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"THATCHERISM IN PRACTICE : A PROGRESS REPORT"

Attached is the text of a speech to be given this evening by the Financial Secretary to the Treasury, the Rt Hon Nigel Lawson MP, to the Zurich Society of Economics at the Kongresshaus, Zurich.

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NOTE TO EDITORS

The Financial Secretary will speak to a large audience of businessmen, politicians, academics and industrialists at the invitation of the Zurich Society of Economists.

The Prime Minister spoke to a meeting of the same Society when Leader of the Opposition in 1977.

THATCHERISM IN PRACTICE: A PROGRESS REPORT

Text of a speech given by the Rt Hon Nigel Lawson MP, Financial Secretary to the Treasury to the Zurich Society of Economics at the Kongresshaus, Zurich, on Wednesday 14 January 1981.

I count it a signal honour to have been invited to address this distinguished society.

I see that the last occasion on which you invited a British politician to address you was some four years ago, when your guest speaker was Margaret Thatcher, at that time Leader of Her Majesty's Opposition. Her theme on that occasion was - and I quote - "the fundamental change in direction which I believe is about to occur" in the western world in general and in the United Kingdom in particular. Two years later Margaret Thatcher was elected Prime Minister - achieving, incidentally, the most decisive election victory secured by any Party in Britain since the Socialist landslide of 1945 - and since then she and the Government she leads have been putting into practice the ideas she expressed to you in 1977.

When, therefore, your Chairman asked me to let him know the subject of my address, it seemed only logical that I should try and provide you with a frank interim assessment of the Thatcher Government's progress to date in the sphere of economic policy.

But perhaps it is sensible first to set the scene - to sketch in the background to the economic situation we inherited when we took office in May 1979.

Throughout most of the post war period, British economic policy tended to be based on two hypotheses:

First, that the prime duty of government was to promote full employment by the use of appropriately expansionary fiscal and monetary policy;

Second, that inflation was a distinct and separate problem, to be solved by direct action on wages and prices, ranging from exhortation, through voluntary and quasi-voluntary guidelines, to statutory controls.

The outcome was disappointing. Despite the best intentions of Governments of both political parties, each successive Government over the past thirty years experienced a higher average rate of both unemployment and inflation than its predecessors.

Thus unemployment averaged a third of a million during the first post-war Conservative Government, half a million under Labour during 1964-70, three-quarters of a million under the Conservatives in 1970-74, and 1¼ million during the last Labour Government.

Similarly with inflation: the average annual increase in retail prices was 3½ per cent under the Conservative Government of 1951-64, 4½ per cent under the first Wilson administration, 9 per cent under the Heath

administration, and 15 per cent during the lifetime of the last Labour Government.

This experience, and in particular the experience of the 1970s, eventually convinced most of those concerned with economic policy, both inside and outside politics, that these two ruling hypotheses were invalid.

It became increasingly widely accepted that inflation could be curbed only if monetary growth was restrained: and furthermore that unemployment could not be reduced more than temporarily by fiscal and monetary expansion: indeed, successively larger monetary injections had produced ever smaller and shorter-lived reductions in unemployment followed by more rapid acceleration in inflation and yet higher unemployment.

But the legacy of this prolonged phase of what had come to be known, rightly or wrongly, as Keynesianism, remained. Not merely in terms of steadily rising inflation and unemployment, and the malign expectations the former, in particular, engendered. But successive fiscal boosts had led to an inexorable growth of public expenditure as a proportion of Gross Domestic Product: from a little over 30 per cent of GDP in 1960 it rose steadily to over 40 per cent by the end of the 1970s. And successive attempts to control inflation by 'direct' means had led to a plethora of controls and restrictions of one kind and another - not to mention an increase in the statutory rights of trade unions, in the hope of securing their support. Between them these two developments had seriously stifled the market economy and blunted the edge of market forces. Finally, there was the enduring legacy of psychology and the attitudes bred by decades of economic miseducation, not least the public's conception of what is and what is not within the power of Government to deliver.

Such, then, was the unpromising long-term context to the economic situation we inherited in May 1979. But the immediate situation itself was not particularly promising, either.

