	24.9	24.6	23.2	22.3	21.7	20.8	19.7
4							19.3	23.3	24.2	24.3	25.0	24.8	25.3	26.4	25.8	24.2	23.1	22.4	21.3	20.1
1972 1								27.4	26.6	26.0	26.4	25.9	26.4	27.4	26.6	24.7	23.4	22.6	21.5	20.1
2									25.9	25.3	26.1	25.5	26.2	27.4	26.5	24.4	23.0	22.2	20.9	19.5
3										24.6	26.2	25.4	26.2	27.7	26.6	24.2	22.7	21.8	20.4	19.0
4											27.8	25.7	26.8	28.5	27.0	24.1	22.4	21.4	20.0	18.4
1973 1												23.7	26.3	28.8	26.8	23.4	21.5	20.5	19.1	17.4
2													28.9	31.4	27.9	23.4	21.1	20.0	18.4	16.7
3														33.9	27.4	21.6	19.2	18.3	16.7	15.0
4															21.2	15.8	14.6	14.7	13.6	12.2
1974 1																10.7	11.5	12.6	11.7	10.4
2																	12.3	13.6	12.1	10.4
3																		14.8	12.0	9.7
4																			9.3	7.3
1975 1																				5.3

(1) Centred by averaging the outstanding amounts at the beginning and end of each quarter.

Source: Central Statistical Office

Velocity of circulation (1)

TABLE F

	1970		1971				1972				1973				1974				1975	
	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2	3	4	1	2
	3.02	3.06	2.98	3.04	3.09	3.05	2.93	2.84	2.71	2.68	2.71	2.55	2.48	2.36	2.23	2.32	2.44	2.42	2.53	2.64

(1) Ratio of GNP at current market price seasonally adjusted expressed at an annual rate to the centred quarterly average of M_3 seasonally adjusted.

Source: Central Statistical Office

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United Kingdom: Bank Lending in Sterling to the Private Sector

(Changes in millions of pounds, seasonally adjusted)

	Actual		At an annual rate
1975 January	48		
February	-118	-287	-1,148
March	-217		
April	128		
May	61	-31	-124
June	-220		
July	74		
August	-27	-127	-508
September	-174		
January-September	-445		-593

Source: Bank of England, Quarterly Bulletin, and Press Releases.

United Kingdom: Bank Lending in Sterling to the Private Sector

(Changes in millions of pounds, seasonally adjusted)

		Actual		At an annual rate
1975	January	48)		
	February	-118)	-287	-1,148
	March	-217)		
	April	128)		
	May	61)	-31	-124
	June	-220)		
	July	74)		
	August	-27)	-127	-508
	September	-174)		
	January-September	-445		-593

Source: Bank of England, Quarterly Bulletin, and Press Releases.

August 7, 1975

MEMORANDUM FOR FILES

Subject: United Kingdom - Monetary Projections

This note briefly reviews recent U.K. developments in, and prospects for, each of the main components of DCE and M3 in fiscal year 1975/76. Three alternative monetary projections are then presented, depicting a range of outcomes in 1975/76 corresponding to the prospective most and least favorable sets of assumptions, as well as a "best" guestimate (Table 1). Finally, these various scenarios are compared with the official U.K. 1975/76 forecasts of DCE and M3, which were made last May.

Public sector borrowing requirement

Recently, there has been speculation in the U.K. press that the 1975/76 public sector borrowing requirement (PSBR) may turn out to be much higher than the £9.1 billion estimated in the April 1975 Budget--perhaps reaching nearer £12 billion. At present there is no firm evidence to substantiate such predictions. However, two recent policy developments, together with some seemingly inevitable slippage in public expenditure programs, suggest a PSBR of at least £10 billion in the current fiscal year:

(a) The July 1975 counter-inflation measures--assuming strict compliance with the new £6-a-week limit to pay rises--is estimated by the Fund staff to add some £(500-550) million (net) to the PSBR in 1975/76;1/ and

(b) The £2 billion supplementary estimates of public expenditure in 1975/76--published last month--are generally expected to add a further £(200-250) million to the 1975/76 PSBR.

Acquisition of public debt by nonbank private sector

Statistics of the nonbank private sector's (NBPS') net acquisition of public sector debt in the first quarter of fiscal year 1975/76 are not yet available. But, in view of the recent further deepening in the U.K. recession--with unemployment and short-time working continuing to rise sharply--personal incomes and savings, and the personal sector's financial surplus, now seem likely to be rather lower in 1975/76 than previously envisaged. Accordingly, it is assumed that the NBPS' take-up of public sector debt in 1975/76 will be somewhat smaller than the £2.5 billion forecast by U.K. officials last May. This seems a reasonable assumption, given the relatively close correlation between the size of the personal sector's financial surplus and the net amount of public sector debt purchased by the NBPS, as shown below.

1/ For details, see my July 25, 1975 memorandum to Mr. Whittome on this topic.

	Personal sector's financial surplus	Net acquisition of public sector debt by NBPS
	(£ millions)	
1972/73	1,291	911
1973/74	2,929	2,547
1974/75 (Prov. outturn)	3,950	4,100
1975/76 (HMG May est.)	2,800	2,500

Sources: CSO, Financial Statistics; and H.M. Treasury

Bank lending to the private sector

Bank lending to the private sector in recent months has been far more subdued than foreseen by either the U.K. authorities or ourselves at the time of last May's annual consultation in London. Not only has there been a drastic downward revision to the estimated May bank lending figure (from £228 million to only £61 million), but--as shown below--lending in June actually fell sharply.

Bank lending to the Private Sector

(Changes in millions of pounds, seasonally adjusted)

	Actual		At an annual rate
1975 January	+48		
February	-118	-287	-1,148
March	-217		
April	+128		
May	+61	-33	-132
June	-222		

Source: Bank of England, Quarterly Bulletin and Press Releases.

As yet it is too early to accurately determine whether this latest fall represents a further slackening in the private sector's demand for bank credit, or is merely an erratic movement. However, other recent economic developments--such as the much lower than projected real consumers' expenditure in the second quarter of 1975, and increasingly pessimistic survey reports on the outlook for business investment--put the odds in favor of the former interpretation. Moreover, in view of our (August 1) revised national accounts projections for the United Kingdom through first half of 1976--prepared for the planned WEO update paper--there appears to be little likelihood of any significant resurgence in private demand for bank credit in the remainder of fiscal year 1975/76. If there is not actually a sizable fall in bank lending to the private sector in 1975/76 (of the order of £1 billion, say) then at least there is unlikely to be any significant growth.

Adjustments

Predicting what the "adjustment" item is likely to be in fiscal year 1975/76 is a rather dubious operation due to the variability of the two components and to the relative lack of information about them. Fortunately this probably does not matter unduly, since in recent fiscal years the adjustment has normally been quite small as shown below.

	Bank lending (+) in sterling to nonresidents	Bank lending (-) in foreign currencies to residents for investment abroad	Adjustment
	(1)	(2)	(3)=(1)+(2)
	(£ millions, not seasonally adjusted)		
1969/70	117	-50	67
1970/71	72	-213	-141
1971/72	206	-420	-214
1972/73	95	-715	-610
1973/74	418	-600	-182
1974/75	60	-30	30
1975/76 (IMF est.)	100	-300	-200

Our projection assumes that bank lending in foreign currencies to residents for investment abroad will have recovered to a modest level during 1975/76, after actually declining in the second half of 1974/75. In part, this reflects an expected turnaround in the company sector's financial position from substantial deficit in 1974/75 to surplus this financial year. Meanwhile, bank lending in sterling to nonresidents in 1975/76 is assumed to be slightly higher than in the previous fiscal year.

External financing of the public and banking sectors

External financing of the public sector plus the net increase in nonresidents' deposits (i.e., financing of the banking sector) in fiscal year 1975/76 is simply assumed to be equal to the prospective current account deficit for the year. Recent developments in the current balance and our revised forecasts are shown below.

Balance of Payments - Current Account

(£ millions, seasonally adjusted)

1975 1st qtr.	-342)	-458
2nd qtr.	-116)	
3rd qtr. (est.)	-300)	-742
4th qtr. (est.)	-442)	
1976 1st qtr. (est.)	-650	
1975 (est.)	-1,200	
1975/76 (est.)	-1,508	

Sources: CSO/DTI, Press Releases; and IMF staff estimates.

Banks' nondeposit liabilities

The increase in the banking sector's net nondeposit liabilities in fiscal year 1975/76 is assumed to be moderately higher than in the previous year. Recent developments in this item, together with our projections for the current fiscal year are presented below.

Banks' Net Nondeposit Liabilities

(Changes in £ millions)

1972/73	802
1973/74	346
1974/75	626
1975/76 (IMF est.)	700

Sources: CSO, Financial Statistics; and IMF staff estimates.

Broadly defined money stock (M3)

According to the latest monthly money stock statistics (shown below), M3 actually declined slightly in June, after having risen relatively slowly in the previous few months--i.e., by around 10 per cent at an annual rate.

(Money Stock (M3)

(Seasonally adjusted)

	M3 (£ million)	Percentage change in M3 Monthly	From 3 months earlier at an annual rate	From 12 months earlier
1974 December	35,830	0.7	10.1	11.4
1975 January	35,970	0.4	9.7	9.6
February	36,440	1.0	10.0	9.1
March	36,750	0.8	10.7	9.9
April	36,830	0.2	9.9	10.1
May	37,370	1.5	10.6	11.3
June	37,280	-0.3	5.9	11.2

Source: Bank of England, Quarterly Bulletin and Press Release.

Comparing our central projection of the likely change in M3 in 1975/76 with the recent monthly data, suggests that/our figure (12.8 per cent) may be a little on the high side. Certainly, the U.K. authorities' May forecast (16 per cent) seems far too high.

Michael B. Hyndman

cc: Mr. Rose
Mr. Woodley
Mr. Karlstroem

Table 1. United Kingdom - Influences on Money Stock and Domestic Credit Expansion

(Changes in millions of pounds)

	1973/74	1974/75	[Aug. 1975] est.	1975/76 HMG (May 1975) estimates	1975/76 IMF (August 1975) estimates I	II	III
1. Public sector borrowing requirement (+)	4,465	7,600	10.5	9,000	10,000	10,000	11,000
2. Net acquisition (-) of public sector debt by nonbank private sector	-2,547	-4,100	-4.1	-2,500	-2,500	-2,000	-2,000
3. Bank lending (+) to private sector	6,672	3,300	1.1	3,000	-1,500	-1,000	--
4. Adjustments (+)	-182	100		...	-200	-200	-200
5. Domestic credit expansion	8,408	6,900	7.5	9,500	5,800	6,800	8,800
6. External financing (-) of public sector	-125	-1,400)	-2.0	)			
7. Net increase (-) in nonresidents' deposits	-1,337	-1,300)	-1.3	-3,500)	-1,500	-1,500	-1,300
8. Increase (-) in banks' nondeposit liabilities	-346	-600)			-700	-700	-700
9. Adjustments (-)	182	-100)			200	200	200
10. Money stock (M3)	6,782 (25%)	3,500 (10.3%)	4.2 (11.2%)	6,000 (16%)	3,800 (10.1%)	4,800 (12.8%)	7,000 (18.7%)
Of which:							
11. Notes and coin	411	900		1,000	...	...	...
12. Deposits	6,371	2,600		5,000	...	...	...

Sources: CSO, Financial Statistics; Bank of England, Quarterly Bulletin; official HMG (secret) estimates; and IMF staff projections.

Notes:
1. HMG estimates of DCE in 1975/76 were in the range £(9,500-10,000) million, with the sum of items (6) through (9) correspondingly in the range -£(3,000-3,500) million.
2. The three alternative IMF staff projections (I-III) correspond to the probable most favorable, central and least favorable sets of assumptions, respectively.
3. Adjustments equals bank lending in sterling to nonresidents less bank lending in foreign currencies to U.K. residents for investment overseas.
4. Figures in parenthesis below M3 data are the corresponding annual percentage changes in M3.

July 30, 1975

MEMORANDUM FOR FILES:

Subject: United Kingdom: Official Forecasts of DCE and M3 in 1975/76

During the 1975 Article VIII consultation with the United Kingdom last May, the staff received official U.K. forecasts of M3 and DCE in financial year 1975/76 (Table 1, attached).

In summary, U.K. officials at that time envisaged a DCE of some £(9,500-10,000) million in 1975/76--much larger than in the previous financial year. This prognosis stemmed from their expectation of further rise in the PSBR to a record £9,100 million in 1975/76, coupled with substantially reduced sales (net) of public sector debt to the general public and only a slightly lower increase in bank lending to the private sector. Correspondingly, M3 was officially projected to rise by at least £6,000 million, equivalent to an annual growth rate of 16 per cent.

These forecasts were based on the following main assumptions:

(1) The public sector borrowing requirement (PSBR) in 1975/76 would be as projected in the Financial Statement and Budget Report 1975/76.

(2) The net acquisition of gilt-edged stocks by the nonbank private sector (NBPS) would be £(1,000-1,500) million lower than in 1974/75, in view of an expected increase in interest rates and deterioration in the current account of the balance of payments during the remainder of 1975.

(3) The NBPS' takeup of local authority debt would likewise be rather lower than in 1974/75.

(4) The increase in the public's holdings of notes and coin would be about the same as in 1974/75.

(5) National savings would be somewhat higher than in 1974/75 due to the introduction of two limited indexed savings-bond schemes.

(6) Bank lending to the private sector would remain very subdued reflecting slack demand for credit attributable to an expected continuing depressed level of economic activity.

(7) There would be a substantial unwinding of the previous financial year's very large "unrecorded" short-term capital inflow of £1,214 million, which was attributed chiefly to possible changes "in leads and lags" of commercial payments associated with the cash flow difficulties of the U.K. corporate sector.

MH

Michael Hyndman

Table 1. United Kingdom: Influences on Money Stock and Domestic Credit Expansion

(Changes in millions of pounds)

	1973/74	1974/75	1975/76 HMG Estimates
1. Public sector borrowing requirement (+)	4,465	7,600	9,000
2. Net acquisition (-) of public sector debt by nonbank private sector	-2,547	-4,100	-2,500
3. Bank lending (+) to private sector	6,672	3,300	3,000
4. Adjustments (+)	-182	100	...
5. Domestic credit expansion	8,408	6,900	9,500
6. External financing (-) of public sector	-125	-1,400)	
7. Net increase (-) in nonresidents' deposits	-1,337	-1,300)	
8. Increase (-) in banks' nondeposit liabilities	-346	-600)	-3,500
9. Adjustments (-)	182	-100)	
10. Money stock (M3)	6,782	3,500	6,000
Of which:			
11. Notes and coin	411	900	1,000
12. Deposits	6,371	2,600	5,000

Sources: CSO, Financial Statistics; Bank of England, Quarterly Bulletin; and HMG, official May 1975 estimates (secret).

Notes: 1. Adjustments equals bank lending in sterling to nonresidents less bank lending in foreign currencies to U.K. residents for investment overseas.

2. HMG estimates of DCE in 1975/76 were in the range £(9,500-10,000) million, with the sum of items (6) through (9) correspondingly in the range -£(3,000-3,500) million.

3. Bank lending to the public sector equals items (1) plus (2).

4. The forecast increase in M3 during 1975/76 implies a growth rate of about 16 per cent per annum.

Mr. Hyndman

EHBrau
8-11-75

United Kingdom - Domestic Credit Expansion 1975-76

This note presents an order of magnitude for domestic credit expansion for fiscal year 1975-76 which appears consistent with the objective of decelerating the rate of price increase to 10 per cent in the second half of 1976; in the absence of a sharp expansionary turnaround in demand management policies and significant exchange rate support, a significantly reduced current account deficit in 1975-76 appears assured by the deepening recession in the United Kingdom economy.

