British Focusing on Export Boom, To Spur Industrial Recovery

Faced with a domestic situation which at best looks hopelessly bleak and at worst a complete disaster, the government of British Prime Minister James Callaghan wants to carry through a policy of export-led growth through revitalization of the manufacturing industry in a medium-term perspective spanning the next two fiscal years. As outlined by Chancellor of the Exchequer Denis Healy in his Dec. 15 "mini-budget," and reiterated by both Mssrs. Callaghan and Healey in New Year's speeches to the country, 1977 will be a "pendulum year" in which resources will be channeled from consumption to manufacturing investment in an attempt to break the historical cycle of a collapsing pound, high interest rates, and low industrial development.

The choice, as laid out by the government, is not one of a "productive" private sector versus a "wasteful" public sector, but the necessity to forge a productive public sector which will form a strong base to generate the economic activity which will allow for maintenance of basic social services. On this basis, the British government rejected the original suggestions by the International Monetary Fund and outside commentators like Milton Friedman to cut government spending by up to £4 billion. Such a deflationary policy, the government charged, would insure the continued collapse of the country's economy. In the "Letter of Intent" to the IMF for their $3.9 billion loan, Healey stressed that although spending cuts of up to £1billion would be made in the fiscal year 1977-1978, any further cuts would be dependent on the extent to which international economic recovery afforded British companies the opportunity for export expansion. Healey told the House of Commons on Dec. 21, "These cuts are necessary for one reason only — to give the economy the best chance of attaining a higher sustainable level of output and employment as fast as possible." He said bluntly that there was "not now and never had been any economic case for massive deflation on the scale that some critics had demanded."

The necessity for the government to succeed in its strategy can be seen clearly in the recent collapse of sterling (its effective devaluation of 20 per cent between March and December 1976 is greater than even the 1947 or 1967 devaluations) and the crisis this caused in the spiraling of the money supply and subsequent investment crunch for industrial finance. While it is true that industry enjoyed a short-lived export "boom" in the fourth quarter of 1975 and first half of 1976, this was due largely to the advantage gained through the collapse of sterling and more than compensated for by the effect of rising import costs for raw materials. Hope of any industrial recovery led by domestic demand is nil, given the government's stated intention to stick to the social contract with the trade unions, probably holding wage increases to the 5-7 per cent range, while attempting to bring inflation down from the current level of 14 per cent to around 10 per cent per annum.

Bearing Fruit?

Already the government's strategy appears to be bearing fruit. After the plunge of sterling to a low close to $1.50, the pound has recently recovered to the $1.70 level. In December, reserve figures show that the country's stock of gold and foreign currency fell only $1,027 million to $4,129 million, despite the repayment of $1,545 million of the tranche arranged through central banks last spring. This indicates an underlying inflow of at least $600 million and perhaps as much as $750 million into the reserves, the biggest single influx of money into Britain for a number of years.

Knowledgable sources in the City of London are crediting the Arab oil producers with strong support for the pound, which coincides with a general improvement of Britain's trade with the Mideast countries to the point where the *London Times* of Jan. 6 was forced to admit that the "Saudis (are) suddenly buying where once they would automatically have bought American..." In addition to the expansion of Arab country trade, which also includes major contracts recently with Egypt and Iran, the British are consolidating their trade agreements with the East bloc, and Callaghan has launched a major campaign to exploit the £1 billion credit tranche offered the Soviets by former Prime Minister Harold Wilson in 1974 for purchases of British goods.

However, in an attempt to finance the government debt and prevent explosive growth in the money supply, the government has followed a policy of such severe credit restriction that industrial investment has been virtually impossible. By maintaining high interest rates to boost the sale of government paper ("gilts"), the government has all but excluded industry from bank borrowing. Additionally, the potential boost to exports from the fall in the value of the pound has been more than wiped out by the corresponding rise in raw material prices, underlining the critical nature of the government's export strategy.

