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10 DOWNING STREET

LONDON SW1A 2AA

From the Principal Private Secretary

10 August 1988

Thank you for sending the various articles to me. This is most helpful - it not only improves my understanding of economics, but should also avoid 'problems'. I hope that you can let me see any future articles.

Andy Bearpark has told me about your commitment to give a series of lectures in the autumn and spring on international economics. I assume that all the lectures will be in the States in view of the Johns Hopkins connection. As you surmise, the media might try to use them to cause us all trouble. Indeed, I would not rule out some unscrupulous press person infiltrating himself into the lectures, persuading one of the students to let him have notes or even to produce a surreptitious tape of what you say. Could I therefore ask that you take special care to avoid anything in these remarks which could be interpreted as comment on the management of the UK economy or international agreements to which the UK has subscribed. You will also need to be on your guard for planted questions.

N. L. WICKS

Professor Sir Alan Walters.

R Wicks o.

Ref. A088/2475

MR BEARPARK

at flag

Many thanks for your minute of 5 August about Professor Walters. I have spoken to the Chancellor and told him about these lectures which I assumed - I hope rightly - are to take place in the United States. I suggest - and the Chancellor would be content with this - that Nigel Wicks should write as proposed, although I think that the penultimate sentence needs something more specific than "cause us embarrassment". I suggest that this sentence should read: "Could I therefore ask you that you take special care to avoid anything in these remarks which could be interpreted as comment on the management of the UK economy or international agreements to which the UK has subscribed."

FER.B

ROBIN BUTLER

9 August 1988

Econ Pol: Domestic
Monetary Policy Pt 19

PERSONAL AND CONFIDENTIAL

file
DASANS

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

5 August 1988

I enclose two further articles which Alan Walters has in various stages of production. I should be grateful if you could cast your eye over these, purely from the point of view of whether they might cause political embarrassment to the Chancellor. It is possible that we will receive more of these in the future, and I would like to suggest that you nominate one, or at most two, senior officials - yourself, Alex, Michael Scholar or Andrew Turnbull perhaps - who might take this on rather than sending them out to your divisions for comment. Could you please give me a ring in the course of the day if you have problems with either of these.

P. A. BEARPARK

Jonathan Taylor, Esq.
H.M. Treasury

PERSONAL AND CONFIDENTIAL

Mr Wicks
No 10 Downing St.

This is due for publication
in Germany in the autumn.
It was written in Nov-Dec 1987
AW

Not for Attribution

DEREGULATION AND PRIVATIZATION

- THE LESSONS FROM THE U.K.

by

Alan Walters

May, 1988

DEREGULATION AND PRIVATIZATION
- THE LESSONS FROM THE U.K.

Alan Walters

Britain's supply side program of deregulation and privatization together with expenditures, tax, and trade union reform, first required financial and macroeconomic stability. Once this was achieved in 1982, the reforms were implemented more and more successfully, in both the economic and political senses.

The economic success can be gauged by the performance of Britain's growth rate, productivity advances, and employment growth relative to that of the large European countries. The UK, which used to grow at half the rate of Germany and France, now grows at twice their rate. This has been achieved during a disinflation and a transition from a large budget deficit to (albeit small) a budget surplus. The basis for the supply-side success seems secure.

I. AN OVERVIEW

The supply side of the Thatcher reform has been just as vital an ingredient of Britain's economic renaissance as the fiscal-monetary (or "monetarist") policies. Yet I believe it is important to stress that in Britain, perhaps as distinct from other countries, the monetary-fiscal stabilization policies were a necessary precursor, or at least accompaniment, to the supply side policies. The grand design was conceived as: first, stabilization to provide room for reform; secondly, to restore the market and the private sector; and third, to change institutional arrangements so that individuals and families can influence and eventually control those services (e.g., health and education) which have long been in the power of politicians, union officials and bureaucrats. Roughly speaking, the time periods for the major thrusts have been:

Stage 1	Stabilization	1980-1982
Stage 2	Supply side	1982-1988
Stage 3	Institution reform	1987-1992(?)

Of course, some supply side measures were taken at the earliest stages (e.g., abolition of exchange control in 1979) and some are still to be fully developed (e.g., housing reform). But the main outline is, I think, fitting.

By the end of 1982, fiscal-monetary stabilization had produced a decline in inflation from 20 percent in mid 1980 to about 5 percent at the end of 1982. Since most price, exchange rate and wage controls had been abolished, these were "true" undistorted readings. Furthermore, the budget deficit and public sector borrowing requirement had all been brought down, mainly by the budget of March 1981, from over 6 percent of GNP to about 3 percent or less. Thus the fiscal-monetary balance was clearly seen to be sustainable -- and indeed has been sustained to 1988 with the public sector borrowing requirement being negative (slightly less than 1 percent of GNP) for the first time since 1970. The monetary base has grown since 1980 at an average of about 5 percent per annum.

This has ensured that inflation has remained under control at, on the average, rather less than 5 percent for the last six years. This ambience of macro-stability has been a necessary condition for many, perhaps most, of the supply side reforms.

II. SUPPLY SIDE REFORMS

Analytically, the supply side reforms could be treated as a reassignment of property rights -- mainly from the public authorities (or other quasi-sovereign entities such as trade unions) to private individuals. As a matter of policy, however, these transfers took the form of:

(a) Deregulation -- removing most government controls from prices, wages and dividends, and from production arrangements;

(b) Privatization -- transferring not only ownership but also control to the private sector;

(c) Trade Union Reforms -- reducing the overweening powers conferred on unions since the Trades Dispute Act of 1906;

(d) Fiscal and Monetary Reforms -- to reduce marginal tax rate and, by eliminating special treatments ("loopholes"), to widen the tax base.

(e) Public Expenditure Reforms -- to restrain the inherent pressure on public spending;

(f) Welfare Reforms -- to reduce the "moral hazard" incentives (the "why work?" syndrome), and the poverty trap.

It is impossible to provide anything like a complete account of all these reforms. I propose therefore, first, to give a very brief assessment of the last four [(c) to (f)] categories and then go on to discuss (a) deregulation and (b) privatization, in some detail.

Trade union reform consisted largely in reducing the power of trade union officials and, by democratizing the unions' decision-making process, "turning the unions over to the members". Now, if the unions violate the law, the trade unions' funds can be sequestered. The reduction of union power, much aided by the high unemployment rates, has been credited with a very large supply side effect. Indeed, Matthews and Minford (1987) have attributed most of the astonishing quadrupling of productivity growth in manufacturing and the doubling of this rate in the economy as a whole, compared with the 1973-79 cycle, to the reform of the trade unions. Others, per contra, have credited, or blamed, the high levels of unemployment for the productivity gain. I must confess I can find little warrant in history for believing that high unemployment promotes productivity growth. (It certainly has done little for France and Germany in the 1980s!) The argument of Matthews and Minford seems plausible, but I would be inclined to attribute only about a third of the productivity gain to union reform.

The Thatcher approach to (d) tax reform was very different from the Reagan policy in the United States. In 1979, the first year of Thatcherism, the top rates of tax were reduced from 98 and 83 percent to 60 percent, but that was nothing like the 1981 reduction of taxes in the United States. And VAT was increased to compensate for a reduction from 35 to 33 per cent in the standard rate of tax. Indeed, in March 1981, Mrs. Thatcher put up taxes by about 2-1/2 percent of GNP, mainly by increasing income taxes -- certainly the biggest fiscal squeeze in the peacetime history of the UK. A simple-minded supply side argument would conclude that this would dramatically reduce productivity and output. (Indeed, the standard bearer of the United States supply side movement, The Wall Street Journal, pilloried the Thatcher government while it lauded the Reagan tax reductions of 1981.) In fact, exactly the opposite occurred! Productivity started rising, countercyclically at that. Gross national product, which had been falling precipitously in 1980 and the first quarter of 1981, reversed and turned strongly upward. Is this a great discrediting of supply side tax cutting? I do not think so. In 1981 the budget deficit (strictly the public sector borrowing requirement) would have been more than 6 percent of GNP and, in my view, that would have eroded entirely the credibility of the Thatcher government's resolve permanently to conquer inflation and eliminate the perennial, indeed biennial, financial crises that had plagued Britain for so long. The surge of confidence in the viability and coherence of the government's policy dominated the direct supply side effects.

From 1981, however, the public could look forward to reductions in tax rates; corporate taxes were reduced from 52 percent to 35 percent. By the 1988 budget, income tax rates had been reduced to a standard rate of 25 percent and a 40 percent maximum marginal rate -- in other words, somewhere near the levels of marginal tax rates (including state and local) in the United States. But Britain, as distinct from the United States, enjoys a budget surplus not a deficit. 1/ In other words, with suitable constraints on public spending, the tax rates are sustainable.

I would attribute perhaps 20 percent of Britain's performance to this record of stable macroeconomic conditions. In particular, maintaining a more-or-less free exchange rate regime enabled Britain to avoid the chronic overvaluation which so plagued countries, such as France, inside the EMS (see Walters, 1986, Ch.7).

On (e), public expenditure reforms, the Thatcher government has been least successful when compared with the original objectives. Although several important changes were introduced, such as the extension of cash limits on the non-demand driven items in departmental budgets, the government did not manage to bring down the levels of real public spending. Even the attempt to hold public spending at a constant real level failed. The ultimate result was a modest decline, from 1981-82, in the fraction of GDP devoted to public spending. Although this was a considerable achievement compared with previous governments (the exception being the brief period - 1975-76 - in the Wilson Labor Government), public spending remains a disappointment. Perhaps the main achievement is to redirect public spending from many wealth-destroying activities to wealth-promoting projects. But I think it has contributed only a little (5% perhaps) to Britain's renaissance.