Demand for liquidity (M3), Table 1:

i. the rate of growth of M3 has decelerated from an annual rate of 25 per cent in 1974-I to 10 per cent in 1975-I and appears to have bottomed out at about 10 per cent in 1975-II. Between 1974-I and 1975-I, the M3/GDP ratio declined by about 15 per cent but the rate of decline slowed in 1975-II.

ii. given the absence of a reliable relationship between M3, income, interest rates, and price expectations for recent periods and given the (anticipated) policy changes, the projection of M3 for 1975-76 must rely on relatively simple methods, subject to considerable margins of error.

iii. the method applied in Table 1 has been to ascertain whether a continuation of a rate of growth of M3 at between 10 per cent and 12 per cent (with a midpoint of 11 per cent) in the year to March 31, 1976 appears consistent and plausible if checked against independent estimates of nominal GDP for 1975-76, and against the target of decelerating the increase in retail prices.

iv. this has been done, firstly, by computing implied M3/GDP ratios for 1975-76 on the basis of the GDP projection of the latest WEO (August 1975) for 1975-76 (rows 4-7); the quarterly GDP interpolation of rows 7 for 1975-76 is a guesstimate.

v. the implied development of the M3/GDP ratio is shown in row 10; accordingly, at the assumptions, the ratio would continue to decline until the first quarter of 1976, i.e., velocity continue to rise, while the projection for 1976-II assumes a reversal in velocity behaviour as the rate of price increase begins to decline appreciably. The implied velocity behaviour for 1975-76 does not appear implausible, although it may be considered a somewhat favorable development: as price increases continue strongly through 1975, velocity would rise further but it is implied (favorably) that the rate of increase is slowing down. This assumes, partly, that the public's price expectations are slowly beginning to change. Against this is set the decline in real personal incomes during 1975-76 which would tend to weaken savings in monetary form. On balance, therefore, the velocity behaviour implied by an M3 expansion rate of about 11 per cent, while not implausible, is favorable.

vi. the second check has been to compute the implied development of the real M3 stock through 1975-76 (row 12) against the desired deceleration of consumer prices (row 11); accordingly, the reduction in the real M3 stock, which had been very sharp in 1974-75, would continue at a reduced rate in 1975-76 and bottom out in 1976-I. Such a development is not implausible although, again, the extent of the implied reduction in 1975-76 is not very great.

Domestic credit expansion (DCE), Table 2:

i. the approach in Table 2 is to compare a desired DCE on the basis of an M3 growth rate of either 10 per cent or 12 per cent as obtained from Table 1 (top half of Table 2) with the likely increase in DCE from the supply side at unchanged policies (bottom half of Table 2).

ii. the desired DCE is derived, apart from adjustments and allowance for growth in non-deposit liabilities, by estimating external finance in 1975-76 at the level of the current account deficit projected in the WEO for 1975-76. This is an uncertain assumption since it depends heavily on the behaviour of capital account items, and the estimated external finance of £1.5 billion in 1975-76 (against £2.8 billion in 1974-75) may be an underestimate. However, at that level, and given the assumptions regarding M3 growth, DCE expansion in 1975-76 consistent with the price and balance of payments objectives for 1975-76 would amount to between £5.9 billion and £6.7 billion, say around £6 billion, and would therefore be slightly less in nominal terms than the actual expansion in 1974-75 and considerably less in real terms.

iii. from the supply side, and at unchanged policies, however, a domestic credit expansion of around £8.4 billion would be generated, exclusively as a result of the large public sector deficit. The public sector borrowing requirement is estimated at £11 billion (as against a United Kingdom estimate of £9.1 billion in May 1975) due to increases estimated by the staff, slippage and known additional outlays (British Leyland, British Steel, etc.); an estimate of around £11 billion is in accord with recent press reports. The uptake of public sector debt is set at the estimate by United Kingdom officials of May 1975 at around £2.5 billion. Bank credit to the private sector, which showed an absolute decline in the first half of 1975, is assumed not to increase at all in 1975-76 due to weak investment demand and the company sector's improving liquidity position.

Conclusion

At an assumed somewhat favorable M3 expansion of between 10 per cent and 12 per cent in 1975-76 and with unchanged fiscal and debt policies, a domestic credit expansion of about £8.4 billion is likely to be generated, which is in excess of the desired (or consistent) expansion by about £2 billion. If this credit expansion were to materialize and were to be fully reflected in higher M3 growth, the resultant M3 growth would be of the order of 16 per cent to 18 per cent in 1975-76. Such a rate of increase would clearly be inconsistent with the United Kingdom price objectives, and very likely the balance of payments objectives as well.

The conclusion is inevitable that domestic bank financing of the public sector must be reduced. The principal means would be a cut in the public sector borrowing requirement (pulling forward the cuts announced for 1976-77). An additional contribution could come from a more aggressive sale of public sector debt. Such a policy would have very unfavorable employment consequences. The hoped for revival in world demand may not materialize early and strongly enough to cushion such employment effects.

Table 1. Development of Money Stock and Projection of Demand for Money

(End of period stocks; in parenthesis annual rates of change)

	1974				1975						
						Partially estimated	Projection				
									1976		
	I	II	III	IV	I	II	III	IV	I	II	III
1. M1 (£ millions)	12,722 (3.6)	13,175 (--)	13,513 (4.9)	14,739 (10.8)	14,735 (11.8)						
2. Quasi-money (£ millions)	21,120 (42.9)	21,662 (40.1)	22,159 (22.5)	22,894 (22.5)	22,589 (7.0)						
3. M3 (£ millions)	33,892 (25.0)	34,838 (21.6)	35,672 (15.2)	37,633 (12.6)	37,324 (10.0)	38,400 (10.2)	39,400 (10.5)	41,400 (10.0)	41,500 (11.2)	43,600 (13.5)	
4. GDP at market prices (£ billions, 1970 prices seasonally adjusted)	27.6 (-3.6)		28.8 (8.4)		28.6 (-1.2)		28.3 (-1.8)		28.4 (0.6)		
5. GDP deflator (per cent change at annual rate)	9.0		21.4		25.0		19.0		13.0		
6. GDP at market prices (£ billions, current prices, seasonally adjusted)	37.2		43.3		48.5		52.6		56.3		
7. GDP at market prices (£ billions, current prices, seasonally adjusted)	18.1	19.1	21.2	22.0	23.6	24.9	25.9	26.7	27.6	28.7	
8. M1/GDP	0.706	0.689	0.637	0.670	0.625						
9. Quasi-money/GDP	1.167	1.134	1.045	1.041	0.957						
10. M3/GDP	1.872	1.824	1.635	1.711	1.581	1.540	1.520	1.550	1.500	1.520	
11. Consumer prices, average during quarter (annual rate of change)	16.1	22.5	21.4	22.0	20.3	21.0	20.0	18.0	15.0	13.0	11.0
12. M3 at 1970 prices (£ billions)	24.4	23.7	23.6	23.8	22.3	21.5	21.7	21.5	21.6	21.7	

DRAFT
Mr. Hyndman

July 23, 1975

MEMORANDUM FOR FILES

Subject: Credit Ceilings for the United Kingdom

This memorandum discusses alternative options for expressing credit ceilings for the United Kingdom for either a credit tranche or oil facility transaction.

1. Central bank or banking system ceiling

The reluctance of the United Kingdom authorities to express their credit policy objectives in terms of targets for overall credit expansion of the banking system naturally leads to considering whether a credit policy target might usefully be expressed in terms of credit expansion by the monetary authorities. There are several reasons why a central bank ceiling might not be advantageous in the British context, including (a) the highly unstable relationship in recent years between the change in net domestic assets of the monetary authorities and reserve money, between the change in net domestic assets of the monetary authorities and overall credit expansion (DCE), and the somewhat less unstable but still difficult to predict relationship between reserve money and liquidity (M3); (b) the well understood and frequently used concept of DCE and its components among policy makers as a basic guideline judging monetary policy; and (c) the reference to developments of bank credit to the private sector, a component of DCE, in activating or not the IBEL (interest bearing eligible liabilities) control system.

These considerations, among others, favor the use of a ceiling on credit expansion by the banking system.

2. <u>The definition of domestic credit expansion</u>

Apart from conceptually and quantitatively minor differences, the major conceptual and quantitative difference between domestic credit expansion as defined by <u>IFS</u> and the United Kingdom authorities lies in the treatment of foreign borrowing by the public sector. The United Kingdom definition of domestic credit includes such borrowing as an item in domestic credit while the <u>IFS</u> definition excludes it.

In the 1969 stand-by arrangement with the United Kingdom which utilized the United Kingdom definition of domestic credit, the authorities supported the inclusion of foreign borrowing in domestic credit expansion on the ground that public sector spending was determined independently of foreign borrowing and that if such borrowing fell either short of, or exceeded, expectations, there would be a corresponding change in the use of domestic finance and domestic demand would not be affected. The staff representatives argued that the balance of payments would vary with the amount of foreign borrowing by the public sector and that any shortfall in such financing would, therefore, seem to call for offsetting adjustments in total credit. However, given that United Kingdom officials were confident that foreign borrowing by the public sector would be close to the amount forecast, the staff representatives accepted the United Kingdom definition of domestic credit as satisfactory in the circumstances. The amount of foreign borrowing involved at that time was equivalent to one fourth of the outer limit of credit expansion agreed for the program period, and equivalent to 40 per cent of the central objective with regard to credit expansion. In the fiscal year 1974/75, foreign borrowing by the public sector constituted one fifth of credit expansion.

The economic reasons for excluding foreign borrowing by the public sector from the definition of domestic credit remain as stated by the staff in 1969. In current circumstances when the margin for further foreign borrowing by the public sector has been considerably reduced, there may be added the operational reason that confident projections of such foreign borrowing are difficult to make, or in any case, to make in public.

3. The form of a credit ceiling encompassing the banking system

If the United Kingdom definition of DCE were accepted as a basis for a credit ceiling encompassing the banking system, or if an alternative definition were adopted, the particular form in which a ceiling is expressed remains to be considered. The question arises as a result of the reluctance of the United Kingdom authorities to accept a specific time path of the credit aggregate as an unambiguous indicator of their credit policy. Two basic technical reasons are advanced for this. First, the United Kingdom authorities have not been able for recent years to establish a satisfactory predictive relationship between income, interest rates, price expectations and liquidity (M3). This makes a precise definition of credit policy infeasible. Second, it is impossible to estimate with sufficient precision the likely purchases of public sector debt by the non-bank private sector; if, as a result, there are sizable unforeseen variations in this item, domestic credit expansion is directly affected in the opposite direction. A subsidiary reason given, especially in situations when a tight credit policy is to be followed, is that actual movements of domestic credit could vary from the projected path by sizable amounts because of purely random factors. Considerations of the latter sort led to the formulation of credit ceilings with margins for error in the 1969 stand-by arrangement with the United Kingdom.

There appear to be four basic ways of formulating a credit ceiling for the United Kingdom while taking cognizance of the difficulties expressed by the authorities. The objection to credit ceilings on the basis that predictions of the demand for liquidity are difficult to make is not considered here.

(a) One alternative is to express a ceiling in the orthodox manner by a single number (phased, if applicable) with the following provisos: beyond the normal consultation clauses in a stand-by arrangement, there would be an explicit discussion of the circumstances in the United Kingdom situation which make the exact setting of any single number difficult. The Executive Board would be advised of the possibility and the readiness of the staff to propose a modification in the ceiling if any of the basic assumptions (other than policy changes) on which the ceiling is based were found to be in error by subsequent developments.

An advantage of this alternative is that it would apply to the United Kingdom the standard applied to other Fund members with respect to credit ceilings. The principal disadvantage might be that the United Kingdom authorities could feel that this approach is more a cosmetic rather than substantive recognition of their difficulties with the concept of a credit ceiling.

(b) The second alternative is to again use a credit ceiling with a margin for error. Presumably, this would go further toward meeting the objections of the authorities and there is the force of precedent. However, the staff might have difficulties with the use of error margins in present circumstances if the margins, again by precedent, were to be of similar size as those agreed in 1969, i.e., equivalent to 60 per cent of the "central objective" with regard to credit expansion. With a likely ceiling on credit expansion of the order of several billion pounds, an error margin acceptable to the authorities could be so large as to raise doubts about the meaning of the credit policy defined by a ceiling with such margins. To be acceptable, the margins would have to be quite narrow, say £1 billion-£1.5 billion above a central objective of, say, £6 billion.

(c) A third possible alternative has emerged from informal staff contacts with the authorities. This alternative, for which there is no precedent has apparently not yet been explored by the staff with respect to its implications and problems. The general intent is to circumvent the difficulties in establishing a magnitude for the overall credit expansion by agreeing individually on magnitudes for the <u>components</u> of domestic credit. Conceptually, this could be done in two ways in accordance with the alternative methods of deriving figures for DCE, using the United Kingdom definition as a basis of presentation.

Under the more straightforward procedure (public sector borrowing requirement <u>minus</u> net acquisition of public sector debt by non-bank private sector <u>plus</u> bank lending to private sector <u>plus</u> adjustments <u>equals</u> DCE) an independent ceiling could be placed as a fiscal policy criterion on the public sector borrowing requirement. This much is clear. The authorities would then present an estimate of the net acquisition of public sector debt (on the basis of an assumed interest rate policy) and also on an estimate of the expansion of bank lending to the private sector, including any adjustments which usually are minor. Presumably the staff would have to regard the estimates as reasonable in terms of the objectives of the program. Because such estimates of individual components cannot constitute ceilings, it would be necessary, however, to arrive at a number for overall credit expansion on the basis of the estimates and the given ceiling on the public sector borrowing requirement.

While this can be done by simple aggregation to arrive at a number for DCE, it is unclear what status of policy significance such a number would have. If the staff were to do the aggregation in the staff paper, a way would have to be found to refer to the resulting DCE number in the letter of intent in such a manner that the DCE number would constitute a benchmark for judging the performance of credit policy and for initiating consultation, if necessary. Unless there were agreement on an overall DCE ceiling in some, even indirect, manner no agreed norm for judging credit policy during the life of the program would exist.

Under the other procedure for deriving DCE (holdings of currency by non-bank private sector <u>plus</u> bank lending to public sector <u>plus</u> external finance of public sector <u>plus</u> bank lending to private sector <u>plus</u> adjustments <u>equals</u> DCE) a ceiling could also be placed on the public sector borrowing requirement as a fiscal policy criterion. By definition, the public sector borrowing requirement <u>minus</u> net acquisition of public sector debt by non-bank private sector <u>equals</u> holdings of currency by non-bank private sector <u>plus</u> bank lending to public sector <u>plus</u> external finance of public sector. As a result, the estimate of net acquisition of public sector debt would under this procedure be replaced by an estimate of the remaining means of financing the public sector borrowing requirement. This procedure is less elegant than the first one, but offers the advantage of requiring an explicit estimate of the financing of thepublic sector borrowing requirement, after net sale of debt, as between currency issue, bank lending to the public sector, and external finance of the public sector. This advantage is, however, not very substantial and the problems of consolidating the component estimates into an agreed overall DCE number remain.

(d) In theory, there is the further possibility of agreeing on a DCE ceiling <u>adjustable</u> with respect to net sale of public sector debt to the non-bank private sector. This type of ceiling could be useful if indeed the basic reluctance of the United Kingdom authorities in agreeing to a single DCE number were to stem from the difficulties of forecasting with confidence the sale of public sector debt. Given other estimates, the ceiling would be based on the assumption that the sale of public sector debt would amount to, say, £3 billion during the program period; it would be reduced by the amount by which debt sale increased above £3 billion/ and it would be increased by the amount by which the debt sale fell short of £3 bill. with a total limit on allowable upward adjustment due to shortfall of say £1 billion. Under this ceiling, it would be important to set a reasonably ambitious target for debt sale (i.e., interest rate policy).

4. <u>Credit ceiling by implication</u>

There may be a further option of arriving at an understanding with respect to credit policy in an indirect way. Under this procedure, a ceiling would also be placed on the public sector borrowing requirement. The authorities and the staff would then "agree", on the basis of the above ceiling and the other policy elements in the program on an estimate of the increase in the holdings of money (M3) during the program period. In addition, the authorities would state that they would so conduct their exchange rate policy that net official reserves would change little during the program period. Both the M3 estimate and the net reserve (exchange rate policy) undertaking would imply a credit expansion. The authorities could undertake to so manage their credit policy as to be consistent with the M3 estimate and the net reserve undertaking. The staff would state that this undertaking means an overall credit expansion of a certain magnitude and that it would evaluate credit policy with reference to this magnitude, rather than something else.