Monetary growth was clearly excessive - and I shall have more to say about that later. Inflation was on a sharply rising trend: over the 6 months to May 1979 retail prices rose at an annual rate of 13.8%, compared with an annual rate of 8.8% over the 6 months to the previous May. Public expenditure was once again on a pronounced upward path, and planned to rise by over 10 per cent in real terms between 1978-79 and 1982-83.
The explosion of the previous Government's pay policy during the winter of 1978-79 had led to massive public sector pay commitments - notably via the agency of the newly-created 'Clegg commission' set up to compare public and private sector remuneration and to make recommendations accordingly - which the Conservative Opposition, in the heat of the pre-election period, had pledged itself to honour.

And, lastly, the world as a whole stood on the brink of recession. Insofar as that recession had been triggered by a massive increase in the price of oil, the UK secured some obvious compensation: nonetheless the fact remains that the course to which the incoming British Government had set itself was inevitably made harder against a backcloth of world recession.

That course represented - and represents - a sharp departure from the dominant post-war policy trends in the UK as I have already described them, although to a Swiss audience, for example, I am conscious that it will appear almost tediously familiar.

Broadly speaking we set as the overriding objective of macroeconomic policy the conquest of inflation; while at the same time we embarked on a microeconomic policy of removing wherever possible major market

distortions from the economy so as to improve the performance of the supply side of the economy, thus laying the only true foundation for wealth creation and the only hope of increased employment in the long term.

Our macroeconomic approach has been most fully articulated in the medium-term financial strategy published at the time of last year's Budget, some 10 months after we took office - although the broad thrust of policy was of course made perfectly clear from day one. Inflation was to be squeezed out of the system by a steady deceleration in the rate of monetary growth over a four-year period; this was to be accompanied by a gradual underlying reduction in the size of the Budget deficit, so that an undue share of the burden of achieving a declining rate of monetary growth would not be borne by interest rates and thus, in particular, by the private sector; and, finally, this fiscal stance was to be achieved so far as possible not by increasing taxation but - consistent with our microeconomic policy objectives - by a steady reduction in the total of government spending in real terms.

Now that the best part of two years has elapsed, how has it all worked out so far ?

In terms of our overriding objective of bringing down the rate of inflation, the progress to date has been most encouraging.

I mentioned a moment ago that, when we took office in May 1979, inflation in the United Kingdom was on a sharply rising trend - and that, based on the latest six months, retail prices were increasing at an annual rate of 13.8 per cent and accelerating. By contrast, over the most recent six-month period for which figures are available, the annual rate of inflation is down to 8.4 per cent.

Although this latter figure is, for seasonal reasons, somewhat too flattering, and the true underlying rate is probably still just in double figures, there is no mistaking either the change of trend or the sharpness of the fall.

Moreover the reduction in the rate of inflation since we took office has occurred over a period during which world inflation, if anything, worsened. Even more significant, it has been achieved without the aid of subsidies, price controls or formal wages policies.

Indeed, pay and price controls have been abolished, as indeed have dividend controls; subsidies are being progressively reduced; and in the nationalised industries - including the state-owned energy industries of coal, gas and electricity - the Government's policy has been to encourage the industries concerned to move steadily towards full economic pricing.

At the same time, a whole range of other restrictions and controls have been either liberalised or abolished altogether.

Perhaps the most dramatic example of this has been the complete abolition, within six months of our taking office, of the very severe regime of exchange controls which had been maintained by successive British governments for over 40 years without a break.

At the time, this decision was widely criticised as rash, if not foolhardy. In the event it has proved highly successful in every material respect - so much so, in fact, that there are more voices to-day asking for the imposition of inflow controls than there are those seeking the reimposition of the old outflow controls.

Let me make it absolutely clear, incidentally, before I go any further, that I am not trying to pretend that our record so far has been one of unalloyed success. Of course we have had our difficulties, our setbacks and our problems - and I shall seek to identify and evaluate these at some length before I sit down. But fashionable comment to-day all too often concentrates exclusively on those difficulties, setbacks and problems; and that would be an error which I am sure you would neither wish me nor indeed expect me to commit.