III. DEREGULATION AND PRIVATIZATION

Deregulation and privatization are both tributaries from the same main stream. Both consist of the assignment of property rights from government and the state to private persons or corporations. For example, the abolition of rent control is an extension or reinstatement of property rights of the owners (and a curtailment of the rights of sitting tenants). Privatization is a transfer of rights in a particular form for which the recipient usually, but not always, pays a price. And in privatization, the regulatory environment determines the new owner's rights.

In the Thatcher supply side reforms, deregulation was the primary policy instrument from 1979. The Thatcher government simply had no truck with the ramshackle "accords" or "solemn and binding" undertakings (often known as Solomon Binding's) which had been the apex of the Wilson-Callaghan government's system of control. The so-called winter of discontent of 1978/79 had demonstrated once again that either controls did not work, or if they did, the effects were to make things worse. In practice, as is generally the case, the wage controls were imposed most readily in the public sector. And the public sector employees responded by taking "industrial action" (a quaint phrase that means exactly the opposite, i.e., a strike or "industrial inaction"). From May 1979, there were no wage or price controls or "accords" or "guidelines" and no agreements with the unions or employer bodies. The exceptions are, however, important. Statutory minimum wage controls remained in place for about 15 percent of the labor force. Rent controls also continued for the rapidly declining private rental sector. And, of course, the government exercised controls over the prices of many nationalized industries, as well as over the prices of many agricultural products.

It was widely predicted that, in consequence of this decontrol, there would be a runaway wage inflation. Certainly inflation did increase to a maximum of 22 percent in mid 1980, but thereafter it fell quite sharply until in early 1983 it settled at about 5 percent (and in 1987/88 was 3-1/2 percent).

In spite of the record unemployment (which has been falling rapidly over the past two years), real wage rates have increased in every year. But there have also been very large increases in productivity - so that wage costs per unit of output have risen little. Indeed, although manufacturing wages rose 8 percent last year, the productivity increase was very nearly as great, so wage costs per unit of output did not rise. The increases in unit labor costs are expected to be among the lowest in the OECD countries.

The next dramatic deregulation was the abolition of exchange controls. Dating from World War II, residents of the UK were allowed access to limited rations of foreign exchange only for purposes approved by the authorities. For example, in 1976-78, emigrants could take out of Britain only Lstg.7,000; any assets other than personal and household goods had to remain in the United Kingdom. Mrs. Thatcher abolished exchange controls "at a stroke" in 1979. Again, dire warnings of massive capital flight and sterling falling into a black hole were common. The reality was a great inflow of capital and, from January 1979 to March 1981, sterling appreciated by about 40 percent in real terms. This appreciation was in small part due to the rise in oil prices, but the main impetus came from a sharp contraction in the money supply from 1979.

In its own terms, the aboliton of exchange controls was an enormous success which paved the way for much of the deregulation that followed. It enabled the Bank of England to eliminate 700 regulatory jobs, and in the private sector it seems likely that exchange control work must have accounted for at least 10,000 equivalent jobs. In the curious accounting of national statistics, all these "jobs" contributed to GNP at least as much as their cost. Perhaps most important, the dismantling of such an edifice of bureaucracy combined with (in 1988) the rescinding of the 1947 law that legalized exchange controls, makes it very difficult and hazardous to reimpose exchange controls. With the political popularity of the freedom to dispose of one's own assets as one wishes, most observers regard reimposition as unthinkable.

Financial deregulation in domestic markets followed soon after the abolition of exchange controls. Credit rationing was eliminated in 1980 and the government set itself the task of controlling, through bill operations, only the short (7 day) money rate and allowing the yield curve freely to be settled by the market. Several restrictions, however, were retained on various kinds of security dealings and other types of credit markets. But in the "big bang" of 1985, virtually all controls and restrictions were abolished. British markets became the least restricted, with the possible exception of Hong Kong, in the world.

In view of the various hesitant retreats from financial deregulation in the United States, it is particularly important to assess British experience -- a task which I can do only superficially here. Since the "big bang", the London markets have attracted much business to the city. For example, it can now claim to have the only truly international stock exchange. The variety of financial institutions, which would not be permitted in the United States because of the Glass-Steagall Banking Act of 1933, the rapidity with which firms adapt to markets conditions, and the rate of innovation, all testify to the vigor of the free market in finance. But, you may ask, is it all "sound"? I suppose one fairly critical test came on October 19th, 1987. Compared with the freezing up of Wall Street, the London Exchange performed extraordinarily well in absorbing this massive downward plunge. There was no dealing hiatus and any investor could readily liquify his holdings. The market worked smoothly. The U.K. is now involved in introducing more protection for investors through the Financial Services Act (1986). The basic idea is to allow the financial sector to police itself, subject to a general rule book of a Securities and Investment Board, without interfering unduly in market freedom. We shall have to wait a few years for a verdict on this Act.

All this newfound freedom has given rise to what has been termed a "credit explosion". Many reputable observers view this with foreboding -- a harbinger of future inflation, which will impair many things as well as financial markets. I believe, however, that these concerns are exaggerated. What determines inflation is money, the spending or circulating media, not credit.

In sum, I judge that financial deregulation has been a great economic success on all the usual criteria. Oddly enough, I think it has also been the instigator of considerable social mobility. The financial world now, more than ever before, rewards merit rather than class and contacts. The city has opened up, and many of its stars are indeed nouveaux riches. A meritocracy in the city has counterpointed the new surge of entrepreneurship in industry. This is a revitalization that Britain had long hoped for, but until 1979, in vain.

The other major deregulations have been in the transport sector. Of course, Britain is not entirely its own master, since the EEC exercises some considerable control over inter-EEC operations. But nevertheless Britain has gone far. There is complete deregulation with free entry of: (i) all trucking; (ii) intercity bus services (combined with complete privatization); and (iii) intracity stage-bus services outside London. The results have been quite dramatic -- particularly in both bus deregulations. As I forecast in a number of articles in the 1970s, the latent demand, suppressed by regulation, was for frequent mini-bus services on urban routes. The free market has demonstrated the validity of this conjecture. Similarly, the frequency and variety of services of intercity buses has put a new complexion on cheap (unsubsidized) travel in Britain. The government intends to deregulate London's buses in 1988/89; one can confidently anticipate a vast improvement in services and a drastic cut in the subsidy. From all my research, confirmed by government experiments, one would expect that the costs of private unregulated services would be about one-third to one-half of the regulated publicly owned services. The success on a political level is evident in the absence of any outcry (other than that which is inspired by threatened union officials) against the new system. All independent enquiries have reported considerable improvements of services and lower costs of operation. It seems unlikely that any future Labour government will reregulate and renationalize, so I judge it a success politically.

IV. PRIVATIZATION

The thirty-five years after World War II had seen great growth of the public sector, with governments attaining what they regarded as the commanding heights of the economy. As a rule, if it was large it was soon nationalized. In Britain, nationalization did not merely include the great basic industries of coal, steel, electricity, gas, telecommunications, railways, airlines, etc. It encompassed many an undertaking which could not be construed as 'basic' at all -- such as railway hotels, warehousing, and even some public houses (bars). It also included the great services; virtually all health, about 35 per cent of the total supply of dwellings, and almost all education.

Certainly by the 1970s it was clear that the public sector was not merely a major drag on Britain's economy, but also that it involved considerable threats to liberty and even to democratic government. 2/ In 1978/79 Britain suffered a 'winter of discontent' during which many public sector services ceased to exist -- garbage collected in the streets and even gravediggers refused to bury the dead (they did, however, offer to bury a number of the living). The disgraceful behavior of the public sector undoubtedly harnessed political opinion behind the privatization movement. The ideas and the problems of privatization had been examined in 'think-tanks', notably the Institute of Economic Affairs, and some sort of program was sketched out, should the Conservative Party be returned to power. 3/ Table 1 lists the major privatizations that occurred under the first two Thatcher governments.

Table 1. - United Kingdom: Privatization of Major Public Enterprises February 1981 to January 1987

Date a/	Enterprise	Proceeds (In millions of Stg.)
February 1981	British Aerospace	43
October 1981	Cable & Wireless	181
November 1983 b/	Britoil	627
December 1983	Cable & Wireless	263
June 1984	Enterprise Oil	382
July 1984	Jaguar Cars	297
November 1984 c/	British Telecom	4,090
May 1985	British Aerospace	346
August 1985	Britoil	426
December 1985	Cable & Wireless	571
December 1986 d/	British Gas	1,796
January 1987 e/	British Airways	415

Source: Yarrow (1986), Table 1; and data provided by the United Kingdom authorities.

a/ Dates shown indicate initial offering.
b/ Of which Stg.334 million in 1982/83 and Stg.293 million in 1983/84.
c/ Of which, Stg.1,352 million in 1984/85, Stg.1,246 million in 1985/86, and Stg.1,084 million in 1986/87. Also included is Stg.408 million generated by the sale of British Telecom stock and preference shares.
d/ Total estimated proceeds are Stg.5,090 million, with the second installment having been due in June 1987 and the third installment due in April 1988. In addition, Stg.750 million of British Gas debt was redeemed in May 1987.
e/ Total estimated proceeds are Stg.825 million, with the second installment paid in August 1987

In addition to those shown in Table 1, there have been many other small privatizations raising less than Stg.100 million each. These took the usual form of divesting the state's control of a corporation in a competitive environment. One remarkable example of these small divestitures was the National Freight Corporation (NFC), a trucking firm with storage and travel businesses, which was launched into the private sector in February 1982. The state-owned company had made losses year in and year out, and the government found it very difficult to find anyone interested in paying anything for such a moribund group. The management and workers, however, perceived their opportunity. After securing some institutional backing in the City (at present 17 percent of the shares are owned by institutions), they proposed a management/worker buy-out, for a sum of Stg.6.5 million (or about $17 million). The original shares, for which the employee or manager paid Stg.1, are now (1988) worth Stg.70. It is not hard to envisage the change in attitudes that privatization engendered. With the same workers, management and, initially, assets, but with <u>critical changes in incentives</u>, the NFC was transformed from a loser to a winner. In the next few years, NFC will be engaged in a massive investment program that envisages considerable expansion both at home and overseas.