This credit ceiling by implication approach may be useful if acceptable to the United Kingom authorities although it may appear to be somewhat contrived in its use of an identity to establish the same concept that does not seem acceptable when established more directly. In addition, the use of this approach is based on the authorities making a relatively firm undertaking with respect to net reserve changes which they may be very reluctant to do.

E. H. Brau

cc: Mr. Woodley
Mr. Finch
Mr. Karlstroem
Mr. Vittas
Mr. Hyndman

Office Memorandum

TO : Mr. Karlstroem

DATE: December 8, 1975

FROM : L. G. Manison L.G.M.

SUBJECT : United Kingdom - Possible Introduction of Selective Import Controls

The recent staff discussions with the U.K. authorities indicated that quantitative restrictions may be placed on the import of motor cars, cathode tubes for television receivers, and certain items of footwear, clothing, and textiles. In this memorandum, recent developments relating to the import, production and domestic sales of these items are examined. The arguments that the U.K. authorities may present in support of import controls are also discussed.

1. Some relevant statistics

Detailed overseas trade statistics are only available for the first eight months of 1975. These data indicate that the value of merchandise imports (f.o.b.) rose by 2.6 per cent,1/ while import volume declined by 8.9 per cent during this period (Table 1). The value of imports excluding petroleum and petroleum products rose by 5.4 per cent over the same period, as petroleum and petroleum product imports declined by 8.9 per cent. Imports of motor cars, clothing, and footwear have risen at a substantially higher rate than total imports during 1975.

In the January-August period of 1975, the following types of imports represented the following percentages of total imports: passenger cars (2.2 per cent), clothing (2.1 per cent), textiles (2.8 per cent), and footwear (0.6 per cent). Data on the value of imports of tubes for color television receivers were not available, although the value of the imports of the item "thermonic, etc. valves and tubes, photocells, transistors, etc." amounted to 0.6 per cent of total imports. Accordingly, if broad import controls were introduced on the aforementioned items, such restrictions would cover less than 10 per cent of total imports.

(a) Motor cars

In the first eight months of 1975, the value of the imports of passenger cars has risen by 52.5 per cent, with the number of imported passenger cars increasing by 27.4 per cent. The rapid rise in car imports has taken place despite a considerable weakening in the domestic demand for cars; the average monthly level of new registrations of cars decreased by 6.7 per cent in the first eight months of 1975, while real consumer expenditures on cars and motorcycles fell by 6.5 per cent in the first half of 1975. The penetration of the domestic car market by imports is indicated by the fact that the ratio of imports to total car sales in the United Kingdom, which averaged 27-28 per cent in 1973 and 1974, increased to 33 per cent in the first nine months of 1975 (Table 2). The data in table 3 indicate that the number of imports of passenger cars as a percentage of percentage of domestic production have risen from 21.9% in the first 8 months to 35.2% in the same period of 1975.

This penetration has been most pronounced with respect to Japanese car imports; their number rose by 125.8 per cent in the first eight months of 1975 and the Japanese share in the imported car market increased from 15.6 per cent in the

1/ Unless otherwise specified, percentage changes refer to levels in the period mentioned compared to levels in the corresponding period of the previous year.

Table 1. United Kingdom: Changes in Total and Selected Import Commodities

	Total imports (f.o.b.)	Total non-oil imports 1/	Passenger cars	Clothing	Footwear	Textiles	Textile yarn and thread	Woven cotton fabrics	Other textile fabrics
As a percentage of total imports in Jan.-Aug. 1975	100.0	82.7	2.2	2.1	0.6	2.8	(0.8)	(0.6)	(0.8)
1974									
Percentage change in: 2/									
Value	50.1	26.1	-18.9	20.6	29.5	33.7	(62.4)	(26.1)	(30.5)
Volume	1.0		-25.6	...	...	...	(...)	(...)	(...)
1975 January-August									
Percentage change in: 2/									
Value	2.6	5.4	52.5	16.8	16.2	-3.1	(-19.7)	(-11.3)	(12.2)
Volume	-8.9		27.4	6.5	-1.0		(-15.1)	(-12.2)	(15.1)

Sources: Department of Trade and Industry, Overseas Trade Statistics.

1/ Imports excluding petroleum and petroleum products.
2/ Percentage changes are calculated by comparison of level in period specified with level in corresponding period of the previous year.

Table 2. United Kingdom: Domestic Market Penetration of Selected Import Commodities

	Clothing	Footwear	Passenger cars 1/
	(Imports as a per cent of consumer expenditures)		
1965			4.9
1970			14.3
1971	7.4	11.1	19.3
1972	7.9	11.1	23.5
1973	10.5	13.2	27.4
1974	10.8	14.8	27.9
1975 First half	11.6	17.6	
January-September			33.0

1/ Imports as a per cent of total car sales.

Table 3. United Kingdom: Production, Exports, and Imports of Passenger Cars, 1971 - January-August 1975

	1971	1972	1973	1974	1974 January-August	1975 January-August
Passenger cars (nos)						
Production	1,741,940	1,921,311	1,747,321	1,534,119	1,034,055	820,470
Imports	283,512	453,888	508,547	356,898	226,966	288,998
Exports	714,478	613,430	605,105	596,187	398,796	353,270
Supply	1,310,974	1,761,769	1,650,763	1,294,830	862,225	756,198
Imports/Production - percentage	16.2	23.6	29.1	23.3	21.9	35.2

Sources: Department of Industry; and Overseas Trade Statistics.

first eight months of 1974 to 22.6 per cent in the same period of 1975. Weak domestic demand and competition from imports have contributed to a decline in the domestic output of passenger cars in 1975. The production of passenger cars fell by 20.7 per cent in the first eight months of 1975 and the decline in the period up to October 25 was 17 per cent compared to the corresponding period of 1974. Employment in the motor car industry, which tended to stagnate and comprised about 3 per cent of total employment in 1974, declined by 5.3 per cent between December 1974 and June 1975; this compares with a decrease in total industrial employment of 3.3 per cent over the same period.

The extent to which import penetration of the domestic car market, especially by the Japanese, can be attributed to dumping and/or other unfair trading practices cannot be determined on the basis of the available information in Washington. In this context, it should be noted that motor car production for the export market has performed considerably better than that for the home market and in the first 10 months of 1975 with the value of exports of passenger cars rising by 17 per cent.

(b) Clothing

The value of imports of clothing and knitted products increased by 16.8 per cent in the first eight months of 1975, with the volume of such imports as measured in physical weight rising by 6.5 per cent. As consumer expenditures on clothing rose by 22 per cent in the first half of 1975, there does seem to have been much/import penetration of the clothing market, at least for the industry as a whole. There is some evidence that imports of knitted outer garmets, especially from Hong Kong, have made some penetration in the clothing market. The value and quantity of such imports have risen by 24.7 per cent and 14.8 per cent, respectively, in the first eight months of 1974. The value of imports of knitted outer garmets from Hong Kong, which now comprise over one third of the import market in these products, increased by 50.9 per cent in the first eight months of 1975, with quantity of such imports measured in terms of weight rising by 43.3 per cent. The production of clothing and footwear declined by 3 per cent in 1974 and in the first seven months of 1975 a further decline of 3.5 per cent was recorded. Employment in the clothing and footwear industry, which accounts for about 2 per cent of total employment, has decreased in recent years, falling by 3.5 per cent in the 12 months ending June 1975.

(c) Footwear

The value of footwear imports rose by 16.2 per cent in the first eight months of 1975, while the quantity of such imports declined by 1 per cent. The value of consumer expenditures on footwear rose by 15.2 per cent in the first half of 1975. Imports as a percentage of consumer expenditures have increased from 11 per cent in 1972 to nearly 18 per cent in the first half of 1975. Although the footwear industry has concentrated its campaign for import controls on the low-cost countries of the Far East, especially Hong Kong, and the Comecon countries, increased market penetration has come from other EEC countries, with the value of shoe imports from Italy increasing by 32 per cent in the first eight months of 1975.

(d) Textiles

The value of the import of textiles declined by 3.1 per cent in the first eight months of 1975. Imports of textile yarn and thread and woven cotton fabrics recorded considerable declines while imports of other textile fabrics, especially synthetic fabrics, showed strong gains. Domestic sales of textile products have tended to stagnate in the first eight months of 1975. Reflecting weak foreign and domestic demand conditions, the domestic production of textiles declined by 7.8 per cent in the first seven months of 1975, and in the 12 months to June 1975 employment in the textile industry, which accounted for about 2.3 per cent of total employment, fell by 7.2 per cent. The absence of significant import penetration in the U.K. textile market during 1975 probably reflects the fact the EEC has already negotiated import restraint agreements with India, Pakistan, Malaysia, Hong Kong, Singapore, Macao, and South Korea this year.

(e) Tubes for television receivers

U.K. businessmen have accused Japanese manufacturers of tubes for colored television receivers of dumping their products on the U.K. market during 1975. In replying to this accusation, the Japanese Trade Centre in London has said that in the case of cathode ray tubes "the authorities found no evidence of dumping". In 1974 Japan supplied 65 per cent of the import market for tubes for U.K. television sets; the corresponding percentage in the first six months was around 50 per cent with the annual sales of Japanese imports being considerably below that in 1974. The very weak domestic demand for colored television receivers has probably contributed more to the frustrations of British television tube manufacturers than competition from Japanese manufacturers. In the first seven months of 1975, deliveries of U.K. made television receivers for the home and export markets declined by 23 per cent, while deliveries of imported receivers fell by more than 50 per cent.

2. The case for selective import controls?

The U.K. authorities could present a number of arguments to justify the introduction of selective import controls. Perhaps the most persuasive argument (which may not be presented, but may be overriding with regard to the authorities' decision to introduce certain import controls) would be that the introduction of import controls on certain products is necessary to appease the trade unions so as to not jeopardize other elements in the Government's economic program which to date have the support of the trade unions. The use of import controls to help preserve employment in certain key industries, such as the car industry, may help in maintaining the present cooperation of the trade unions in limiting their demands for wage increases to £6 per week. However, to determine the validity of this argument one would have to resort to political judgment.

Any argument suggesting that import controls on certain types of textiles, clothing, footwear, motor cars, and television tubes would lead to a significant reduction in imports, and hence improve the balance of payments, would not carry much weight insofar as imports of the aforementioned items presently amount to about 8 per cent of total imports. If expenditures on domestically produced items are increased as a result of new import controls it is possible that the demand by domestic manufacturers for import components may subsequently rise. For example, the application of quotas on motor car and footwear imports may eventually lead to increased rubber imports.

Probably the argument that is most likely to be presented is that sudden and rapid increases in certain types of imports are providing unfair competition in particular sectors of the economy and are threatening to destroy industries which may be viable over the medium term.1/ Thus, it may be contended that with the smaller market now available for particular products, such as that for motor cars, unrestricted competition may irrepairably damage certain sectors of industry as the impact of the world recession is unevenly distributed among major industrial countries.2/ In the case of the motor car industry, it may be argued that the present rate of penetration of imports into the U.K. car market is too rapid and that the level of 33 per cent (ratio of imports to total car sales) in the first nine months of 1975 is excessive. Terry Dodsworth, in discussing the possible introduction of selective import controls, noted that "there seems to be a general consensus among large manufacturing nations that 25 per cent (or imports to total car sales) is a reasonable figure. This is the kind of proportion that the Department of Trade would find acceptable here."3/ It may be further argued that the rapid Japanese penetration of the car market in 1975 does not represent normal trading patterns and that British car manufacturers faced with a falling domestic demand for motor vehicles should be protected in the short term against such competition. While it is admitted that import penetration in the U.K. car market has been very rapid in 1975, it is noted that there has been a continuous marked increase in such penetration since 1965 despite the fluctuations in world economic activity. Whether import penetration in the car industry would decrease as the world economy recovered and whether the British car industry would be competitive over the medium term is debatable. The improved export performance of the British car industry during 1975 does provide some indication of the ability of the industry to be competitive over the medium term.

In other sectors of U.K. industry which have experienced strong competition from imports and where import controls may be introduced, such as on certain types of clothing, footwear, and textiles, it is doubtful that these industries would be particularly viable over the medium term.4/ While import controls may help in moderating the perennial decline in employment in these industries, it is unlikely that they would be competitive with foreign imports over the medium term; this is particularly so with reference to labor-intensive products. Apparently, footwear manufacturers have argued that short-term controls (three years at a maximum) are required to allow the breathing space necessary for industry to re-equip itself to deal with foreign competition. Whether the modernization of capital equipment in traditionally labor-intensive industries, such as footwear and clothing, will make such industries competitive over the medium term is also subject to debate.

1/ This would be in accordance with Article XIX of GATT which permits the adoption of import controls to protect industries seriously threatened by a sudden increase in competition from imports.

2/ A comparison of rates of growth of imports and import-GDP ratios with other industrial countries is given in Appendix Table I.

3/ Financial Times, November 22, 1975, p. 20.

4/ Sweden faced with a similar rapid erosion of its domestic footwear industry by foreign competition recently imposed import quotas on certain types of footwear for national security purposes.

WITHDRAWAL NOTICE

PROJECT

Project number	2009-008
Project name	EUR Division Files
Project tab number	191
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DOCUMENT

Series / File	United Kingdom-Stand-By (97063)
Original box / file No	80 / 1
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From	C. Ward
To	Batchelor
Subject / Title	IMF: Import Restrictions: Gold Coins
Number of pages	4
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COMMENTS

THIS DOCUMENT IS IN THE COURSE OF A SYSTEMATIC PUBLIC DISCLOSURE REVIEW PROCESS

Entered by bhooten Entered on 2010-02-26

Office Memorandum

Mr Hydreon
Mr Hole
Pl let me know (quickly) if you have any points
PPW 18/8

SECRET

TO : The Managing Director DATE: August 18, 1975

FROM : W. John R. Woodley JW.

SUBJECT : United Kingdom

1. On August 14 and 15, together with other staff members, I met with Messrs. Cassell (Treasury), Price (Bank of England), Bull and Sweeney of the Executive Director's office. While Cassell indicated that final decisions had not been taken and all options should be kept open, he wanted to review conditions and procedures for an oil facility and first credit tranche drawing or stand-by arrangement. Cassell returned to London with the attached papers. It was indicated that they had been done hurridly to meet his needs, and that on the staff side the positions were ad referendum to my colleagues and you. In fact, the papers contain no quantities; we listened to their suggestions and reserved any reaction. On the U.K. side, Cassell expressed concern about how his people would react to the DCE question and other efforts to quantify targets. As the weeks go by however, positions are being crystallized, and it is now time for us to know where we stand on the major issues.

2. The U.K. policies as described can be combined together into a reasonable program. Output is projected as virtually stagnant, with unemployment rising to 5 per cent and recovery in 1976 basically dependent upon a revival of exports. The price target is to reduce the rate of increase to about 10 per cent in the second half of 1976. In the meantime, the price rise is expected to decelerate slowly from the present 28 per cent. Assuming the new incomes policy is effective, wage increases would be about 11 to 12 per cent resulting in a sharp reversal of the increase in real wages that occurred in the first half of 1975. The balance of payments on current account shows a sharp improvement from 1974 to 1975, but then remains at about the 1975 second half level in the first half of 1976. Improvement in 1976 is linked to continuing restraint on domestic demand, the lagged effects of exchange rate changes, and a revival in export demand.

3. The key policies related to the outcome above are:

(a) The July incomes policy lasting until August 1976.

(b) The public sector borrowing requirement (PSBR) which is regarded as consistent with stable output and rising unemployment, and therefore leaves scope for export expansion when demand revives.

(c) A neutral attitude toward credit to the private sector on the basis that demand for credit is slack and unlikely to revive. Restraint is promised if the situation changes.

(d) On the external side, avoiding controls and letting the exchange rate move to maintain the present competitive position.

