Another Autopsy on Britain's Balance
of Payments: 1958-1967 [1]

I

The history of Britain's balance of payments on international account since the second World War makes dismal reading. There have been five major foreign exchange crises — in 1951, 1955, 1959, 1964 and 1967 — and two devaluations, in 1949 and 1967. In 1964 the deficit on current and long term capital account was the largest in recorded history. In 1965 and 1966 the payments position improved but in 1967 there was a sudden deterioration and in November of the same year the pound was devalued. In retrospect it is sometimes argued that the pound ought to have been devalued in 1964. Indeed at the time of the 1964 crisis itself there was a small devaluation lobby, and rumour has it that the Conservative Party had prepared a contingency plan for devaluation in the event of re-election to office at the General Election in November. As it happened, the Conservative party suffered defeat; the Labour Party inherited a deficit of £744 million, and rejected devaluation as a method of balance of payments adjustment.

Whether or not devaluation was appropriate in 1964, and whether or not the Labour Government was wise in rejecting devaluation as a solution to the payments deficit, while resorting to it in 1967, requires a thorough analysis of the origins of payments disequilibrium in these two years, and a comparison of these years with previous years — especially 1960. It will be suggested in this paper that the "underlying" balance of payments (2) on trade and current account remained virtually unchanged over the period 1960

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(2) *i.e.* the balance of payments at a given pressure of demand.

to 1967; that the slightly greater deficit on current account in 1964 than in 1960 can largely be accounted for by the rate at which demand expanded in 1964, and that in general Britain's payments troubles have had little to do with growing price uncompetitiveness in world markets (3).

II

From the national income identity $Y = C + I + X - M$, where C is consumption, I is investment, X is exports and M is imports, the payments position on current account can be represented as $X - M = Y - E$, where $E = C + I$, or total domestic expenditure. This is the so-called absorption approach to the balance of payments which is designed to highlight the nature of balance of payments deficits in an operationally meaningful way. In fact, it tells us very little about the origins of deficits. The equation simply states that the value of domestic expenditure cannot exceed the value of domestic output unless imports exceed exports; or, to put it another way, that a balance of payments deficit implies expenditure in excess of domestic output. The equation tells us nothing, however, about the underlying causes of a deficit or why expenditure exceeds output and imports exceed exports. Excessive expenditure could be autonomous due to lax fiscal or monetary policy, or it could be the result of the necessity to maintain full employment in the event of domestic prices becoming increasingly uncompetitive compared with world prices. From the equation $X - M = Y - E$, if X and M are unresponsive to changes in E it can be seen that Y must bear the brunt of adjustment. That is, if the balance of payments

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(3) Since devaluation in November 1967 took place against the background of a much smaller "accounting" deficit than in 1964, this paper also provides, in passing, a case study of the ultimate importance of the "market" balance of payments in dictating balance of payments adjustment. The "accounting" deficit is the deficit as officially defined, *i.e.* the balance on current and long term capital account (plus the "normal" balancing item). This balance is sometimes referred to as the "basic" balance and is used in the U.K. as the main criterion of balance of payments equilibrium. There are, of course, a number of definitions of balance of payments equilibrium (see C. KINDLEBERGER, "Measuring Equilibrium in the Balance of Payments", *Journal of Political Economy*, December 1969), but the balance on current and long term capital account perhaps gives the best idea of underlying trends and developments in relation to the state of the domestic economy.

The market balance of payments refers to balance in the foreign exchange market. Pressure in the foreign exchange market due to short term capital movements may force exchange rate adjustment despite an improving "basic" balance.

deficit is largely due to growing price uncompetitiveness a reduction in expenditure will cause unemployment. Seemingly excessive expenditure, therefore, associated with balance of payments difficulties, could be a necessary prerequisite of "full" employment. A meaningful analysis of balance of payments difficulties requires an assessment of the "full" employment balance of payments, or the balance of payments at a constant pressure of demand.

III

Britain's payments position on visible account, current account and long term capital account is summarised in Table 1 for the period 1955 to 1967. The official balance is defined as the balance on current and long term capital account; it is these items within the accounting balance which, together with the balancing item, give the balance of monetary movements or accommodating transfers. The balance on long term capital account is normally excluded from econometric work on the relation between the workings of the domestic economy and the balance of payments on the grounds that it is largely independent of such factors as the pressure of domestic demand and movements in the terms of trade. The balance on long term capital account clearly has a bearing, however, on the balance of supply and demand in the foreign exchange market and could exert a decisive influence on what form a balance of payments adjustment ultimately takes. Equally important in this respect are autonomous or induced private short term capital movements. These are excluded from the official definition of balance of payments equilibrium in many countries (including Britain) but will influence the extent of official action required to stabilise the exchange rate in the event of disequilibrium between other payments (4).