Principles of Privatization

As in every society, there is a wide variety of opinion about what should be in the private sector and what should be left to the public authorities. In Britain we were not starting with a tabula rasa. We faced the reality of a large, inefficient, politicized public sector. The <u>cost</u> of privatization, in terms of the scarce time of administrators, the legal proceedings, the exploration of the market, the restructuring of balance sheets, and the problems of displacement on a crowded political agenda, is always substantial, and, one may add, far larger than privatization enthusiasts tend to envisage. In a democratic and free society, legal rights must be protected and due process must be observed.

The first issue then is what privatizations should have priority. Where are the gains from privatization to be greatest? Where should our effort be concentrated first?

The criteria, not mutually exclusive, may be broadly construed as the following:

(a) <u>Competition</u>. Those nationalized concerns that are in industries which, in the absence of government control and ownership, would be naturally highly competitive should be considered prime candidates for privatization.

(b) <u>Rapid technological change</u>. When an industry is either experiencing, or about to experience, rapid technological change, one should consider it a prime candidate for privatization, <u>even it it is not naturally or inherently competitive</u>.

(c) <u>Constraining the Unions</u>. It is well known that trade unions thrive in the public sector. Sheltered from the chill winds of competition, often politicized with their sponsored politicians in key legislative or executive positions, such leaders or officials of labor unions have wielded not only great economic leverage but also considerable political power. Privatization removes the ability of the concern to pass on its high wage awards and its inefficiency to the customer or to the books of the Treasury.

In commending these criteria as useful guideposts for a government's privatization policy, I do not mean to imply that one should consider only these considerations. As one may imagine, there are many others. Perhaps the most important are political factors. The political advantages to the conservatives of increasing private house ownership, for example, played a major role in the privatization of public housing. There are also many problems of precisely how the privatization is to be achieved, in what form, and in what time frame.

The objective of privatization is to transfer control to the private sector. In Anglo-Saxon law, this means selling more than 50 per cent of the voting equity to private investors. In practice it is wise to sell a larger fraction to the private sector so that the public holding is sufficiently small to be non-threatening.

Performance

One of the main presumptions of privatization is that somehow concerns must be 'put in order' before they are sold. Often, though by no means always, this implies restructuring the balance sheet, making the corporation more efficient by eliminating excess labor, changing work practices, etc. Then a reasonably hopeful story can be told in the stock offering Prospectus required by company law. (I deal with regulatory frameworks below.)

A striking feature of British experience has been the dramatic improvement in the performance of corporations that are put on the list for future privatization. Marked gains in efficiency, productivity, quality control, etc., are characteristic of those who are about to be privatized. In one sense, this is simply a recognition that "the party is over". Best prepare for the reality of competition. British Airways, Jaguar, and even British Telecom were remarkable examples of the beneficial effects of being on the program for privatization. A more recent example, a few weeks before its privatization, Rolls-Royce PLC reported a 56 percent increase in profits in 1986: from $123.5 million in 1985 to $192 million in 1986. [4]

But there is a more important reason -- and one which I find difficult to exaggerate. Privatization is an arduous process involving many obstacles. It requires great energy and drive to deliver the corporation to the market. As legal, administrative and political problems multiply apace, it is too easy for some real-world Sir Humphrey to conclude that "the time is not ripe." In order to overcome this entirely natural lethargy, the British government appointed chief executive officers in the nationalized corporations who, on the one hand, strongly believed in the privatization program and, on the other hand, would be appropriate, even ideal, chief executives of the newly privatized concern. Thus, by making suitable appointments in the public corporation, the government could <u>harness the dynamic energy of self-interest at the early stages of the long road to the private sector</u>. Remarkable examples of this are to be found in the appointment of Sir George Jefferson to British Telecom, Sir John Egan at Jaguar, and Lord King in British Airways. It is difficult to imagine that so many corporations would have eventually reached their private goal without the drive, determination and, indeed, some ruthlessness on the part of these very able men. As a corollary, once such able men are in the driving seat they can command considerable bargaining power in securing what they regard as appropriate conditions of regulation, etc., for the newly privatized firms. This has its dangers to which I return below. 5/

Capital restructuring has been characteristic of many privatizations. In the case of British Airways, for example, it was clear that most of the proceeds of substantial loans from Banks (about $1 billion with government guarantees) had not been spent on equipment and capital. It had been frittered away in inefficient scheduling, overmanning, excessive wage awards etc. It was thought best to write this down so that the balance sheet reflected the reality of its assets rather than past misdeeds. So the government recognized its loss, and the balance sheet in the Prospectus is 'clean'.

The case for restructuring the balance sheet was always most powerfully made by the market men, in particular the merchant bankers who advised on the deals. I must confess that I have never really agreed with, or perhaps understood, the argument. If British Airways were sold with the bank debt still on the books, would it not merely mean that a lower price would be obtained for the equity since the firm would carry the debt servicing charges? (Assuming of course that the value of the equity exceeded the nominal debt.) Does the state get more money for the disposal in the sense that the difference in price of the equity more than compensates for the write-offs? I do not know the answers and I must leave these questions for others to resolve.

"Natural" Monopolies and Regulation.

There is a considerable variety in the concerns that have been privatized. One important analytical distinction is between those that are inherently competitive and those which may be classed as monopolies, particularly so-called natural monopolies. In the case of competitive industries, there are few problems about releasing the hitherto publicly-owned concern into a competitive environment. If, as often occurs, under public ownership the corporation enjoyed an artificial monopoly, where, for example, new entrants were denied access, then there are the transitional problems of repealing such restrictions and allowing competition to work. It would be wrong to belittle the difficulties of eliminating such rent-creating barriers to competition.

With the great natural monopolies, however, there is a different problem. First it is necessary very much to circumscribe what can be construed as a natural monopoly as distinct from one that is fostered and protected by the state. Perhaps the most obvious example is the connection from the house or office telephone to the first system switching station. From thereon, however, there can easily be competitive arrangements for telecommunications. Similarly, the customer distribution systems for electricity and gas are natural monopolies, except for large customers; but this does not extend to the generation of electricity or the production and transport of bulk gas. Thus, the coverage of any regulatory system should extend only to these natural monopoly elements. This implies that the public needs to be protected against exploitation by British Telecom of their local link monopoly. In fact, of course, that particular monopoly is in the process of being eroded by competition from various other forms of communication such as cable, radio, etc. So one might argue for a "sun-set" type of regulation that automatically declines over time.

In Britain, we wanted to avoid the obvious and egregious wastes which were inherent in the general system of regulation of the privately owned utilities in the United States. Typically, they are controlled by the specification of a maximum rate of return on capital. Thus it pays to invest capital in the utility even though the marginal rate of return is low and well below the cost of funds, provided that, for example, the average rate of return exceeds the maximum allowed. [6/] We were also most anxious to avoid the immense bureaucratic costs and lengthy legal procedures. In practice, however, the privatized monopolies have managed to get away with some continuation of the general protection they had enjoyed as nationalized corporations. In part, this is due to the fact to which I referred above, namely that, in order to push through the process of privatization, powerful and dynamic executives were appointed who extracted from the government promises of some transitory shelter from competition.

However understandable, it is undeniably also to be regretted. But one should look at it in an appropriate perspective. First, in the two major examples, British Telecom and British Gas, there was certainly no increase in the protection from competition in the process of privatization. On the contrary, in both cases the pre-privatization period saw considerable liberalization (for example in the Telecommunication Act of 1981, which liberalized the equipment conditions for attachment to the system). Certainly there was no reduction in competition. Much of the protection was rationalized on the grounds that one needed to get competitors (such as the Mercury competitor for BT) established, and that they would only stay in the business if they had some "concessionaire" arrangement. With BT now having spent some time as a private sector corporation, we can now see that there is much more competition than appeared to be possible at the time they were privatized. 7/ As a general rule, most people, and particularly economists, underestimate the ingenuity of competitors.

Secondly, even if the monopoly is substantially the same in private as in public hands, there will be efficiency gains which will accrue ultimately to the people. The private company will have a great incentive to minimize costs, since these will augment profits by economizing on inputs of capital, labor etc. The potential for improving profits will be well known to investors and so will be reflected in the competitively determined issue price (subject to the arguments discussed above). Thus the government seller will capitalize on the expected efficiency gains from private management and control. Such gains are appropriated by the community as a whole. Similarly, any expectation that the private monopoly will exert its power to restrict output and expand profits, in the classical way described in the text books, will also be reflected in the issue price. There is, however, no apparent evidence of BT restricting its output to increase its profits, but we do not know whether there was any expectation of such behavior, nor can we measure such conjectural effects on the issue price.

