ESSAYS IN INTERNATIONAL FINANCE

No. 30, August 1958

THE POUND STERLING, 1951-1958

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Princeton, New Jersey

This is the thirtieth in the series ESSAYS IN INTERNATIONAL FINANCE *published by the International Finance Section of the Department of Economics and Sociology in Princeton University. Seven years ago, the author, Roy F. Harrod, wrote an essay entitled "The Pound Sterling" which was published as Number 13 in this series. The present paper, while written to stand alone, is a continuation of the account he gave earlier.*

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GARDNER PATTERSON, *Director*
International Finance Section

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I. ECONOMIC BACKGROUND

IT SEEMS expedient, before proceeding to a monetary analysis, to set out some basic economic facts for the period under review. During this time the population of working age in Britain was almost constant; but the working population increased by 3.4 percent owing to an increasing employment of women, and of men also, the latter presumably owing to late retirement. This may have been a natural trend; but it may have been due, in whole or in part, to the prevalence of an excess of aggregate demand over the supply potential of the economy during some of the years in question. In the following table the growth of various economic magnitudes is expressed both in absolute terms and *per person in civil employment*. It would be difficult to estimate the numbers employed under some of these heads separately; there are some advantages in using a single divisor for all the magnitudes; but the consequence is that they must not be taken to show productivity per person under each of the heads separately.

TABLE I

INCREASE IN UNITED KINGDOM ACTIVITY

1948-1956

(In volume or at constant prices)

	Level in 1956 (1948 = 100)	*Average annual rate of increase per person in civil employment*
Gross domestic product	125.7	2.0
Industrial production	136.0	3.0
Manufacturing production	140.0	3.4
Consumption	116.2	1.0
Government expenditure on goods and services	129.7	2.4
Fixed capital formation	156.2	4.8
Exports	149.0	4.2
Imports	137.0	3.1

The high rates of increase in fixed capital formation and exports may be observed. The rate of increase in consumption was notably low; thus in this post-war period the British people maintained the "austerity" for which they had previously gained a reputation; this fact was not fully appreciated during some periods when sterling was under suspicion.

Magnitudes such as these are not fully informative without a yardstick for comparison. It seems suitable to refer to the United States as a country of vigorous progress. Higher rates of increase may be expected in countries working their way up from an initial low level of income or capital endowment, or regaining ground lost by war-time devastation or dislocation. I have taken 1955 as a more suitable terminal date than 1956, since the latter year was one of boom in the United States while the United Kingdom had already entered a phase of pause or recession.

TABLE II

AVERAGE ANNUAL RATE OF INCREASE PER PERSON IN CIVIL EMPLOYMENT

1948-1955

	United Kingdom	*United States*
Gross national product	2.2*	3.1
Industrial production	3.7	3.2
Manufacturing production	4.2	3.5
Consumption	1.2	2.5
Government expenditure on goods and services	2.9	6.4
Fixed capital formation	4.9	2.4
Exports	4.2	0.6
Imports	3.8	3.0

* Gross domestic product.

It is to be observed that the first three items resemble each other more closely in the United States than in the United Kingdom. This was due to the fact that the American economy was better balanced in 1948. Britain had more leeway to make from the war, and this called for concentration of attention upon an increase in manufacturing output. What is called "tertiary" production—the provision of services—is a large component of gross domestic product. Parts of this rise automatically with increased output, e.g. those required for its distribution to consumers. The goods representing the increase in British physical production were largely destined for export or gross capital formation, and, as such, would not be likely to give rise to so much "tertiary" production as consumer goods. The lower increase in services may also have been connected directly with "austerity." This British lack of balance is reflected in the fact that 78.4 percent of the number added to her labor force in this period went into manufacturing industry, while only 28.2 percent so went in the United States.

The government expenditure figures indicate the more massive provision by the United States of weapons for the defence of the free world.

The exceptionally low level of the increase of United States exports was due to the greater dependence of the rest of the world on imports from the United States in the opening year, which led to the well known "dollar shortage" of extreme severity. It was incumbent on Britain, by contrast, to increase her rate of exportation.

It seems desirable also at the outset to group together certain key figures on a yearly basis for the whole period. The strands in the following discussion will necessarily be interwoven and a general conspectus may prove useful in more than one of the following sections. In order to obtain a clear view of the course of the trade cycle, I have put down for each year its increase over the preceding year.