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(4) As long ago as 1948 the International Monetary Fund stated that it was of great importance for them to know the total financial pressure on the monetary authorities resulting from international transactions as distinct from knowledge of the balance of monetary movements, and in 1949 the Fund coined the phrase "compensatory official financing" defined simply as the financing undertaken by the monetary authorities to provide exchange to cover a surplus or deficit in the rest of the balance of payments. The United States uses a "liquidity" definition of equilibrium, but this also has come under attack on "technical, analytical and factual grounds" (C. KINDLEBERGER, op. cit., p. 879).

Whether the current balance, or the current plus the long term capital balance, is taken for analysis, it has been noticed that over the years Britain's payments deficits in successive crises have worsened (see Table 1). In 1955, for example, the visible deficit was £313 million, the current deficit £155 million and the official deficit £277 million. In 1960 the respective deficits were £406 m., £265 m., and £475 million; and in 1964, £537 m., £381 m., and £744 million. Since the pressure of demand was roughly the same in 1964 as in 1960, and was higher in 1955 than in either of the other two years, the *level* of demand pressure *alone* cannot be used as an explanation of the phenomenon of *deteriorating* deficits.

TABLE I

THE U.K. BALANCE OF PAYMENTS 1955-1967 (£ million)

	Visible Balance (1)	Current Account Balance (2)	Balance on Current and Long Term Capital Account (2)
1955	−313	−115	−277
1956	+ 53	+208	+ 21
1957	− 29	+233	+127
1958	+ 29	+344	+148
1959	−117	+143	−112
1960	−406	−265	−457
1961	−152	− 4	+ 64
1962	−102	+112	+ 14
1963	− 80	+114	− 35
1964	−537	−381	−744
1965	−265	− 50	−252
1966	−103	+ 64	− 48
1967	−548	−283	−417

Source: *United Kingdom Balance of Payments 1969*, H.M.S.O., London.

(1) Not including payments for U.S. military aircraft and excluding allowance for unrecorded exports. Imports and exports are f.o.b.

(2) Including payments for U.S. military aircraft and allowance for unrecorded exports.

Three plausible alternative hypotheses may be put forward. One is that the economy has been run at too high a pressure of demand in relation to productive potential at certain periods causing

a rapid upsurge in imports. The economy has been subsequently stopped to maintain foreign exchange reserves, and to preserve the foreign exchange value of sterling, and this has impaired future competitiveness by discouraging investment and raising unit costs of production in periods of stagnation. A second hypothesis, related to the first, and predicting the same result in the long run, is that there has been a *gradual* erosion of competitiveness over time by defining "full" employment too ambitiously, causing costs and prices to rise faster than in other industrial countries. A third hypothesis is that the size of payments deficits is related to the speed of demand expansion from troughs to peaks of the trade cycle, in addition to the level of demand at the peak, and that in successive upswings in 1955, 1960 and 1964, the speed of expansion has been faster than in the previous upswing. The argument is that the more rapid the expansion the less time producers have to react to changes in demand and the greater will be the extent of bottlenecks in the economy for imports to fill. Moreover, when conditions return to normal imports will not fall to their trend level because during the boom with imports high manufacturers and consumers are likely to acquire a taste for imports which they will be reluctant to relinquish when home supplies become available again (5).

Support for the first hypothesis would be given by upsurges in imports in particular boom years together with a significant negative trend factor relating the balance of trade (or balance of payments on current account) to the pressure of domestic demand The second hypothesis could be supported by an appeal to the facts on the price of our exports relative to those of our important customers and competitors, and coupled again with a significant negative trend term relating the balance of trade to time. The third hypothesis would be supported by finding that the speed of domestic expansion and the rate of expansion of imports had been greater in successive booms; that imports are more sensitive to upswings than downswings, and that no significant negative time trend exists relating the balance of payments to the pressure of demand.

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(5) This hypothesis was first put forward in the wake of the 1964 crisis by F. BRECHLING and J. N. WOLFE, "The End of Stop-Go", *Lloyds Bank Review*, January 1965.