4. The outlook and policies as described above appear reasonable and as warranting support from the Fund. Nevertheless, there are issues you might wish to raise with the Chancellor.

(a) The PSBR which was £7.6 revised to £8.0 billion last year was set at about £9 billion or 10 per cent of GDP at the time of the April budget for FY 1975/76. The current estimate is £10.5 billion, the increase being due to a variety of factors mostly of a non-policy type. Even Treasury officials admit that they know little of what local government units are spending and that the rapid inflation has reduced the effectiveness of traditional controls. The Chancellor is emphasizing the use of cash limits on expenditures next year and government officials are working on the problem now, but in the meantime one has to have serious reservations about the possibility of staying at the present £10.5 billion figure.

You could press the Chancellor for a commitment to take budget measures if the PSBR becomes larger than the current £10.5 billion estimate.

(b) On incomes policy, there are reports of public acceptance and the Chancellor is apparently determined to win any confrontation in the public sector. Particular doubts must persist on any scheme which involves such a sharp change in trends and which is likely to affect differentials so much (the £6 per week increase is about 12 per cent but if it tends to become a minimum as well as a maximum, it would be 25 per cent for the lowest paid workers). Moreover, the re-entry problem on August 1, 1976 will be acute, although further income policy measures are expected.

Despite the reservations above, the sensible course seems to be to support the present policy stance.

(c) The present exchange rate policy seems satisfactory. The difficult issue is to appraise if the exchange rate is moving as fast as the deterioration in the relative wage and price situation and if this can be maintained. Our judgment is that with recent changes the present situation is probably satisfactory.

Your emphasis on the need to keep the exchange rate moving so long as price and wage increases are so relatively unfavorable would be helpful.

(d) On the question of whether the government is making reasonable efforts to use other sources of financing, Cassell said they did not believe another Euro-dollar loan was feasible. On adjusting short-term rates to hold sterling balances and influence other short-term capital investments, he said the interest rate had been raised recently, but they were not using short-term rates aggresively at this time, partly for domestic reasons but mainly because they were uncertain that the situation required it. On the approach to the EEC oil facility, an appropriate expression was promised.

You could argue that further serious deterioration in the situation would warrant higher short-term interest rates to improve the capital flow situation.

5. Some difficult issues remain regarding the use of Fund facilities.

(a) With great reluctance, the U.K. authorities have apparently moved toward accepting the concept of a DCE performance target--through March 1976 for the oil facility and for the same period plus another 6 months to be set after the spring budget for a first credit tranche stand-by. Their projections call for an increase in FY 1975/76 in domestic credit of £7.5 billion (public sector, £6.4 and private £1.1). With a negative balance of payments factor of £3.3 billion and other adjustments, the increase in M 3 would be about 11 per cent. This compares with a rise in nominal GNP of about 16 to 17 per cent. The rise in M 3 appears broadly satisfactory. The difficulty with trying to reduce the domestic bank credit target is that almost all of it is to finance the budget deficit remaining after large sales of debt to the non-banking sector with only minor provision for credit to the private sector. Even this amount looks excessive in terms of the actual decline in bank credit to the private sector in the first half of the year. At least I have been unable to devise a scheme to reallocate credit to the private sector.

(b) The balance of payments need for the use of the Fund, in particular the oil facility, involves a difficult projection for the second half of 1975. The current account estimates do not cause difficulties, with a sharp deterioration in 1974 and a big improvement in 1975, particularly in the first half of the year. The estimates given by the U.K. authorities are close to staff estimates and do not appear unreasonable. The difficulties occur on capital account: the need for the use of the Fund on the basis of a comparison of 1974 and 1975 arises from the swing (from increase in 1974 to fall in 1975) in sterling balances of £1.8 billion, a swing in largely unpredictable short-term capital items of £758 million and a reduction in Central Government official borrowing of £219 million (see official estimates below). The change from the first to the second half of 1975 is a deterioration on current account of £627 million, an increased outflow of sterling balances offset by larger public sector borrowing, and the disappearance of Central Government borrowing. For the year as a whole, without recourse to the Fund, there would be a loss of official reserves of about £1.1 billion (SDR 2.0 billion) with £830 million projected for the second half of the year.

(c) Difficulties occur with the projections. First, there are large variations in sterling balances and short-term capital movements, and, while these are not necessarily unreasonable, the staff is simply in no position to appraise them. Second, even if the projections are exact, there would be little, if any, loss of official reserves with a Fund drawing of SDR 2 billion. The proposition is thus to completely fill the gap and not require any use of "own reserves". Third, the reserve loss through July amounts to about £260 million. August is reportedly being another bad month, but even so, dealing with a Board paper before the end of September will mean that about three quarters of the reserve loss for the year as a whole is projected for the last quarter of the year. I suggested delaying the drawing to Cassell who argued that very big reserves losses could occur very quickly, and that considerable time was involved in processing a Fund paper. My conclusion is that there is room for negotiation on the issues of timing and amount of use of Fund resources.

PSBR as % credit pte small loans pte savings

ex rate
[illegible]
[illegible]

(millions of pound sterling)

	1973	1974	1975	1975 I	1975 II
Current account	-835	-3,668	-1,695	-533	-1,160
Public sector borrowing 1/	1,040	1,147	780	237	540
Sterling balances	154	1,558	-225	55	-275
Other, short term 2/	149	358	-400	-466	65
Surplus or deficit	210	-565	1,540	-707	-830
Financing					
Reserves	-210	-79	1,115	284	830
Govt. borrowing 3/		644	425	423	--

1/ Foreign borrowing by public sector other than the Central Government.
2/ Includes some long term, short-term capital, and errors and omissions.
3/ Central Government borrowing, i.e., the $2.5 billion Euro-dollar loan of 1974.

(d) My particular concern on this subject is with exchange rate policy. We agreed during the May consultation mission that an exchange rate policy justified as "following market forces" had to be appraised taking into account borrowing abroad by local authorities and the Central Government (£1.9 billion in 1974 and £1.2 billion projected for 1975). Use of a Fund drawing in 1975 would raise their "intervention" for 1975 to ab ove the 1974 level, and be counter to any real dependence on "market prices". In other words, use of Fund resources could be regarded as substantial support of the exchange rate and would require us to defend the proposition that the present and prospective path of exchange rate change is about right. I don't regard this as an unreasonable proposition if the U.K. authorities agree to continue adjusting so long as the deterioration in their competitive position is so rapid and the balance of payments needs correction.

(e) The timing that the U.K. authorities suggested was that necessary Fund papers would be issued shortly after your discussion with the Chancellor at the Annual Meeting. I pointed out to them that the implications of this were that no policy changes would be made regardless of the content of these discussions. I also told them that in my opinion the staff would be gravely handicapped by lack of knowledge, particularly on the budget and the balance of payments, and this would be harmful both to the United Kingdom and the Fund. I promised, however, that the staff would work on appropriate papers during the next 2 weeks and would use Mr. Bull as a channel for requests for information. Their main arguments against a mission are that it could not be kept secret and that the staff is fully informed on current policies.

(f) In view of your concurrent discussions with Mr. Bull, we had no discussion of amounts for the oil facility. Cassell did ask about drawing the first credit tranche instead of using a stand-by arrangement. Our reply on this was that much depended on the package involved and the size of the need. I indicated a preference for meeting the problem by an oil facility drawing to meet immediate needs and a first credit tranche stand-by to cover contingencies over the next 12 months.

8. In summary, assuming that progress is being made on the DCE, the conditionality requirements for a first credit tranche drawing appear to be satisfactory. The policy issues you might wish to take up with the Chancellor are in paragraphs 4(a), (c) and (d). On the oil facility, per se, a reasonable case can be made for "need" (see paragraph 5(b)), but there would be a case for delay if you wished to argue it (paragraph 5(c). Any suggestion of delay however, would require a high degree of certainty that the funds are firmly available.

I think a meeting on the above is urgent to permit us to go along from day to day on the U.K. issues.

Attachments

cc: Mr. Whittome
Mr. Finch

Washington
August 15, 1975
Woodley/Cassell

Oil Facility

1. Inform the Fund of intention to request drawing under the oil facility to meet a balance of payments need in 1975.

2. Balance of payments objective for 1975 and outline economic and financial policies designed to achieve this and to achieve medium-term solution to the balance of payments problem. Energy policies government is following. Consult with the Fund on balance of payments policies while purchases outstanding.

3. Policies consistent with p.2 of Rome Communiqué. Refrain from restrictions on current payments or transactions.

4. Repurchase commitment in accordance with Decision on 1975 oil facility.

Memo on Economic Policy

1. Balance of payments in 1974 indicating current account, oil deficit and movement of gross official reserves. Extraordinary nature of capital inflow, and trends during the year. Results in 1975, first half.

2. Domestic policies adopted to meet situation. Outline of strategy of April 1975 budget including cyclical stance, and shift of resources to exports. Comment on developments since budget, and expenditure control plans of White Paper and subsequently. PSBR for 1975/76. Longer range plans for reducing PSBR, including any specification that is possible, to leave scope for export and private (investment) expansion.

3. Incomes policy--description of 1974 and first half of 1975, leading to July measures. Expected effects during 12 months in terms of prices and wages.

4. Monetary policy--IBEL policy during 1974, suspension in early 1975 because of depressed demand for credit, but reimpositon if necessary. Monetary policy

for FY 1975/76 including interest rates.

5. Implications of domestic policies for real output, employment, and prices in 75/76. Also, implications of domestic policies for a specified DCE objective (and M 3 growth)[1/] given balance of payments policies in 6 below. (Within overall growth, can anything be said to give priority to private sector?)

6. With above domestic policies, exchange rate policy related to market forces and maintenance of competitive positon of U.K. manufactures consistent with achieving continued current account improvement.

7. Sharp improvement in current account in 1975. This offset by deterioration in capital account despite considerable official borrowing with resulting need for use of oil facility. Government making reasonable efforts to obtain capital inflows. Interest rates have b een adjusted to meet problem. Government expressed intention to apply for a loan from EEC under EEC recycling arrangement (when available).

8. The medium-term strategy on the balance of payments is continued restraint on domestic demand arising in particular from curbing public expenditures and continuation of exchange rate policy described above. Expected that 1975 change in the rate will have lagged effects in 1976 and beyond. North Sea oil will have major effect on balance of payments, and anticipated that by 1978/79 current account deficit can be eliminated.

9. Government taken steps to conserve oil and develop alternative sources of energy. Measures and anything on results in 1974 or 1975.

10. Description of any restrictions on current international payments or transactions since January 1974 and appropriate policy statement on restrictions.

1/ If M 3 not specified, balance of payments target will be.

Washington
August 15, 1975

Main Program Elements
First Credit Tranche

1. Purpose of stand-by arrangement to support economic policies—strengthen balance of payments and moderate domestic inflationary policies in 1975. For later, export led growth back to full employment.

2. Fiscal policy

   (a) Rationale and strategy of April budget.

   (b) Government sector borrowing requirement for FY 1975/76, and developments so far in FY, and commitment to quantify in spring for FY 1976/77.

   (c) Further progress in 1976/77 in reducing public expenditures. Longer-term expenditure programs.

3. Monetary policy

   (a) Statement contained in budget and reiterated in July. Interest rate policy.

   (b) DCE objective on basis of monetary and balance of payments policy, FY 1975/76, and commitment to quantify for calendar 1976.

4. July incomes policy and expected effects.

5. Expected balance of payments outcome in FY 1975/76/and/calendar 1976 in spring.

6. Intention to avoid use of restrictions on current transactions.

7. Exchange rate policy

   (a) As in oil facility, but citation of Section 4(a). (Reserve intention).

   (b) Consult on initiative of MD.

8. In stand-by agreement, consult at request of MD, if objective in 3(b) exceeded or intentions in 2(b) and 7 not being carried out.

Hueri/Pietrac

Office Memorandum

TO : Mr. Whittome

DATE: August 29, 1975

FROM : B. S. Karlstroem

SUBJECT : United Kingdom - Briefing Material for the Managing Director (Interim Committee)

CONFIDENTIAL

1. Recent developments

The trend of real output was flat in 1974, with a marked fall in industrial production largely offset by output gains in the agricultural and service sectors.

Public sector outlays on goods and services rose by about 2.0 per cent in 1974, while private expenditure on fixed capital declined by more than 5.0 per cent mainly because of a steep fall in housebuilding. In the second half of 1974, investment plans in private industry were revised downward sharply in response to mounting liquidity strains and the deteriorating outlook for demand and profits. The foreign balance measured in real terms strengthened. There was a steep rise in exports in the first quarter of 1974 which subsequently flattened out. In contrast, imports were on a downward trend throughout the year, reflecting primarily a reduction in stock investment.

In the course of 1974, pressures on resources eased. The unemployment rate increased from 2.2 per cent at the end of 1973 to 3 per cent at the end of 1974. At the same time, however, the rate of inflation, which had increased in 1973 in response to soaring import prices and excessive demand pressures, escalated further during 1974, with the cost of living index rising by 19 per cent in the 12 months to December 1974.

The trends in the domestic economy that were noticeable during 1974--no growth in production, increasing slack and rising unemployment, escalating rates of inflation, and a weakening in the investment climate--have become even more pronounced in 1975. Industrial output (seasonally adjusted) in the first half of 1975 was 8 per cent lower than in the second half of 1974. Stock decumulation contributed further to the sluggish trend in output and private investment has declined.

The unemployment rate, which--although rising--remained fairly modest by international standards through the early part of 1975, has recently shot up very quickly. In mid-August 1975, this rate (seasonally adjusted) was over 4 per cent (just under one million), pointing to a significantly higher level of unemployment during the coming winter than had been expected in the official forecasts prepared in conjunction with the latest budget (April 1975).

The rate of price inflation (measured as the 12 monthly increase in the consumer price index) has escalated further and was in July running at 26 per cent. Wage increases (weekly wage rates) are now rising at an even faster pace--the increase was over 31 per cent in the 12 months to July.

The current account deficit in the balance of payments was gradually reduced in the course of 1974 as the recession in the United Kingdom kept demand very low and stocks were run down. The overall balance of payments showed a surplus in 1974, and official reserves rose by SDR 300 million (US$460 million), admittedly after heavy public sector borrowing abroad in Euro-currency markets. Such borrowing amounted to US$4.1 billion in calendar 1974.

A further and very sharp reduction in the current account deficit occurred in the first half of 1975. The seasonally adjusted deficit was then running at an annual rate of only about £900 million (US$2.1 billion), again the result primarily of depressed domestic economic activity and low import demand. However, the capital account showed intermittent signs of weakness: there was a very large outflow of capital in April which was reflected partly in reserves but mainly in the exchange rate. Continued borrowing by the public sector in Euro-currency markets (US$1.5 billion during the first seven months of 1975) limited the reserve loss over the period January-July 1975 to SDR 360 million (US$620 million).

2. Outlook

The recession seems to deepen further, unemployment is bound to continue increasing, the rate of inflation remains very high and is likely to be reduced only gradually. At the same time, the current account deficit is unlikely to stay as low as it was in the first half of 1975 as some restocking is inevitable (even under the present recessionary conditions).

The recent informal talks in Washington between staff and British officials indicated that real output (GNP), after a significant decline in the first half of 1975, is likely to remain flat in the second half of this year and possibly rise a little in the first half of 1976; that the unemployment rate is likely to hit 5 per cent in the first half of 1976--a very high figure by U.K. standards but not quite so dramatic in an international context; that the rate of inflation will remain above 20 per cent throughout this year but then hopefully taper off and reach 10 per cent in the second half of 1976 (this is the official target).

The outlook for the balance of payments has been discussed in some detail with British officials. They envisage a pronounced widening of the current account deficit--from an annual rate of about £900 million in the first half of 1975 to some £2.5 billion in the second half. The deficit in the first half of 1976 is likely to be much the same. This reversal of the trend (from the improvement over the past year) is due first to an expected turnaround in the stock position (stocks are presently too low to be maintained for any length of time); and, secondly, to the initial adverse (J-curve) effects of the depreciation of the exchange rate over the past several months.

