The Anatomy of a Crisis: Investment and Output in Britain 1958-62

Economists' concern about the trade cycle has greatly diminished over the last decade or so. The determination of the trend, not the cycle, of economic growth is now the fashion. It is, therefore, something of a surprise when we are presented in real life with a conjunction of economic phenomena which resemble a distinguishable part of a trade cycle. This article is about a period of very recent economic history — mainly 1959-61 — which can reasonably be regarded as a piece of trade cycle history, which might well have important implications for the future trend of economic growth.

The distinction between the trade cycle and the theory of — or factors which determine — economic growth is, of course, somewhat artificial. The factors which determine expenditure in any one period of time also help to determine expenditure over time. If a trade cycle is the result of alterations in the level of demand (expenditure) in relation to the level of supply (output), the long-run economic trend is mainly a matter of long-run changes in output and induced changes in the level of expenditure. In this sense trade cycle theory has been absorbed by the theory of economic growth. It still remains true, however, that emphasis in trend theory lies on the factors which primarily determine the growth of output; and, of these factors, capital investment is regarded as the most significant but also the most variable. An economy can be almost fully employed with little disposition to fluctuate in a cyclical sense, but also exhibiting no marked upward trend in output. One explanation — amongst others — of this phenomenon might be that capital investment had been relatively low.

Insufficient capital investment is usually the main reason put forward to explain the relatively slow rate of growth in the U.K. since 1945. It could also partially account for the relative stability of the British economy since the war. Virtually throughout the

post-1945 period the rate of increase in output has been less than the increase of demand for that output. Demand has needed to be almost continuously restrained from rising too fast in relation to changes in output. The much criticised " stop-and-go " policy has been a policy of controlling demand; there is not much evidence that it has affected the long-run rate of growth of output.

In the United States, on the other hand, the government there has had a much greater cyclical problem in needing to adjust demand in an upward direction more often than not to keep up with the rate of growth of capacity. The fear of emerging genuine excess capacity has been very much greater in the U.S. than in Britain. A consequence of American potential output to run ahead of demand has been a relatively greater instability of economic activity than in England. The paradox is, however, that a situation of too much demand in relation to changes in output in England has had much the same effect as too little demand in relation to changes in output in the U.S. — namely a relative stagnation of the long-run rate of growth.

It might, then, be said that in England future long-term growth has been sacrificed for greater short-term economic stability. This is, of course, simply another way of saying that a high investment economy in a free enterprise society tends to be more unstable than is a high consumption economy; and Britain is — or has been — a high consumption economy. For instance, consumers' expenditure as a percentage of total final expenditure has remained about 55.50% over the last eight years. But over the last few years there seems to have been a shift of resources away from consumption in favour of higher investment. Consumption may now be somewhat lower at any level of real disposable income than before 1955-56. The 1959-61 boom might well mark the first stage of Britain's reemergence as a high investment economy, and one which we can expect to become more volatile than we have been used to in the post-war period. The chief problem is whether or not we are now entering on the first genuine downswing of the post-war trade cycle as a result of these changes in investment and consumption.

Since 1958 the proportion of national income devoted to investment has been rising relatively fast. Gross fixed investment increased from 16.2 per cent of G.D.P. in 1954 to 17.4 per cent in the first quarter of 1959 and since then it has surged upwards to just over

20 per cent of G.D.P. in the third quarter of 1961. Net fixed capital formation has followed the same trend, rising from 7.3 per cent of G.D.P. in 1954 to 9.4 per cent in 1960. A large part of the rise in gross investment has been accounted for by the rise in investment by the manufacturing sector. It has risen from 4.0 per cent of G.D.P. in the first quarter of 1959 to 5.5 per cent in the third quarter of 1961. Over the last two years or more the British economy has been characterised by one of the biggest private manufacturing investment booms in its recent economic history.