In recent years these hypotheses have been examined by a number of investigators with varying conclusions (6). Brechling and Wolfe present and substantiate the speed of expansion hypothesis. Oppenheimer rejects Brechling and Wolfe's explanation and accuses them of looking in the wrong place for an explanation of Britain's balance of payments weakness. He concludes: "the relationship between business cycles, inflation and the balance of payments, orthodox or unorthodox, is of quite secondary importance. When a country in Britain's situation suffers a marked deterioration in its trade balance not due to any increase in the pressure of demand... orthodox theory diagnoses uncompetitiveness. And uncompetitiveness is not a cyclical problem" (p. 183). Smyth rebuts Oppenheimer. Smyth, in testing the Brechling-Wolfe hypothesis with respect to exports of manufactures, concludes that: "the assertion of Oppenheimer that the U.K.'s poor export performance is due to lack of competitiveness and not, to any significant extent, to bottleneck influences, is seen to be invalid" (p. 32). Eltis on the other hand puts forward a simple explanation. He points to the fact that while the deficits and surpluses on current account have become larger and smaller respectively with successive booms and slumps, the current account does not show continuous deterioration if net Government invisible imports are excluded. There was a steady growth of net Government invisible imports from £55 million in 1953 to £472 million in 1966. Paish also comes to this conclusion at least for the period up to 1966. He says: "if we abstract from cyclical fluctuations by calculating the yearly averages for whole cycles we find that... the average balance of payments on current account deteriorated progressively from a surplus of £119 millions in 1952-57 to one of £61 million in 1958-61 and to a deficit of £66 million in 1962-66. The worsening between the first and second cycles was due almost entirely to a greater rise in public sector payments abroad on invisible account, but between

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(6) F. BRECHLING and J. N. WOLFE, *op. cit.*

P. OPPENHEIMER, "Is Britain's Trade Gap Due to Bad Management of the Business Cycle?", *Bulletin of the Oxford Institute of Economics and Statistics*, August 1965.

D. J. SMYTH, "Stop-Go and the U.K. Exports of Manufactures", *Bulletin of the Oxford Institute of Economics and Statistics*, February 1968.

W. ELTIS, "Economic Growth and the British Balance of Payments", *District Bank Review*, December 1967.

F. PAISH, "How the Economy Works", *Lloyds Bank Review*, April 1968.

the second and third cycles the worsening of the trade balance was greater than on invisible account" (p. 12). While the observation by Eltis and Paish is correct, it is hardly legitimate to isolate one single item from the balance of payments as the villain of the piece; in fact, Government expenditure abroad has been offset by increases in receipts from other invisible items and the invisible balance as a whole has shown a fair degree of stability over the period under review.

IV

To go over the ground again, but in a slightly different way, we shall derive some very simple statistical relationships between two measures of the pressure of domestic demand and the balance of trade (B_T), and the balance on current account (B_C), respectively, taking quarterly data for the period 1958 to 1966. With the aid of the estimated relationships we shall compare first 1960 and 1964, and then 1964 and 1967, together with the intervening years. The two indexes of demand pressure taken are Paish's quarterly index of unutilised capacity (U.c) (7), and a quarterly index of the percentage level of unemployment (U) (8). On the assumption that imports are increasingly responsive to demand pressure, the greater the pressure of demand, non-linear equations are fitted to the data of the form $y = a + b_1(x)^{-1}$, and estimated by ordinary least squares techniques. A time trend is then added giving equations of the form $y = a + b_1(x)^{-1} + b_2(t)$, where t is time in quarters. We thus derive one set of four equations where y is the balance of trade, and another set of four equations where y is the balance of payments on current account. The estimated equations are given in Table 2, together with other relevant information. With 36 observations all the equations are significant at the 5 per cent confidence level and above. The implied "trade-off" curves are drawn in figure 1, using equations [1], [1a], [2] and [2a].

From the equations, or the "trade-off" curves, it can be seen what one might have expected the balance of trade or balance of payments on current account to have been in the various years, given the prevailing level of demand pressure. The difference

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(7) From F. PAISH, *Rise and Fall of Incomes Policy*, Hobart Papers 47, Institute of Economic Affairs, London, 1969, pp. 30-31.

(8) *Source*: National Institute of Economic and Social Research, Quarterly Reviews.

