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### THE FIFTH MAIS LECTURE

"THE BRITISH EXPERIMENT"

by

The Rt Hon Nigel Lawson MP  
Chancellor of the Exchequer

Delivered at the City University Business School,  
Centre for Banking and International Finance at  
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I am deeply honoured to have been invited to deliver this year's Mais lecture.

As a City institution, the Mais lecture is still in its infancy; but it is an unusually precocious infant, having already fully realised the hopes of those who fathered it.

#### CONTINUITY OF POLICY

I am not, of course, the first Chancellor of the Exchequer to have been thus honoured.

My distinguished predecessor, Geoffrey Howe, was the author of the 1981 Mais lecture.

"I have chosen as my title The Fight Against Inflation", he began, speaking at a time when inflation in this country was still in double figures.

He went on to explain:

"This is not because inflation is the only aspect of the economy on which Government should have a policy, or indeed because the conquest of inflation is our only goal. The ultimate goal must be to restore the British economy to growth and prosperity:

defeating inflation is one crucial condition for that. The other is by improving the performance of the economy, by making it more flexible and adaptable in its response to technological change and developments in market conditions. Both tasks are vital. But while the conquest of inflation may not be a sufficient condition for sustainable economic growth, it is, we believe, a necessary condition."

Re-reading this explanation, it is hard not to be struck by three things.

The first is that, during the intervening years, the policy approach embraced there has been unequivocally vindicated by events.

Inflation has been reduced to 5 per cent - the lowest level since the 1960s - and we are now embarking on the fourth year of a sustained economic recovery which has already seen the nation's output surpass the pre-recession peak.

The second is that, not surprisingly, given the vindication of events, the approach to economic policy set out by Geoffrey Howe in the 1981 Mais lecture remains an accurate description of the policy we are pursuing today.

But third, and rather more surprisingly, given the continuity of policy and its undoubted achievements, there exists in many quarters a curious confusion about the thrust of Government policy at the present time.

Has the emphasis of policy changed from the defeat of inflation to the promotion of growth and employment? And even if it hasn't, given the present low level of inflation and high level of unemployment, isn't it high time it did?

It is important to dispel that confusion, for it rests upon a fundamental fallacy.

It is of course true that this Government has attached, and continues to attach, greater importance to the conquest of inflation than did most if not all of its post-War predecessors.

But the idea that this and this alone is what distinguishes us is to misunderstand the fundamental nature of the new approach to economic policy that was inaugurated in 1979 and has been pursued ever since.

Every Government is concerned about inflation, just as every Government is concerned about prosperity and unemployment.

The question is, what is the cause of inflation and its cure, and what is the cause of unemployment and its cure.

## THE ROLES OF MACRO AND MICRO POLICY

The conventional post-War wisdom was that unemployment was a consequence of inadequate economic growth, and economic growth was to be secured by macro-economic policy - the fiscal stimulus of an enlarged Budget deficit, with monetary policy (to the extent that it could be said to exist at all) on the whole passively following fiscal policy.

Inflation, by contrast, was increasingly seen as a matter to be dealt with by micro-economic policy - the panoply of controls and subsidies associated with the era of incomes policy

The conclusion on which the present Government's economic policy is based is that there is indeed a proper distinction between the objectives of macro-economic and micro-economic policy, and a need to be concerned with both of them.

But the proper role of each is precisely the opposite of that assigned to it by the conventional post-War wisdom.

It is the conquest of inflation, and not the pursuit of growth and employment, which is or should be the objective of macro-economic policy.

And it is the creation of conditions conducive to growth and employment, and not the suppression of price rises, which is or should be the objective of micro-economic policy.

Needless to say, this fundamentally important role reversal implies a major change in the nature of the macro and micro policies themselves.

Instead of monetary policy simply accommodating increased budget deficits (except when periodic sterling crises brought the process to a temporary halt), fiscal policy has to be in harmony with declining monetary growth.

And instead of micro-economic policy consisting of increasingly numerous forms of intervention and interference with market forces, its role is now seen as removing controls and allowing markets to work better.

But at this stage the most important point to emphasise is that this Government is pursuing simultaneously both a macro and a micro policy, that the one complements the other, that the macro policy is unequivocally directed at the continuing reduction in inflation with the ultimate objective of stable prices, and that the micro policy is equally wholeheartedly designed to make the economy work better and thus generate more jobs.