The boom occurred under general conditions of relatively high economic activity. The boom probably started in the last quarter of 1958, but the rapid rise in activity occurred during the second quarter of 1959. Gross fixed investment rose nearly 15% during 1959, and showed further considerable increases — both in 1960 and up to the third quarter of 1961. Consumption expenditure rose very sharply in 1959 and early 1960, but since then it remained stable. Stockholding increased spectacularly from the third quarter of 1959 to the end of 1960 and thereafter the rate of increase declined sharply. Finally government spending remained fairly steady until the end of 1960 but then jumped sharply. Important shifts occurred in the main components of demand during the course of the boom. These shifts in expenditure help to give the appearance of overall stability during this period of rapid economic change.

There were, however, important features which allowed extra expenditure to be absorbed by the economy with relative ease. The sharp rise in consumer expenditure induced by the relaxation of controls during 1959 and by the rise in investment demand during 1959 and 1960 simply utilised capacity already existing in the economy as a result of the long period of economic stagnation of 1955-58. Immediate pressure on the consumer goods industries — the labour market excepted — was slight. After the middle of 1960, however, the consumer goods industries exercised little extra pressure on the economy. Further stability resulted from the convenient changes in the rate of growth of stockholding and public expenditure. Stockholding increased at a phenomenally high rate between the third quarter of 1958 and the middle of 1960; public authorities spending on the other hand did not rise very much over the same period. After the third quarter of 1960 the roles were reversed. The rate of increase of demand for stocks decreased, whilst government spending rose substantially.

With these changes in demand the level of prices altered relatively little. Indeed, they seemed to have been as much influenced by changes in the terms of trade as by the level of demand or trend of wages. Prices increased very slightly in 1959 when the terms of trade swung heavily in our favour; but during 1960 and 1961 they rose, on average, by over 3% per annum when improvements in the terms of trade were relatively slight.

But, most spectacularly, the relative ease with which the increase and shifts of expenditure were absorbed had its main counterpart in an alarming deterioration of the balance of payments. The balance of payments surplus on current account was reduced from the extremely high level of £ 320 million in 1958 (an exceptional year) to only £ 90 million in 1959, and during 1960 the surplus was converted into the biggest deficit since 1947. The deficit continued well into 1961. Another way of putting this is that the rise in investment — which triggered off and sustained the boom — was financed by a deficit on the balance of payments which was covered partly by foreigners investing on short-term in London, partly by utilising the gold reserve, and partly by borrowing from the I.M.F. The investment boom did not, in effect, absorb resources from the home economy. On the contrary, with the increase in internal savings supplemented by large foreign investment in England, we were able to maintain a large export of capital and finance the internal boom with a relatively small rise in prices.

The first stage of the boom was virtually over by the middle of 1960 — consumer expenditure rose very little after that date. Bank Rate had been raised to 5% as early as January, 1960; the budget was slightly restrictive in its effects; H.P. controls were reintroduced and a formal reintroduction of the credit squeeze occurred at the end of April. But it is likely that these changes in policy reinforced rather than inaugurated a downward trend in consumer expenditure. Investment, on the other hand, continued to rise until the last quarter of 1961. There was, however, a change in the composition of investment. From about the middle of 1960 investment in manufacturing industry began to rise much more sharply than other forms of investment. This was apparent in the considerable rise in investment in plant and machinery. Indeed, the rise in manufacturing investment coincided almost exactly with the fall in consumer expenditure. Industrial production rose very

little from mid-1960 onwards; output increased from the second quarter of 1960 to the third quarter of 1961 by only 2%.

With the investment boom continuing and output failing to rise, excess capacity in industry must have been increasing very substantially for at least the last twenty months or so.

It also seems likely that a large proportion of the excess capacity became concentrated in the private manufacturing sector in view of the large rise in investment, without a consequent rise in output, in that sector. This contrasts with previous periods of restriction during which excess capacity became more evenly distributed in the economy. During 1959-60 the rate of investment in the service industries, for instance, seems to have kept pace only with the rise in demand. It is only in manufacturing industries that investment seems to have risen at a much faster rate than output.