TABLE 2

THE BALANCE OF TRADE AND THE PRESSURE OF DEMAND

(Quarterly data) 1958-1966

[1] $B_T = + 53.652 - 187.432 \ (U)^{-1}$
     (30.575)   (50.981)
     $r^2 = 0.297$ d.w $= 0.865$

[2] $B_T = + 5.957 - 171.895 \ (U.c)^{-1}$
     (15.503)   (39.156)
     $r^2 = 0.375$ d.w $= 1.673$

[3] $B_T = + 49.025 - 160.400 \ (U)^{-1} - 0.638 \ (t)$
     (31.432)   (63.138)   (0.867)
     $r^2 = 0.309$ d.w $= 0.877$

[4] $B_T = + 25.373 - 156.148 \ (U.c)^{-1} - 1.433 \ (t)$
     (16.913)   (37.491)   (0.631)
     $r^2 = 0.464$ d.w $= 1.814$

THE BALANCE OF PAYMENTS ON CURRENT ACCOUNT AND THE PRESSURE OF DEMAND

(Quarterly data) 1958-1966

[1a] $B_C = + 128.261 - 230.750 \ (U)^{-1}$
      (35.756)   (59.319)
      $r^2 = 0.321$ d.w $= 0.824$

[2a] $B_C = + 74.711 - 255.987 \ (U.c)^{-1}$
      (17.020)   (42.987)
      $r^2 = 0.463$ d.w $= 1.719$

[3a] $B_C = + 121.933 - 193.783 \ (U)^{-1} \quad (1) \ 748.0 -$
      (36.451)   (73.219)   (1.006)
      $r^2 = 0.337$ d.w $= 0.842$

[4a] $B_C = + 98.793 - 206.456 \ (U.c)^{-1} - 1.777 \ (t)$
      (18.137)   (40.204)   (0.677)
      $r^2 = 0.560$ d.w $= 1.995$

Notes:

Standard errors in brackets.
d.w. is Durbin-Watson Statistics.

between the actual and predicted results for the years in question (the residuals) can then be examined. While it seems that no more than 50 per cent of the variance in the balance of payments is related to variations in our measures of demand pressure, the regression coefficients in equations [1], [2], [1a] and [2a] are highly significant and can therefore be used with some confidence for the purpose at hand. The residuals plotted on the basis of equations [1], [2], [1a] and [2a] are highly cyclical. If there

has been a significant trend factor at work leading to a long run deterioration in the "full" employment balance of payments one should observe a systematic tendency over time for the positive residuals to become smaller, and the negative residuals to become larger, at the same pressure of demand. But there is little evidence of this. The residuals from equations [1] and [2] are plotted in figure 2. and it can be seen that the peaks of the positive residuals all seem to be at roughly the same level and the negative residuals show no consistent downward trend.

When a time trend was added to the equations (see equations [3], [4], [3a] and [4a] in Table 2) it emerged as statistically significant in both sets of equations using unutilised capacity as the demand variable, but insignificant in magnitude. To account for the larger deficit in 1964 than 1960 it does seem we are left with the rate of expansion hypothesis, but let us look at the two years in more detail.

A Comparison of 1960 and 1964

In 1960 the actual deficit on the balance of trade was £406 million and the deficit on current account was £265 million. In 1964 the visible trade deficit was £537 million and the current account deficit £381 million. Since the balance on invisible account (which makes up the difference between the balance of trade and the balance on current account) was almost exactly the same in 1964 as 1960, a separate analysis of the balance of trade and the current balance is not necessary (9). We shall therefore concentrate simply on the balance of trade. The question is: was the deterioration in the size of trade deficit of £131 million between 1960 and 1964 the result of a worsening trend (due to growing price uncompetitiveness, for example); a greater pressure of demand; the speed of expansion in 1964, compared with 1960, or other factors?

The pressure of demand in 1964, measured by unemployment and unutilised capacity was slightly less in 1964 than in 1960. We would predict from equations [1] and [2], therefore, on the basis

(9) The gap in the visible account between the two years is not the same as the gap in the current account since the figures for the current balance include payments for U.S. military aircraft and an allowance for the underrecording of exports, which are excluded from the visible account figures.

of demand pressure alone, a somewhat lower deficit in 1964 than in 1960. Had the pressure of demand been the same in 1964 as in 1960 we should have expected the deterioration in the deficit to be about £10 million greater than it actually was on the basis of the level of unemployment, and £50 million greater than it was on the basis of the level of unutilised capacity.

If we now turn to equations [3] and [4], which include a time trend, we find that the trend term has a negative sign in both cases and is significant at the ·5 per cent confidence level in equation [4]. The evidence suggests a gradual worsening of the visible trade balance over the period 1958 to 1966, independent of changes in demand pressure, of between £1 to £2 million per quarter (10). Suppose the trend term is taken as £—1.5 million per quarter, this amounts to a deterioration over four years of £24 million. Now if we take the deterioration in the balance of trade at a *constant* level of demand to have been between £140 million and £180 million (instead of the actual £131 million), and allow for the trend factor, we are left with a deterioration of between £116 million and £156 million to account for.