Thus the whole argument as to whether the emphasis of policy has or ought to have switched from the defeat of inflation to the promotion of growth and employment can be seen to rest on a simple fallacy.



## THE UNITED STATES CONUNDRUM

The recent performance of the US economy has greatly added to popular confusion over the role and capability of macro and micro policy. Like ourselves, the United States has been pursuing a rigorously anti-inflationary monetary policy.

Unlike us, she has pursued a lax fiscal policy leading to a greatly increased budget deficit.

Yet while the United States has enjoyed the same success as we have in getting inflation down, she has a very much better record than ours over employment.

This has led a number of observers to conclude that it is the American budget deficit that is the cause of her markedly better employment performance.

Not so.

There is indeed an important lesson to be learned from the US experience, but it is not that.

For one thing, the American option, which rests on the unique position of the dollar as the world's reserve currency, is not open to any other country.

Indeed, how long it is open to the United States, as her consequential current account balance of payments deficit climbs into the stratosphere, is a question that has yet to be answered - and in the meantime the high level of nominal employment

and real US interest rates imposes uncomfortable strains on the debtor nations and, largely through them, on the world's banks.

But the key point in this context is that the superior US employment record goes back well before the relatively recent increase in her budget deficit.

Over the past fifteen years, the average annual level of unemployment on Western Europe has declined only once - in 1973.

Over the same period in the United States, unemployment has declined in almost as many years as it has increased.

Over the past ten years, the total number of people in work in Western Europe has fallen.

In the United States over the same period, the number of people in work has risen by over 15 million.

This sharp contrast has not been the product of macro policy. It has been almost entirely due to the more efficient, competitive, innovative and adaptive labour and goods markets in the United States.

Over the past 10 years, the workers of Western Europe have seen their real earnings rise by around an eighth; over the same period, their American counterparts have been prepared to accept a small reduction in real earnings.

Relatively free markets, the spirit of enterprise, and workers who prefer to price themselves into jobs rather than out of them, are a powerful engine of employment.

There is indeed an important lesson to be learned from the American experience, but it has nothing to do with the deficit.

## THE MEDIUM TERM FRAMEWORK

I have identified one major and fundamental innovation of policy as the dedication of macro-economic policy to the conquest of inflation, and micro-economic policy to the conquest of unemployment.

Another has been the setting of policy firmly within a medium-term framework - and sticking to it.

I well remember the mood of 1979, shortly after we had been elected for the first time, when the argument among the commentators was whether the U-turn would come in a year's time - or in six months.

So far as I can recall, the 'smart' money was on six months.

Things have changed since then; and a major part in securing that change has been the Medium Term Financial Strategy, the cornerstone of the Government's macro-economic policy.

Not the least of the virtues of the MTFS has been the discipline it has imposed on Government itself.

But a medium term approach has also been a vital part of conditioning expectations so that the private sector could see the degree of adjustment necessary and the overall approach that the Government would take - in other words the "rules of the game".

In a market economy the private sector is bound to take into account its expectations of the behaviour of the Government when deciding its own behaviour.

This goes for companies and employees alike.

When macro-economic policy was directed to maintaining (or attempting to maintain) desired levels of real demand and was prepared to accommodate whatever inflationary pressure arose along the way, this was soon appreciated by those involved in decisions about output, prices and pay.

Now that the approach to policy has changed it has been essential to set out clearly and for some years ahead the framework the Government would pursue.

It has been an explicit aspect of policy that it would not accommodate inflationary pressure.

In effect, the MTFS has set out a nominal framework designed gradually to reduce the growth of money GDP and improve the division of that growth between real output growth and inflation.

It was clear that unless and until the private sector believed that the Government meant what it said, inflation would be slow to come down and the transitional impact on output prolonged.

An explicit medium term approach has been a necessary part of earning that credibility.

Of course statements of intent are not sufficient. Credibility has to be earned, and when the private sector attempted to test the determination of Government in the early stages with wage and price pressure during 1979 and 1980 it was essential to maintain the framework of policy, come what may.

That credibility now exists, and serves to buttress the medium term strategy as a clear guide to the intentions of Government.

## MONETARY POLICY

Although changes in particular targets and assumptions have been made, the essential point is that the policy recognises the fact - and it is a fact - that inflation is above all a monetary phenomenon, in anything other than the short run.

