

Research Department
Federal Reserve
Bank of
San Francisco

June 18, 1976

Land of Hope and Glory

People of a certain age can remember when the British Empire seemed immutable, with a currency whose value remained always stable at close to five dollars to the pound. But now all has changed; the Empire is gone, and the pound perennially seems to be the weakest instead of the strongest trading currency. Its value declined to \$4.03 in 1940, to \$2.80 in 1949, to \$2.40 in 1967—and then to \$1.70 during this spring's precipitous decline, representing a 42-percent drop from the level set by the 1971 Smithsonian Agreement. At that point, an international rescue party came to the rescue—reminiscent of Kitchener at Khartoum—by providing the United Kingdom with a \$5.3-billion standby line of short-term credit.

This 11-nation aid package, along with the recent agreement by the key coal miners' union to abide by the Government's proposed wage program, stabilized the situation and gave the U.K. a welcome breathing space. Indeed, even as the pound rose to \$1.77, it appeared undervalued to most observers, based on relative inflation rates and trade relationships among the major trading nations. But this development left unanswered the larger question of the U.K.'s ability to surmount the structural problems facing her ever since World War II or even earlier, as typified by the two ugly but descriptive terms which Britain introduced into the language—"stop-go policy" and "stagflation."

Combatting problems

Ironically, Britain's domestic situation has improved significantly in recent months. Real output has recovered from the late-1975 recession low, and it should strengthen even more over coming months, perhaps returning to the 1973 peak level by late 1976. Just as planned, this is an export-led recovery, with export demand rising at a 13-percent annual rate in the first four months of this year in response to the ever-cheaper pound. The nation suffered an enormous £3,650 million current-account deficit in 1974 in the wake of the worldwide industrial boom and the OPEC-imposed oil increase. But some progress has already been made in redressing this situation, and over the next several years, the balance of payments may actually return to surplus—helped by North Sea oil, which should provide a net contribution of £1,300 million to the payments balance by 1978.

Most importantly, the U.K. has begun to combat its severe inflationary problem, cutting in half the 30-percent rate of inflation recorded last summer. (Still, new pressures will develop as the prices of imported goods rise in the wake of the latest devaluation.) Fiscal and monetary policies have played a role in this decelerating inflation. Government borrowing this spring fell significantly from the year-ago level, although the £11-billion deficit (in relative terms) remained much larger than even the U.S.

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deficit. Monetary policy began to tighten in 1975, as the growth of the money supply went from an unparalleled 31-percent annual rate in the second quarter to a 12-percent rate in the final quarter of the year. The latter figure was close to the average money-supply growth of the entire 1971-75 period.

Controlling incomes

Nonetheless, the crucial element in the U.K.'s anti-inflation program has been an incomes policy, centered around a Government-Trade Union Congress pact to control wage increases. On the heels of 1974's 26-percent average increase, the two sides agreed on a "social contract," whereby the TUC pledged to keep wage demands in line with the cost of living in return for the Government's pledge to defend current living standards and to distribute social burdens fairly.

Last summer, the Government and the TUC agreed to limit all wage increases to no more than £6 a week—a limit which has been generally respected. The rise in average earnings has come down from the spring-1975 level of 25-30 percent to about half that amount today, and the average increase would have been even smaller but for the completion during this period of a legally-mandated movement to equal pay for women. Following up, the Government in its latest pact with the TUC has called for a 4½-percent rise in average wage rates over the next twelve months, accompanied by income-tax cuts.

Several factors could curb the effectiveness, or the popularity, of this incomes policy. Real wages and salaries have fallen significantly over the past year of wage restraint, and they could fall slightly more over the next year. The losses are concentrated among higher-salaried workers; the real income of individuals at the £10,000 annual salary level has dropped more than 20 percent over the past three years, and could fall another 5 to 7 percent by mid-1977. This factor helps explain the resurgence of the "brain drain," with many managers and professionals following Ringo Starr, Sean Connery and the Rolling Stones to warmer climes.

Continuing problems

The state of Britain is typified by the sickly performance of its nationalized industries, which occupy "the commanding heights" of the national economy—coal, steel, electricity, gas, railways and airlines. Their poor showing reflects a series of government decisions to impose non-economic priorities on economic enterprises—for example, by preserving services to remote communities or preserving outmoded jobs in older industries.

Yet the U.K.'s structural problems (and resultant poor growth record) date back at least a hundred years, and not just to the onset of nationalization policies in the post-1945 period. A Brookings Institute study group, writing in *British Economic Prospects* (1968), attributed this situation primarily to industry's chronic reluctance to invest in new

processes. This situation, according to the study group, can be blamed more on poor management practices than on the frequently-cited troubles caused by unions. (As evidence, foreign-owned firms in the U.K. generally earn a higher return on capital than do British firms.) Part of the problem is Britain's low basic wage structure, which in turn reflects its poor growth record.

This system encourages over-manning, hoarding of labor, and a proliferation of overtime not linked to product demand. (Not too surprisingly, during the period of three-day workweeks brought on by the 1974 coal strike, output held up far better than anticipated as labor efficiencies were temporarily adopted.) The system also fosters wage drift unrelated to productivity gains, and discourages labor-saving investment and technological innovation. As a result, the nation's export performance has not benefited as much as might be expected from the U.K.'s apparent advantage in wage costs. Thus, over the past two decades, Britain's share of world trade in manufactures has dropped from 23 to 7½ percent.

As depicted in the Brookings study, British industry is basically defensive and custodial in outlook, unable to respond quickly and in a sustained way to export opportunities. But Charles Kindleberger argues that this verdict is too harsh (January 1974 *Challenge*), since British businessmen over the past century have frequently taken advantage of new business opportunities

and maximized profits within their limits of operation.

Innovation—within limits

Kindleberger adds, however, "The issue is not altogether whether British industry maximized within a static framework, but largely why it did not break out of existing constraints through creative response and innovation." During the first century of the Industrial Revolution, Britain had been a major source of new products and new processes, and it was often the first country to apply inventions originated elsewhere. But by 1900, while the flow of inventions and discoveries continued, the rate of applications declined. "The British response to change was to continue along old ways, exporting old products." Then as the Continental nations and the United States built up their strength (and their tariff barriers), Britain followed the alternative of selling ever-increasing quantities in protected Empire markets.

These long-standing problems have been aggravated by yet newer problems in the 1970s, forcing a major reordering of priorities. Thus, the Government places primary emphasis today on investment in promising manufacturing projects through the National Economic Development Council. The magnitude of the shift was signaled last fall by (former) Prime Minister Harold Wilson, who pointed out that industrial development would take precedence over consumption—"or even our social objectives."

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