This, however, seems of less importance than do certain features regarding the nature of that investment boom. In the first place despite the rise in manufacturing investment productivity in the manufacturing sector has fallen. Secondly, it is disturbing to find that so little of the potential output of the manufacturing sector has been demanded.

Though the usual measurement of productivity — i.e., output per man hour worked — is notoriously arbitrary and an oversimplified notion of a highly complex phenomenon incorporating many interrelated inputs to output, such a measurement does concentrate attention on what is possibly the most important single factor of production — labour. The fall in productivity in a sector which has experienced a substantial investment boom is, to say the least, surprising. And it is not something which can be explained entirely by a failure of output to rise. It does, however, suggest some characteristics about the nature of the investment boom. In the first place, despite the investment boom, employers continued to hold on to their labour; increased investment was accompanied by increased under-employment of labour in the same industries. This would suggest that the nature of the investment boom has not been of the labour saving type. Capital investment has not been substituted for labour on any substantial scale; otherwise labour would have been released as output failed to rise. A rise in demand for output in the future is expected to increase the demand for labour. Employers are, therefore, holding on to the bulk of their

labour force in the belief that it will be needed to help raise output in the future.

If this is correct, it is discouraging that more effort has not been undertaken by industrialists to economise on labour, which is not only the scarcest factor of production but one which has been the biggest bottleneck to rapid economic expansion throughout the post-war period. But more important, the manufacturing sector is probably the only sector where substantial economies on the use of labour can be made. The service and distribution industries are net absorbers of labour. Any substantial and widespread increase in demand for output will, therefore, be immediately reflected in the demand for labour. Those sectors of the economy having a high labour-output ratio — e.g., services and distribution — will have to compete for labour in those sectors where the labour-output ratio is higher than is perhaps technologically justified. Inevitably labour costs and money incomes will rise as fast — if not faster — than output; equally inevitably the government will take action which would stop the rise in output.

It seems possible then, in the light of employment policies in the manufacturing sector, that the manufacturing investment boom has been somewhat wasteful of our most scarce natural asset. In this respect the manufacturing sector has also restricted its own potentiality of expansion in the future despite the large scale investment over the last eighteen months. With any general rise in output the manufacturing sector will either find itself having to struggle to retain labour — with consequent higher labour costs of production — or even to compete for extra labour supplies. Again, shortage of labour might well prove to be a bottleneck to economic expansion; but industrialists in the manufacturing investment sector seem to have missed an opportunity to become less reliant on what is likely to continue as a perpetually tight labour market.

The second disquieting aspect, and potentially by far the more serious, of the nature of the 1959-61 boom is that relatively little of the industrial capacity generated during that period has, so far, been used in the form of rising output. It is, of course, extremely difficult to determine the extent to which productive capacity in manufacturing industry has increased over the last two years. An increase in capacity is not necessarily the equivalent of an increase

in fixed investment. Effective productive capacity depends on, for instance, the extent to which plant can be utilised. Maximum utilisation would be, of course, twenty-four hours a day, seven days a week minus a nominal period needed for basic plant maintenance. But utilisation also depends on availability of labour and on the number of hours and shifts they are prepared to work. Effective capacity also depends on the price of the product. Short-run price inflexibility, for instance, can be a serious obstacle to sharply increasing output — which involves rising short-run costs — over the short period.

Despite these qualifications, it is probably reasonable to conclude that capacity (as determined mainly by the rise in fixed investment) in manufacturing has increased by about a third over the last three years. Because of changes in the working week, and because increases in capacity have not been evenly spread throughout the manufacturing sector, the effective increase in capacity might be estimated at between 17-25% over 1959. Manufacturing output, however, has increased since 1959 by less than five per cent. It would, as a result, not be impossible that, under ideal labour conditions, manufacturing output could rise by between 14-18% over the next ten months. Alternatively expressed, if the ratio of output to capacity (as determined by the stock of capital) had remained constant over the last two years, manufacturing output might well have increased at something over 8 per cent per annum.