Due to a change in the regulations governing export registration, exports have apparently been underrecorded since 1964. The Balance of Payments Pink Book gives £20 million as the value of unrecorded exports in 1964. Making allowance for this, we are left with a deterioration of between £96 million and £136 million still to be "explained".

The noticeable difference between 1960 and 1964 does seem to be the faster expansion of imports in the boom of 1964, and the slow down of the growth of exports compared with 1960. These were sudden changes which can hardly be related to unfavourable movements in relative prices. Unless the elasticity of imports with respect to income altered between 1960 and 1964, the greater growth of imports in 1964 must have been related to the speed of expansion itself. The absolute rise in the value of the physical increase in stocks and work in progress was roughly the same in the two years. The percentage increase in consumer expenditure, however, was 6.79 in 1964 compared with 4.98 in 1960, and the rise in gross

(10) A simple time trend fitted to the data yielded a significant result of the balance of trade (Bт) deteriorating at approximately £1.9 million per quarter (t) *i.e.*

$$Bт = -22.27 - 1.920 \ (t)$$
$$(15.31) \quad (0.763)$$

FIGURE I - TRADE-OFF CURVES BETWEEN THE BALANCE OF PAYMENTS
AND THE PRESSURE OF DEMAND
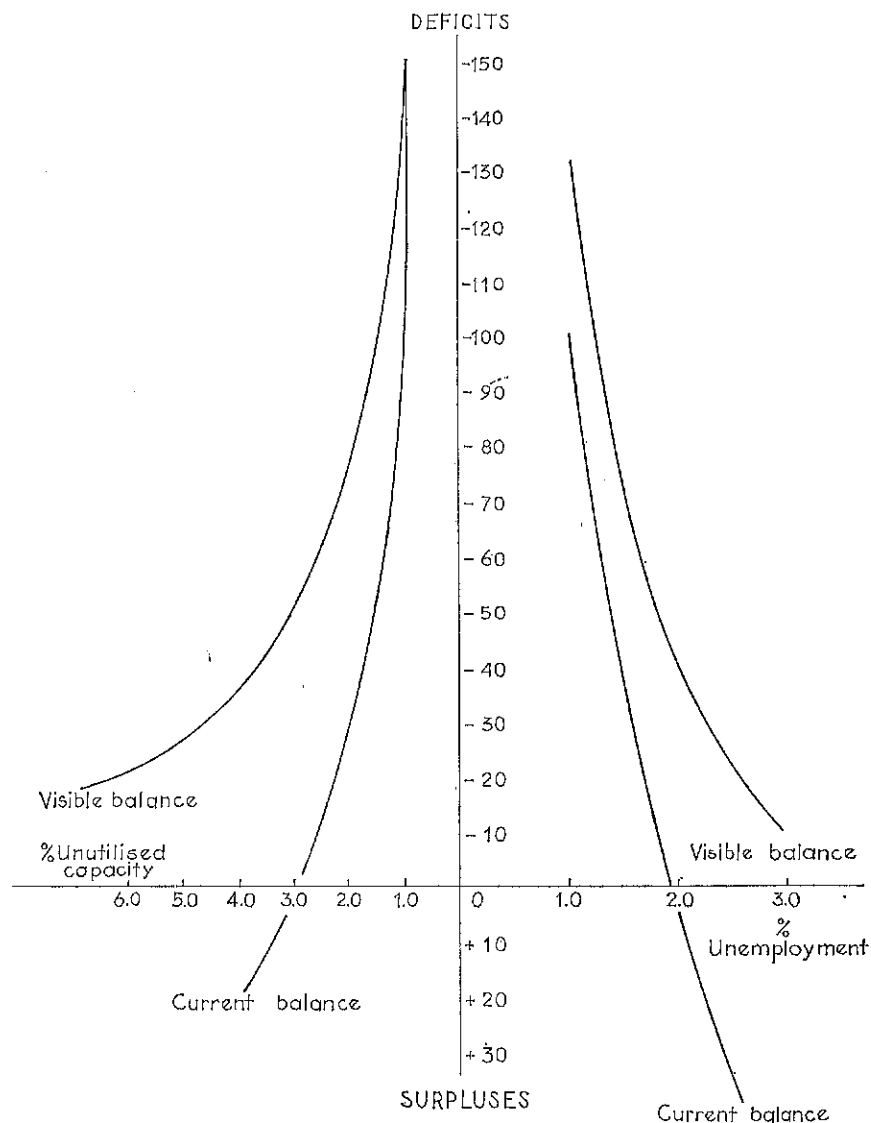
national product 7.91 per cent and 6.45 per cent respectively. Coupled
with these figures the trade deficit rose to £406 million in 1960
from £117 million in 1959, with export growth at 6 per cent and
import growth at 13.7 per cent. In 1964 the deficit deteriorated to
£537 million from £80 million in 1963, with export growth at
4.3 per cent and import growth at 15.4 per cent. It can be seen