3. Economic policies

The strategy of economic policy underlying the latest budget was to allow the recession to create more spare capacity in the economy in the hope that this unused capacity would be absorbed through increased exports. This plan to wait for an export-led upswing was based first on the assumption that economic activity abroad would revive within about a year, and, secondly, that the depreciation of the pound sterling over the past few years would make it possible for U.K. exporters to benefit substantially from the coming upturn in the world economy.

This economic strategy is presumably still the prevailing one. The last Fund mission strongly supported these policies. However, there are several problems involved in the present policy stance. These problems were discussed in a note, dated August 18, 1975, to the Managing Director from Mr. Woodley (attached). The combination of high inflation rates, increasing slack and therefore a lower tax base, together with expansionary fiscal measures in 1974, has led to an extremely large public sector deficit, now estimated--perhaps conservatively--at over £10 billion for 1975/76. Reluctance to reduce this deficit for fear of intolerable unemployment levels stands in conflict with the need to contain the current account deficit in the balance of payments and to reduce the rate of inflation.

The possible monetary consequences of the present fiscal position are of main concern to the Fund staff (see the memorandum of August 18 referred to above). The present rate of monetary expansion does not give rise to concern--M3 is presently growing at an annual rate of between 10 and 12 per cent. (In large part this low rate of increase reflects a depressed demand for credit by the private sector.) The worries relate to the growth of monetary aggregates in 1976 when the Government may have to rely heavily on the banking sector to finance its still very large deficit and when private sector demand for credit may revive. If a large proportion of the fiscal deficit is financed through the banking system, there will inevitably be a sharp acceleration in the growth of monetary aggregates, and as a result it will be difficult to control the external position.

The authorities have for some time followed a policy of allowing the exchange rate to adjust to differential rates of inflation. The effective exchange rate is now some 28 per cent lower than at the time of the Smithsonian agreement, compared to an effective depreciation of about 18 per cent a year ago. Short-term pressures on sterling are smoothed out by letting reserves fluctuate, sometimes very sharply (for instance in late July and early August when reserve losses appear to have been large). Given the very high rate of inflation in the United Kingdom relative to most other industrial countries, continued depreciation seems necessary and unavoidable.

The U.K. authorities are trying to deal with the inflation problem primarily through incomes policies which were strengthened in July 1975, by introducing statutory elements into what was formerly a voluntary (and very loose) agreement between the Government and the TUC. The percentage increase in wage rates implied under the new rules is limited to about 10 1/2 per cent (12 per cent after allowing for adjustments for equal pay for women). There are reports of public acceptance of the tougher stance taken in July and the Chancellor is apparently determined to win any confrontation in the public sector. The policy does indeed need to be implemented with a strong hand to achieve the officially stated target of reducing the rate of inflation to 10 per cent by the second half of 1976.

Office Memorandum Mr Hole — Pl let me know (quickly) if you have any points [illegible] 18/8

SECRET

TO : The Managing Director

DATE: August 18, 1975

FROM : W. John R. Woodley JW.

SUBJECT : United Kingdom

1. On August 14 and 15, together with other staff members, I met with Messrs. Cassell (Treasury), Price (Bank of England), Bull and Sweeney of the Executive Director's office. While Cassell indicated that final decisions had not been taken and all options should be kept open, he wanted to review conditions and procedures for an oil facility and first credit tranche drawing or stand-by arrangement. Cassell returned to London with the attached papers. It was indicated that they had been done hurridly to meet his needs, and that on the staff side the positions were ad referendum to my colleagues and you. In fact, the papers contain no quantities; we listened to their suggestions and reserved any reaction. On the U.K. side, Cassell expressed concern about how his people would react to the DCE question and other efforts to quantify targets. As the weeks go by however, positions are being crystallized, and it is now time for us to know where we stand on the major issues.

2. The U.K. policies as described can be combined together into a reasonable program. Output is projected as virtually stagnant, with unemployment rising to 5 per cent and recovery in 1976 basically dependent upon a revival of exports. The price target is to reduce the rate of increase to about 10 per cent in the second half of 1976. In the meantime, the price rise is expected to decelerate slowly from the present 28 per cent. Assuming the new incomes policy is effective, wage increases would be about 11 to 12 per cent resulting in a sharp reversal of the increase in real wages that occurred in the first half of 1975. The balance of payments on current account shows a sharp improvement from 1974 to 1975, but then remains at about the 1975 second half level in the first half of 1976. Improvement in 1976 is linked to continuing restraint on domestic demand, the lagged effects of exchange rate changes, and a revival in export demand.

3. The key policies related to the outcome above are:

(a) The July incomes policy lasting until August 1976.

(b) The public sector borrowing requirement (PSBR) which is regarded as consistent with stable output and rising unemployment, and therefore leaves scope for export expansion when demand revives.

(c) A neutral attitude toward credit to the private sector on the basis that demand for credit is slack and unlikely to revive. Restraint is promised if the situation changes.

(d) On the external side, avoiding controls and letting the exchange rate move to maintain the present competitive position.

4. The outlook and policies as described above appear reasonable and as warranting support from the Fund. Nevertheless, there are issues you might wish to raise with the Chancellor.

(a) The PSBR which was £7.6 revised to £8.0 billion last year was set at about £9 billion or 10 per cent of GDP at the time of the April budget for FY 1975/76. The current estimate is £10.5 billion, the increase being due to a variety of factors mostly of a non-policy type. Even Treasury officials admit that they know little of what local government units are spending and that the rapid inflation has reduced the effectiveness of traditional controls. The Chancellor is emphasizing the use of cash limits on expenditures next year and government officials are working on the problem now, but in the meantime one has to have serious reservations about the possibility of staying at the present £10.5 billion figure.

You could press the Chancellor for a commitment to take budget measures if the PSBR becomes larger than the current £10.5 billion estimate.

(b) On incomes policy, there are reports of public acceptance and the Chancellor is apparently determined to win any confrontation in the public sector. Particular doubts must persist on any scheme which involves such a sharp change in trends and which is likely to affect differentials so much (the £6 per week increase is about 12 per cent but if it tends to become a minimum as well as a maximum it would be 25 per cent for the lowest paid workers). Moreover, the re-entry problem on August 1, 1976 will be acute, although further income policy measures are expected.

Despite the reservations above, the sensible course seems to be to support the present policy stance.

(c) The present exchange rate policy seems satisfactory. The difficult issue is to appraise if the exchange rate is moving as fast as the deterioration in the relative wage and price situation and if this can be maintained. Our judgment is that with recent changes the present situation is probably satisfactory.

Your emphasis on the need to keep the exchange rate moving so long as price and wage increases are so relatively unfavorable would be helpful.

(d) On the question of whether the government is making reasonable efforts to use other sources of financing, Cassell said they did not believe another Euro-dollar loan was feasible. On adjusting short-term rates to hold sterling balances and influence other short-term capital investments, he said the interest rate had been raised recently, but they were not using short-term rates aggresively at this time, partly for domestic reasons but mainly because they were uncertain that the situation required it. On the approach to the EEC oil facility, an appropriate expression was promised.

You could argue that further serious deterioration in the situation would warrant higher short-term interest rates to improve the capital flow situation.

5. Some difficult issues remain regarding the use of Fund facilities.

(a) With great reluctance, the U.K. authorities have apparently moved toward accepting the concept of a DCE performance target--through March 1976 for the oil facility and for the same period plus another 6 months to be set after the spring budget for a first credit tranche stand-by. Their projections call for an increase in FY 1975/76 in domestic credit of £7.5 billion (public sector, £6.4 and private £1.1). With a negative balance of payments factor of £3.3 billion and other adjustments, the increase in M 3 would be about 11 per cent. This compares with a rise in nominal GNP of about 16 to 17 per cent. The rise in M 3 appears broadly satisfactory. The difficulty with trying to reduce the domestic bank credit target is that almost all of it is to finance the budget deficit remaining after large sales of debt to the non-banking sector with only minor provision for credit to the private sector. Even this amount looks excessive in terms of the actual decline in bank credit to the private sector in the first half of the year. At least I have been unable to devise a scheme to reallocate credit to the private sector.

(b) The balance of payments need for the use of the Fund, in particular the oil facility, involves a difficult projection for the second half of 1975. The current account estimates do not cause difficulties, with a sharp deterioration in 1974 and a big improvement in 1975, particularly in the first half of the year. The estimates given by the U.K. authorities are close to staff estimates and do not appear unreasonable. The difficulties occur on capital account: the need for the use of the Fund on the basis of a comparison of 1974 and 1975 arises from the swing (from increase in 1974 to fall in 1975) in sterling balances of £1.8 billion, a swing in largely unpredictable short-term capital items of £758 million and a reduction in Central Government official borrowing of £219 million (see official estimates below). The change from the first to the second half of 1975 is a deterioration on current account of £627 million, an increased outflow of sterling balances offset by larger public sector borrowing, and the disappearance of Central Government borrowing. For the year as a whole, without recourse to the Fund, there would be a loss of official reserves of about £1.1 billion (SDR 2.0 billion) with £830 million projected for the second half of the year.

(c) Difficulties occur with the projections. First, there are large variations in sterling balances and short-term capital movements, and, while these are not necessarily unreasonable, the staff is simply in no position to appraise them. Second, even if the projections are exact, there would be little, if any, loss of official reserves with a Fund drawing of SDR 2 billion. The proposition is thus to completely fill the gap and not require any use of "own reserves". Third, the reserve loss through July amounts to about £260 million. August is reportedly being another bad month, but even so, dealing with a Board paper before the end of September will mean that about three quarters of the reserve loss for the year as a whole is projected for the last quarter of the year. I suggested delaying the drawing to Cassell who argued that very big reserves losses could occur very quickly, and that considerable time was involved in processing a Fund paper. My conclusion is that there is room for negotiation on the issues of timing and amount of use of Fund resources.

PSBR n% credit pte [illegible] loan Pte Saving

ex rate
extend facility
until [illegible]

(millions of pound sterling)

	1973	1974	1975	1975 I	1975 II
Current account	-835	-3,668	-1,695	-533	-1,160
Public sector borrowing 1/	1,040	1,147	780	237	540
Sterling balances	154	1,558	-225	55	-275
Other, short term 2/	149	358	-400	-466	65
Surplus or deficit	210	-565	1,540	-707	-830
Financing					
Reserves	-210	-79	1,115	284	830
Govt. borrowing 3/		644	425	423	—

1/ Foreign borrowing by public sector other than the Central Government.
2/ Includes some long term, short-term capital, and errors and omissions.
3/ Central Government borrowing, i.e., the $2.5 billion Euro-dollar loan of 1974.

(d) My particular concern on this subject is with exchange rate policy. We agreed during the May consultation mission that an exchange rate policy justified as "following market forces" had to be appraised taking into account borrowing abroad by local authorities and the Central Government (£1.9 billion in 1974 and £1.2 billion projected for 1975). Use of a Fund drawing in 1975 would raise their "intervention" for 1975 to ab ove the 1974 level, and be counter to any real dependence on "market prices". In other words, use of Fund resources could be regarded as substantial support of the exchange rate and would require us to defend the proposition that the present and prospective path of exchange rate change is about right. I don't regard this as an unreasonable proposition if the U.K. authorities agree to continue adjusting so long as the deterioration in their competitive position is so rapid and the balance of payments needs correction.

(e) The timing that the U.K. authorities suggested was that necessary Fund papers would be issued shortly after your discussion with the Chancellor at the Annual Meeting. I pointed out to them that the implications of this were that no policy changes would be made regardless of the content of these discussions. I also told them that in my opinion the staff would be gravely handicapped by lack of knowledge, particularly on the budget and the balance of payments, and this would be harmful both to the United Kingdom and the Fund. I promised, however, that the staff would work on appropriate papers during the next 2 weeks and would use Mr. Bull as a channel for requests for information. Their main arguments against a mission are that it could not be kept secret and that the staff is fully informed on current policies.

(f) In view of your concurrent discussions with Mr. Bull, we had no discussion of amounts for the oil facility. Cassell did ask about drawing the first credit tranche instead of using a stand-by arrangement. Our reply on this was that much depended on the package involved and the size of the need. I indicated a preference for meeting the problem by an oil facility drawing to meet immediate needs and a first credit tranche stand-by to cover contingencies over the next 12 months.

8. In summary, assuming that progress is being made on the DCE, the conditionality requirements for a first credit tranche drawing appear to be satisfactory. The policy issues you might wish to take up with the Chancellor are in paragraphs 4(a), (c) and (d). On the oil facility, per se, a reasonable case can be made for "need" (see paragraph 5(b)), but there would be a case for delay if you wished to argue it (paragraph 5(c). Any suggestion of delay however, would require a high degree of certainty that the funds are firmly available.

I think a meeting on the above is urgent to permit us to go along from day to day on the U.K. issues.

Attachments

cc: Mr. Whittome
Mr. Finch

No 1.

Notes of Meeting on Domestic Economic Prospects
Wednesday, November 12, 1975

The following are the main points which emerged from a meeting held in H.M. Treasury at 10:00 a.m. November 12, 1975 to discuss domestic and economic prospects.

Demand and unemployment

In the wake of the very sharp reduction in activity which had already occurred, the U.K. representatives were fairly confident in foreseeing some imminent unwinding of the trade cycle, although they were unsure how far this would progress in the forecast period (to first quarter 1975). There were many imponderables in the forecast, such as the likely pace of recovery in world trade and the prospective personal savings ratio which thus far had remained somewhat surprisingly high. The U.K. representatives envisaged stockbuilding gradually becoming positive during 1976, although this would depend on the rather uncertain financial position of companies; a large build-up of company sector financial surplus was projected next year as a result of the cycle and the envisaged moderation in cost increases. Despite the incipient economic recovery projected for 1976 (officials forecast that real GDP would grow by 4.5 per cent between second half 1975 and second half 1976), the level capacity utilization was expected to remain low, and unemployment to continue rising, peaking around the end of 1976 at some 1 1/4 to 1 1/2 million.

The main assumptions underlying the official national accounts forecasts were summarized by the U.K. representatives as follows:

(a) On world trade, officials were more bullish than the OECD, projecting that in 1976 world export markets would grow by 6.6 per cent on a year-on-year basis. This compares with the OECD's projection of 3 1/2 to 4 per cent, although the U.K. representatives thought that this would probably be revised upwards somewhat in the near future.

(b) The exchange rate assumption was essentially one of constant competitiveness--i.e., U.K. prices of manufactured exports relative to world prices of manufactures were assumed constant over the forecast period, implying some fall in the terms of trade. A further depreciation in the exchange rate was envisaged by the U.K. representatives in the next few months and thereafter a leveling off.

(c) On domestic costs and prices, the U.K. representatives assumed that there would be a fairly sharp slowdown in the rate of increase in wages as a result of strict adherence to the present incomes policy. For the period to be covered by the next stage of incomes policy (i.e., between 1976 third quarter and 1977 third quarter), officials were assuming a 10 per cent rise in average earnings, based on a norm of 8 per cent, and a 2 per cent allowance for slippage. Between September 1975 and September 1976, the retail price index is now expected to increase by 12 per cent, instead of the 10 per cent earlier hoped for.

(d) Nominal interest rates are expected to remain broadly unchanged during the next two years, thereafter easing slightly. Given the projected slowdown in inflation, real interest rates are likely to switch from being highly negative to perhaps just positive over the course of the forecast period.

Asked about the reliability of the personal savings ratio projections underlying the consumption forecasts, the U.K. representatives explained that in making them they had tried to take into account the influence on the average propensity to save of both the increase in rate of unemployment and inflation, and the stock of real wealth and liquid assets. Among the factors underlying the savings ratio projections was the fact that people did not adjust their spending habits quickly to unanticipated changes in prices and thus with the recent much higher than generally expected price rises their actual expenditures tended to be continuously below "normal" levels for that rate of inflation. As regards the precautionary motives for saving, the U.K. representatives commented that as people became unemployed they would tend to reduce their rate of saving and that once they became convinced that the recession had bottomed out, then the savings ratio would stop declining. A third and rather compelling reason cited for the continuing savings ratio remaining high was the continuing decline in liquid assets (as a result of rapid inflation), which the personal sector was presumably trying to replenish. This process of replenishment was expected to result in the stock of liquid assets approaching more normal levels towards the end of 1976 or in early 1977. A final consideration behind their savings ratio projections was the assumption that the savings ratio would tend to follow the projected fall in real personal disposable income but with a lag.