Public Debt

The Public Sector Borrowing Requirement (PSBR) has been kept well in the bounds laid out by Healey in his July 1976 mini-budget, spurring market confidence in the government's desire to keep public spending under control. The PSBR in the first half of 1976 was £5,150 million — even slightly below Healey's estimate of a £11,500 million total PSBR for 1976. In his Dec. 15 mini-budget, Healey announced that the government would be reducing the PSBR to £58,700 million in 1977-78 (a

	1975	1976 Jun	Jul	Aug	Sep	Oct	Nov
PRODUCTION							
Industrial Production (1970-100)	100	100.2	101.8	100.8	102.4	102.5	—
Capital Spending (in £ million)	434 (I-IV avg)	408 (II)	—	—	411 (III)	—	—
Consumer Goods Production (1970-100)	110.6 (Dec)	112	106	100	100	—	—
Basic Materials (1970-100)	256.7 (Dec)	—	—	—	344	327.8	331.9
Steel Production (weekly avg 1000 tons)	390 (year)	433	367	373	430	457.7	487.1
CONSUMPTION							
Retail Sales (1970-100)	178	—	—	204.3	206.4	206.8	—
TRADE (£ billion)							
Imports	21.97	2.67	2.71	2.58	2.70	2.58	2.79
Exports	18.77	2.17	2.06	2.16	2.24	2.29	2.29
Visible Balance	-3.20	-0.50	-0.65	-0.42	-0.46	-0.29	-0.50
Visible Balance Jan-Nov 1976: -3.90							
MONETARY POLICY							
Minimum Lending Rate (%) Dec. 24, 1976: 14.25	11.25	11.50	11.50	11.50	13.0	15.0	14.5

reduction of £2 billion) and by another £3 billion in the following year. Towards this end, cuts in government spending of £1 billion and £1.5 billion in 1977-78 and 1978-79 respectively were announced to hit defense, food subsidies, and regional employment subsidies most heavily. The government's success in keeping the PSBR within forecasted levels reflects the fact that local authority spending is being forced to comply with budgeted levels, which in most areas means severe cuts in basic health, education, transport, and other social services.

To finance central government debt, the Bank of England raised the Minimum Lending Rate (MLR) to 13 per cent from 11.5 per cent on Sept. 16 in an attempt to spur sales of gilts, which had been lagging during the summer months. The Bank of England's move did create a short-term demand for gilts, but the continued collapse of the pound brought fears that MLR would be raised even higher, and gilt sales slackened. Net sales of gilts in the third quarter amounted to only £590 million.

The resultant bulge in bank lending to the private sector (£650 million in mid-October), largely due to worries of further credit restriction and trade financing, sparked the government to raise the MLR to an all-time record of 15 per cent and call in a further 2 per cent in special deposits. Gilt sales revived with this move. In addition, the Bank of England introduced the "corset," the prohibition of bank lending in sterling for trade with non-scheduled areas and for trade not covered by the exchange control commodity scheme. This move is expected to generate a once-for-all inflow of funds amounting to several billion pounds, in the estimate of bankers. Sale of gilts has remained high even after the lowering of the MLR to 14.5 per cent in the beginning of December.

The government's policy on gilt sales is a reflection of its overall determination, as made clear to the IMF, to keep the growth of M3 (money supply on the wider definition) to 12 per cent in the current year. While figures for the earlier part of the year indicated that the target was being adhered to (growth of £735 million in the first quarter and £1,550 million in the second quarter), the jump in the M3 in the third quarter by £2,120 million (despite the fall of the central government borrowing requirement from £1,985 million in the second quarter to £1,790 million in the third) showed that the government's strategy was in danger of failing. Hence the introduction of the measures reported above.

The Balance of Payments

In the three months to November, the deficit on visible trade was £1,243 million compared with £1,163 million in the previous three months. In November itself the current account was estimated to be in deficit by £310 million, with the deficit on trade goods at £510 million and a surplus on invisibles of £200 million. A large part of the deficit is accounted for by a very sharp rise in the oil import bill of £146 million from the unusually low October figure. Imports were up sharply by 4 per cent in the three months to November, largely due to the food imports required because of the summer drought and the higher raw materials costs due to the collapse of the pound. North Sea oil production was 3 million tons in the third quarter of 1976 (15 per cent of the domestic requirement) and reduced the import bill by £160 billion.