Arguably the most important change that has occurred, however, is not one that can be quantified in any way, but one that is no less real for that. I refer to the change in the crucial psychological climate of the economy; the new mood of realism that now prevails on both sides of industry. In the labour market, after a year of unreality in which wage settlements were made far beyond the capacity of firms to pay and far in excess of what was sensibly compatible with the Government's monetary framework, and in which average earnings rose by over 20 per cent, we are now, in the present wage round, seeing

single figure settlements become commonplace - without, to repeat, any formal pay policy, with all its rigidities, distortions, and high political costs.

At the same time there has been a marked improvement in industrial relations, with many fewer man-hours lost in strikes.

The change on the management side of industry has been equally profound. Managers who in the past were seeking little more than a passive point of equilibrium between Government guidance on the one hand and trade union pressures on the other, are now actively managing again. As a result, British companies throughout the length and breadth of the country are becoming more efficient, leaner, tauter, fitter and more productive.

While this may not itself constitute economic success, it is undoubtedly a necessary precondition of success, and has long been recognised as such.

Let me now turn to the difficulties, setbacks and problems - both expected and unexpected - we have encountered on the way. These may usefully be divided into two main categories: those connected with the execution of our policies, and those connected with the outcome of those policies - or indeed of the other forces, outside government control, which bear upon the economy.

In the context of the first of these two categories, I mentioned earlier in this talk that the heart of our economic policy is the Government's published and indeed quantified medium term financial strategy, the core of which is a steady deceleration in the rate of monetary growth over a four-year period, buttressed by a gradual reduction in the size

of the underlying budget deficit, which in turn is to be achieved by a steady reduction in the real level of total government spending.

On the crucial monetary front, the picture is somewhat obscure and decidedly patchy.

What is quite clear is that we inherited a situation of excessive monetary growth, which had to be tackled as a matter of urgency. Over the eighteen months immediately prior to our taking office, narrow money - M1, or notes and coins plus private sector sterling sight deposits - had been rising at an annual rate of 14½ per cent, and the usual measure of broad money - sterling M3, defined as M1 plus public sector sight deposits and all sterling time deposits - at 13½ per cent.

In fact, this latter figure was an understatement of the true underlying growth of broad money. In mid-1978 the previous Labour government had reimposed the so-called 'corset', a device invented by the Bank of England during the latter period of the previous Conservative Government, and designed to curb bank advances (and thus deposits) by the imposition on the banks of financial penalties for the excessive growth of such advances and deposits. In practice this artifical constraint merely led to various forms of disintermediation: most notably (though by no means exclusively) through the financing of the private sector via acceptance credits. Since such acceptances are not included in the definition of sterling M3, the only lasting effect of the corset was to distort this particular statistic without in any way curbing the true growth of broad money. The present Government duly abolished the corset last June: with the wisdom of hindsight a strong case can be made for the proposition that we should have followed our original instinct and announced its abolition immediately on taking office, a year

previously: a thermometer deliberately designed to give a false reading, however flattering, is no use to anyone.

Be that as it may, the aftermath of the abolition of the corset was inevitably the unwinding of all the disintermediation and other distortions that had accumulated during the two years in which it was in force, thus artificially inflating the published sterling M3 figures by as much as they had previously been artificially deflated.

However, a rather better guide to the true growth path of broad money can be seen from the published series for what we call PSL 1 (PSL standing for private sector liquidity). Some 90 per cent of PSL 1 is accounted for by sterling M3; but it does also include other money market instruments and thus catches the acceptance credits used to evade the corset. I therefore propose to use this series when referring to broad money, even though it has to be said that not even PSL 1 has been wholly unaffected by the distortions and counter-distortions of the corset saga. Over the eighteen months prior to our taking office, then, narrow money had been growing at an annual rate of 14½ per cent and broad money at an annual rate of some 15½ per cent.

Over the eighteen months since we took office, the annual rate of growth of narrow money has fallen sharply to 5 per cent (and there has been a similar sharp fall in the rate of growth of the monetary base, or MO), but the annual rate of growth of broad money has remained almost unchanged at 16 per cent. This compares with a published target for the period concerned of 9 per cent, plus or minus 2 per cent.

