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The Government's Economic Strategy

A few days ago the House of Commons debated a motion of no confidence the Government's economic policy. I am glad to say that the motion was defeated - otherwise I suspect I should not have been here to-day. This satisfactory result apart, the debate was the occasion for the unveiling of a further batch of Government measures designed to alleviate the problem of youth unemployment, including a pioneering scheme to assist the young to price themselves into jobs on a permanent basis.

It was also the occasion for a notable speech from the backbenches by Mr Joel Barnett, who held the post of Chief Secretary to the Treasury throughout the lifetime of the last Labour Government. The essence of his speech is contained in the following extract:

> "All Governments, including the Labour Government for whom I share some responsibility, deserve censure not for the reasons that many of my right Hon and Hon friends suggest ...but for implying that a change of this or that policy will provide more growth and higher living standards. Increased public expenditure, including increases in benefits for all and sundry, leads to enormous disappointment. [We are all guilty of leading people to believe that. Indeed, such a policy could lead to the sort of explosions that we have seen all over the country.] It is the disappointment of expectations for which all of us bear responsibility."

The economic strategy of the present Government is essentially based on similar perception: a recognition of the fact that the policies of the past have proved increasingly disappointing in practice, an analysis of just why it is, that performance has fallen so far short of expectation, and a determination to learn from this chastening experience.

It is fashionable to suppose that the reason for the dangerous gulf between economic expectation and reality, between promise and performance, is the practice of cynical politicians of irresponsibly bidding for popular support in the electoral auction. But this can scarcely be the whole truth. There has been a whole breed of commentators of one kind and another who have never dreamed of running for elec~~toral~~ive office, yet who have been equally culpable in this regard.

HE REIGNING ERROR

We have to look deeper than this. And when we do, we discover at the bottom of it all a reigning intellectual error which has dominated the thinking of a generation, which has done grave damage to our nation as a result - damage from which we are still suffering - and from which it is essential that we emancipate ourselves.

That error is simple but fundamental. After the war, the overriding determination, so far as economic policy was concerned, was to avoid a repetition of the 'thirties. And the great depression had been caused, it was held, by a deficiency of aggregate demand. The task of Government, therefore, was to ensure that demand was maintained. And whenever unemployment rose, it was clear that measures to increase demand were indicated. What, then, was the error?

The error was a simple confusion between nominal or money demand and real demand.

The levers at the disposal of successive Chancellors of the Exchequer - both those labelled 'fiscal policy' and those labelled 'monetary policy' were of necessity all about money. Certainly, they enabled any Chancellor to fine-tune nominal demand to his heart's delight. But it wasn't nominal demand that Governments were interested in. What they were rightly concerned about was output and employment. But this depended not on nominal demand, but on real demand - and on real supply, too. And the money levers successive Chancellor were pulling away at seemed to have less and less connection with the real variables they were seeking to influence, until it became doubtful whether there was any long-term connection whatever.

Thus in the 'sixties Britain's gross national product roughly doubled in money terms. Roughly a third of this represented higher real output, and the other two-thirds reflected higher prices. This may not have seemed a particularly impressive performance at the time, and indeed by the contemporary standard of our overseas competitors it wasn't.

But it does give a stark perspective to our experience during th 'seventies. In that decade nominal GDP more than quadrupled. But of that massive increase, only 5 per cent represented an incr in real output: the other 95 per cent reflected higher prices.

In other words, the increase in nominal or money demand, which successive Governments were so assiduously boosting, was causing not real growth but inflation.

Looked at dispassionately, this discovery is scarcely surprising. It is not, after all, all that astonishing that monetary causes have monetary consequences, and that the main effect of ever larger injections of money is primarily to reduce the value of money itself. Nor is it surprising that real changes, above all the improvement in our industrial performance as a nation on which any improvement in our living standards crucially depends, cannot be secured by pumping ever more money into the economy, in whatever shape or form or direction. But in the context of the intellectual climate of our time, it is little short of revolutionary.

And it is this fundamental truth that lies at the heart of our economic strategy.

TWO-PRONGED APPROACH

Thus it is that the Government's strategy is not about setting the instruments of demand management and the exchange rate to levels that will supposedly restore the economy to full employment but which will in practice only embed inflation deeper into our lives. Rather, it is concerned with creating an economic climate that encourages workers and managements to take the decisions, and make the changes, that are necessary if that goal is to be achieved.