FIGURE 2 - RESIDUALS. (VISIBLE BALANCE), PLOTTED
FROM EQUATIONS (1) AND (2)
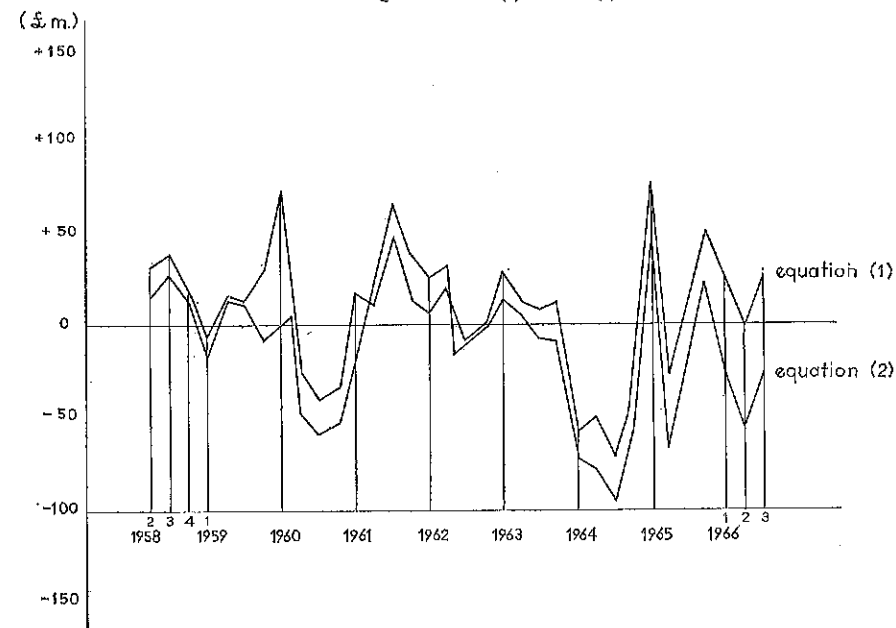
from Table 3 that had imports grown no faster in 1964 than in
1960, the import bill would have been some £75 million less, and
had exports maintained their trend rate of growth of 6.0 per cent
per annum, export earnings would have been £70 million higher
than they actually were. Differences in the rate of growth of
imports and exports in 1960 and 1964, related to the speed of
domestic expansion, seem sufficient to account for the deterioration
in the balance of trade between 1960 and 1964 which is " unexplain-
ed " by the unrecording of exports and an unfavourable trend.
    When quarterly changes in the pressure of demand, as measured
by unutilised capacity, were explicitly considered as an additional

TABLE 3

THE GROWTH OF EXPORTS AND IMPORTS

	Exports and Re-Exports (f.o.b.) £m.	% Growth	Imports (f.o.b.) £m.	% Growth
1955	3,073	10.34	3,386	13.28
1956	3,377	9.89	3,324	— 1.83
1957	3,509	3.90	3,538	6.43
1958	3,406	— 2.93	3,377	— 4.55
1959	3,522	3.40	3,639	7.75
1960	3,732	5.96	4,138	13.71
1961	3,891	4.26	4,043	— 2.34
1962	3,993	2.62	4,095	1.28
1963	4,282	7.23	4,362	6.52
1964	4,466	4.29	5,003	15.38
1965	4,777	6.96	5,042	0.17
1966	5,108	6.92	5,211	3.35
1967 (1)	5,026	— 1.60	5,574	6.96

Source: *United Kingdom Balance of Payments 1969*, H.M.S.O., London.