The well known general recession in 1952 comes out clearly. The increase in government expenditure, which goes against the trend in that year, was due to defense items. These, however, although substantial in relation to British resources, were not so large as those in the United States, where they made 1952 a year of continuing expansion. The American recession, which was the counterpart of the British 1952 recession, came in 1953-1954. The subsequent industrial investment boom in the United States also lagged behind the British by about a year. It is vital to bear this in mind in the interpretation of more recent events, not least of those of the present (1958) recession.

The course of the British investment boom of 1954-1956 can also be traced. The steep increase in fixed capital formation in 1953 was solely due to the special efforts made by the Conservative Government (elected in the second half of 1951) to increase residential house building. The rather low figure for the increase in fixed capital formation by manufacturing industry (column 7) in 1954, was due to the fact that the orders which gathered strong momentum during that year had not had time to cause a corresponding increase in output. Deliveries of plant and machinery did, however, increase strongly in 1954; it was natural that they should respond to higher orders more rapidly than fixed capital formation, because the latter includes construction. The last two columns (9 and 10) provide the most cycle-sensitive figures. The increase in factory building starts in 1953 shows revival from the previous recession. The further increases in 1954 and 1955 engendered strong inflationary pressure.

TABLE III

PERCENTAGE INCREASE OVER PRECEDING YEAR

1949-1957

(In volume or at constant prices)

	Gross Domestic Product (1)	Consumption (2)	Govt. Expenditure on Goods and Services (3)	Exports (4)	Manufacturing Production (5)	Fixed Capital Formation (6)	Fixed Capital Formation by Manufacturing Industry (7)	Deliveries of Plant and Machinery (8)	Factory Building Starts by Manufacturing Industry (9)	Domestic Machine Tool Orders (10)
1949	3.6	1.7	8.7	10.0	7.0	9.3	12.0	9.6	—	—
1950	2.7	2.4	−0.8	15.0	8.4	5.0	15.1	12.1	14.5	—
1951	3.9	−0.5	7.8	−1.5	4.3	0.4	7.1	9.5	−8.3	—
1952	0.3	−0.6	10.7	−6.4	−4.1	1.5	−3.1	−5.3	−39.8	—
1953	3.9	4.2	1.6	2.2	6.0	10.7	−2.8	1.3	45.6	—
1954	4.1	4.4	−0.8	4.5	8.1	7.9	2.2	10.0	57.7	49.5**
1955	3.5	3.1	−1.4	7.4	6.8	6.4	18.1	10.3	42.9	27.4**
1956	1.4	0.5	1.3	5.7	−1.4	5.2	13.7	2.2	−13.5	−15.2
1957	—	2.0	—	1.9	1.9	5.2	—	—	−28.2*	−11.1

* First three quarters of 1957.

** All orders; separate figures for domestic orders not available.

These last two columns comprise the best figures we have—and they certainly need supplementing—to indicate the course of "*ex ante* investment." They confirm the view that variations in *ex ante* investment play a key part in the trade cycle. The figures showing *ex post* investment (6 and 8) are naturally more damped.

The year 1956 shows a flattening out, and even symptoms of recession. The only items showing normal rates of increase in that year are exports, which do not depend mainly on British internal conditions, and the two capital formation items (6 and 7), which contain a big element of construction and were therefore sustained by orders placed in earlier years. The substantial decline in the sensitive items (9 and 10) is to be observed.

II. LEGACY OF PREVIOUS PERIOD

In *The Pound Sterling,** I focussed attention upon the two large mistakes made in the post-war quinquennium, the failure to fund externally held sterling balances and the devaluation of sterling in 1949.

Britain has continued to be harassed by sterling balances held outside the sterling area. She has had to pay out far more gold on these than could possibly have been required by any reasonable terms of funding, containing an obligation for annual gold payments. They have continued until 1958 to be a cause of acute embarrassment, and domestic monetary policy has from time to time been deflected from its best course with a view to courting the opinion of the holders of balances and preventing their making further withdrawals.

Opinions may differ about whether there need ever have been any post-war devaluation of sterling (i.e. below the level of $4.03); it seems incontestable that the devaluation to $2.8 in 1949 was premature and excessive. The year in which to have allowed a much more moderate devaluation, if one was required at all, would seem to have been 1952, when the British economy was somewhat slack, and would therefore have benefited from an abnormally large increase in the volume of exports, when the American economy was booming, and when world dollar prices were falling, so that a moderate increase in the sterling price of the dollar would not have set up any substantial price spiral inside Britain. Furthermore, had it been possible to prolong the restraint in wage demands, which was successfully achieved in the period 1948-1950, for another three years, the habit of expecting a substantial annual increase in money wages might never have been re-formed.