And that is why, as has been emphasised ever since it was first launched, there are two sides to the strategy. The first is the commitment to secure a progressive reduction over the medium-term in the growth of money supply and money income as the means of securing a permanent reduction in inflation. The second, and the one that gets fewer headlines, is the whole array of specific measures taken to improve the supply side of the economy by encouraging competition, efficiency and enterprise.

These two sides of the strategy are complementary. The reductio of monetary growth and inflation is a pre-condition for sustaine growth of output and employment. High inflation is a social evi in its own right, and should be removed for that reason alone. But in addition, by creating uncertainties and involving high nominal rate of interest it discourages investment and initiativ and distorts the workings of the price mechanism in allocating the economy's resources in the most efficient way. It is thus a major impediment to the improvement in our industrial performa that is so essential.

HE MEDIUM TERM
INANCIAL
TRATEGY

The monetary framework set out in the medium-term strategy is a commitment to pursue the reduction in the growth of the money supply and money income that is essential to bringing down inflation. The aim is gradually to reduce the growth of total money expenditure in the economy - in effect to set a sort of cash limit for the whole economy. At the same time, the Governm is committed to pursuing the fiscal policies that are consistent with that monetary objective. It is not our intention simply to rely on high interest rates to curb monetary growth.

This policy has involved some harsh decisions, not least on taxe As this year's Budget showed, we have not shrunk from this. And since then it has become increasingly clear that the Budget judgement was right. Short-term interest rates in the United States are now at 20 per cent compared with $13\frac{1}{2}$ per cent in this country. Indeed ours are to-day among the lowest in the world.

Other countries, from Ireland the Federal Republic or Germany, have since followed suit, and are seeking to reduce their Budget deficits too. Everyone now recognises that a tight fiscal policy is the only way of avoiding being forced to follow American interest rates to an uncomfortable extent. And the United States government itself has declared its intention of reducing its Budget deficit so as to assist it in bringing its own interest rates down.

No country can insulate itself from the need to fight inflation. The only practical choice is the mix of fiscal and monetary instruments you use: the balance between taxing (given a particular quantum of public expenditure) and genuine borrowing.

Moreover, by demonstrating the strength of our commitment to the strategy on which we have embarked, we are helping to change the whole climate of expectations in which pay and price fixing takes place. For more than a generation pay bargainers have been able to conduct their negotiations on the comfortable assumption that the government of the day would in the end print the money to validate whatever increase in pay emerged. The present Government's medium-term financial strategy served notice that this was no longer the case.

The speed with which inflationary expectations are adjusted downwards will determine in large part what growth of output can be accommodated within the overall limit set by the growth of money income. The less that is taken out in inflation, the more can be taken out in real output and employment. The financial strategy thus poses in a stark way the reality that has been evaded, with such disastrous consequences, for so long: the fact that excessive pay increases mean fewer jobs.

This message is already widely understood throughout the private sector of the economy. The urgent need is to find some effective way of bringing similar disciplines to bear on the public sector. Cash limits and external financing limits have a crucial part to play here, and it is in the interest neither of the economy in general nor of the private sector in particular that we should down-grade them.

In that part of the public sector for which central Government is directly responsible, and over which it has complete control, significant progress has already been made. This is illustrated for example, by the fact that the size of the civil service is not merely a good deal smaller than when we took office: it is now down to the lowest level it has been since 1969.

But greater problems remain so far as the nationalised industries and local government are concerned.

Nevertheless, despite all the difficulties, the past year has seen the rate of inflation very nearly halved, and the lower it goes the less restrictive the Government's monetary guidelines become. But an increase in real demand, brought about by a reduction in the share of the national cash limit appropriated by rising prices, is not enough in itself to raise the level of economic activity, unless British industry can meet that demand at competitive prices. That is why the other half of the Government's strategy is an attempt to improve the supply side of the economy by encouraging efficiency and competition.