The distinguishing feature of the 1959-61 boom is, then, the failure of demand for final output to rise sufficiently to absorb the rise in potential output. But little explanation is to be found in a too slow rate of growth of consumers' net disposable income. Between the first quarter of 1959 and the third quarter of 1961, net disposable income increased by over 16% at current prices, and over 12% in real terms. It is significant, however, that consumers' expenditure rose by 5% in real terms in 1959, but since then, it has risen by not much more than 1%. On the surface this suggests either extraordinary instability in consumer behaviour or a possible downward shift of the consumption function (i.e., a rise in the propensity to save). Personal savings have more than doubled in the last two years and there has been a consequent fall in the average propensity to consume.

More particularly, the rise in consumer expenditure in 1959 was financed to a considerable extent by an increase in H.P. and other

debt. The failure of consumer demand to increase further in 1960 and 1961 can only in part be associated with the reimposition of H.P. controls and the reintroduction of the credit squeeze in the spring of 1960. Similarly the relatively high rate of debt repayment in 1961 probably did not have a significant influence in restraining consumer demand. Indeed, it might have been expected that net consumer debt would have risen quite sharply in 1961. It is possible, however, that additions to consumer debt are closely influenced by changes or expected changes in disposable income. Many potential borrowers either failed to achieve an expected increase in incomes or achieved an insufficient increase of income to embark on further debt-financed consumer expenditure. In this respect, the wages pause had its most important effect in affecting the rate of debt accumulation. If this is correct the propensity to borrow for consumer purposes will not rise very much in relation to any given distribution of income. Changes in the distribution, as well as changes in the volume, of disposable incomes might importantly influence changes in the volume of consumer debt. The debt-income ratio might have been stable in 1960 (following the rise in 1959) but fell in 1961 with a slight shift in the distribution of income away from the lower income (high spending) groups.

The shift in the distribution of income at a time of rising disposable income partially explains the surprising rise in personal savings, which was exceptional in 1961. But the rise in personal savings cannot be entirely dissociated from the sharp rise in interest rates which occurred after the beginning of 1960; nor from the increasing tendency towards contractual savings in the form of pension fund contribution, life assurance and, above all, mortgage repayments. Contractual savings are rising almost as fast as disposable incomes, thus leaving relatively small amounts for extra consumption or inducing large scale consumer debt outlays.

A further important "leakage" of expenditure from home output was due to the striking rise in imports of manufactured goods between 1959-61. Imports of consumer goods rose by over 50% in 1959 and by a further 36% in 1960; this was followed by a slight fall in 1961. The rise in imports diverted a substantial amount of purchasing power from home industry.

There are, then, a considerable number of reasons to explain the failure of consumer demand to rise; and not all of them are

by any means to be associated with government policy to " restrain demand ", nor should they be dismissed as being of a temporary nature.

But British industry, in the aggregate, has never relied exclusively on the home market to absorb its output. On the contrary, over 25% of the national output is exported, of which an extremely high proportion (over 80%) is accounted for by exports of manufactures. A rise in productive capacity in the manufacturing industries should, therefore, increase the potential supply of exports of manufactures. And, fairly clearly, there has been an increase in capacity in the consumer and, possibly to a lesser extent, in the capital goods industries. Supply conditions in Britain have been favourable for an increase in exports.

A rise in British exports depends, however, not only on capacity to produce at home more goods for export but also on foreigners' demand for these exportables. On the whole, demand conditions were relatively favourable over the 1959-61 period. World income and production rose by about 6 per cent per annum over the period; but world trade rose faster than world production, and world exports of manufactures increased the fastest of all. They rose on average by almost 10% each year between 1959 and 1961. British exports of manufactures rose by about half this amount- hence the fall of the British share in world exports from 17.3% in 1959 to 15.5% in 1961.