Stockbuilding projections, the U.K. representatives explained, were based essentially on past manufacturing stock-output ratios which they noted are still very high. Significant further destocking was still expected by officials during the forecast period; in first half 1976 destocking was likely to be much lower than in the second half of this year, and close to zero in the second half of 1976. Stocks of finished manufactures were expected to amount to about £300 million at current prices (£200 million at 1970 prices) at the end of 1976. In the case of stock of materials and fuels, however, no significant restocking was expected until the end of the forecast period, reflecting mainly cash flow considerations of the company sector. Referring to the public figures for expenditure on stocks, the U.K. representatives noted that they believed the destocking shown thus far this year was somewhat of an underestimate due to the data being based largely on deliveries. They also noted that their forecasts included an item for the discrepancy between the expenditure-based estimate of GDP and the compromise estimate of GDP--this discrepancy which was allocated chiefly to stockbuilding was to be phased out over the next three quarters of the projection.

The discussion then turned to several queries concerning the expenditure components of GDP. First, the exceptional high rise in real public consumption between the two halves of 1975 was explained by the U.K. representatives as being due to a problem of seasonal adjustment of the first half data. As regards fixed investment, the staff had queried the sharp rise in total fixed investment between the two halves of 1975. This was largely caused by the sizable growth in North Sea oil investment, which was thought to have peaked in the second half of 1975.

A discussion on the sensitivity of the data provided to the Fund mission then ensued, with Mr. Whittome asking to what extent the figures were quotable. The U.K. representatives explained that the unemployment projections were especially sensitive and that their forecast of unemployment rise to between 1 1/4 and 1 1/2 million by the end of 1976 would cause some alarm if incorporated in either the Letter of Application or the staff papers.

The U.K. representatives suggested that a way around this difficulty would be to talk in terms of projecting some range of possible unemployment which would then be attributable to the staff and to emphasize the lag existing between the expected upturn in GDP and upturn in employment. Alternatively, they would agree to the staff describing unemployment prospects as "likely to rise continuously through 1976 with a turning point perhaps between the fourth quarter of 1976 and the first quarter of 1977."

Finally, turning to a point raised by the staff, the U.K. representatives explained that the reason why employment in manufacturing was projected to fall rather steeper than overall employment was simply that the lag between a change in output and a change in unemployment was larger in manufacturing--on average probably about three quarters. Asked whether the sharp rise in wholesale prices of raw materials and fuels last month was consistent with the forecasts, the U.K. representatives explained that this was the case since two thirds of the increase was due to the recent 10 per cent rise in the OPEC price of crude oil. Finally, on capacity utilization it emerged that the economy was currently about 13-14 per cent below for employment capacity utilization in mid-1973, or some 10 per cent below normal levels of capacity utilization (allowing for the fact that 1973 was a period of overheating).

No. 2

Notes of Meeting on Restrictions
Wednesday, November 12, 1975, at 12:00 m.

Present:

U.K. Representatives	IMF Representatives
Mr. Littler	Mr. Whittome
Mr. Cassell	Mr. Finch
Mr. Bell	Mr. Vittas
Mr. Bachelor	Mr. Brau
	Mr. Hyndman

Mr. Littler noted that the memorandum of policy for the Oil Facility had standard language regarding the Government's policy with respect to trade controls, namely that the Government had no intention of introducing general or widespread import controls, inconsistently with the Rome Communique. However, the authorities at this time could not exclude the possibility of selective import controls. A decision on this might be reached in November after which more exchanges with the staff could be necessary. He requested the staff's suggestion on how to proceed further on the topic of restrictions at this time. Mr. Whittome summarized Mr. Witteveen's advice against introducing import restrictions and the conclusion reached in the discussions between the Managing Director and the Chancellor that effective consultation would be necessary in some form if import controls were introduced at a later time. It was also understood that if decisions were reached in the near future regarding import controls they would be announced at the same time when cuts in public expenditure were made public. In particular, the Managing Director understands that any resort to import controls would be of an anti-dumping nature and consistent with EEC and GATT rules. Mr. Whittome was therefore surprised by the recent statement made by the Chancellor which implied that import controls might be considerably wider in application than anti-dumping measures which necessarily are selective.

Mr. Littler wished the further discussion to remain confidential and private. He indicated that the Government were receiving considerable pressure both from the TUC and the CBI to introduce some form of import restraints. The authorities clearly wished to maintain a generally liberal trade outlook but were examining specific areas for action where it might be easier to gauge likely repercussions. In particular, they were exploring in two directions. The first was that any restrictive action would be geared to the situation of a particular industry with a viable future but which was threatened in the short term by imports. The other direction being explored was that of confining import controls to imports from the EEC only. His specific question was what the IMF's attitude to import controls would be which had received the approval of the EEC. The staff indicated that it would be necessary for the United Kingdom to consult with the IMF. The IMF would have to consider the implications of the action for third countries; these would depend on the commodities affected, the proportion of imports being subjected to controls, and the time limit put on the controls. Since the EEC were not likely to accept British import controls without some such understandings and conditions, it was likely that the IMF would find the restrictions as not inconsistent with the Rome Communique, even though the IMF's judgment was separate, in principle, of that of the EEC. It would clearly be easier to make a case if the proportion of imports affected were small and it was shown, for example, by data concerning market shares of imports, that domestic producers were affected by rising import market shares. Mr. Littler made clear that a restriction pertaining only to imports from the EEC was of interest because of an existing safeguard provision in this regard under the EEC Treaty. In terms of the GATT, any measures would be justified under

Article XIX (pertaining to: Emergency Action on Imports of Particular Products). Mr. Whittome reiterated the importance of attaching a time limit to the maintenance of any new import restrictions. A limit of 12 months had become the ruling principle.

Mr. Littler went on to say that proof of dumping was difficult to establish or establish quickly. British traders were suspicious of U.S. action in this field and therefore the Government was under strong pressure. The Government was conscious of possible retaliation and was searching for industries for which respectable arguments could be made on ad hoc grounds. Industries in which action could be taken had been narrowed down to footwear, color television tubes, and some items of clothing. Mr. Littler could go no further in identifying other industries that were looked into. The authorities were attempting to preempt the pressure for wider measures of import control. Mr. Whittome re-emphasized that any anti-dumping measure was, in principle, specific as to the article which was being hurt by dumping and as to the country which engaged in the dumping. It would, therefore, be very difficult to claim that the British footwear industry in general was hurt by dumping. This would be a case very easy to criticize. In particular, he wished to emphasize that the Managing Director interpreted the references to anti-dumping measures in the sense that he had just now reiterated them. Mr. Whittome was quite sure that the Managing Director would be disappointed if a wider interpretation were now given to the actions which might be construed as falling under the anti-dumping category. Mr. Littler took as a point of example the situation of British firms producing television tubes. Competition was being felt from Japanese and U.S. producers, in particular, and the difficulty lay in either price cutting or price holding in the face of cost pressures on the part of the foreign companies. While the authorities would not be able to quickly prove dumping, there seemed little doubt that the British firms were not overcharging or inefficient, but were simply being undercut in prices. Any possible import control action contemplated would be aimed at limiting that specific import commodity involved. Therefore, there would be a protective duty for a limited period of time for the specific commodity. He wished the staff to note that the argument was being made in terms of the situation of a particular industry rather than in terms of the balance of payments situation. As to the period for which such protective duties might be introduced, he rather thought that the desire would be to have them for more than 12 months, but he thought helpful the advice of the staff concerning the principle of the 12-month limit. The staff emphasized that it would be critical to put a 12-month time period on any measures.

Mr. Whittome asked again whether any further indication could be given as to the range of products to which restrictive measures could apply. Mr. Littler said that he could go no further than he had done earlier. He summarized that he had gained three principal impressions from this confidential part of the discussions: (1) concerning implications for the application to the Oil Facility of any import controls that were confined to imports from EEC sources; (2) concerning the point by the staff that anti-dumping measures are measures which are country-specific and commodity-specific; and (3) concerning a 12-month time limit to be put on any restrictive action. The staff then made known that it would describe the April 1975 restrictions concerning gold coins as resulting in an incidental restriction on imports. There was no exchange restriction involved in this measure. The staff also left with the authorities a list of questions concerning specific trade measures taken principally in 1975, on which it sought amplification and explanation for purposes of writing the staff report. If nothing unexpected were raised in any areas where clarification was sought, the measures taken would be recorded in the staff report and described as being consistent with the provisions of the Rome Communique.

NO. 3

Meeting on Balance of Payments Need
and the Exchange Rate
Wednesday, November 12, 1975

Present:

U.K. Representatives	IMF Representatives
	Mr. Whittome
	Mr. Finch
	Mr. Vittas
	Mr. Brau
	Mr. Hyndman

Balance of payments need

Three questions were covered with respect to balance of payments need.

1. Whether the reserves fall to date (US$1,076 million) was adequate to justify a request for a drawing under the Oil Facility. It was agreed that this was indeed the case, especially considering that by the time the request was formally made the November figure would also be available.

2. Whether the reserves fall for 1975 was a whole would be sufficient to cover the Oil Facility drawing and allow for a "decency" margin. The U.K. representatives said that it was highly probably that the reserves fall would exceed the Oil Facility drawing (SDR 1 billion) though perhaps not by very much. They pointed out that in December there would be an outflow of $250 million on account of repayments of U.S. loans. Moreover, in November and December there would be a fall in reserves of about $200 million per month on account of government transactions. In fact, in December the fall might be considerably higher due to the payment of bonuses to U.K. troops stationed in Germany. It was also expected that in the remainder of the year there would be a further switching out from sterling amounting to

£50-100 million by one or two oil-exporting countries. As to credit items, it was now likely that the second tranche of the Iranian loan would not be drawn before the end of the year. The Iranians had a contractual obligation to supply the second tranche of this loan in the period between November and January. There was earlier an understanding that the loan would be drawn on December 2, but it now seemed likely that it would be delayed. It was agreed that the final accounts would show a fall in reserves of at least $1.3 billion.

3. Whether a reasonable effort had been made to secure alternative sources of financing the balance of payments deficit.

The U.K. representatives said that they did not expect any inflows from official holders of sterling in the remainder of the year. There would probably be some outflow by one or two holders (mainly Nigeria) because of payments needs. As for public sector borrowing, the official view is that until it is demonstrated that the new pay policy is working satisfactorily the United Kingdom would not be able to borrow more than insignificant amounts in the Euro-currency markets. They expected, however, the situation to improve considerably after the first quarter of 1975, though they did not anticipate that any borrowing could be as large as in 1973/74. As for bilateral loans from OPEC countries, there was no clear possibility for the next six months, though there was some <u>hope</u> for a loan of up to $200 million from one particular source. With regard to private flows, they felt that it would be prudent not to expect any significant net movement. However, if a rather aggressive exchange rate policy were to be pursued, the effect on capital flows would be adverse for some time. Private flows would also depend on developments in U.S. interest rates. If these were to rise, the U.K. authorities would probably not find it appropriate to maintain the recently high interest differential in favor of sterling. This could have some impact on the capital account.

On the EEC facility, the U.K. officials said that they reserved their position until it became known, probably within a week, what amounts the EEC would obtain. The EEC Commission was now seeking a loan from Saudi Arabia. If the loan were to be of the order of $0.5 billion, the United Kingdom would decide not to make an application. The Irish had already made a formal application for $200 million and the Italians were interested to get as much as they could possibly get. However, if the Commission would obtain much more than $0.5 billion, then the United Kingdom would probably make a request. At any rate, though, the EEC facility was high on the list of potential financing sources, no drawings could be expected before next February at the earliest.

As for the OECD safety net, the U.K. representatives said that they considered it as a last resort and agreed that recourse to it would require prior use of conditional Fund liquidity. In concluding, they stressed that they considered the borrowing from the IMF as a complement rather than a subsitute for other financing sources.

Two other points were made in relation to alternative financing.

1. The United Kingdom could probably have obtained an additional $200-250 million in 1975 had it been prepared to accept a higher spread on loans from the Euro-currency markets. However, such an action would have been interpreted by the market as "desperation" borrowing and would have made it more difficult for the United Kingdom to borrow in the future.

2. One encouraging recent development was that spreads were beginning to narrow. This had raised hopes that rather more than the $500 million previously forecast could be obtained from the Euro-currency markets in the next six months. However, repayments of earlier loans amounting to about $350 million are falling due in that period. P It was agreed that the U.K. representatives would provide a preliminary draft of those parts of the oil facility paper dealing with financing.

Oil Facility balance of payments table

The following information was provided to explain the revisions of the balance of payments forecasts for 1975 between August and November. (a) On the basis of more recent information, overseas sterling holdings were now expected to fall by £710 million in the second half of 1975. About £380 million of this fall already took place in the third quarter. (b) Other capital flows were now expected to amount to £851 million, mainly on account of a very large positive balancing item in the third quarter and in October 1975. However, at the moment there is little detailed information about the capital account in the third quarter. (c) The capital inflow on account of public sector foreign currency borrowing had been scaled down as a result of their prunning down their assessment of how quickly they would be able to re-enter the Euro-currency market. (d) The impact of the switching out from sterling with respect to royalty payments by oil companies is believed to be unimportant.

Exchange rate

There has been no marked change in official attitudes with respect to exchange rate policy since the Managing Director and the Chancellor met. The rate has been depreciating quite markedly during 1975 as a matter of deliberate policy. The authorities did not stand in the way of the fall, but intervened occasionally to moderate the movement because of fears of dislodging oil producers' sterling deposits.

The authorities intend to continue this process of controlled depreciation in the months ahead in order to ensure that the movement is sufficient to at least maintain the existing degree of competitiveness (as is measured in the United Kingdom). However, the Chancellor has not yet taken any final decision as to the pace at which the pound should depreciate.

The index of competitiveness which the U.K. authorities use is a ratio of U.K.export prices of manufactures to those of the United Kingdom's main competitors. With 1970 = 100, the index now stands at 93.8. The index fell quite markedly in 1973, but has since oscillated erratically and in the course of 1975 there has been little net change (as far as one can tell from the available partial information). The year 1970 just happens to be the base year of the index. Its selection does not imply any judgment that at that time the United Kingdom was competitive in any more general sense.

In discussion, the U.K. representatives did not disagree with our suggestion that this sort of exchange rate policy was probably not adequate, considering the persistence of a large deficit on current account at a time when unemployment was expected to be exceptionally high and rising. They emphasized, however, that because of the importance attached to other considerations no decision had been taken to-date to seek a sharper depreciation. Such considerations included concern about the large overhang of external liabilities and about the probable repercussions of a deliberate policy of sharp depreciation on incomes policies. They indicated, however, that while these were very important difficulties standing in the way of an aggressive exchange rate policy, they were not necessarily regarded as decisive arguments against it.

The U.K. representatives emphasized that they would not like to see in the staff papers any open description of their exchange rate policy directly attributed to them. They provided a draft of a description that would be acceptable to them and it was agreed that the matter would be further discussed in the next few days. They also asked whether we were expecting any substantive discussion of their exchange rate policy at the Board. We replied that this was unlikely.

Medium-term targets

The U.K. representatives said that they hoped for a big improvement in the current account over the next two or three years due to the expected turnaround in the oil account (North Sea oil). They argued that the Chancellor had never publicly stated a medium-term target in more specific terms than suggested above.

Other issues

The U.K. representatives undertook to provide data on the cost of servicing the foreign currency public sector debt in the next few years.

Meeting on Fiscal Policy and the PSBR
Thursday, November 13, 1975

At the outset of the meeting to discuss fiscal policy and the PSBR, Mr. Whittome stressed the general presentational point that since the Letter of Application would have a keen international as well as domestic audience, it was imperative that it read coherently and convincingly. Mr. Little concurred, but with the reservation that while some aspects of the Government's policy intentions would need further elaboration (vis-avis official published statements to-date), there were others--such as exchange rate policy and medium-term fiscal policy objectives--which probably needed toning down (relative to privately expressed intentions).