You cannot have sustained inflation unless Governments pursue financial policies that accommodate higher inflation. One of our central aims has been to maintain monetary conditions that are consistent with steadily reducing inflation.

And intermediate targets have an essential part to play.

It is not enough for the Government simply to say that it is going to reduce inflation.

That could just as well have meant further controls, offering at best temporary success.

It was vital to demonstrate the Government's long term commitment to appropriate monetary policies.

I do not pretend that operating monetary targets has been easy at a time of rapid financial innovation - here as in the United States.

Monetary developments have required, and will continue to require intelligent interpretation and the exercise of appropriate discretion.

But intermediate targets will continue to play a vital part in the Government's macro-economic strategy.

#### .... AND ITS EVOLUTION

Largely for reasons of continuity and simplicity, monetary policy was framed initially in terms of Sterling M3, although it was explicitly recognised from the start that other aggregates contained useful information and would have to be monitored.

In the early stages of the MTFS the meaning of the Sterling M3 figures was severely distorted by the ending of foreign exchange controls and the abolition - which might usefully have occurred rather sooner - of the corset. These changes were important and necessary in their own right on micro-economic policy grounds, but they undoubtedly made it more difficult to interpret developments during the summer of 1980.

It was clearly important to assess the performance of £M3 in the light of the behaviour of other measures of money, and of other indicators of financial conditions, such as asset prices and the exchange rate.



Over the period as a whole, by maintaining appropriate monetary conditions, and exercising judgement in the assessment of these conditions, the rate of growth of money GDP has been brought down from about 15 per cent in 1978-79 to about 8 per cent last year.

This is broadly the pattern that was envisaged when the MTFS was first launched.

Monetary policy has led neither to overkill nor to the accommodation of inflation.

## INFLATION AND UNEMPLOYMENT

It is, incidentally, sometimes argued that the reduction of inflation has been brought about not by the Government's monetary policy but by 3 million unemployed.

The implication is that high unemployment has reduced wage demands which in turn has reduced inflation.

This view derives from the widespread error of seeing inflation in terms of a simple cost mark-up framework.

In fact, a look at the pattern of wage and price increases makes it clear that wages did not lead the disinflationary process.

If anything they followed.

The reduction of inflation originated in the goods market - as evidenced by the initial decline of profit margins - and only gradually permeated through to wage settlements.

Indeed it was the slowness of wages to adjust that was such an important factor in the rise of unemployment.

So far from high unemployment being the cause of lower earnings and thus lower inflation, it was the failure of wages to adjust at a time of falling inflation that was responsible for much of the increased unemployment, from which we continue to suffer.

## FISCAL POLICY

The other crucial dimension of the MTFs has been the approach to fiscal policy and the budget judgement.

Successive versions of the MTFs have set out a framework within which monetary growth could be brought down without - in the words of the original 1980 MTFs - "excessive reliance on interest rates".

Each version of the MTFs has included projections of a path for the PSBR which is considered to be consistent with the monetary objectives at acceptable interest rate levels.

The full consequences of having an excessive PSBR may take some time to come through.

While the outstanding stock of government debt relative to income would tend to grow at a faster rate than was consistent with the existing structure of interest rates, there is a seductive argument that quite large changes in the PSBR only influence the total outstanding stock of debt slowly and that a period of high borrowing may therefore not be too disruptive.

In practice, however, the long term consequences would tend to be foreseen by the financial markets, and the effects of interest rates brought forward as a result of changes in expectations.

Even more important, in practice, the markets might not believe that the Government was prepared to allow real interest rates to rise to the extent necessary to persuade people to accept a higher stock of government debt. They might instead expect increased monetisation of the deficit, with the result that inflationary expectations and nominal interest rates would tend to rise.

## BUDGET DEFICITS AND INTEREST RATES

Thus even relatively small changes in the PSBR path from that perceived to be consistent over a period of years with existing trends in wealth and portfolio shares could have major effects on interest rates, particularly long rates if they are expected to be other than temporary.

There has been a lot of ink spilled recently as some have tried to argue there is no relation between budget deficits and interest rates.

It is true that a simple-minded historical statistical comparison of interest rates and budget deficits proves little.

But this is because much of the variation in deficits has been cyclical - with high deficits at times of recession - and so has much of the short term variation of interest rates.