World demand conditions were favourable to an increase in British exports between 1959 and 1961 and also there seemed to be sufficient capacity at home to allow a considerable rise in exports without inducing pressure on prices at home. A situation of favourable conditions both of home supply and foreign demand has been relatively rare in the post 1945 period. But exports still failed to rise.

There is no simple or straight-forward explanation for our laggard export trades. Our export prices do not seem to be above the world level, even though British costs probably are slightly in excess of international costs. The margin of profitability on British exports is, therefore, less than on, say, German exports. But the relevant comparison where the supply of exports is concerned is with British home prices and British exports prices. On this basis it is more profitable to sell at home than abroad. But in the face

of a stagnant home market it could reasonably be expected that home manufacturers would tend to push exports in order to utilise growing excess capacity even at lower rates of return than might be achieved if products could have been sold at home.

It is possible, of course, that though the overall conditions of foreign demand and home supply were conducive to an expansion of British exports, there existed particular features militating against an expansion of British exports.

The sharp fall in British exports to the Sterling Area could be associated with, for instance, the failure of spending power in Sterling Area countries to rise as fast as elsewhere. The large capital imports in many primary producing countries more or less supplemented the fall in incomes consequent upon the continued deterioration of the terms of trade of primary producing countries. The S.A. market was essentially a stagnant market between 1959 and 1961, and the British share of this market fell in the face of increased competition from, especially, Germany, Japan and the United States. A further whittling away of Imperial Preference did not help matters, nor did the imposition of import controls in some S.A. countries. In addition, the S.A. countries continued the long-term trend of increasing industrialisation which further reduced demand for some traditional British exports. The really alarming aspect of the decline in British-S.A. trade was, however, the extent to which S.A. customers switched to non-British sources for some of their imports. This might have been due to inadequate British salesmanship, or inferior quality or haphazard delivery. But, more importantly, it might suggest a shift of demand away from the whole range of products which Britain exports.

The dismal performance of Britain's exporters in the S.A. countries contrasts with the relative success of British sales in Europe. The rise in exports to Europe is, perhaps, partially accounted for by the rapid rise in incomes on the continent; a fairly impressive sales-drive by British businessmen in Europe; and, also, the fact that parts of the European economy became overstrained and some shortages in supply occurred in the latter half of 1960 and early 1961.

The latter might partly explain the odd paradox that exports of some commodities which declined substantially to the S.A. countries during 1959-61 increased most to Europe (e.g., iron and steel goods and machinery other than electric). Closely associated with this is the possibility that the range of British output might not

have been big enough to meet the changing — and broadening — pattern of demand in S.A. countries, but was sufficient to satisfy demand in Europe at a time of increasing supply inelasticity in some sectors there. In this respect the U.K. might be regarded, so far as a considerable percentage of her exports is concerned, as a marginal supplier to the rest of the world. This is partially borne out by the fact that since 1957 British exports increased by about half the rate of the world average, but fell at almost twice the average rate when world exports fell.

World demand conditions for exports, then, though generally favourable for expansion, were least favourable to British exporters. It has been pointed out above that this situation did not seem to be due to adverse prices, but could be explained, in part, by the lack of any real incentive to push exports. More worryingly foreign demand for British exports might have shifted adversely in relation to the change in the structure of British output.

To this extent the problem of British exports is, in the first instance, a problem of supply. But unlike the 1945-55 period when exports were being hindered by an absolute shortage of supply, it is now more a matter of inappropriate supply in relation to world demand. In this sense the rise in manufacturing investment might have been based on products not usually exported; but owing to the very broad range of British manufactured exports this could not be a conclusive explanation of the failure of exports to rise.