In order to forestall such exploitation, however, a very simple system of regulation was established which was fully explained in the prospectus. This is often called the "RPI minus x" system. In BT it was clear that the monopoly power existed over mainly local calls; for long distance there was increasing competition. Over a five year period, BT was required to increase the price of local calls by no more than the Retail Price Index minus 3 per cent. This was the basic system of regulation used. Note that it did not control profits, nor did it require any investigation of costs. It was a simple maximum price control (allowing for inflation). Over and above this there was the Director General's Office of Telecommunications (OFTEL) which was charged with the job of promoting competition and identifying abuses. OFTEL is also charged with the task of ensuring that BT carries out its legal responsibilities to provide rural call boxes and emergency services.

So far there has been considerable satisfaction with this new regulatory arrangement. It was adapted for the recently privatized British Gas - an industry considerably larger than BT, but one with a similar local monopoly. Of course, it is too soon to give a considered account of this new approach to regulation and, in any case, I cannot do justice to the nuances in this paper. But I suspect that, in two or three years time, experience will provide an informed, if not a definitive, answer. At the very minimum, it avoids the massive wastes inherent in the British political and administrative arrangements for controlling existing nationalized industries and in the United States system of profits control. 8/

Political Considerations

There is always an abiding suspicion that the real motives for privatization are ideological. Unfortunately, it is impossible to discern motives. All one can do is find indirect and unsatisfactory indicators on what peoples' motives might have been. But fortunately, motives are irrelevant in discussing the logic of argument and the evidence of reality. We can argue the effects of privatization and gain insights from the empirical results without knowledge of the motives of the policy makers. Similarly, we can point to the political effects without ascribing motivations.

There is little doubt that privatization changed the nexus of interests of voters. Perhaps the main effect was in the privatization of dwellings (about one million privatized, covering at least two million, and perhaps as many as three million voters). The tenants became owners. As a rule, those who own their own houses are more likely to vote Conservative, and so housing disposals were in the electoral interests of Mrs. Thatcher's government.

The privatization of state-owned enterprises might be thought to offer more dubious political dividends. However, in the more recent privatizations, particularly BT and British Gas, there was a deliberate attempt to democratize the ownership, as described above. For example, of the British Gas issue, one sixth of the households that have a gas connection (incidentally, the vast majority) have also a share holding in British Gas. With British Telecom's flotation in November 1984, BT attracted 2 million investors, about a half of whom had never before bought shares, and even today BT has around 1.7 million shareholders.

The number of shareholders in the U.K. has shot up from about 3 million in 1979 to 8.5 million, or nearly 20 percent of the adult population, according to a survey commissioned by the Stock Exchange and the Treasury. [9]

Truly, this was returning industry to the people. It is far too soon to evaluate the political consequences of this considerable change in ownership. I suspect they will be found to be large and will perhaps lay the foundation for the property-owning democracy which has long been the goal of the non-socialist parties of the West.

Provisional Conclusions on Privatization

The most obvious conclusion is that privatization has been a considerable success on all the occasions it has been pursued. The extent of the success has varied, but is consistent with the principles hinted at above. In retrospect, one cannot find a single example of a privatized concern that has not experienced a considerable improvement in efficiency and performance. [10] Perhaps the most surprising consequence has been the political popularity of privatization, even after the crash of October 19, 1987. In the case of housing, what was once a bitterly opposed policy is now embraced by <u>all</u> political parties, albeit with different degrees of enthusiasm, as a consensus privatization program. Indeed, it is anticipated that, if a new Thatcher government is returned in 1991 or 1992, privatization will be extended to industries now thought to be firmly in the public sector, such as London's subway system, railways and coal, and perhaps even health and education. This will truly return industry to the people.

V. THE RESULTS OF SUPPLY SIDE POLICIES

It is not possible neatly to decompose cause (from the supply side) to effect (on the performance of the U.K. economy). One could go through a list of the improvements in productivity, etc. for the various elements of privatization and deregulation. But we could record only the direct effects. It would not be possible to trace the much more important indirect benefits of deregulation, etc. For example, we could note that through quality enhancement and efficiency gains, Jaguar has probably increased productivity of both labor and capital by some 120 per cent -- but we could not measure the effects on suppliers, other industry in the area, etc.

Here I will just review some macro effects. We could compare, for example, the performance of the economy before 1980 and from 1981 onwards. [11/] Certainly there is evidence of an improved 1980s' performance on the 1970s' dismal record. But such comparisons are inherently flawed. The international environment, so much a determinant of economic performance, does not stay constant. It is as misleading to compare the 1980s with the halcyon 1960s as it is with the miserable 1970s. But it is more illuminating to compare the U.K. with other countries, and particularly the great states of Europe, for the same period. Then all countries face the same international economic environment; each, so to speak, has the same handicap.

The touchstone of performance to most economists is economic growth (or perhaps per capita growth - but this matters little in the context of Western countries). The comparison of the United Kingdom with Germany and France is shown in Table 2 for the period up to 1980 and 1981 on. Since the U.K. emerged from the slump in 1981, some year or so ahead of Germany and France in 1982, one might want to make some adjustment for this timing. But the broad picture remains the same. In the 1970s and 1960s, Britain grew at about half the rate of growth of Germany and France. Since 1981, the U.K. has grown at about twice the rate of growth of the two great states of mainland Europe. Perhaps this sharp reversal in the growth league table is the clearest evidence that things have changed. Indeed, in the year just passed (1987), Britain's growth rate was 4.5 per cent whereas for Germany it was 1.7 per cent and France 1.6 per cent.

One of the special factors to which many people allude in order to explain away Britain's performance is North Sea oil. It is difficult, however, to establish that very much is due to the North Sea bounty. Probably the maximum contribution to growth was in the period 1978-1983. But 1983 saw the big fall in the oil price and North Sea revenue had already peaked. Indeed, if we take 1987 as a sample year after the oil price fall, the growth rate including oil was, as mentioned above, 4.5 per cent. However, the growth rate of the non-oil economy is calculated to come to 5.5 per cent. (Incidentally, those who believe in the oil-explanation would also have the task of explaining why the performance of both the Netherlands and Norway have been so miserable. Why did not Britain catch the Dutch disease?)

Table 2. - Growth Rates
in Real Gross National Product, 1961-87

(Percent change)

Area/Country	1961-65 annual average	1966-70 annual average	1971-75 annual average	1976-80 annual average	1981	1982	1983	1984	1985	1986	1987 a/
OECD countries b/	5.3	4.6	3.0	3.3	2.1	-0.2	2.7	4.7	3.2	2.7	2.8
United States	4.6	3.0	2.2	3.4	1.9	-2.5	3.6	6.8	3.0	2.9	2.9
Canada	5.3	4.6	5.2	3.7	3.0	-3.4	3.7	6.1	4.3	3.0	3.7
Japan	12.4	11.0	4.3	5.0	3.7	3.1	3.2	5.1	4.7	2.5	3.6
European Community c/	4.9	4.6	2.9	3.0	.2	.8	1.5	2.4	2.6	2.6	2.3
France	5.9	5.4	4.0	3.6	1.2	2.5	.7	1.4	1.7	2.1	1.6
West Germany	4.7	4.2	2.1	3.4	.0	-1.0	1.9	3.3	2.0	2.5	1.7
Italy	4.8	6.6	2.4	3.8	1.1	.2	.5	3.5	2.7	2.7	2.7
United Kingdom	3.2	2.5	2.1	1.7	-1.2	1.0	3.7	2.2	3.7	2.3	4.5
Developing countries	5.3	5.8	5.7	5.0	2.2	.9	.5	2.8	1.7	4.0	3.3
Communist countries d/	4.4	5.0	4.2	2.8	2.0	2.6	2.7	2.3	2.3	4.1	(e/)
U.S.S.R.	4.7	5.0	3.0	2.3	1.3	2.7	3.2	1.5	.8	3.8	1.0
Eastern Europe	3.9	3.8	4.9	1.9	-1.0	.9	1.9	3.5	.5	2.7	2.0
China	-.2	8.3	5.5	6.1	4.9	8.3	9.1	12.0	12.0	7.5	9.5

Source: Department of Commerce, International Monetary Fund, Organization for Economic Cooperation and Development, and Council of Economic Advisers.

a/ Preliminary estimates.
b/ OECD (Organization for Economic Cooperation and Development) includes Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey and United Kingdom, not shown separately.
c/ Includes Belgium, Denmark, Greece, Ireland, Luxembourg, Netherlands, Portugal, and Spain, not shown separately.
d/ Includes North Korea and Yugoslavia, not shown separately.
e/ Not available.

Remarkably, Britain's GNP has been growing strongly since the middle of 1981 -- a record sustained expansion of seven years. One might also note that this expansion has not been fueled by increasing inflation: quite the contrary, inflation has fallen. It is now (1988) 3-1/2 per cent and seemingly fairly stable. Nor can one argue (as for the United States) that growth has been bought by massive imports of capital and sowing future trouble in the form of unsustainale budget deficits and mounting domestic and foreign debt. On the contrary again, at the end of 1986 Britain was the largest creditor nation -- exceeding in net foreign assets both Japan and Germany. 12/ And the government accounts were in surplus in 1987 and forecast to be in surplus in 1988-89.