Does this mean that monetary policy, in the sense that matters for the conquest of inflation, has been tight, as the Government manifestly

intended - and indeed still intends - or has it been alarmingly lax? We have all along made it clear, most notably in the Green Paper on Monetary Control we published last March, that to assess underlying monetary conditions properly it is necessary to take account of the evidence of all the various monetary indicators. And certainly the evidence of the main financial indicators which generally speaking reflect monetary conditions - the strong exchange rate, high interest rates, the tight corporate liquidity position, and decelerating inflation- would appear to confirm the message of the narrow money figures: namely, that monetary policy has indeed been tight.

Unfortunately it is not quite as simple as that. For the purpose of setting the annual target for monetary growth - and indeed for the 4-year path set out in the medium-term financial strategy - we have (like our predecessors, but unlike most other countries, incidentally) chosen broad money as the most useful guide.

I believe we were and remain right to do so. Narrow money has the advantage of being easier to control, but is suffers from being almost too easy to control. In particular, a rise in interest rates (and short term interest rates have risen to unprecedented levels during the present Government) will inevitably lead to a marked switch from non-interest bearing sight deposits to interest bearing time deposits, thus sharply depressing the growth of narrow money far beyond any true change in underlying monetary conditions. Nor can we forget that under the Heath administration, when monetary growth exploded, with the inevitable inflationary consequences, the authorities were lulled into a false sense of security by the fact that the rate of growth of narrow money was declining steadily, throughout that Government's lifetime, from some 13½ per cent in 1970-71 to 3½ per cent in 1973-74.

Thus despite the tight conditions that have undoubtedly prevailed so far, we cannot, I believe, view with equanimity, so far as the medium term course of inflation is concerned, the fact that the growth of broad money has been running well ahead of the target rate. So far, however, the excess growth that has occurred need not have adverse inflationary consequences. In reinforcement of the message conveyed by the various financial indicators to which I have already referred, it has to be borne in mind that a high level of short term interest rates, in addition to artificially depressing the rate of growth of narrow money, has probably also artificially inflated the rate of growth of broad money.

This occurs in two ways. First, there is an 'investment' demand for interest-bearing money which is held for non-monetary purposes and which will be switched back into non-money assets as soon as short rates fall. Second, since the whole structure of interest rates tends to rise and fall together, albeit by different amounts at different ends of the spectrum, a sharp rise in short rates paradoxically encourages companies to resort to short-term bank finance, rather than long-term bond issues, to which they will revert once the general structure of interest rates has fallen to what appear to be normal or even favourable levels.

This emphatically does not mean that monetary growth is, other than for short periods at particular times, inflated by high interest rates and reduced by low rates. What I am referring to is an essentially temporary phenomenon: at a particular stage in the process of bringing down inflation, through which the British economy has just been passing, high interest rates have a much less dampening effect on the demand for money (and hence on its supply) than might have been expected; but

this excess demand can be expected to disappear again as the cycle enters its subsequent phase.

The conclusion I draw from all this - and I make no apology, before so expert an audience as this, for going into the matter in considerable detail: it is scarcely surprising that in the sophisticated modern world, and in particular for a country as financially advanced as the UK, monetary control is a highly complex matter; but that is no reason for getting it wrong, still less for abandoning the task altogether - to repeat, the conclusion I draw from all this is that monetary conditions in the UK have not been inflationary so far, but that it is essential from now on to secure a lower rate of growth of broad money, and indeed, over the three remaining years of the medium term financial strategy, it might well be prudent to claw back at least some of the excess growth that has already occurred.

To some extent, as I have already indicated, this will be greatly facilitated by the natural development of the economic cycle: in particular, as the de-stocking phase, which has been particularly dramatic over the past year, enters its final phase, the private sector's demand for bank finance will greatly moderate; and there are already signs that this process has begun.

But the crucial determinant of the Government's success in controlling the growth of broad money must clearly lie, first, in a better control of public sector borrowing (and hence of government spending), along the lines mapped out in the medium term financial strategy and, second, in a better ability to finance in a non-monetary way the public sector borrowing requirement that does emerge - in other words, improvements in funding techniques.

Both elements are vital. So far as funding is concerned, the position is to some extent complicated by the fact that in the United Kingdom, almost uniquely in the world, it is the Central Bank rather than the Treasury which is responsible for financing the Government's Budget deficit. But this oddity should not be allowed to become an impediment to what needs to be done. Since the publication of the Government's discussion paper last March - the Green Paper on Monetary Control to which I have already referred - it has become increasingly clear that there is a need to strengthen the instruments of monetary control. We have had a period of intensive discussion of all this, and the Chancellor announced his preliminary conclusions to the House of Commons in November.