A number of other alternatives present themselves. First it is possible that British manufacturers did not invest heavily in those products increasing most rapidly in world trade. For instance gross fixed capital formation at home in chemicals and allied industries — products which are rapidly growing in international commerce — fell both in 1959 and 1960. Further, gross investment in engineering and electrical goods — which are, again, expanding industries in world trade — also fell in 1959. But, on the other hand, investment in textiles — which are relatively declining in world trade — rose in 1959 and 1960. Very broadly it might be said that the British investment boom of 1959-61 concentrated on increasing the supply of consumer goods (particularly consumer durables) whilst the rise in demand for world exports was concentrated largely on capital goods. It is, as a result, not surprising that excess capacity resulting from relative stagnation of demand at home was not easily or quickly absorbed by a rising demand

for exports. Even with the large increase in supply of consumer goods at home demand for imports of consumer goods increased, which again suggests that the structure of output has become slightly out of line with the general pattern of demand. There seems to have been a shift of tastes and preferences away from British products both at home and abroad.

The reasons for this emerging qualitative imbalance of supply and demand are somewhat obscure. On the supply side the rise in unusable capacity at home resulting from the investment boom reflects, to some extent, the inadaptability and relative shortsightedness of British manufacturers. The manufacturing investment boom occurred under conditions of high protective tariffs sheltering the home market. Manufacturers naturally took advantage of the protected home consumer market to supply it with mainly consumer products largely in greater quantities rather than in improved quality or in broadening the range of products.

The rise in British manufacturing capacity coincided, however, with a world boom of manufacturing investment with a consequent international increase in capacity. From about 1957-58 onwards exporters have had to compete in new circumstances of rapidly rising capacity and a consequent increase in international competition. British exporters have, on the whole, failed to adapt to these new circumstances. This increased competition has made itself felt not only in a struggle for export markets but in meeting competitors on " home territory ". This was made apparent in the U.K. from 1958 onwards. But the increase in international competition in the home market was enhanced by the gradual abolition of quota restriction on imports and the slight lowering of tariffs which have occurred since 1960. British manufacturers failed to combat the first stages of erosion of the home market, which they have for so long taken for granted, by increased international competition. And British manufacturers do not yet seem to be in a position to meet the growing qualitative as well as quantitative demand for goods emerging with the changing pattern of income at home as well as abroad.

The first really substantial investment boom in British post-war history has been a flop. In the jargon of older cycle theory a considerable amount of malinvestment seems to have occurred.

Malinvestment has occurred in relation to the use of labour needed to increase output. Under conditions of relatively high labour costs it could have been expected that new investment would tend to be substantially labour saving or would even result in a displacement of labour. The demand for labour in manufacturing industry seems as high as ever, and any substantial increase in demand for output would seem to call for an increase in demand for labour. This might be an important restriction on rapid future expansion.

The extent to which increased capacity, resulting from the investment boom, has remained unused is also suggestive that malinvestment has occurred in relation to meeting demand for output. The failure of output to rise in 1960 and 1961 is not only — or perhaps even mainly — associated with government policy. Real disposable incomes increased considerably between 1959 and 1961. The rise in incomes, however, led more to a rise in savings and imports than to a rise in demand for home output. H.P. restrictions on consumer demand, though probably having some restrictive effect on expenditure, served mainly to exaggerate the swing to savings and debt repayment. The failure of exports to increase can be partially explained, perhaps, by manufacturers concentrating mainly on the home market for extra sales of, particularly, consumer goods. When the home market proved less buoyant than was expected, resources were unable to be easily used abroad in the face of greatly increased international competition and the fact that the rapid demand in export markets was mainly for capital, not consumer, goods.

How this extra capacity will be absorbed in the future remains to be seen. It will not be allowed to exert a depressive influence on the level of employment — as undoubtedly would have happened before 1944 — though it might retard economic growth for some time in the future. Even on this basis the costs of absorbing the excess capacity over time might well be relatively high — especially in attempting to stimulate foreign demand for British output.

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