Of course, this record of high growth is not evenly distributed over all sectors. For some reason, perhaps because of the emphasis of the economic planners such as the late Lord Kaldor, economists have always been keen to judge the performance of an economy by the behavior of the manufacturing industries (a sector which accounts for only about 25 per cent of total output). The decline of manufacturing production from 1979 to 1982 was the issue which engaged the attention of critics. It was pointed out that manufactures did not regain their 1979 peak until 1986. Certainly manufactures suffered a relative decline compared with other sectors up to 1985 (but note that since then they have been growing relatively more rapidly). Oddly enough, the same economists did not reflect on the great classical principle of relative advantage. It was well known that Britain had a relative advantage in non-manufactures, particularly services and agriculture. For example, in 1979 German productivity in manufacturing was more than twice that of Britain - but in agriculture their productivity was only half that of the U.K. It was entirely to the good that when the controls and distortions were removed, Britain reallocated its resources both between manufactures and other sectors, and within manufactures itself, to increase productivity and profits. Again the record shows this clearly. In the 1970s, productivity growth per person averaged 1.64 per cent. Productivity in manufacturing has grown dramatically over 1981-85 -- 30 per cent over a five-year period. [13/] Britain is rapidly catching up on Germany and France. Many distinguished economists believed that, in the early period 1981-83, the dramatic increases were a flash in the pan, which would not persist and even be lost in later years (see Walters, 1986, Ch.10). But the pan has flashed so long now that it must be classified as a new and brilliant jewel in the crown of the economy. In 1987, for example, the productivity increase in manufacturing was 7-1/2 per cent -- near Hong Kong or Taiwan standards. Of course, it will be said, this cannot go on and on. But we must be wary of the mistake of the "flashers" who have found their confident predictions so rudely discredited. There is much more life in supply side reforms yet.

The decline of manufactures for 1979-82 expanded what used to be regarded as politically the most explosive indicator, unemployment. Of course, it was clear that <u>all</u> the countries of Western Europe were experiencing an unprecedented (at least since World War II) surge in unemployment. Much statistical expertise was lavished during 1980-83 to show that unemployment was more severe in Britain than in Germany and France (as well as on the easier task of showing this in comparisons with

Table 3. - Unemployment (as % of labor force)

	1980 (avg.)	1983 (avg.)	1987 (Dec.)
Belgium	9.4	14.5	15.4
Denmark	6.1	10.7	8.0
Germany	3.3	8.6	9.0
France	6.4	9.1	10.4
Ireland	8.3	15.3	18.7
Netherlands	4.7	15.6	14.3
United Kingdom	6.3	11.7	9.4
Average: (excl. U.K.)	6.6	12.1	10.4 *

* Average of 12 EEC countries.

Sources: Commission of European Communities, Annual Economic Report, 1983-4, Brussels (for 1980 and 1983); and OECD Main Economic Indicators, February 1988, Paris (for December 1987).

the United States and Japan). By 1983, however, both the increase from 1980 and the percentage level of unemployment in the U.K. were about the same as those of the rest of the European Economic Community.

For almost two years now (January, 1988), Britain's unemployment rate has been falling very steeply by about 50,000 or 0.2 per cent a month, and is now about 9.4 per cent, whereas French unemployment still seems to be rising (at about 10.4 per cent in January,1988). Oddly enough, since the critics were mainly Keynesian in persuasion, little attention was paid to <u>employment</u>. Britain's <u>employment</u> started <u>rising</u> from mid 1983 and continued to rise through to 1988. Again this contrasts with continental Europe which continued with generally falling levels of employment over this period.

To sum up, considering the restructuring of the economy, the sharp reduction in inflation, the turnaround from an unsustainable deficit to a surplus, and the massive shakeout in industry, the picture of unemployment/employment is somewhat better than those of other EEC countries. This still does not mean that it is satisfactory. Indeed, it is a sobering thought that recent calculations of the NAIRU by Richard Layard and others suggest that 10 per cent is about as low an unemployment rate as Britain can afford; any lower rate will be associated with accelerating inflation. This calculation, if it is to be believed somewhere near the true value, illustrates how much more needs to be done in improving labor mobility, sharpening incentives and deregulating in order to improve the workings of the labor market. [14]

VI. CONCLUSION

Even Mrs. Thatcher's worst enemies, or at least those who are not indisputably deranged, would concede that the various supply side measures which she has pioneered have had a significant effect on the growth and performance of the British economy. Perhaps most of these basic changes will not be undone by a future Labour government. Mrs. Thatcher has moved the agenda of political debate over towards a more liberal (I use that word in the European not the American sense) order.

FOOTNOTES

1/ This road to a budget surplus has been associated with a sharp increase in the current account deficit of the balance of payments in 1987 and 1988. This constitutes yet another refutation of the New Cambridge School and the conventional wisdom widely publicized in the United States that the US current account deficit is largely a consequence of the federal budget deficit.

2/ For example, it was widely thought that no government could possibly rule without the consent of the National Union of Mineworkers. The union had toppled the government of Edward Heath in 1974 and had been the power behind the Wilson and Callaghan governments of 1974-79.

3/ It would be wrong to imagine that the privatization movement was embraced with any enthusiasm by the Conservative Party. After all, when it was in power in the 1950s, early 1960s and early 1970s, it had done little or nothing to reverse the trend towards public ownership. The real drive behind the program came from the Prime Minister and her group of ministers.

4/ Wall Street Journal, March 20, 1987, page 8. (See also Appendix for the profit record of other privatized companies.)

5/ Of course, as the performance of the public corporation improves, there are always the faint-hearted supporters who will say that, since the concern is now in good shape and earning profits there is no reason for privatization. Just as when there is a leaky roof, while it is raining one cannot repair it since one will get wet, whereas when it is fine there is no need to repair it. Nevertheless I have heard such arguments used to delay or abort privatization.

6/ Unfortunately the civil servants were enamored with the United States system, and it was only after long argument that they conceded that alternatives might be superior.

7/ The concrete evidence for this statement derives from the accounts and report at the 1987 shareholders meeting. Vigorous competition was blamed for limiting profits. It was quite clear that such effective competition was something of a surprise to the analysts. The main competitor, Mercury, has captured 37 percent of the market of major telecommunications users, particularly in the City, where 18 out of 19 financial institutions are using Mercury. (Financial Times, March 23, 1987, p.7.)

8/ It is of interest to recall that, for reasons which I need not discuss, I suggested an alternative method of control called an "output-related profits tax." Pour encourager les autres, the lower the rate of growth of the monopoly's output, the higher the rate of tax on profits. A superficial view of such a tax would be that it is a perversity; normally one would have a lower rate of tax for low earnings and a higher rate on higher earnings. But this tax rate decreases with respect to output increases above a preset trend line. It was meant to discourage monopolistic restrictions on output growth. Although, as I expected, the rather startling form of such a tax inhibited its use, I still think there is a place for such an arrangement in the control of utilities.

9/ This statement was made by Mr. Norman Lamont, Financial Secretary to the Treasury, on March 18, 1987.

10/ With some trepidation, I would even include British Petroleum Co. on this list, although I would conjecture that it gained least from privatization.

11/ Mrs. Thatcher came to power in mid 1979, but her policies did not begin to bite until 1981 onwards.

12/ At the end of 1986, the figures for net foreign assets were in US$ billion: USA - 275; Japan - 179; Germany - 114; and U.K. - 186. See Bank of England (1987, p.536).

13/ See The Chancellor of the Exchequer's Mansion House speech, October 17, 1985.

14/ Minford and Peel (op.cit.) argue that one of the big factors explaining the poor working of the labor market is the lack of physical mobility due to the housing laws on rent restrictions, etc. I find their case persuasive.

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APPENDIX. - BRITISH TELECOM

The British Telecom (BT) sale was not only the largest ever (until British Gas) and the most successful public flotation in the world, it also has led to a revolution in the development of telecommunications in Britain. In addition to opening the market to increased competition, there is now an explicit regulatory environment in the form of a licensing system with the powers of the Director General's Office of Telecommunications (OFTEL), the Monopolies and Mergers Commission, and the courts to police it.

But perhaps the most interesting changes are in the management structure and attitudes of BT itself. As Sir George Jefferson describes it (in the Quilter Goodison lecture 1985), before privatization BT was an administration, a branch of government, rather than a business. Its staff were effectively district commissioners administering a government-controlled service through a board consisting principally of part-timers who tried to take detailed decisions on most issues centrally. By 1980, despite a turnover of about $8 billion, it had only one profit center. The accounts, which had been qualified for years, were of the simple Civil Service cash-book variety. The government wished to break up the nationalized concern into regional companies before disposition. It was, however, strongly argued that to sort out the accounting complexities of any such division would delay the privatization for at least two years. This sounds like an excuse -- but, alas, there was ample evidence that it was true.

Staffing arrangements were typically of the civil service forms -- owing more to hierarchy and ease of negotiations. It is quite remarkable that one trade union covered <u>all</u> workers in the nationalized concern right up to board level. Departmental compartmentalization with vertical hierarchies emphasized that the organization was meant to serve internal interests rather than the customer. The commercial development of the business was centered on engineering concepts rather than market and commercial needs. The customers, although they frequently called BT to complain, did not call the tune. In fact, it was rather difficult for any new subscribers to call anyone, since they normally could not get the standard telephone on demand and had to join a waiting list usually for a shared "party" line.