Increasingly, as those discussions developed, it became clear that funding was at the heart of the matter - not least because it is the method of, as well as the need for, funding which largely determines the system by which interest rates are generated at both the short end and the long end of the market. It is in this context that a great deal of interest has been evinced in the various systems of monetary base control, a variant of which is of course the essence, as I understand it, of the Swiss system of monetary control. Thus it was that the Chancellor announced to Parliament on 24th November last a number of minor changes designed, inter alia, to "allow the market a greater role in the determination of short-term interest rates" and to "be consistent with a gradual evolution towards a monetary base system".

But the differences between Britain and Switzerland are very considerable, and need to be borne in mind. One of them is the relative importance of the public sector and the relative size of the Budget deficit. In Switzerland these are small by comparison with

most other industrial countries. By contrast, in the UK we have a relatively large public sector and the public sector deficit to be financed is very large indeed in relation to the total capital flows in the economy. Indeed, in recent years issues of gilt-edged stock have represented not far short of 90 per cent of total capital issues. It is this difference, incidentally, which to some extent explains the greater importance the UK attaches to the behaviour of broad money.

A second major difference between Britain and Switzerland is we in the UK have very little idea of the size of cash balances the banks would wish to hold if we were to move to a system of monetary base control under which the central bank no longer supplied the banks, at a known non-penal rate, with whatever reserve assets their balance sheets required.

It follows from this that any move towards monetary base control in the UK is bound to be evolutionary; and, in the meantime, that we are bound to pay more attention to other aspects of improving our funding techniques.

At the same time, we are keenly aware of the need to achieve a better control of public sector borrowing. At the time of the Budget, last March, the total Public Sector Borrowing Requirement for 1980-81 was estimated at £8½ billion, or some 3¾ per cent of forecast GDP. In his statement to the House last November, the Chancellor admitted that it looked like turning out some £3 billion higher than this - more than half the excess due to the recession being deeper than expected, thus causing increased expenditure on unemployment benefit, lower tax revenues, and higher borrowing by the nationalised industries - whose

need for external finance is an important component of the total public sector borrowing requirement.

It may well prove that the final outturn is even greater than this: in addition to the direct effects of the recession on tax revenues, there is the tendency, when money is tight, for both companies and individuals to delay payment of the tax due from them so far as they are able to do so. The difficulties of accurately forecasting the public sector borrowing requirement are inevitably very considerable. In the first place, it is the difference between two vast magnitudes - public expenditure and public revenues - each of which is running in the region of £100 billion. Thus an error of 1 per cent on either side means a difference of £1 billion to the PSBR. Again, not much more than half the total represents borrowing by and on behalf of central government: the other half is divided more or less equally between the borrowing needs of the nationalised industries and other public corporations, which are particularly susceptible to the vagaries of trading conditions, and borrowing by local government.

This last element adds a further dimension of uncertainty, since under our existing system the central Government has no control whatever over the proportion of their capital expenditure the various local authorities decide to finance by borrowing (rather than by local taxation), despite the fact that local authorities are able to borrow at privileged rates which bear more relation to the cost of Government credit than to the credit rating of the individual authority. Nor is this the only way in which the constitutional principle of local government autonomy impinges on public finance. At the end of the day, central government has no direct control whatever over the one quarter or so of total general government expenditure that is accounted for by local government current spending.

Needless to say, none of these difficulties - still less the traditional tendency, by no means confined to Britain, for every Minister round the Cabinet table to be against Government expenditure in theory but in favour of it in practice so far as his own most exceptional Department is concerned - none of these difficulties absolve the Government from the continuing need to do whatever is necessary to keep public spending and borrowing under control, in conformity with the medium term financial strategy.

Indeed, we have already taken a number of highly unpopular decisions, some of them involving highly controversial legislation in the welfare and other fields, to just this end. Total expenditure, in real terms, will be very slightly higher this year (1980-81) than it was last year - though still very much less than our predecessors had planned - but from then on the medium term financial strategy sets out a steadily declining trend, until by 1982-83 it should be some 4 per cent lower than in 1979-80 - the year in which we took office - and 11½ per cent lower than the planned figure we inherited from our predecessors. We are determined to keep to that path.