Over the cycle low interest rates and high deficits often go together in recessions - and vice versa in upturns. But that is most unlikely to be the pattern for successive years of structurally high deficits - then the tendency for high interest rates is likely to be dominant.

Developments in the relative behaviour of interest rates in the US and UK provide some evidence of the impact of a sustainable period of different deficit profiles.

In 1975-76 at the time of peak borrowing by the previous Government UK long term interest rates were 6 per cent higher than equivalent US rates.

In 1979 the gap was still 4 per cent.

Now the position has changed.

For the first time since the end of the last war UK long term interest rates are lower than US rates. And the gap has gradually widened so that now it is around 2 per cent.

## THE ROAD TO RECOVERY

Despite some initial difficulties, partly associated with the onset of the recession, the strategy of reducing the PSBR as a percentage of GDP has been successfully implemented.

The crucial decisions were taken in Geoffrey Howe's 1981 budget; substantial increases in tax revenue brought the deficit back onto a downward path.

It was a very unpopular set of measures, not least among the economics industry.

We now know that the bottom of the cycle occurred very shortly afterwards.

I do not want to push the suggestion of causality too far.

There had been signs in the forward indicators before the budget that the bottom of the cycle was imminent and that was the message in the Treasury forecast published the previous December.

But there is no evidence that the Budget of 1981 "deepened the recession" as 364 economists confidently predicted at the time.

Rather, it was a significant turning point both in terms of the public's acceptance of the determination of government policy, and in economic performance.

It is sometimes suggested that the turnaround was simply the natural stockbuilding cycle that was dampened by the budget action.

I would simply observe that there was not much being said at the time about stockbuilding cycles or imminent recovery - except by Treasury Ministers themselves.

In my speech to the IFS in March 1981 I answered the hypothetical question - more common then than now - "but where is the growth going to come from?" in these terms:



"The most obvious answer is that, just as the recession had as three important components a massive wave of destocking, a sharp increase in the savings ratio, and the world recession, so the recovery is likely to be assisted by a slowing down in the rate of destocking, as inventories approach the desired level, by a fall in the savings ratio, as inflation and inflationary expectations fall, and by some upturn in the world economy .....

## EXCHANGE RATE POLICY

A further frequent source of misunderstanding has concerned the Government's exchange rate policy.

Intervention has been restricted to occasions when there was a risk of disorderly markets.

Otherwise it is not clear that intervention serves much purpose unless it is unsterilised - in other words, it is allowed to affect monetary policy generally.

In this case it needs to be seen in the light of other aspects of monetary policy.

Exchange rate movements can be a useful guide to the tightness or looseness of monetary conditions, but this is by no means always the case.

It is important to ask why the exchange rate has been moving.

If it is a reflection of policies overseas the case for taking it into account is rather weaker than when it appears to reflect domestic monetary conditions.

Most current discussion of the exchange rate is in any case vitiated by the emphasis commonly laid upon the various measures of competitiveness, which gives the impression that a rise in the exchange rate and a rise in domestic costs relative to other countries come to much the same thing.

I doubt if this is ever the case; but, certainly, given a policy of controlling the money supply with the intention of controlling total nominal spending their effects are quite different.

Exchange rate appreciation may have adverse affects upon net exports but there is a beneficial impact on domestic spending from lower inflation.

The effects on GDP are therefore ambiguous.

With an increase in domestic prices and costs, however, this is not the case.

Net exports suffer but so does domestic spending as the higher costs and prices bump up against the monetary target.

(For precisely similar reasons, incidentally, exchange rate depreciation is simply a sub-optimal way of bringing about lower real wages.)

The plain fact is that the recession of 1980-81 owed much more to the unwarranted cost increases in 1979-80 than to the rise in the exchange rate.

Implicitly many critics argue that exchange rate policy should have been operated to accommodate that wage pressure.

But that would have flown directly in the face of the declared strategy to bring down inflation.

A refusal to accommodate that wage pressure was an essential part of changing the implicit belief of the private sector that government would accommodate whatever action it chose to take.

## ON TO STABLE PRICES

That phase is now over.

The Government's commitment to the further reduction of inflation is well understood.

Inflation has fallen further and faster than any of our critics thought possible when we first put the strategy in practice.

But from now on progress is bound to be slower.