Much has changed. The old vertical hierarchies are being broken down. Instead of the civil-service procedure of "passing the buck", managers are now being encouraged to manage. Promotions and appointments now depend more on suitability and success rather than seniority and status. There is, however, no wholesale change of personnel. On the contrary, as Sir George Jefferson emphasized, the existing personnel were as good as one could obtain in private business. State ownership had shackled them and never allowed them to develop more than a small fraction of their potential. In sum, the "culture" of BT has changed.

One would expect that these changes would be reflected gradually in the profits of BT and, due to competition, in the prices and growth of privatization as BT began to adapt to the new environment. So they did. And this has continued with an increase of 22 percent in profits for 1985/6 compared with 1984/5. OFTEL reported in November 1986 that BT's prices have fallen 89.5 percent over the last three years, and that unit costs had fallen by 5 percent per annum in the last two years. A massive investment program (costing about $3 billion per annum) is under way, spreading digital technology and optical fibres throughout the system.

Mr Wicks

Sept 29th.

Nigel,

This has got to proof stage, but I do not think that there is any smoking gun here.

A

13 Monetary and Fiscal Policy in the UK

Alan Walters

13.1 INTRODUCTION

Some twenty-three years ago, a most distinguished group of British economists, all associated with the National Institute of Economic and Social Research, wrote a book, *The British Economy in 1975* (ed. Wilfred Beckerman, London, 1965). A feature of that book, which today may seem most remarkable but in those days was hardly noticed, was that money, monetary policy, and the exchange rate were not mentioned, even *en passante*. Inflation, it was thought, would be controlled by incomes policies, and the co-operative spirit of unions and management. Fiscal policy was the major lever in ensuring that aggregate demand was sufficient to create the full employment level of output and to ensure that there was only an acceptably small percentage of unemployed. Beckerman *et al.* recommended an expansion of government spending to ensure this blissful state.

Monetary policy, to paraphrase the late Lord Kaldor, should be concerned mainly with the maintenance of 'orderly' (financial) markets'; and broadly speaking, the Radcliffe Committee Report (1959) had endorsed Kaldor's view. Liquidity was the important determinant of monetary conditions, but since no one could define it, there seemed to be few constraints on monetary policy.

Some eleven years later, in December 1976, Mr Healey, then Chancellor of the Exchequer, signed the famous, or infamous, letter of intent to the IMF. Monetary restraints had been introduced by the Treasury some time earlier in the April budget, but clearly the IMF commitment implied that they were to be taken much more seriously as a central feature of the economic policy of the UK.

It would be nice to report that between 1965 and 1975 an intellectual revolution caused this change. The arguments of monetarists, and particularly of Freidman and his followers, were quite pursuasive, but I fear that they would have had little effect on British policy except for the massive macroeconomic errors of the Heath government. 'Competition and Credit Control' (CCC), introduced in 1971, intended to sweep away the controls on credit markets so that the allocation of credit could be determined by cost, but it also swept away the inhibitions those controls exercised over the expansion of the money supply, especially since the authorities were unwilling to tolerate interest rates they thought politically unacceptable. The money supply, on all measures, increased sharply and inflation duly followed. Two major lessons on monetary policy emerged from the turmoil. The first was that rapid increases in monetary growth should be avoided. The second was that monetary policy should be considered in close conjunction with fiscal policy. Possibly a third macroeconomic lesson was that expansionary fiscal and monetary policies did not solve the problem of unemployment.

Such lessons, however, did not penetrate every politician or policy-maker. In the period from the first election of 1974, the Labour government embarked on a very rapid expansion of public spending financed by a large increase in the public sector financial deficit to 7.2 per cent of the GDP in 1975–6, which soon gave rise to the sterling crisis of July 1975. It was undoubtedly this bitter experience of escalating interest rates, depleted reserves, collapsing sterling, inflation at 26 per cent (end of 1975) etc., rather than intellectual conversion of the cabinet, that gave rise to the first commitments to a monetarist constraint in April, 1976.[1] Politicians may be impervious to ideas but not to experience, particularly if it is thought to affect elections.

Of course in 1976 it was not, indeed could never be, the pure stuff of monetarism. The choice of M3 and later sterling M3 as the aggregate to be monitored and contained meant a considerable departure from the 'medium of exchange' definition of money. More than half of M3 consisted of interest bearing deposits which were rarely, if ever, used as a medium of exchange.[2] This, however, did not seem at the time to be a significant issue since, with the exception of débâcle of CCC, the correlation of all the major monetary aggregates has been very close, and there seemed no obvious reason why such affinity should not continue.[3]

But M3 had two other advantages. The first is that it was closely related to fiscal variables, and particularly the PSBR. If we suppose that there are no changes in the non-deposit liabilities of the banking system, we can decompose the change in (sterling) M3 into:

plus	PSBR less sales of debt to non-bank domestic sector
minus	Lending to private sector in sterling
	External financing of public and private deficits.

In effect, the constraint on the expansion of M3 could be, and was, translated, via assumptions about the private sector lending and external finance, to a permissible PSBR and budget deficit. Indeed, John Fforde has suggested that the main effect of monetary objectives was to provide some discipline on the PSBR and other budgetary constraints.[4]

There was another important institutional reason for adopting an M3 target. After its brief and unseemly flirtation with CCC, Britain returned to

its system of extensive credit controls and rationing. The constraint on M3 could be translated into the containment of bank lending, external borrowing, etc., and was familiar to officials in the Bank and Treasury. Thus the new targets were not new after all; they were simply new arrangements of old targets. Similarly the mechanisms were not new; they were the old mechanisms (bank rate, after October 1972 minimum lending rate, operations in the bill market, credit controls, exchange controls, etc.) with somewhat different rationalisations. There was clearly no suggestion of a system of monetary base control as in Germany or Switzerland.

One would have imagined that the use of M3 and its association with fiscal policy from 1976 onwards would have ensured that monetary (or more strictly M3) policy and fiscal policy were usually, if not always, in harmony. One should not see, for example, the pattern of loose fiscal and tight monetary policy that was observed in the United States in 1980–83. Such a consistent monetary and fiscal policy would make it difficult to disentangle the effects of each.[5] I shall argue that, fortunately for the analyst, there have been significant divergencies between fiscal and monetary policy, certainly before the 1976 accord and on several key occasions afterwards. These have been largely a consequence of accidents or misinterpretations, which have given grist for the analytical mill.

13.2 NEO-CLASSICISTS AND RATIONAL EXPECTATIONS

It is necessary to review briefly the rival theories of macroeconomic policy so that we know where we are, or should be, according to our beliefs about the efficacy of markets and policy. The Keynesian view of the economy asserted that many markets – particularly the labour market – did not work in the sense that although there was excess supply (of people seeking jobs) the wage rate did not fall – at least it did not fall in the short or even medium term sufficient to clear the market. Unemployment persisted. Similar arguments were applied to the product markets, and it was pointed out that prices, particularly of manufactures, were sticky and did not respond readily to changes in demand. Many Keynesians were content to rest these propositions on general statements about the non-competitive nature of markets, but Keynes himself was concerned to stress the maze of uncertainty and risk within which decisions of great moment were taken. The upshot, however, was that there was no clearly argued case for regarding these markets as failures.

The reactions to this have taken two forms. First the neoclassicists have argued that, in the absence of villains or governments or other parties preventing free contractual arrangements, the microeconomics must require price adjustments and so the markets must clear. There will be no frustrated buyers or sellers, such as the unemployed who would be willing to work at below the market wage (and at or below their marginal productivity) but cannot find jobs. It is alleged that Keynesians cannot justify a theory that has obviously flawed microfoundations.[6] This pure form of the new classical macroeconomics has markets that clear and where the normal principles of demand and supply are applied. It is, however, a travesty to suggest that the new classicists thought attributed *all* the massive unemployment in the United States or Great Britain of 1932 to workers' choice for leisure rather than income, or to job-search, or to the cushioning effects of unemployment and welfare benefits.[7] But the new classicists did identify such optimising causes of apparent joblessness which had been thrust aside by Keynesians and largely pooh-poohed by NKs. Explanations for 'market failures' have been sought from the behaviour of government, the theory of information, which itself was much developed by George Stigler at Chicago, and above all from a new *forward*-looking approach to the formation of expectations (the so-called 'rational expectations' or RE).

RE, in its stark form, simply asserts that people form expectations by taking into account all the information to which they have access, and then with full knowledge of the economic model, including the government's policy rules, they will form expectations that are *consistent* with that model and information set.[8] RE asserted that private sector agents would not make systematic errors (that is to say, reduce their profits or utility) which were avoidable by taking their knowledge of data and model into account. In particular this raised the spectre that monetary and fiscal policy could be ineffective in terms of real output and employment. Where prices respond fully to demand and supply, any counter-cyclical monetary expansion may not be effective because producers will fully anticipate the consequences and raise prices rapidly. All the kick of the monetary expansion will be dissipated in the price rise more or less immediately. Thus known policy rules will have no effect on real output or employment.[9] Only unanticipated or surprise policies will have an effect – and then only until people discern the new government behaviour pattern. This is widely known as the 'policy ineffectiveness' proposition. It applies to interest rate policy rules, such as those which adjust interest rates to eliminate deviations in output and prices, as much as to quantitative monetary growth rules; indeed, unless there is some fix on a *nominal* magnitude, prices will be indeterminate. Anything can happen to inflation.