Moreover, up to now we have been severely impeded on the public expenditure front by the massive explosion in public service pay, which accounts for some 30 per cent of total general government expenditure. This arose partly as a result of the long-standing 'fair comparison' system for determing civil service pay, but more particularly by the recommendations of the egregious comparability commission newly set up, as I mentioned much earlier in this talk, to deal with pay in the rest of the public service. Again, with the wisdom of hindsight, it is possible to argue that the Conservative Party should never, when in opposition, pledged itself to honour whatever cheques the Clegg Commission, as it is (or was) commonly known, cared to present. But it would be foolish not to recognise that some kind of public service pay explosion was bound to occur in the aftermath of a period of formal incomes policy.

During this phase, not only was the cost of the public services greatly inflated, but a quite disporportionate and wholly unfair share of the burden of the recession and of the Government's harsh but necessary anti-inflation policies fell on the private sector.

That phase, however, is now over: the Clegg Commission has been abolished, the civil service pay system has been set aside, and a firm control of public service pay costs has been reimposed.

So far as public borrowing is concerned, it is undoubtedly unsatisfactory that the current year's outturn should be all set to be significantly in excess of the Budget forecast, even when (as is proper) due allowance is made for the automatic consequences of the recession being deeper than was forecast at the time. But the lessons of the overshoot will not have been lost; and meanwhile there is no reason to suppose that next year's borrowing requirement cannot be brought back more or less on track - by which I mean the 3 per cent of GDP set out in the medium term financial

strategy plus the automatic consequences for the public finances of GDP in 1981-82 being lower than was foreshadowed, for illustrative purposes, when the medium-term financial strategy was published almost a year ago.

As the Government's Financial Statement and Budget Report declared at the time, " This particular course for the PSBR is not to be interpreted as a target path. It is a projection of the course of the PSBR based on the assumed growth of GDP and present public expenditure plans that should be broadly compatible with the monetary objectives. Fiscal policy for any particular year will be consistent with declining monetary growth in the particular circumstances of the time." And as I myself made clear in a speech a year ago, subsequently reprinted in the Treasury's Economic Progress Report at the time of the Budget, this meant,in particular, that in a recession it would be wholly appropriate, and wholly consistent with declining monetary growth, for the PSBR to be allowed to rise above the medium term trend line.

This does not mean, of course, that the brakes are off. It does not mean, in particular, as I explained in that speech, that discretionary action to boost the Budget deficit over and above the natural increase brought about by recession is either sensible or desirable. But that is emphatically not what we have in mind.

Indeed, in order to prevent this the Chancellor has already announced, in addition to various public expenditure measures, increases in taxation which will bring in an additional £2 billion next year. It is some measure of our dedication to the principles of sound finance, and to our determination to bring down inflation, that despite the fact that, as a Government, we would like to see taxation reduced, we have so far, on balance, increased the real burden of taxation overall. Of course, we have

been able to introduce a number of specific reliefs geared to small businesses, and we have cut income tax rates for the overwhelming bulk of the population - with the politically-inspired and economically counter-productive top marginal rates of tax being very substantially reduced. But all these reductions have so far had to be more than offset by increases in other taxes, notably on consumers' expenditure and North Sea Oil. The convenient theory so popular in some circles across the Atlantic - that cuts in tax rates produce increased tax revenues - is, alas, as a general proposition, simply too good to be true. Thus while the struggle to cut government spending - despite a reduction in the number of civil servants of no less than 35,000 since we took office - has proved the least tractable the Government has had to wage so far, the overall fiscal picture is by no means a gloomy one. But it is clear that, if adequate monetary control is to be assured, we cannot afford to allow success in funding to depend on precision in forecasting the public sector's overall borrowing a year in advance. A firmer basis than this is required - and we are in the process of constructing it.

Earlier on in this talk I mentioned that the difficulties, setbacks and problems that we have encountered in the economic field since we took office could be divided into two categories: those connected with the execution of our policies, and those connected with the outcome of those policies, and of the other forces, outside government control, which bear upon the economy.