* *Essays in International Finance,* No. 13, written in 1951 and published February 1952.

It may be permitted to quote from the concluding page of *The Pound Sterling*. The following words were written during 1951:

"General opinion seems hostile to the revaluation of sterling. Yet, again in a roundabout way, similar results may be achieved. Failing revaluation, prices, wages and other costs in Britain are likely to pursue a steady upward course for some time. Thus in the end exporters will have to charge higher prices for British goods, owing to the rise in their sterling costs, and the terms of trade will move in favour of Britain. The volume of exports will be cut down through the prolongation of delivery dates, and the consequent loss of orders. If the British authorities fail to raise the external value of sterling into line with its internal value, then in due course its internal value will move downwards into line with its external value. I should judge that the internal level of wages, etc., has scarcely begun to adjust itself to the new external value of sterling as established in September 1949. This long painful process lies ahead of Britain, if no upward valuation of sterling is undertaken, with all the debilitating effects of a decline in the internal value of a currency. Thus events will in a slow and painful way produce a result that could be achieved by right policy more quickly. But, all's well that ends well."

It is here predicted that "exporters will have to charge higher prices." Export prices rose by 5 percent in the following year. It is predicted that "the terms of trade will move in favour of Britain." They moved by 18 percent in favour of Britain in the two following years. It is predicted that "the volume of exports will be cut down." They fell by 7 percent in the following two years. It is predicted that "prices, wages and other costs in Britain are likely to pursue a steady upward course for some time." This last prediction has very evidently been fulfilled.

In 1951 the prices that Britain had to pay for imports had risen by 53 percent over 1948. Part of this increase was due to the Korean war. In 1953 and 1954 the import price index ran roughly level at 131 (1948 = 100), after which it began to move up again. While a rise of 31 percent is decidedly less than we would expect as the long-run effect of a devaluation of 44 percent, in the absence of any fall of dollar prices, we may provisionally accept it as the effect of devaluation for comparison with the internal price level. In 1951 consumer prices had risen 15 percent on 1948, the prices of fixed assets by 15 percent, the index of official wage rates by 13 percent and average weekly wage earnings ("weekly pay packet") by 20 percent. These internal prices had not been adjusted to a rise in import prices of 53 percent, or even 31 percent.

In 1948 wages had not yet risen as much as the cost of living by comparison with 1938. British workers had had ten hard years of austerity, and it was idle to expect that they would accept another 2 percent reduction in their standard of living below the 1948 level, at a time when output per head was notoriously rising. Even the increase of weekly wage earnings by 1951 was inadequate from the workers' point of view, giving a lift of only 4.4 percent over the cost of living in three years (1948-1951) during which the gross domestic produce per person in civil employment had risen 10.5 percent and the index of manufacturing production per person in manufacturing employment had risen 13 percent. A Draconian policy of compressing the real standard of living of wage earners, after so long a period of real austerity, was not in question at that time. Nor is it by any means clear that it would have been desirable, quite apart from the human aspect. It might have prevented the improvement in the terms of trade which subsequently occurred, and thus have worsened Britain's external balance. By holding down consumption so severely, it might have reduced the motive for investment—for consumption and investment must grow in a balanced relation to one another. Table I does not suggest that the increase in consumption has been excessive.

It is also to be noted that export prices in 1951 (at + 27 percent) had risen more than wage rates or wage earnings.

Thus it was inevitable that after 1951 there would be a spiralling process, most deleterious to the sound working of the economy. Wage earners were bound to insist on higher pay. This would necessitate an increase in end-product prices, which would cause and justify still further wage demands. It is a familiar story. The point is that, given the price structure as it existed in 1951, this development was quite inevitable.

There was at the time, and has since been, some confusion about the Korean war, which has caused commentators to under-estimate the debilitating effect of the devaluation. The Korean war caused a sharp worsening in Britain's terms of trade; this proved to be temporary and the terms were subsequently restored to the pre-devaluation level, although—until very recently—remaining much less favourable to Britain than before the second world war. The Korean war also caused a rise in import prices additional to that due to devaluation, and these subsequently fell. All this caused embarrassment. The fact that these effects of the Korean war were temporary has distracted attention from the fact that the rise in import prices due to devaluation was a lasting one and was the prime mover in the upward spiral of wages and prices that Britain has subsequently experienced.