The combination of rational expectations and new classical market clearing propositions have undermined and at least made ambiguous the expected effects of monetary policy in counter-cyclical operations.[10] Of course one might well argue that, with markets clearing and even without rational expectations, there is little point in pursuing counter-cyclical monetary policy; the 'problem' has been assumed away. But it is not enough to assert that the market clearing model is clearly inappropriate because of, for example, the persistence of high rates of unemployment.

The crucial distinction between the NC and Keynesian approach is that, although the NC allow costs of making adjustments in *real* variables, they do not see any reason why there should be any significant lag in the adjustment of nominal variables such as prices. In the Keynesian models also there are costs and lags in adjusting real variables. But the Keynesian models, as distinct from the NC, also have a large role for lags and costs in the adjustment of *nominal* variables – and particularly wages. Indeed, most of the characteristic results of the Keynesian models derive from the differential rate of adjustment of wage rates, prices, etc., through overlapping contract arrangements. The Keynesian argument is that in a crucial sense the price system does not work, and hence the presumption that government should pursue contra-cyclical policies.

Many, perhaps most, RE models have included price and particularly wage adjustment processes, sometimes specified in terms of contracts, which take time to adjust to the final market clearing conditions. In fact such processes are a reflection of our ignorance of the underlying nature of optimisation, including the problems of identification, information and compliance. Nevertheless, such temporary stickiness in prices and wages in the Keynesian models does enable monetary policy to have real effects, and there arises at least the possibility of an effective counter-cyclical policy.[11] Normally it is supposed that different sets of prices react at different speeds with wages the most important laggard. Thus an increase in money first affects prices and so reduces real wages; this accounts for the temporary upturn in output and employment, which is later eliminated and reversed as nominal wages catch up and perhaps even cause an overshoot in real wages. The long-run result is, of course, higher prices.

Another noteworthy contribution of new classicism is to show that, under certain pure assumptions – in particular that people live for ever, or that they pursue full-bequest policies to their heirs – different mixtures of bond and tax finance of a given level of public spending has no effect on real output. If an increase in government expenditure is financed by increasing taxes (i.e. the deficit remains the same) then it will have exactly the same effects on output as if the deficit and the borrowing increased by the amount of the spending increase. Whether we finance by deficit or by tax increases is immaterial, at least as far as private consumption is concerned. The rationalisation of this result arises from the fact that people know that, if taxes are not raised this year to pay for increased spending, taxes will certainly be raised in future years in order to service the debt. Thus, with an increased deficit and bond finance, people will save more in order to pay their future tax bills, and so the deficit will not increase aggregate demand or output. The dissaving of the government is offset by the increase in private saving.[12] The NC position on an *expansion* of public expenditure, however financed, is that it will crowd out private spending and thus have little if any effect on permanent demand

and output. However, because of the costs of making real adjustments, there will be a financing effect on the transitory path of output.[13]

13.3 NEW KEYNESIANS[14]

The main elements of New Keynesianism (I think NK, rather than NEWKS) are:

(1) Some propositions about the high costs of information to firms which give rise, in particular, to the argument that increments in wages promote productivity gains, which explain, not the rigidity, but the relative stickiness of wages;
(2) The asymmetry in information in capital markets which are, of course, imperfect, and which implies that there is too little equity and firms are driven to use bank or bond finance with its attendant risks, and this is exacerbated by the fact that production risks cannot be shifted;
(3) The perversity that affects labour markets also is manifest in credit markets, where, because of the asymmetry of information, increasing interest rates may lower the return on capital – due to adverse selection or additional riskiness;
(4) Monetary policy exerts influence but rarely and when it does it is through the availability of credit which affects investment, but this will not be effective in a recession when there is a shortage of willing borrowers.[15]

On the monetary side, the NK view is quite clear. Since credit is a close substitute, money is not required for transactions. And, in any case, the relationship between transactions and income is not one-to-one since most transactions are asset sales and purchases. Although the NK view is that governments can influence market interest rates, it is asserted that this is not 'an important' mechanism by which government controls economic activity. It is through credit availability that monetary policy works – and then only in non-recessionary phases of the trade cycle.[16] Greenwald and Stiglitz do not tell us whether they believe that an increase in the monetary growth rate would lead to inflation in the long run, but the drift of their discussion is clearly against such a conclusion. However, I think most NKs would accept that long-run result, albeit with many reservations and doubts about the definition of money, etc.

13.4 REALITY AND THE NK

Although one may complain about the basis of the NK's process, there is, in the Greenwald Stiglitz account, a considerable description of the pathology of a recession. It would be interesting, but far beyond my present plans, to

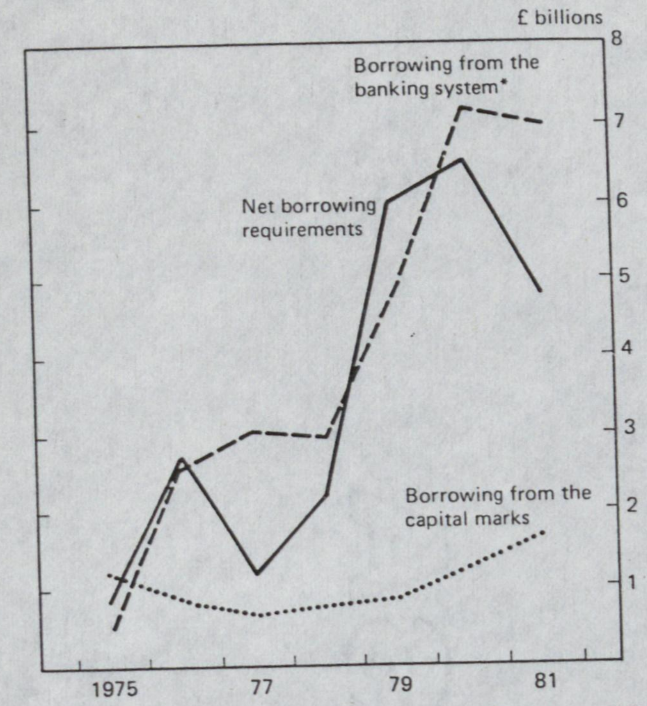
of

review all past recessions to see how they shape up to the NK outline. A more modest task is to assess the monetary aspects of the recent recession (or indeed depression) of the early 1980s – clearly the most severe for the United Kingdom in post-war years – in terms of the NK's outline.

There is some correspondence between the NK account of the performance of labour markets and the reality of the 1980s. (But I must leave to others the explanation of why, in the presence of massive unemployment real wages continue to increase in the United Kingdom and not fall, as they did in the United States.) On the monetary conditions, however, there is no correspondence whatsoever. The NK view that 'banks may be willing to lend to any "good" prospect at the going interest rate, but there is a shortage of willing borrowers' appears to be the opposite of what actually occurred. Of course much depends on the definition of the dates of the recession, but I assume that most NKs would define the recession phase in the United Kingdom to include the period when there was thought to be a considerable amount of excess capacity.[17] Clearly this must cover the years 1980 through to at least 1983. Throughout this period, bank lending to the private sector surged far beyond both government targets and economists' expectations. There was a plethora, not a shortage, of willing borrowers. The banks did not languish with excess reserves for which they could not find suitable borrowers. On the contrary, the banks were bidding vigorously for deposits in order to expand their highly profitable loans.

The increase in the private sector demand for loans was in part explained by the asymmetry of the recession. Corporations, particularly producers of tradeable manufactures, were hard hit by the appreciation of sterling. But, with little adjustment in wages, this appreciation improved both the wealth and liquidity of households, so they increased deposits in the financial sector, made attractive by the high real rates of interest that emerged from the government's effort to contain bank lending, an important item in the sterling M3 aggregate. The financial sector's capacity to lend was also augmented by deregulation – particularly the removal of the corset and of exchange controls.

It has been suggested (by a reviewer) that the NK position would be that 'bank-financed new capital fell somewhat in 1979–81'. Although Greenwald and Stiglitz do not specify that they are concerned only with financing new capital in their article, it would be ungenerous not to consider such an interpretation. There are no data on 'bank-financed new capital'. We can only compare bank lending to industrial and commercial companies with data on capital formation. Fig 13.1 shows how bank lending *rose* from an annual rate of £2 bn in 1978 to an annual rate of £7 bn in current pounds in 1980 and 1981 – a three-and-a-half-fold increase.[18] On the other hand, total private investment *fell* by about £8 bn (at 1980 prices) – divided between £5 bn in stocks and £3 bn fixed.[19] It is, of course, conceivable, but surely most unlikely, that these data are consistent with the NK story. A 250 per cent



*Including commercial bills held by the Issue Department of the Bank of England.

Figure 13.1 Industrial and commercial companies' finance.

Source: Bank of England Quarterly Bulletin, vol. 23, no. 2 (June 1983) p. 205.

increase in bank lending is very difficult to rationalise in terms of the moribund lending inactivity which NK suppose is typical of the recession. The evidence shows that there was a dramatic increase in bank-financed lending for new capital, particularly in the service and energy industries.[20] All this requires a more detailed analysis that I can give here. But I believe that there is sufficient evidence to reject the NK vision of languishing bank lending being unable to lift investment out of the doldrums.[21]

It is more difficult to establish whether, as NK assert, interest rates were not '(an important) mechanism by which government controls activity'.[22] We shall have to defer the examination of interest rate effects in the context of fiscal as well as monetary policy. Certainly – and a point which does not discredit the NK view – the high interest rates (and they were very high until March 1981) did not appear to have an immediate impact on the volume of loans to the private sector.[23] But changes in interest rates, especially when most of the loans are at floating rates, have profound effects other than those

on changes in loan demand, on profitability and bankruptcy and so on the level of activity.