I have dealt at some length with the former; for it is on the successful execution of our economic policies that everything else depends.

But what of the latter?

The recession has bitten quite deep, with output now running - according to official statistics - perhaps some 6 per cent below the level prevailing when we took office, although precise estimates vary. But all the signs suggest that, taking the economy as a whole, we have now more or less reached the bottom, and better times are clearly in sight. The depth of the recession, coupled as it has been with a long overdue shedding of surplus manpower in overmanned companies and industries, and by the closure of plants that never had an economic future, has unfortunately but inexorably led to record post-war levels of recorded unemployment - now over the 2 million mark - although the figures would have been very much less had it not been for the unrealistic wage bargains struck a year ago. Fortunately, as I have already mentioned, that phase is now over; but unemployment remains high - and rising, although it is unlikely to continue to rise in 1981 at the rate we have seen in 1980.

This is inevitably, in human terms, a matter of considerable concern to the Government. What can be done to alleviate the hardship is being done - particularly so far as school leavers are concerned. But while it is no part of the Government's economic policy deliberately to create increased unemployment, any attempt to pump more money into the system in order to create more jobs in the short-term would merely ensure fewer jobs, and still higher unemployment in the future. And that is a price we are not prepared to pay. Indeed it is our present policies, both for the containment of inflation and the reinvigoration of the supply side of the economy, that offer the only hope of reversing the long term trend to even higher unemployment that has been such a feature of the past 30 years.

Then there is the exchange rate. The continuing strength of the £, despite the abolition of exchange controls, is a phenomenon which has surprised many if not most observers. No doubt it has a lot to do with the UK's new-found self-sufficiency in oil; but whatever the precise mix of reasons - which

in any event can never be objectively determined - the one thing that is clear is that it is the product of the free play of market forces. The present Government has no exchange rate policy as such - for the simple reason, as Switzerland among others has experienced, that the attempt to have such a policy greatly complicates (if it does not actually make it impossible) the difficult enough task of pursuing a sound monetary policy, without at the end of the day having any significant effect on the real exchange rate, whatever may happen to nominal rates.

Moreover, the strength of the £ has undoubtedly been one of the main channels through which the crucial and marked change in trend from rising to falling inflation has been effected. It has, however, imposed a severe burden on much of manufacturing industry, and in particular on exporters. British exports have so far held up pretty well, and the current account of the balance of payments is in sizeable surplus - probably over £2 billion for the calendar year just ended. But there has inevitably been a sharp decline in the profitability of exporting.

But all these are difficulties and problems which cannot be avoided - at least not without incurring far greater problems. They are an inescapable consequence of a particular conjuncture: the world recession; the overdue welcome restructuring of much of British industry, not by the Government but by industry itself; the emergence of North Sea oil as a major factor in the British economic scene; and the inevitable withdrawal symptoms as the inflationary drug is gradually drained out of the system.

It is perhaps unfortunate that all these things should have come together at the same time. But to have abandoned the fight against

inflation on the grounds that the world recession and the transformation of sterling into a petro-currency provided sufficient adjustment problems for the here and now would have been a dereliction of duty which we had no intention of committing - nor, indeed, would we have been praised for committing it. For the British people, and British industry, have the resilience to weather the present difficulties and to survive, strengthened, to inherit the better future that lies ahead.

By contrast, to abandon present policies would be to sacrifice that future and to unleash even worse inflationary forces than those which we are now well on the way to overcoming. That we will not do.

I began this talk by indicating some of the important differences between the economic policy of the Thatcher Government and that of its predecessors, of both political parties.

But perhaps the most important difference is one that owes little or nothing to economic theory. It is this. The British people, and British industry, now know that they have a Government that means what it says. A Government that, instead of staggering from one short-term expedient to the next under the pressure of events, the whole adding up to a drearily familiar cycle of which ever-increasing inflation was the inevitable outcome, has set itself on a firm course, lasting the lifetime of a Parliament, with known rules, and under which it is known in particular that inflationary impulses, whatever their origin , will not be accommodated.

It is this that has led to the new climate of realism, the breath of fresh air that is blowing through British industry to-day. The water may be choppy, but we are still on course, and intend to remain so.