Double-digit inflation was, in essence, an aberration of the 'seventies; fortunately, thanks to the policies embarked on in 1979 it never persisted long enough to become embedded in expectations or a part of our economic bloodstream.

But low levels of inflation have been the norm - as indeed they are throughout the industrialised world.

Stable prices are a blessed condition, but one that we in this country have not experienced other than very fleetingly for 50 years.

To achieve stable prices thus implies fighting and changing the culture and the psychology of two generations.

That cannot be achieved overnight.

But let there be no doubt that that is our goal.

## THE ENTERPRISE CULTURE

In the field of microeconomic policy, too, what we are seeking to do is to change a psychology, to change a business culture.

The abolition of pay controls, price controls, dividend controls, foreign exchange controls, bank lending controls, hire purchase controls, industrial building controls - all these have been beneficial in themselves, but will bring even greater benefit to the nation as part of the process of rediscovering the enterprise culture.

A process that will be carried further by progressive reductions in the burden of taxation - provided we maintain, as we must, the downward trend of public expenditure as a proportion of GDP.

And one that will be further promoted by the onward march of privatisation and the breaking up of monopolies and restrictive practices - not least in the City of London.

In the context, moreover, the labour market is clearly of vital importance; and the labour legislation already enacted, and that currently before Parliament, present a long overdue start in a key area of the national economy.

On almost all of these fronts we are opposed, inevitably, by vested interests of one kind or another.

On almost all of them it will take time for the changes to have their full effect.

But the climate is changing: of that there can be no doubt.

And my Budget this year was an attempt to assist that change.



### THE IMPORTANCE OF PROFITABILITY

At the heart of the enterprise culture must lie a commitment to profitability, which, over the years, the Corporation tax changes embodied in this year's Finance Bill should serve to reinforce.

But already one of the most encouraging aspects of the present recovery is the sharp recovery that is occurring in company profits.

Gross trading profits of all industrial and commercial companies, net of stock appreciation, rose by around two-fifths between 1981 and 1983 as a whole; and will be significantly up again this year.

The CBI have forecast that the net real rate of return before interest and tax at current replacement cost may exceed 8 per cent this year for non-North Sea Industrial and Commercial companies.

This compares with 4 per cent in 1981 and will be the highest rate of return since 1973.

Even that, however, is well below the returns of 10-12 per cent that was the norm during the 1960's.

The trend is in the right direction, but it still has further to go.

## THE PROSPECT FOR JOBS

It is the rediscovery of the enterprize culture, operating within the framework of markets progressively liberated from rigidities and distortions, that will provide the only answer to the curse of unemployment, and the only true generator of new jobs.

So far, although the numbers in work are now rising, unemployment has yet to fall.

But that is no reason to accept the dismal thesis that in the technological world of today, rising unemployment is inevitable.

It isn't - as the American experience so clearly shows.

Moreover, it is important to recognise that, in the UK, a very significant part of the increase in unemployment over the past five years is simply the emergence into the open of the unsustainable disguised unemployment of the second half of the 'seventies, when overmanning - in manufacturing in particular - was rife.

In 1979 the level of productivity in manufacturing was well below that of the rest of Europe, let alone the United States.

The potential for a rapid and substantial catching up was clearly there.

That potential is now being realised, with an average growth of manufacturing productivity of around 6 per cent a year for the past three years, and little sign of slackening.

In the short term this represents a very painful adjustment.

But in the longer term it will mean not only higher living standards, but higher levels of employment, too.

## CONCLUSION

In conclusion, I owe you an explanation of the title I have chosen: The British Experiment.

That experiment, if experiment it is - and I borrow the term from those who have been less than enthusiastic about it - consists of seeking, within an explicit medium term context, to provide increasing freedom for markets to work within a framework of firm monetary and fiscal discipline.

It stands in contrast to the post-war trend towards ever more ad hoc interference with free markets within a context of increasingly financial indiscipline.

That was the road that led to stagnation, unemployment - and above all accelerating inflation.

That, in truth, was the experiment that failed.

But many of those who embarked on it did so not because they believed in it.

They did so because they had reached the conclusion that political and electoral pressures in a democracy gave them no option.

The true British Experiment is a political experiment. It is the demonstration that trade union power can be curbed within a free society, and that inflation can be eradicated within a democracy.

And the growing success of that demonstration is of the most fundamental importance to us all.