The largest effect of the devaluation on the wage/price structure may have been achieved by 1954. The whole effect had not been achieved by then; for instance, the price of a postage stamp was put up for the first time in 1957, a clear effect of the devaluation; it is impossible to judge whether even in 1958 there may not still be some maladjustment between the internal and external price structure. In 1954, which we take as the year in which the main effect had worn through, import prices stood at 131, consumer prices at 126, fixed assets prices at 128, wage rates at 132 and wage earnings at 150. This was clearly a more tenable relation than that obtaining in 1951. It is to be noted that "real" wage earnings had risen 19 percent in this six-year period (1948-1954) during which manufacturing output per person in manufacturing employment had risen 20 percent and the gross domestic product per person in civil employment 15 percent. Thus in this period wage earners managed to secure entitlement only to a very small increase in their share of the gross domestic product.

It appears that the rise in prices until 1954 may be attributed to the rise in costs, stemming ultimately from the devaluation. In this three year period, from 1951 to 1954, the price increase cannot be attributed to a demand-inflation. 1952 was notoriously a year of recession (as indicated in Table III). Throughout this period (1951-1954), the number of unemployed was considerably greater than the number of unfilled vacancies; this was the only post-war period in which this has been so, except for 1957-1958. From 1951 until mid-1954 the machine tool industry was working off its backlog of orders.

In 1954 the economy reentered a period of demand inflation, and a new force was introduced tending to raise wages and prices. But even in this period (1954-1956) the previous formation of a habit of expecting money wage increases every year since the war, except in the two years of restraint 1948-1950, may well have caused the upward movement of wages to have been greater than it would otherwise have been. It is to be stressed that these annual increases had been justified by the upsurge of world prices, which impinged on British import prices, in the three years after the war, and then by devaluation. It is difficult to persuade those, for whom a habit has in fact been well justified for so long a period, that it has ceased to be so. This habit has persisted after 1956, when demand-inflation was no longer present; but a change now appears to be occurring.

III. EXTERNAL ACCOUNTS OF THE UNITED KINGDOM

In *The Pound Sterling* certain tables were presented which, taken together, gave a conspectus of the external balance of the United Kingdom in the preceding years. The twice yearly White Papers on the United

Kingdom balance of payments provide a great wealth of information, meticulously marshalled and sorted. Yet from these it is not always easy to get a bird's eye view of the realities of the situation. Accordingly I have provided tables, in continuation, grouping items under very broad categories.

TABLE IV

UNITED KINGDOM BALANCE OF PAYMENTS ON CURRENT ACCOUNT 1952-1957 (INCLUSIVE)

(£ million)

		Overall	*With Non-Dollar, Non-Sterling Area*	*With Sterling Area*	*With Dollar Area*	*With Non-Territorial Organisations*
Exports		18,317				
"Invisible" exports*		7,332				
		25,649				
Imports, f.o.b.	19,360					
"Invisible" imports	5,556	24,916				
Balance		+ 733	−1	+1,670	−892	−44

* Defense aid is *not* included.

Source: The *United Kingdom Balance of Payments* White Papers are subject to revisions in successive issues. But the latest issues do not give all the figures required for the following tables. In these tables each year has been taken as a self-consistent whole from the latest issue that gives all the relevant figures, and the figures for each year have been added together. Cmd. 399 (1958) has been used for the years 1955-57, Cmd. 273 (1957) for 1954, Cmd. 122 (1957) for 1953 and Cmd. 9731 (1956) for 1952.

It should be noted that the gain of gold to Britain from the external trade of the Rest of the Sterling Area shown as £244 million, was not a net gain in gold, since the deficit of £156 million shown in the opposite column had to be paid for entirely in gold (see Table VI).

This table reveals a pattern that is profoundly unsatisfactory. This large sum of gold paid out to the non-dollar non-sterling world, with which the United Kingdom was not in deficit, may be contrasted with the comparatively small sum paid to the dollar area with which the United Kingdom has, and ought to continue to have, if multilateral trade is to flow in its natural channels, a substantial deficit. The figure for investment appears to be on the high side. It includes unidentified