(1) Figures unadjusted for devaluation in November 1967.

explanatory variable in the regression analysis, the variable $\Delta(U.c)^{-1}$ emerged as highly significant (11). The two equations reported below are extension of [4] and [4a] in Table 2. The first relates to the balance of trade (B_T) and the second to the current balance (B_C)

[5] $B_T = 32.4 - 196.4\,(U.c)^{-1} + 156.7\,\Delta\,(U.c)^{-1} - 1.1\,(t)$ $r^2 = 0.58$
         (16.2)   (36.7)   (51.8)   (0.6)

[5a] $B_C = 105.6 - 249.0\,(U.c)^{-1} + 167.2\,\Delta\,(U.c)^{-1} - 1.4\,(t)$ $r^2 = 0.65$
          (17.4)   (39.7)   (55.7)   (0.7)

(11) Since no distinction was made between upswings and downswings of activity, the possibility of a ratchet effect was not explored. The ratchet hypothesis is obviously not refuted, but the level of significance of the regression coefficients on $\Delta(U.c)^{-1}$ reported suggests a fair degree of symmetry and that any ratchet effect is probably quite weak in relation to the balance of payments as a whole (as distinct perhaps from individual items in the account e.g., imports). This lends support to our previous finding that the degree of "underlying" deterioration in the balance of payments for this type of reason, and others, has probably been exaggerated.

What is most interesting is that the residuals plotted from the above equations hardly differ from zero in the 2nd, 3rd and 4th quarters of 1964. In the case of the trade balance the differences between the actual and predicted values are $+3.3$; -6.6, and -17.4, and in the case of the current balance the equivalent values are -7.1; -0.1, and -18.2. It appears that equations [5] and [5a] "explain" almost perfectly Britain's balance of payments difficulties on trade and current account in 1964.

The unimportance of the trend term and the overriding importance of the upsurge in imports in accounting for the bigger deficit in 1964, at roughly the same pressure of demand as in 1960, should not surprise us. As far as competitiveness is concerned the price of our exports of manufactures rose only 7 per cent between 1960 and 1964, compared with 7 per cent for Germany; 4 per cent for France; 1 per cent for America and 3 per cent for all countries in the world. And needless to say, declines in competitiveness cannot possibly be used to explain deteriorations in the balance of trade in a single year of approximately £450 million, as occurred between 1963 and 1964.

The difference in the size of the *overall* deficit on current and long term capital account between 1960 and 1964 was much larger than the £131 million difference on trade account. Since the invisible account was the same in 1964 as in 1960 the remaining difference must have been due, of course, to a difference in the balance on long term capital account. In 1960 there was a deficit balance of £192 million and in 1964 a deficit balance of £363 million. The difference can be attributed partly to a greater volume of private overseas investment abroad in 1964 and partly to a lesser volume of foreign investment in Britain.

In answer to our original question, therefore, of whether the pound should have been devalued in 1964, we reach the conclusion that Britain's balance of payments trouble had little to do with factors traditionally associated with the advocation of expenditure switching policies. We confirm Brechling and Wolfe's hypothesis that the worse overall deficit in 1964 compared with 1960 at the same pressure of demand can be attributed almost exclusively to the speed of expansion in 1964 and an unfavourable change in the balance of long term capital movements. Given the uncertainties of curing trade deficits by devaluation, and the impact of devaluation on the internal price level, it is to be hoped that no country

is ever " forced " to devalue its currency through a change in the whim of private investors or because the government of the day overexpands the economy through incompetence or for electoral advantage. On the evidence the Government acted quite responsibly in attempting to control demand before contemplating devaluation. But if the Labour Government was not unwise in rejecting devaluation in 1964, what was the justification in 1967? What happened in the intervening years to make devaluation inevitable?

V

The Balance of Payments 1965-1967

There was a marked improvement in the balance of payments in 1965 and 1966. The visible deficit fell from £537 in 1964 to £265 in 1965 and £103 in 1966 (12). The current balance was in deficit by only £50 million in 1965 and was in surplus in 1966 to the extent of £64 million. The basic balance on current and long term capital account fell from a deficit of £744 million in 1964 to £252 million in 1965 and £48 million in 1966. The improvement was the result of some deflation of the internal economy, but for the years in question, on the basis of equations [1] and [2], the balance on visible account was much healthier than one would have predicted given the level of demand presssure. The visible deficit in 1966 was £103 million and the pressure of demand was higher as measured by the level of unemployment than in 1959 and 1962 when the trade deficit was of roughly the same magnitude. If we substract from the deficit the unrecording of exports, amounting to £60 million, the " true " deficit was apparently no more than £50 million.