In the recent past, there was a sharp increase in exports starting in the third quarter of 1975 and extending through the first half of 1976. Exports rose by 14 per cent during this period, and the proportion of income due to the exterior balances was higher in 1975 — and grew further in 1976 — than in all but one of the preceding 20 years. However, most of this increase was stimulated by the relative competitiveness of British industry due to the collapse of the pound. The general collapse in world trade in the middle of 1976, in addition to a leveling off of destocking in British industry and the concurrent need to import relatively more expensive raw materials, indicates that without the special export arrangements between Arab, East bloc and Third World countries of the kind the government is now contracting for, an improvement in the trade balance is extremely unlikely.

Industry: Production and Investment

The latest estimates of the Gross Domestic Product (GDP) show that there was little change in the level of economic activity between the second and third quarters of 1976, and that there has been no growth in output during 1976, following the improvement in the last quarter of 1975. Industrial production fell by 0.3 per cent in the third quarter after rising slightly by 1.0 per cent in the second quarter. Industrial output in November was at 102.5 (1970 equals 100), only marginally up from 102.4 in October.

Those sectors which stand to benefit most from the government's export push show the best production and investment levels. As can be seen from the accompanying table, steel production registered its highest level for 20 months in November, up a full 7.5 per cent from October. There has been a similar increase in metal manufacture and vehicle production, especially tractor production, following major trade deals with Poland, Iran and Egypt.

There was a period of heavy destocking during 1975 and early 1976, with a drop-off in the level of destocking in late 1976. The volume of stockbuilding fell by £27 million in the third quarter compared with a fall of £118 million in the second quarter. A continuing decline in the level of stocks held by the construction industry was the principal factor behind the third quarter fall; manufacturers and retailers both increased their level of stock marginally by £5 million. This is deceptive however, since the manufacturing industry in particular will hold raw materials as a hedge against the pound when it is falling on the markets. In addition to financing trade on the expectation of further pound collapse, it is likely that the increase in bank lending to the private sector went to finance the build-up of these stocks.

Capital expenditure in industry rose by nearly 4 per cent in the third quarter of 1976, but this was due primarily to a sharp increase in North Sea oil investment. As indicated above, bank advances to industry in October were not used primarily for investment. Similarly, although the mini-boom of 1975 added to overall company profits, these funds were used to improve cash flows after massive accumulation of liquid liabilities (mainly bank borrowing). Fixed investment by manufacturing, distributive, and service industries (in 1970 prices) was in the neighborhood of £4,300 million in early 1974, but had plunged to £3,300 million by early 1976.

A recovery is expected, given the ability to improve exports — the latest estimates from the Department of Industry forecast a rise of 10-15 per cent in the volume of new investment by manufacturing industries and 5 per cent growth for the distributive and service industries — but the government's raising of the MLR raised severe questions about the ability of industry to borrow. Although the level of private industrial fixed investment in the first quarter was smaller than at any time since 1968, it is estimated to have risen 2.5 per cent in the second quarter and .75 per cent in the third quarter. Metal manufacturing (spurred by export prospects) showed a 10 per cent rise in the level of investment in the first three quarters of 1976 over 1975, but large falls in investment levels were recorded in textiles (29 per cent) and paper, printing, and publishing (21 per cent).

Consumer Spending

According to government estimates, virtually the entire rise in consumer spending from 1975 to 1976 is accounted for by a wave of buying by continental and other foreign shoppers.

France Outlook Grimmest in Europe

French Prime Minister Raymond Barre's severe deflation program, inaugurated last September, has succeeded in giving the coup de grace to an already faltering French economy. By the end of first quarter 1976, the rapid upswing in French industrial production, kicked off by the fall 1975 pump-priming program and the cyclical rebuilding of rundown inventories, had already begun to peter out. This showed up initially as a flattening in industrial orders during the second quarter, followed by a plunge in the third quarter and an increase in unsold inventories. Hardest hit was private capital investment, which tapered off sharply in the spring; order books in the critical capital industries dwindled from that point on.

Then, in September, Barre's "anti-inflation" gambit — taken in the context of an already flagging internal consumption and the onset of austerity programs in France's European and Third World trading partners — threw the French economy into a virtual tailspin. In October, industrial production dropped 4.7 per cent from the previous month; unemployment soared nearly 30 per cent from the 1976 low of 808,000 reached in July to