So far the spur to greater efficiency has been provided chiefly by the rigours of the overall financial and economic climate, which have compelled firms to tackle the problems of overmanning and inefficient work practices that lie at the root of low productivity. As a lengthy report on the state of British industry, which appeared in the Financial Times a few days ago, put it: "Almost every company in manufacturing industry has a story to tell of increased efficiencies, often far exceeding anything it would have thought possible even a year ago." It is encouraging, too, that a growing number of companies are taking this opportunity to institute genuine forms of employee-involvement.

The quiet revolution that is now occurring throughout British industry is an event of the most momentous importance. It is the foundation on which our future prosperity as a nation will be built, and without which we would have been doomed to continued decline. The tragedy is that the restructuring that is now taking place was put off for so long, with the result that the shedding of labour has had to be all the greater - and has had to take place, moreover, at a time of world recession. That, alas is the price we have all had to pay for the errors an follies of the past.

PPLY SIDE
SURES

But more positively, the strategy also provides incentives to greater efficiency by removing restrictions and opening up new opportunities. This side of the strategy is inevitably more diffused than the monetary side. It operates not so much at the macro level as at the micro level, in the individual firm and industry. And it operates basically by improving a extending the market mechanism.

We took several major steps in this direction in our first months of office. All price controls, dividend controls, an exchange controls were abolished. Marginal rates of tax wer cut substantially. In the housing market, legislation was introduced to make council houses available for sale, so mak a start on removing one of the main barriers to labour mobility. Capital taxation has been recast so as to bear less onerously on family businesses and more recently the Government has introduced several measures to encourage ente

The establishment of enterprise zones is one of these; another is the new business start-up scheme, under which investors will be able to obtain relief against income tax on up to £10,000 invested in new businesses. Yet another is the loan guarantee scheme, which has already attracted an encouraging response from go-ahead small firms. The beneficial results of measures of this sort are not likely to be seen quickly. They will come about only over time as people and businesses respond to their new opportunities.

The list of such measures - and I have by no means given it on full - is a substantial one, but there is still much to be done. If we are to create a dynamic, market-oriented conomy, responsive to changing needs and opportunities, we must reduce the size of the public sector through progressive privatisation and break down monopoly power in the labour market. We must do all that we can to ensure that our labour laws are not a hindrance to growth and employment or for that matter an unjustified infringement of individual liberty.

More immediately, the Government for its part is once again critically examining the total of its own expenditure in order to ensure that the burden imposed on the private sector in terms of taxes, local government rates and interest rates is kept to a minimum.

E PSBR AND £M3

Of course, it is one thing to enunciate an economic strategy: another thing to carry it out in practice. In a speech I made in Zurich six months ago I concluded that we needed to improve our control in two key areas - first public expenditure and the PSBR, and second our ability to finance that PSBR by satisfactory funding techniques.

A great deal has happened in the intervening months. There has been the Budget, to which I have already referred, which was framed to produce a PSBR for the current year of some £10½ billion, or 4¼% of GDP compared with 6% in 1980-81. The Civil Service strike, which I very much hope will soon come to an end, has temporarily reduced the flow of revenue into the Exchequer, and caused us to incur an additional debt interest cost as a result. But even allowing for this our best judgment at the present time, peering through the statistical fog as best we can, is that there is no reason to expect a PSBR overshoot this year.

We have also been able, despite the strike, and despite holding interest rates steady against the upward trend in the world as a whole, to pursue a successful funding policy and thus contain the growth of £M3. It is true that recorded growth has been running at a little over 14 per cent at an annual rate. But after adjusting for the temporary effects of the strike, we are confident that the underlying rate of growth is within the target range of 6% to 10%. This has been achieved by a substantial increase in the flexibility of our overall fun ding operations.

W MOVES IN
TIONAL SAVINGS

As well as a number of smaller innovations in the gilt-edged market, there have been two major changes: a substantially increased emphasis on National Savings, and the introduction of indexed gilts.

So far as National Savings are concerned, we began to take major initiatives in this field in 1980-81, and comfortably met our target of £2 billion of net inflows for that year, chiefly through the maintenance of competitve rates on the National Savings Bank Investment Account - Invac - and through the introduction last September of the second index-linked issue of Savings Certificates, the so-called granny bond, available to all those aged 60 and over..

