Briefing Note

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ECONOMIC POLICY IN THE INDUSTRIAL COUNTRIES

The Government's critics frequently allege that its economic policy is (a) uniquely restrictive and eccentric in its desire to defeat inflation, and (b) directly responsible for the recent decline in output and employment. These facile allegations are contradicted by the facts.

Monetary targets for the UK economy were first set by Labour

* Following the breakdown in 1972 of the system of fixed exchange rates, and the inflationary boost to the industrial economies from the 1973 oil crisis, governments worldwide came to recognise the need for internal control to protect their currencies.

* Britain under Labour learned the lesson slowly and painfully. In 'Towards Full Employment and Price Stability' (1977), the OECD commented that "because of the circumstances in which it came to power ... the (Labour) Government was in no position to make a serious attempt to control inflation until much later than most other OECD countries ... The peak of the inflation rate therefore did not come until mid-1975" (when it approached 30 per cent).

* Rapid inflation precipitated a financial crisis in 1976. Labour was forced to accept IMF credit and conditions which included monetary and fiscal restraint. Labour's Chancellor, Mr. Denis Healey, told the left-wing critics within his Party, "The fact is that no one wants to lend us money. We have to negotiate; we have to accept the facts of arithmetic ..." (Daily Telegraph, 20th October 1976).

* Public sector spending and borrowing were cut and explicit targets were set for the money supply for the first time (December 1976).

* Inflation was brought under control, and Mr. Healey became a confirmed monetarist. He told the House of Commons, "Because we are observing strict monetary and fiscal policies, if wage increases continue at the sort of level at which they have been running (i.e. 17 per cent per annum in January 1979) ... the result will be seen in rising prices, fewer jobs, lower output and more bankruptcies" (Hansard, 16th January 1979, Col. 1628).

* But election loomed and attempts at imposing wage restraint via the social contract failed. Mr. Healey traded relaxation of his 'strict' policies for short-term gains on unemployment, and inflation was once again on a sharply rising trend when the present Government took office.

Following the 1979 oil crisis, monetary policy was tightened in almost every OECD country because the danger of inflation was more widely appreciated. As a result, the boost to inflation was much less than it had been after the 1973 oil crisis. And this time, Britain was not among the last nations to respond. Our rate of inflation is now around the EEC average.

Money supply and government deficit in France were set to expand in 1981, following the election of the new Socialist government. This led to the prospect of accelerating inflation, and made inevitable the recent devaluation of the franc. That had to be supported by corrective action to bring the money supply under control and by substantial cuts in public expenditure.

Most OECD countries are reducing public spending and borrowing in order to bring down interest rates. The total public sector deficit of the OECD countries is twice as high as a proportion of GDP as in 1973. This massive increase in the demand for loans has forced up interest rates worldwide. Almost every OECD country is taking steps to reverse this trend. The US, Japan, Germany, the Netherlands, Australia, Italy, Sweden and Ireland have all announced intentions to cut planned public spending; some have also increased taxation. The Canadian Budget will almost certainly reduce the Government's deficit.

Tighter fiscal policy has meant painful decisions for most governments. The US plans to reduce nominal spending on education, training, social services, health and medicaid; and recent reports indicate that some tax increases are being considered, despite the administration's strong commitments to the contrary. In Holland, a variety of social security benefits, including sickness benefit and eligibility for unemployment benefit, have been cut, as has Child Benefit in Germany. Planned growth in welfare spending has been cut in Belgium, Denmark, Sweden and Germany. In Ireland, public sector wages have been frozen; and France has recently announced the deferral of £1½ billion capital investment.

The firm stand on fiscal policy taken in the UK in the 1981 Budget was very successful in bringing interest rates here down below those in almost all other OECD countries for much of 1981. The recent increase in US interest rates and to a lesser extent the rapid increase in bank lending, has brought UK rates more into line with those abroad. The Government is determined not to add unduly to these pressures by excessive public sector borrowing.

Output and Unemployment. Following the 1979 oil crisis, growth in output has slackened and unemployment has risen in almost all the major OECD countries. The young have been particularly hard-hit - youth unemployment is running at at least twice the adult rate in the OECD as a whole.

The UK (along with Belgium and the US) suffered rapidly accelerating unemployment until mid-1981, which Sir Geoffrey Howe has attributed to "past follies, and the ingrained habits which those follies helped to create" (Financial Times, 4th January 1982). Prominent among these was the failure of wage settlements to adjust rapidly enough to falling output and rising unemployment. In the OECD as a whole, real earnings rose by 0.5 per cent in 1980 and about 1 per cent in 1981. Comparable UK figures are much higher - 5 per cent and 3 per cent respectively. This led to a dramatic fall in competitiveness, output and jobs. It is noteworthy that in Japan, where unit labour costs have risen only half as fast as in other OECD countries, employment has been rising.

Future prospects in the UK. The world economy is emerging only slowly from recession, hindered by high interest rates. Yet there are good omens too. Commodity prices seem to be easing, and inflation in OECD countries is being brought under control.

At home, moderating pay settlements and dramatically improving productivity (associated mostly with a reduction in chronic overmanning) produced a real and worthwhile upturn in the economy in the second half of last year. Unemployment is now rising more slowly than in other OECD countries; short time working is falling and overtime and job vacancies are rising. Most significantly, profit margins, which fell to disastrously low levels as wages surged ahead throughout the 1970s, are now beginning to rise. Sir Geoffrey Howe singled this out "as the most encouraging development of all, for better profits are the precondition for renewed investment and secure jobs in the future" (Ibid.).

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