The discussion proper opened with a brief resume of the short-term outlook for public expenditure growth. It appeared from the present survey of public expenditure that there was likely to be a marked rise in volume terms in public expenditure programs in 1975/76 and 1976/77, compared with the estimates in the January 1975 White Paper (Public Expenditure to 1978/79, Cmnd. 5879). This expected upsurge was attributed to sharp rises both in public expenditure in industrial fields and in the cost of social security benefits (reflecting an increase in the number of beneficiaries). Ministers had been asked to plan cuts in expenditure programs for Cabinet consideration in the next few weeks, with the object of securing a small cut in real programs (including a contingency reserve but excluding debt interest) in 1976/77 and little growth in either 1977/78 or 1978/79.

Public sector borrowing requirement

The staff sought clarification of a number of points on the PSBR made by the Chancellor in his recent meeting with the MD.

On the reliability of the estimated £12 billion PSBR for 1975/76, the U.K. representatives indicated that probably there was at most a ±£1 billion margin of error. This degree of confidence reflected their knowledge of actual public account figures for a sizable portion of the present financial year: 7 months for the Central government; 6 months for local authorities (notwithstanding an inexplicably high market borrowing figure); 6 months for public corporations transfer receipts from the Exchequer; and 3 months for details of public sector borrowing from abroad.

Asked why the growth in public expenditure (at 1975 survey prices and including debt interest) was now officially projected to be 4.4 per cent in 1975/76 instead of only 1.5 per cent as estimated in the January 1975 White Paper, the U.K. representatives cited a number of reasons:

(a)	increased industrial expenditure--including government assistance for BLMC and the establishment of the British National Oil Corporation (BNOC);	+£400 million
(b)	increased agricultural support (net);	+£40 million
(c)	increased sugar refinery support	+£100 million
	plus a shortfall;	+£150 million
(d)	additional social security payments;	+£100 million
(e)	increase in nationalized industries' stocks, less a shortfall;	+£395 million
(f)	additional export credit refinancing; and	+£50 million
(g)	compensating item in respect of nationalized industry price restraint	-£50 million
		£1,187 million

They also explained that some of these changes were incorporated in the 1975/76 Budget.

The staff were somewhat surprised that local authority expenditure had not been a major factor behind the marked upward revision in the projected rate of growth of public expenditure in 1975/76. The U.K. representatives responded that the Government had endeavored to limit the increase in local authority rates in 1975/76 to less than 25 per cent, partly by providing a generous rates support grant and partly by urging local authorities to restraint their investment expenditure. But the local authorities had in fact raised their rates by 35 per cent --prior to the April 1975 Budget-- with the result that they have accumulated an unusually large surplus on current account. Accordingly, the 1975/76 Budget provided for increased local authority financing from revenue and only a small amount from market borrowing. However, in the first half of 1975/76 local authority borrowing from the market totaled £750 million, against a Budget estimate of £297 million for 1975/76 as a whole. Given these developments, officials are now projecting zero market borrowing by the local authorities in second half 1975/76, and thus added £400 million to "other" miscellaneous items in the table showing changes in the PSBR officially estimated for the current fiscal year. The U.K. representatives were reasonably confident about their volume forecasts of local authority expenditure in the current fiscal year, but were much less certain about the reliability of their corresponding price assumptions.

The U.K. representatives confirmed that the 1976/77 PSBR projection of £12.5 billion was based on the same (realistic) time profile of unemployment as in the national accounts forecast--i.e., unemployment continuing to rise during 1976, peaking about the end of next year at around 1 1/4-1 1/2 million.

A discussion then ensued on the Chancellor's intentions as regards offsetting inflation-induced public expenditure rise with cuts in public expenditure. Distinguishing between externally generated price increases and domestically generated increases, the U.K. representatives stated that if domestic prices were to rise by more than allowed for in the official forecasts, then the volume of public expenditure would be reduced. An exception to this principle is opened-ended expenditure such as pensions. These would be subject to an automatic rise in expenditure as inflation rises, which would be far more than offset by an automatic rise in revenue thereby not adding to the PSBR and maybe actually reducing it. Turning to the Chancellor's refusal to "be committed to offset all increases in import prices if the forecasts were badly out," the U.K. representatives interpreted this as merely a caveat against a possible further increase in oil prices. Nevertheless, it was the Government's firm intention to hold the PSBR to £12 billion in 1976/77.

The discussion then focused on the Government's--as yet unannounced--intentions to reduce public expenditure. Cuts of some £2 billion (at 1974 survey prices) relative to the estimates in the January 1975 White Paper (Cmnd. 5879) on public expenditure, had been under active consideration by the Chancellor for 1975/76. These would have produced a fairly flat growth profile for real public expenditure (including debt interest) from 1976/77 through the remainder of the survey period. Because of the much larger growth in real public expenditure (at 1975 survey prices) in 1975/76 revealed by the present nearly-completed survey, correspondingly bigger real expenditure cuts will be needed merely to achieve the desired flat growth profile. Accordingly, the Chancellor now aims to reduce real public expenditure (including debt interest) in 1976/77 by at least £3 billion at 1975 survey prices, and preferably £3 3/4 billion. Certainly the Chancellor wants to offset the demand content of debt interest (estimated at some 20-25 per cent of cash flow). The growth profile of real public expenditure resulting from a £3 billion cut is shown below:

	1977/78	1978/79	1979/80
	(Percentage change from previous year)		
Public expenditure at 1975 survey prices			
(a) excluding debt interest	-0.4	-0.1	0.6
(b) including debt interest	1.~~0~~2	-0.5	-0.6

On either basis the change between 1976/77 and 1979/80 is negligible.

The outlook provided by the new survey differs from that in Cmnd. 5879 in three main respects: it includes substantial additional industrial expenditure; it incorporates a lower forecast rate of inflation in the medium term, thereby scaling down the rate of change in expenditure at constant prices; and it includes debt interest projections at constant prices which are initially much lower and therefore shows a rising profile of debt interest payments. For the purposes of the survey, nominal interest rates are assumed to be roughly maintained over the next few years (as in the financial forecast).

A discussion followed on the implications of the Chancellor's projected real expenditure cuts for the PSBR in the medium term. The staff questioned the assumptions whereby the PSBR could be reduced to 4 per cent of GDP by 1979/80. In the first place, the Chancellor had said that "if a reduction in public expenditure of £2 billion at 1974 prices could be agreed, then public expenditure would increase over the three years to 1979/80 by 2.5 per cent." The U.K. representatives explained that this was the most pessimistic growth rate assumption--i.e., a conservative estimate of what Ministers might agree to. More likely a cut of the above magnitude would reduce the growth in real public expenditure between 1976/77 and 1979/80 to nearer 2 per cent.

The staff then asked about the Chancellor's argument that, if the £2 billion cut in public expenditure were accompanied over this period by a revenue increase in line with the growth rate of GDP (12 per cent), then the PSBR would be reduced by 4 per cent of GDP. In the first place, it was doubtful, in the staff's view, whether an average annual real GDP growth rate of as high as 4 per cent could be maintained over the whole three years to 1979/80, since there was a likelihood that it would not be evenly spread and thus bottlenecks might easily arise. The U.K. representatives maintained that the 12 per cent growth rate over the period was actually rather conservative, given that the economy would only just be recovering from a recession. In fact, their medium-term forecasts suggested a figure of some 16 per cent. Secondly, the staff drew attention to the risk that the desired reduction in the PSBR may not be achieved in this limited plan because the public expenditure deflator tended to rise faster than the GDP deflator. This was not a problem--according to officials--as the volume estimates of public expenditure already included a relative price effect.

As for the Chancellor's statement that a PSBR of 4 per cent of GDP was achievable in 1979/80 on the foregoing assumptions plus some additional taxation and the economy moving to full capacity working, the U.K. representatives admitted that this calculation was erroneous. It had entailed double counting. However, officials assured the staff that the Chancellor was planning to take additional taxation measures with a view to at least reducing the PSBR in 1979/80 to below the 7 per cent of GDP level which they consider could otherwise be achieved.

On medium-term objectives for the PSBR, both the staff and the U.K. representatives agreed that it would be necessary to formulate some phraseology for the staff papers which were more than just vague expressions of the Chancellor's intentions to reduce the size of the PSBR after 1976/77.

In discussing the extensive use of cash ceilings, due to be made in 1976/77, the U.K. representatives explained there were still some areas of public expenditure to which they would not be applied. One obvious example was open-ended expenditure such as pensions. Another exception was local authorities' current expenditure, although the Government was able to exercise some indirect influence over it via the rates support grant. Local authorities' capital spending would be subject to a strict cash ceiling. The U.K. representatives thought that perhaps some 50 per cent of total public expenditure would be subject to cash limits.

The U.K. representatives said that the Government was determined that the cash limits would be rigidly adhered to. They stressed that if prices rose faster than assumed in setting the cash limit for any given expenditure, then the expenditure concerned would have to be correspondingly reduced in volume terms.

No.5

Meeting on Counter-Inflationary Policy
Thursday, November 13, 1975

At the beginning of the meeting, the U.K. representatives summarized the main elements of the Government's counter-inflationary policy. The cornerstone was a limit of £6 per week on pay increases for all those earnings less than £8,500. No increases were allowed for those earning more than £8,500. After allowing for equal pay for women, the pay limit implied an annual rate of increase in average earnings of about 12 per cent. The policy on incomes was voluntary,but it was backed by legal sanctions which had been approved by Parliament and were described in detail in the White Paper.

The policy has so far worked satisfactorily. Since the beginning of August when the pay limit was introduced about 1 1/4 million workers have settled for £6 a week. The number included some important groups, for example low paid workers in the public sector. This, together with the fact that so far there has been no frontal assault against the limit, hold out the prospect that most other major groups would also settle within the limit.

The objective of the policy was to get the year-on-year rate of increase of the retail price index down to 10 per cent by the autumn of next year and to single figures thereafter. It now seemed likely that this objective would be achieved somewhat later than originally expected. The U.K. representatives felt, however, that in the Letter of Application and the staff report the emphasis should be placed on the fact that developments to-date were within the range of the target rather on the likelihood that eventually there may be some margin of error, since admission of the latter would certainly erode the public's acceptance of the pay limit.

The Chancellor had made it clear from the outset that the incomes policy would last for several years until the rate of inflation in the United Kingdom was brought down to the level obtaining in the United Kingdom's international competitors. Accordingly, consideration was now being given to the arrangements which would supercede the pay limit when the latter expired in July 1976. It was likely that in the next round they would not aim for flat rate increases in wages but instead try to introduce more flexibility in order to reduce pressure on differentials. Nevertheless, the main elements of the policy would not change. Discussions with the TUC had already started, but no final decisions were expected before May or June of next year.

The U.K. representatives added that it had proved necessary to make public in one form or another some working assumptions which indicated the range of pay increases envisaged by the authorities for round two of the incomes policy. For example, in making projections for national insurance benefits in the next fiscal year two sets of figures were produced, one on the assumption that wage increases after July 1976 would be 5 per cent and the other on the assumption that it would be 10 per cent. Also, in the negotiations for the setting of cash limits on the rate support grant it had been necessary to make assumptions about pay settlements beyond August 1976. For working purposes, it had been assumed that the increase would be in the range of 5-10 per cent.

If the objective were to be, an increase in earnings of 10 per cent, the pay limit would have to be 8 per cent to allow for the inevitable slippage. With a pay limit of 8 per cent then the year-on-year rate of increase in the retail price index would be expected to fall to 7-8 per cent by the end of 1977. The deceleration from end-1976 would not be particularly impressive but this was due to the anticipated adverse influence of external factors (high world commodity prices).

As for price policy, the U.K. representatives said that the present Government had retained the Price Code and the price control system that had been introduced by its predecessor. Some revisions have been made at various times, but the basic mechanism has not changed. However, the extent to which the price controls are biting is very different than in 1973/74 because of the recession. It was now felt that if the controls were completely removed this would not make much difference to the price level, but it would certainly upset the TUC and the unions. Various ideas as to how the price control system would develop in the future were being considered but they were still in a very preliminary stage. It was recognized, however, that whatever the control apparatus it should not be allowed to lead to a squeeze on profit margins since this would have an adverse impact on investment and hence on employment. (The Chancellor had recently made some statements to this effect.)

The U.K. representatives confirmed that the phasing out of the price subsidies to public utilities (mainly electricity and post office) by the end of this fiscal year was still a policy intention. This was not true, however, in the case of subsidies to British Rail which had structural problems. The objective in this particular case was to try to retain the amount of subsidies at the present level. The official policy was also to phase out food subsidies but over a much longer period of time.

In the course of the discussion, it was agreed that both the Ltter of Application and the staff report would include a section that described the counter-inflationary policy, stressed its apparent success to date, and then added something about the plans for a second round. There were two areas where the drafting should be careful to avoid inferences that might create difficulties for the U.K. authorities: (1) the forecast about the rate of increase in the retail price indext should not be attributed to them. The

U.K. representatives thought that the emphasis should be placed on the fact that to-date developments were within the margin of the target; and (2) the reference to the arrangements that would supercede the pay limit when the latter expired in August 1976 should not include the range of figures that were being considered since if they became known they would most likely be interpreted by the trade unions as starting points for the next round of wage bargaining. They thought that it would be preferable to describe the official intentions in terms of the stated objective to get the rate of increase in the RPI down to the level of the United Kingdom's international competitors. At any rate, if a figure was mentioned it should not directly be attributed to them.

The mission agreed that if a figure was mentioned it should not be attributed to the U.K. authorities. It argued, however, that it would probably be helpful if a figure was mentioned, especially if the figure was on the low side of the range envisaged since if it leaked it could only have a favorable effect on the attitudes of the trade unions.

The U.K. representatives said that the recent sharp increase in wholesale input prices had been foreseen and allowed for in the official projections for the retail price index. They also said that their forecasters were now inclined to believe that they had overstated the likely increase in the retail price index next year.

No. 6

Note of Meeting on Energy
Thursday, November 13, 1975

The authorities said that the United Kingdom is well placed in the energy field as a result of North Sea oil and gas. Aside from oil and gas, the United Kingdom had been conducting a review of their coal policy. The authorities were planning to close down old mines and modernizing the equipment of others to achieve an annual rate of production of 120 million tons. There is also an expansion in the construction of nuclear generators. With respect to North Sea oil, the objective remains to attain self-sufficiency in oil by about 1980. The Government has decided to levy a special tax on North Sea oil production, which is levied prior to the corporation tax, but makes large capital allowance and thus allows a quick capital recovery. Gas from the North Sea is expected to improve in importance over the years and the domestic market for gas is expected to expand considerably. A large proportion of domestic needs will be filled by North Sea gas. Two basic principles shaped energy conservation measures: (a) that economic results should be achieved through conservation, and (b) that everyone should be affected. The principal means to conservation of energy was appropriate pricing. Subsidies for fuels had been phased out and taxes increased, resulting since the end of 1973, in an increase in the price of petrol of 25 per cent, of gas by 20 per cent, of coal by 79 per cent for industrial users and 23 per cent for domestic users, and of electricity by 44 per cent by industrial and 32 per cent for domestic users. The United Kingdom passed on in full the increased cost of crude oil to consumers. In addition to pricing policy, persuasion and mandatory conservation measures had been used. The mandatory measures included speed limits, heating regulations for public buildings, and the like.

Results so far indicate that the consumption of primary fuel was down by 13 per cent in August 1975 over August 1974. With allowance for the warm weather, it might be down by about 10 per cent, representing the lowest consumption since early 1973. Part of the reduction is due to the recession, but the other may be attributed to the effect of increased prices and other measures.