In the this year's Budget we reduced the qualifying age for the index-linked certificate to 50 and confirmed a 1981-82 National Savings target of £3 billion of net inflows I can today announce that, from 7th September, the index-linked Savings Certificate will be available to everyone, irrespective of their age. The familiar nickname of 'granny bond' can now be decently laid to rest. We will have in its place an inflation-proof bond for every member of the family - the people's bond, if you like. At the same time, we are increasing this year's overall National Savings target from £3 billion to £3½ billion.

The great advantage of funding in this way is, of course, that it reduces the extent of our reliance on the gilt-edged market, and hence eases the pressure on long-term interest rates. It also takes account of where the increase in the nation's savings is actually occurring. Last year, 1980-81 saw a substantial improvement in the financial position of the personal sector, in contrast to the corporate sector, and in particulai a sharp increase in the level of discretionary personal saving. Hence we have been able to attract inflows into National Savings on an unprecedented scale without imposing an excessive squeeze on the building societies, which have still generally been able to meet the demand for mortgages.

But I see this increased prominence we have given to National Savings not as some short-term phenomenon but as a long-term shift of policy. For some years, until the advent of the present Government, the National Savings presence in the savi market had been allowed steadily to decline: indeed it was coming to be looked on almost as quaint relic of the past. We have now, in relative terms, restored the flow to its former levels, before the decline occurred, and we intend to keep it there.

SUCCESS OF
NDEXED GILTS

The second major new development has been the launch of indexed gilts, with both interest payments and capital repayments linked to rises in the RPI, first announced in the Budget. This was described in the Financial Times as far and away the most important measure in the Budget. I am not sure I would necessarily go that far. But the implications of government borrowing of this kind are indeed far reaching.

There are two major arguments for indexed gilts which I would like briefly to rehearse. The first is about risk, and the cost of funding. With conventional gilts substantial risks are run by both investors and the Exchequer, owing to uncertainty about future rates of inflation. An indexed gilt eliminates these risks. Investors can be expected to accept a lower real rate of interest in return for insurance against inflation. And this in turn can be expected, over time, to reduce the real cost of servicing government debt.

The other key argument brings us back to control over the money supply. The possession of a new debt instrument of this kind, sold by a new method, namely auction, gives the Bank of England considerable added flexibility in its funding operations, which enables it to match more closely the needs of investors. Indexed gilts should be saleable at times of uncertainty in the capital market without the need to raise nominal interest rates.

The second indexed gilt issue three weeks ago proves this point. The market was in a highly uncertain condition. The prospects for domestic and US interest rates were cloudy. Market sentiment on gilts was bearish. The huge BP rights issue overhung the market. In the normal way we would have been unable to sell stock, even at the unacceptably high 15½% which long rates had then reached. The consequent funding pause would have led to an increase in £M3 growth, which in turn would have tended to generate more uncertainty about inflation.

Yet in these circumstances we were able to sell £1 billion of indexed gilts. The yield, at around 2.8% real, was, I agree, higher than that for the first issue. But one might expect the first tranche of such a stock to attract a novelty or scarcity premium. And 2.8% real seems modes[t] when compared to rates on offer elsewhere, particularly in New York. Far from casting doubt on the principle of indexed debt I regard this episode as proof of its usefulness as a funding tool.

I accept, however, that commentators ~~now~~ who have drawn atten[tion] to the eligibility restrictions on indexed gilts - at pres[ent] only pension funds and life offices may hold it - as a factor contributing to the issue's initial under-subscription, have a point. This is a complex issue, particularly so far as tax treatment is concerned, but it is something we may need to look at again.

The indexed gilt is undoubtedly a major new departure whic[h] dwarfs other changes in the market. But we have also intr[od]uced innovations in the marketing of conventional stocks. Ther[e] was a very successful convertible issue in January. And [on] two occasions now we have used the technique of smaller tr[an]ches of existing stocks, or 'tranchettes', rather than overwhel[ming] the market with a large tap.

[IM]PROVING MONETARY [CO]NTROL

Finally, it may help to complete the picture of our evolv[ing] monetar[y] control techniques if I briefly describe the kind of changes we are in the process of making at the short end of the yield curve, as it were. In his Budget speech the Chancellor explained that we would be making changes in o[ur] dealings with the money markets, and in the determination of short-term interest rates, changes which consultations on the Green Paper on monetary control had shown to be desirable and useful.