The better trade figures than one would have predicted on the basis of demand pressure were partly due to the imposition of the temporary import surcharge of 15 per cent on October 26th 1964. This is certainly true of the first quarter of 1965 when the difference between the actual trade balance and that predicted on the basis of the level of unutilised capacity amounted to + £75

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(12) Excluding payments for U.S. military aircraft and underrecording of exports.

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million. The overall effect on the import surcharge from the 4th quarter of 1964 to the last quarter of 1965 is estimated to have been a saving of imports of between £100 and £150 million, or 1 to 2 per cent of the import bill (13). Import growth was very much slower in 1965 with a change over 1964 of only 0.17 per cent; and in 1966 it was below its trend rate of growth at 3.4 per cent. Exports, on the other hand, rose above their trend rate in 1965 and 1966 at 6.96 per cent and 6.92 per cent respectively.

In early 1967 it seemed possible that Britain would produce an external surplus large enough to repay the accumulation of external debts. The pressure of demand was still falling, but unemployment was not excessive, and the first six months of 1967 were good for sterling. The current balance was + £41 million in the 1st quarter and — £87 million in the 2nd quarter, and the overall balance was +51 million and —£105 million in the 1st and 2nd quarters respectively. The first quarter's trade balance and current balance were better than might have been predicted, given the pressure of demand, but in the 2nd quarter the situation undoubtedly worsened. The sterling value of exports fell; the trade deficit rose to £115 million and the current deficit to £87 million. The set back was temporary, however, and in the 3rd quarter the situation improved again. The visible deficit fell to £78 million and the current account was in surplus by £18 million. The pressure of demand was still falling up to the 3rd quarter, although it is probable that the unemployment figures exaggerated the slackness of demand. It was in 1967 that the relation between unemployment and unfilled vacancies began to change with both series rising together. The percentage level of unemployment in relation to the demand for labour as measured by unfilled vacancies was probably exaggerated by 0.3 per cent compared with previous years. Taking a revised unemployment figure for 1967, the difference in demand pressure between the first three quarters of 1967 and the first three quarters of 1964 was insignificant. The actual trade deficit of £222 million in the first three quarters of 1967 compares with £410 million for the equivalent quarters of 1964 and £289 million for the same period in 1960 when the level of demand was also approximately the same. Even if no allowance is made

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(13) J. JOHNSTON and M. HENDERSON, " Assessing the Effects of the Import Surcharge ", *Manchester School*, May 1967.

for the changing structure of unemployment there is no evidence of a seriously deteriorating "underlying" balance of trade between 1960 and 1967.

The figures for the 3rd quarter of 1967 exceeded expectations in many respects. The growth of world trade had already begun to slow down, and exports were also beginning to be affected by the closure of the Suez Canal following the Middle East crisis in June. The average monthly cost to export receipts of the Suez Canal closure is estimated to have been about £20 million. But even in August of 1967 the National Institute of Economic and and Social Research was forecasting in its *Quarterly Review* that the balance of payments — including estimates for the effect of the war in the Middle East — would show in 1967 and 1968 a small surplus of the order of £25 to £50 million (including the "normal" positive balancing item of £50 million a year). The Institute went on to say that "this, however, conceals some underlying improvement" (p. 8), which is in line with the conclusions reached here.

The straw that broke the camel's back was unquestionably the Liverpool and London dock strikes in September. It is true that the bad second quarter trade figures and the events in the Middle East had caused nervousness in the foreign exchange markets in July, and that the possibility of devaluation had begun to be discussed in academic circles and the press in the summer, but it was the dock strikes more than anything else which made the balance of payments appear so dangerously vulnerable to exogenous influences. Between the 3rd and 4th quarters of 1967 there was a rise in the visible trade deficit from £78 million to £326 million, £130 million of which was due to a fall in the sterling value of exports, mainly resulting from delays in export shipments.

The decision to devalue was taken on the 18th November. It was taken against the background of a lack of confidence, not so much in Britain's ability to pay her way through an underlying worsening in her trading position, but in her ability to cope with the sorts of emergencies and contingencies such as were suffered in the bleak months of July to September. It was a foreign exchange crisis unrelated to any major crisis on trading account — at least compared with 1964 or 1960. Had the dock strikes been averted Britain may well have weathered the Suez Canal Closure

and, in line with the National Institute's predictions, virtually broken even in 1967. As it was, Britain was "blown off-course" and, in the face of pressure in the foreign exchange market, had little choice but to alter the par value of the pound. The basic deficit against which Britain devalued, however, was considerably less than in 1964. It was the "market" balance not the "accounting" balance of payments which proved decisive.

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