The authorities gave the staff certain corrections in tables provided earlier, which indicated that production from known North Sea oil reserves would reach 110 million tons by 1980, instead of 103 million estimated earlier this year. In oil it is likely that they would be self-sufficient by 1980 from existing fields and that there would be an exportable surplus thereafter. In gas, self-sufficiency would not be reached but a larger proportion of the domestic market would be supplied from North Sea gas sources. With respect to the price of a barrel of North Sea oil, the authorities said that it was put at approximately US$13. The cost of oil was in the range of $2-6 per barrel, the cost depending importantly on the timing of development as the relative cost of capital equipment has accelerated and economies of scale are being reduced as the newer discoveries are generally of smaller size.

INTERNATIONAL MONETARY FUND
WASHINGTON, D.C. 20431

CABLE ADDRESS
INTERFUND

London,
November 18, 1975

Dear Mr. Managing Director:

The talks in London took longer and were more detailed than anticipated. But, there was a general willingness to seek compromises in an attempt to meet the obvious difficulties of both sides.

To begin with I must briefly summarize the economic prospects as officials now see them. The forecasts suggest that unemployment will continue to grow during 1976 and will peak at a figure of around 1 1/2 million (6.4 per cent of total employees) around the end of 1976 or early in 1977. This assumption assumes continued slack domestic demand, but a strikingly rapid and high rate of stock decumulation which has been a feature of 1975, is expected to cease around the third quarter of 1976. This, together with an improvement in the foreign balance, lies behind an expected increase of real GDP of 4.5 per cent between the second half of 1975 and the second half of 1976. Whilst maintaining that no official forecasts have been made which cover a period beyond 1977 Q1, it is clear that real GDP is expected to continue to grow and that for 1977 over 1976 the rate of growth may well be somewhat over 6 per cent. In such a case "full employment" may be being approached by the end of 1977, in the sense that though actual unemployment will still then be high the projected level of unemployment through 1978, even in the absence of any further growth of output, would be close to a full employment situation.

It is still expected that the price targets will either be reached or nearly reached. This is regarded as a vital precondition for securing a further period of wage restraint when the present £6 limit ceases in August 1976. From this summary, you will see that policy has to be formulated against the background of rising unemployment through 1976, and the risk that measures of restraint may need to be considered or introduced by the end of 1977.

1. I attach a copy of the draft Letter of Application. The agreement is that the Cabinet will take decisions on import restrictions and public sector expenditure cuts around the end of the first week in December. The Chancellor has looked at the draft and sees nothing immediately difficult but he reserves the right, as I reserved your right, to raise issues between now and early December. The passages on the still undecided subjects cannot be drafted with any finality. It may help if I set out the position as it now stands under particular headings. Mr. Finch can, of course, fill you in on any points on which you desire more information.

"Need"

2. Now that we have had an opportunity to go carefully over the balance of payments figures, it is obvious that the United Kingdom's loss of gross official reserves during calendar 1975 will exceed the amount being drawn under the Oil Facility by only a relatively small amount (it being understood that precision in forecasting reserve movements is misleading). The current official forecast is that reserves will fall $1.4 billion during calendar 1975, as against the $1.2 billion (SDR 1 billion) which is being drawn under the Oil Facility. We have made the point that any paper that went to the Board must as a minimum be able to show with every plausibility that official reserves will fall by $1.3 billion during 1975.

3. The smaller loss that is now expected is in part attributable to the expected receipt of a second tranche ($400 million) of the oil loan from Iran, which is now foreseen to be received in early December. One consequence of the smaller than expected loss is that the United Kingdom will not be able to claim much credit for its "restraint" in confining its drawing under the Oil Facility to SDR 1 billion. A second consequence is that the first credit tranche money cannot be taken until calendar 1976, if the reserve loss during calendar 1975 is to exceed the amount being drawn under the Oil Facility. We are satisfied that the United Kingdom has made all reasonable efforts to borrow as much as possible through market loans and we have agreed a form of wording which covers this potentially tricky point of presentation.

4. The timing of the drawing on the first credit tranche leads to the question whether it should take the form of a stand-by arrangement or a drawing. They would prefer a drawing basically for two reasons. First, from the Chancellor's point of view the whole potentially difficult political matter would be over and disposed with within a short space of time, and secondly that through the use of a drawing rather than a stand-by they would avoid one extra document, namely the stand-by arrangement paper which, although it is formally a Fund document, they could be forced, under questioning in the House of Commons, to publish. I have argued that a stand-by would be a preferable arrangement. I have taken this line partly because this would be the normal form of extending assistance in the first credit tranche and with the United Kingdom there is virtue in "normality" but also because a drawing, if the present timetable of a Board meeting in late December is held, would occur in early January and this would look like a very contrived procedure to ensure that the British had the required loss of reserves during calendar 1975 to enable them to draw under the Oil Facility (and indeed this would be the case). I have told them that there would be an advantage in taking a stand-by arrangement and drawing the money in the spring of 1976, unless they had an urgent need to draw earlier. As at present, this question is unresolved and officials have said that they would like to think over the matter further before submitting a recommendation to the Chancellor.

Gold Tranche

5. As regards their outstanding obligation in the gold tranche, they will shortly repay it, and will then redraw the whole of the gold tranche just before they draw the oil money. Instructions to this effect will be sent to their Executive Director's office shortly.

DCE

6. They have now accepted that there should be a quantified figure for DCE covering both the six months to the end of the current fiscal year (namely to March 31, 1976), and also covering the whole of the fiscal year 1976/77. The figure that we have agreed on is in each case probably somewhat generous, but we are in the awkward position of being faced with a given figure for the public sector borrowing requirement and an already extremely low figure for the expected increase in the private sector credit. Given certain reasonable assumptions, these figures are consistent with an expansion of M3 during the second half of this fiscal year at an annual rate of 18 per cent and during next financial year of 14 per cent. These figures are to be compared with rates of increase in nominal GNP of 16 per cent and 14 per cent, respectively, but if, as is likely, prices exceed their targets this last figure will be somewhat higher. We have, however, secured their agreement to some reasonably strong language on the general stance of monetary policy and--more important than words--both the Chancellor and the Governor spoke with much greater force and determination on this subject than they have before.

PSBR

7. Unfortunately, the Chancellor, when he saw you earlier in November, gave an exposition (paragraph 13 of the agreed minute) in which he contemplated that on certain assumptions the PSBR would fall to some 4 per cent of GDP by the fiscal year 1979/80. Unfortunately, when we looked at the subject more carefully, this figure cannot be sustained. There are two main points. First, there is the assumption that in the fiscal year 1976/77 and in each of the three successive fiscal years GDP will rise in real terms by 4 per cent per annum. This seems to me a wholly unlikely achievement given recent U.K. economic history. There is great uncertainty as to what the potential rate of output should now be assumed to be, but probably the figure is around 2 1/2 per cent per annum. There is equal uncertainty about the amount of existing slack, but it would require a heroic assumption to assume that the potential rate of growth plus existing slack would allow increases in GDP of 4 per cent per annum in four consecutive years without the economy running considerably before the end of 1979/80 into many intractible bottlenecks. The second main qualification is that the Chancellor, having assumed the rate of growth referred to above, has added (see the last sentence of the paragraph) a further reduction equivalent to 3 per cent of GDP in respect of what he considers to be "below capacity" working. U.K. officials are now fully prepared to admit that this amounts to double counting. In sum, therefore, the Chancellor's presentation envisaged a reduction of PSBR to 7 per cent of GDP by 1979/80 and, moreover, this depends on some possibly unlikely assumptions about the sustainable rate of growth. We strongly expressed our view on several

occasions that this was a wholly inadequate rate of reduction. We found that our views were shared by a great majority of the officials with whom we talked and, of course, by the Bank of England.

8. The draft letter necessarily confines itself to the more immediate future and we have confirmed the commitment which you obtained, namely that the PSBR this year should be no more than £12 billion and should not be higher in money terms in 1976/77. This can be represented as a progress of a sort in that as a proportion of national income, the PSBR will fall from nearly 13 per cent this year to around 11 per cent next year.

9. There is somewhat better picture to report as regards public sector expenditures. This subject has again been considered in the Cabinet and I have been asked to let you know on a private and personal basis that the Chancellor believes that he can now do somewhat better than he thought at the time he spoke to you (paragraph 9 of the agreed minute). The precise figure is still uncertain, but he would hope that (in 1975 prices) the cuts would be around £3.5 billion. However, even with these cuts, which have required some political courage, the PSBR remains an intractible problem which will require further action. We have said that unless further cuts are put in hand, increases in taxation will be needed.

10. We have certainly not heard the end of this subject, but you are already very familiar with it and there is little to add. We always reach the same conclusions, whether we argue in resource or monetary terms. We have also stressed our point about the long lags involved and said that if by chance increases in other components in demand did not occur as expected, the slack resulting from reduced pressures from the public sector could be taken up by a cut in taxation which would of itself have some welcome effects.

Balance of payments

11. Their estimates on the extent and speed of the pick-up of demand in U.K. external markets seem likely to be optimistic. Nevertheless, there has been a substantial improvement in the current account position in 1975 when the deficit will fall to some £2 billion. The improvement in 1976 will be only small, largely because destocking is expected to cease. Thereafter North Sea oil will have an increasing effect and we have managed to obtain a statement in the Letter that the current account is expected to move into surplus during 1978. We had no difficulty with the exposition on energy policy.

Import restrictions

12. As you know, this is a subject which has given us much difficulty and no finaldecisions have been taken. It seems very probable that some selective controls of the type sketched to you by the Chancellor will be imposed, but whether or not action will be taken on cars no one yet knows. We have put forward our views with some strength. It has proved very difficult to draft the various paragraphs which would be needed to take into account each of the possible scenarios and final work on this subject, as well as on the paragraph dealing with the public sector expenditure cuts, will have to be left until the position is somewhat clearer.

Timing

13. We have maintained your position that the paper should not be sent to the Board until something definite had been decided as regards public sector expenditure cuts and import restrictions. As of now, it seems unlikely that really firm decisions on the cuts will be taken before the end of the first week in December. I have said that I thought that the Chancellor's letter must contain a reference to these and that they must be expressed in quantitative terms. A roughly similar delay may be needed on the question of import restrictions, and indeed the Chancellor would plan for obvious political reasons to make a virtually simultaneous announcement on these two issues. This means that the staff paper could hardly be issued to the Board before, say, December 12 or 15. As regards your caveat on exchange rate, I have said that we would not of course expect any intention to depreciate the exchange rate by more than was required to maintain competitivity to be put in a letter of intent. However, we would expect that the Chancellor would find a method of informing you privately if new decisions on the exchange rate were taken. We spent a lot of time discussing this question, and I have found officials very evenly divided between those who share our opinion and those who saw the greatest dangers in any such course.

On a related issue the latest news from Brussels is that the total to be raised for the EEC oil facility will probably not exceed $500 million. This disappointing result has led some (including the Belgians, the British, and the Dutch) to question whether it makes political sense to go forward given the publicity and the high numbers that surrounded the initial announcements on this subject. If it fell through in time we might be able to pick up some more money!

Yours sincerely,

L. A. Whittome

L. A. Whittome

Mr. Johannes H. Witteveen
International Monetary Fund
Washington, D.C.

11/21/75

United Kingdom:

Public Sector Borrowing Requirement,
1963-1974

	In millions of pounds	In per cent of GDP
Calendar years		
1963	832	3.1
1964	995	3.4
1965	1,188	3.8
1966	959	2.9
1967	1,831	5.2
1968	1,316	3.5
1969	-466	-1.2
1970	-18	--
1971	1,371	2.8
1972	2,054	3.8
1973	4,218	6.7
1974	6,325	8.7
Financial years		
1969/70	-526	-1.3
1970/71	802	1.8
1971/72	1,016	2.0
1972/73	2,516	4.4
1973/74	4,458	7.0
1974/75	7,889	10.2

Sources: Central Statistics Office, Economic Trends and Financial Statistics; and Bank of England, An Introduction to Flow of Funds Accounting.

United Kingdom: Imports of Cars and Trucks[1/]

(C.i.f. value in thousands of pounds)

	1974	1975 Jan.-Aug.
	(In thousands of pounds)	
Passenger motor cars, whether or not assembled	356,898	349,987
	(2.9)	(4.1)
Buses, lorries, and trucks, and road tractors for tractor-trailer combinations	83,909	62,473
	(0.7)	(0.7)
Total	440,807	412,460
	(3.6)	(4.8)
Total manufactured imports	12,130,500	8,582,581
Total imports	23,116,718	15,643,334

Source: Department of Trade, Overseas Trade Statistics.

1/ Figures in parenthesis are percentages of total manufactured imports.

November 13, 1975

MEMORANDUM FOR FILES

I met with Sir Douglas Wass this evening. After some general discussion we focused on a few particular topics:

(1) PSBR. He emphasized that it was not an objective of policy to reduce the PSBR. Rather the objectives of policy, namely a growth in investment, an improved current account position, and an improved employment situation, implied (or necessitated) a reduction in the PSBR.

(2) No decision has yet been taken on import restrictions. We related this subject briefly and Sir Douglas said that our views were noted. If measures were taken, the probable route would be under Article XIX of the GATT.

(3) He agreed that at the time of the Board meeting the further tranche of the Iranian loan should be brought to the attention of the Board. He is clearly thinking in terms of a first credit tranche drawing, which would be discussed by the Board in late December and drawn in January.

(4) He also emphasized that no decision had been reached on the exchange rate. At the least, they would depreciate in line with any deterioration in relative prices. The discussion was whether or not to do more and if so by how much and when.

(5) He said it was the intention to secure a current account surplus in 1978.

L. A. Whittome

Mr. Hyndman

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- [ ] Night Letter
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SPECIAL INSTRUCTIONS

cc: Mr. Polak
Mr. Sturc
Mr. Pfeifer
Mr. Evans

Drafted by DWGreen

Department Off.Man.Dir.

Date November 21, 1975

AUTHORIZATION

Signature

Second Signature When Required

FOR CODE ROOM

Time Received

Time Dispatched

Number of Words

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Operator

INTERNATIONAL MONETARY FUND
WASHINGTON D.C.

To: Rt. Hon. Denis W. Healey, M.B.E., M.P.
Chancellor of the Exchequer
Treasury Chambers
London, England.

I have reviewed the letter of application for the first credit tranche that was discussed with your officials. Subject to the satisfactory resolution of the issues mentioned below and some minor rewording which will be given directly to your officials, I believe that the present text does represent a reasonable compromise which I would be prepared to present to the Board, even though in some respects it provides us with only a minimum.

My first concern relates to paragraph 8 and the description of the policy on public expenditure cuts. I regard it as essential that the proposed additional sentences in this paragraph will give substance to the general declaration of medium-term policy and will quantify appropriately restrained expenditure objectives for the next few years along the lines we have discussed.

My second concern relates to paragraph 15. This paragraph has to incorporate an acceptable policy regarding trade measures. As I said in my most recent message to you, I advise against any restrictions on car imports. Restrictions on such an important category of imports would give me the greatest difficulties. As Mr. Whittome has told your officials, we regard the avoidance of restrictions to be critically important. Your policy in this respect should be clearly compatible with the prescriptions laid down by the Board. Consequently, I would have to examine the

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SPECIAL INSTRUCTIONS

INTERNATIONAL MONETARY FUND
WASHINGTON D.C.

To:

precise character of any action that might be planned in this delicate area very carefully in order to determine whether I could continue to support the request. In this connection, I would also note the importance I would attach to an assurance that any import measure, even on a minor import, would be temporary with a stated terminal date (which in my opinion should) not stretch beyond the end of 1976.

One other outstanding question is whether the first ~~credit~~ tranche transaction should take the form of a stand-by or an immediate purchase. I understand that on present indications gross reserves are unlikely to decline by more than $1.4 million in 1975 before taking into account transactions with the Fund. In these circumstances, a first tranche drawing in 1975 would, under our normal practice, reduce the amount available under the oil facility below the SDR 1 billion presently contemplated. Although delaying the transactions into January would avoid this problem technically, I believe it might be considered a contrivance to increase the use made by the United Kingdom of the limited resources available for the oil facility. A stand-by arrangement avoids this problem as it allows the use of the resources to be made later in 1976 when additional financing needs will have been shown.

Warmest regards,

WITTEVEEN

Drafted by ____

Department ____

Date ____

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Signature

Second Signature When Required

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