The principal objective of the new system, which will come into operation later in the summer, is to allow the market a greater role in the determination of the structure of short-term interest rates. What this means in practice is that in its day-to-day operations with the discount market the Bank will not announce in advance the rates at which it proposes to deal, but will respond to offers of bills from the discount houses.

This means, of course, that the existing MLR will lose its operational significance - indeed it has already to a large extent done so - and, as the Chancellor said, before very long it may be suspended altogether. As this new system is introduced we shall make a number of consequential changes to liquidity requirements on banks, designed principally to ensure that the bill market is sufficiently wide and deep for the Bank's dealings.

It would not be useful to detail the way in which the new arrangements will operate from day to day. Suffice it to say that it is our hope that by involving the market more closely in the determination of interest rates we will improve our ability to respond quickly, flexibly and appropriately to changing monetary conditions.

HE PROSPECT
EFORE US

But let me return to the overall picture.

The past ~~two~~ three years have been a time of immense difficulty for the British economy. Our industry has been obliged to contend with conditions of unprecedented severity, at least by post-war standards, and unemployment has risen sharply.

It is small consolation that this is a world-wide phenomenon. It is little comfort that the reason why the world recession has affected us more severely than most other countries is to be found in accumulation of our past economic weaknesses in terms of relative inflation, efficiency, and industrial relations. But both these propositions are true.

[Meanwhile, there is mounting evidence that we have reached the trough of the recession. Industrial and manufacturing output has stabilised since the turn of the year; and even on the employment front, while the number out of work is still rising, it is notable that the underlying monthly increase has been falling steadily for the past eight months: indeed, this month's increase was the smallest since the end of 1979.

As for the long-awaited upturn, it is now clear that world events, including the vigour and nature of the new US administration's courageous attack on American inflation, point to a rather slower recovery from the world recession than was earlier foreseen, and this inevitably affects us in Britain along with the rest of the world.

But come the upturn will; as the world recovery takes shape, as our own de-stocking phase draws to a close, and not least as industrial profitability is restored through the cost-cutting that has already occurred, thus enabling new projects and new investment to yield an adequate return. But the strength of that upturn will depend crucially on how quickly inflation is brought down within the overall monetary constraint.

It is tempting to believe that there is some easy way out, some more comfortable alternative.

It is tempting to believe that we can do without financial discipline altogether, and that the laws of arithmetic can be repealed.

It is particularly tempting to dress up as economic wisdom the politically expedient and electorally convenient. But it was yielding to just this temptation, the illusion that we could escape from the discipline of a fixed exchange rate and put no new financial discipline in its place, the elevation of wishful thinking into an economic doctrine by invoking the magic name of Keynes, which got us where we are now.

It is a thousand pities that government and industry have had to tackle the chronic problems of over-manning and inefficiency in the midst of a recession. It would have been so much easier in an expanding economy to re-employ the labour released. But the unhappy fact is that in the years of expansion there was no pressure to tackle these problems.

Short-term considerations predominated; sleeping dogs were let lie; if a decision was called for, the easy option was invariably chosen.

In one sense we are always in the short term. In another we are always in yesterday's medium-term and suffering the consequences of the mistakes and [delays] made then. It was all very well for Keynes to say that in the long run we are dead. As a former US Treasury Sec? pointed out a few years ago, now Keynes is dead and we are living in the long run. The Government's strategy is and of necessity for the medium-term. It has ~~involved~~ involved hard decisions in the ~~present~~ short term. Maybe (this year, for instance, as) ~~1981 would~~ have been more comfortable without it. But what then? The aims of our strategy are to bring about a permanent reduction in inflation and more efficient, competitive and healthy economy (— and that we are well on the way to economic recovery). The achievement of these objectives is essential if we are to make our way in the world. We have taken what seemed the easy way out in the past, and the consequences are there for all to see. This time we must bring about the changes in attitudes and institutions that are essential if we are to achieve the healthy economy and higher living standards that we all seek.

Beneath the surface of the monthly statistics and the suffering our industry has been through, we have made great and hard-won gains over these past [three] years, gains of an absolutely fundamental nature which hitherto eluded us. It would be the height of folly to throw those gains away. This Government is determined not to do so; rather to build on them in the years that lie ahead.