I conclude, therefore, that the NK description of the financial characteristics of an economy in recession does not merely lack verisimilitude, but appears to be the antithesis of reality. But it may be objected that verisimilitude is not an appropriate evaluation; one might argue that the real test is whether the NK version gives new and useful insights into the monetary effects on macroeconomic processes. This remains unproven.

13.5 THREE RECESSIONS: MONETARY VERSUS FISCAL POLICY

In much of the discussion of economic policy, the general thrust is to find ways of avoiding, on the one hand, substantial and sustained recessions (depressions) and, on the other hand, persistent inflation. It is unlikely, and probably undesirable, that we can avoid most mild recessions or price changes. But the deep and lasting recessions just like persistent inflation are to be avoided. In this section I review the efficacy of monetary and fiscal policy during the three recessions, 1956–8, 1973–6, and 1979–82.[24] These are the only three post-war recessions in which the annual index of real GNP actually fell, although it must be noted that the fall in the average GDP estimate for the 1957–8 period was very small. (See table 4 of *Economic Trends 1985*.) These three recessions were clearly the most sustained and deepest of the post-war years.

Throughout the discussion of these recessions, the monetary base (M0) or transactions balances (M1) will be used as the basic indicator of monetary policy. The standard argument against the use of M0 is that it is endogenous – in this context it is determined by demand. The Bank of England supplies whatever M0, that is bankers' balances at the Bank and currency, which the private sector want. True – but that does not invalidate M0, suitably interpreted, as a measure of the monetary stance. The main monetary instruments of the Authorities are interest rates and joint open market operations. A monetary squeeze is engineered through raising short-term market interest rates through Bank Rate, MLR and money market operations. The change in interest rates has an effect on M0 (and usually M1) one to two quarters later as people adjust their currency and balances to the new interest rates. In this sense then the Authorities, ~~albeit~~ determine a systematic component of M0.

With this chain of causation, it is natural to ask why one uses M0 rather than interest rates as an indicator of monetary policy. The main reason is the difficulty of interpreting *real* rates from the observed nominal counterparts. Quite small changes in inflationary expectations have large proportional changes, magnified by the tax system, on real interest rates: during two of the periods examined here, inflationary expectations were going through dramatic changes and hence measures of real interest rates had very large elements of uncertainty; hence the choice of M0. Another consequence of choosing M0 is that it does lag some three to six months behind monetary policy (i.e. interest rate changes). This contemporaneous movement of M0 and real output are consistent with a *lead* of monetary policy of as long as six months or so. But throughout the discussion the relevant changes in nominal interest rates will be recorded, so the reader who is suspicious of M0 can follow the story with interest rates instead.

13.5.1 1956–8 recession

It is not difficult to demonstrate that there was a substantial monetary squeeze dating from early 1955, as is illustrated in Figure 13.2, panel 3. Bank rate was increased from 3 per cent to 4.5 per cent in February, rising to 5 per cent in February 1956. The annual increase in the money supply had been between £235 and £268 million for the previous three years, and might be thought to be a remarkable manifestation of Friedman's celebrated 'rule'. But then the higher Bank rate in 1955 was associated with a sharp *reduction* of the money stock by £248 million (see Supplement to *Bank of England Quarterly Bulletin*, September 1969). In terms of the narrow money supply, a period of three years in which the expansion had been steady at about 4 to 4.5 per cent a year was reversed in 1955 to a 3.3 per cent *contraction* at the trough and a 1.2 per cent contraction on the average for the year. The reduction in the rate of growth of the *real* money supply was even more sharp. The further reduction of the money supply continued into the first half of 1956, when it started at last to grow again but at a slower rate than in the early 1950s.

During the first three quarters of 1955 fiscal policy was clearly expansionary. Although the budget of 1954 had been more or less neutral, expansionary measures had been introduced in August. And these were followed by the election budget of 1955, with six pence off the standard rate of tax. After the election the give-aways of the election budget were gradually taken back, beginning with increased purchase taxes in October 1955, being later followed in early 1956 by planned reductions in government spending and reductions in investment allowances. But the expansionary effects of the decisions of economic policy included in the budget of spring 1955 were difficult to contain, let alone reverse, and the expansion continued throughout 1956 and into 1957. After a 5 per cent increase in general government spending from 1954 to 1955, there was, in nominal terms, almost a 9 per cent increase from 1955 to 1956 compared with a little more than 4 per cent increase in revenues.[25] Although this is not a neat picture of fiscal management, it undoubtedly demonstrates that the fiscal stance was expansionary

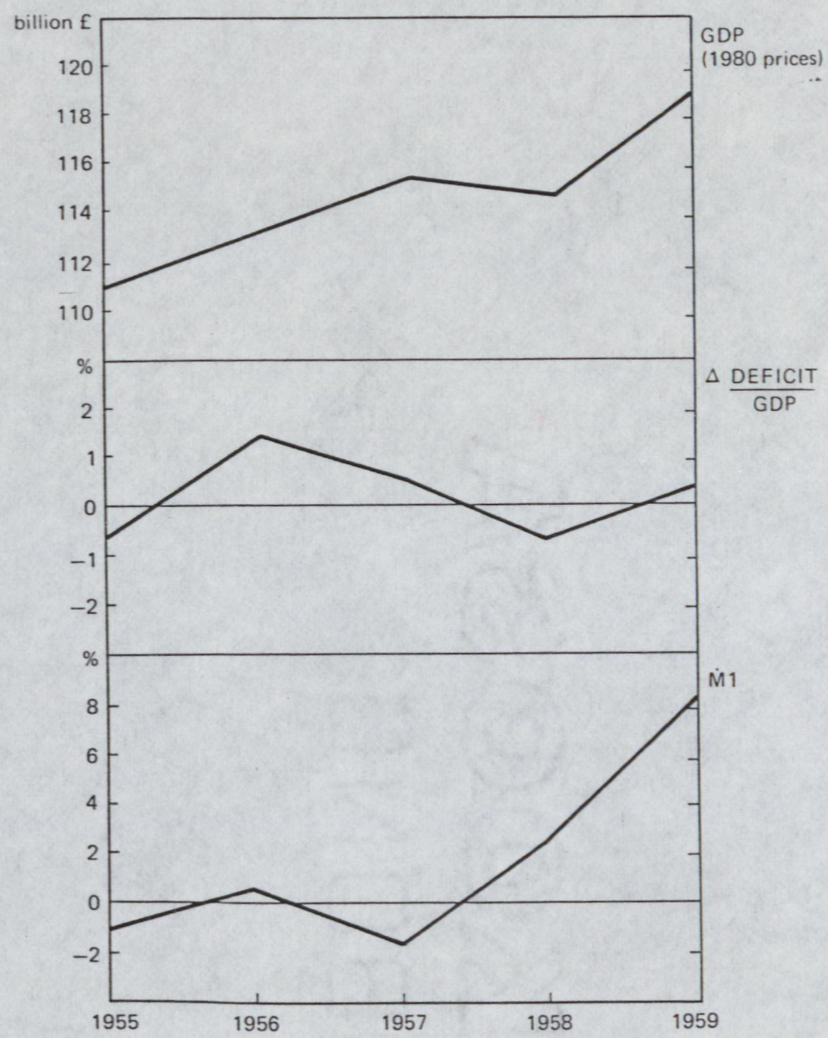


Figure 13.2

between 1955 and 1956. This is confirmed by the annual data representing the change in the budget deficit as a percentage of the GDP at market prices, shown in Figure 13.2, panel 2.

The contrast between the expansionary fiscal policy and the sharply contractionary monetary policy provides almost laboratory conditions for a test of the effects of monetary and fiscal policy on real output. Perhaps the most sensitive indicator of output was the index of industrial production. This showed a sharp and sustained rise during the reocvery phase 1952 to

1954; but this slackened off throughout 1955 until there was a sharp decline in the first months of 1956 followed by stagnation until the third quarter of 1958. As for GDP, the rate of growth had averaged 4 per cent for three years 1952–5, then it fell to 1 per cent for two years, 1956–7, finally reaching stagnation in 1958, as shown in Figure 13.2, panel 1. Clearly, in 1955–7, the economy failed to respond to the fiscal stimulus and succumbed to the monetary contraction.

But it is often said stopping booms is no problem for monetary contractions, but that starting a recovery with money is like pushing on a string. But there was very little push exerted on that string until 1957, as illustrated in Figure 13.2, panel 3.[26] Indeed, both in terms of the monetary aggregates and in terms of Bank rate, it is clear that the monetary squeeze continued through virtually to the end of 1957; then throughout 1958 a much easier monetary policy was pursued. This timing accords well with the rise of the industrial production index – which might be dated either in the last quarter of 1958 or the first quarter of 1959. And GDP showed a sharp upturn in 1959 compared with 1958.

Although the upturn in activity is *consistent* with a monetary explanation, we cannot point to a contrary path for fiscal policy. General government spending (in nominal terms) continued to expand at about 8 per cent per annum for 1956 to 1957, that is to say only fractionally less than the expansion in 1955–6. Similarly there was no clear intimation of fiscal squeeze in the figures for the deficit. As shown in Figure 13.2, there was a reduction in the deficit in 1958 and an increase in 1959. Since the upturn in the economy occurred in late 1958 or early 1959, one cannot claim that it was the fiscal expansion of 1959 that ignited the recovery – but not can one plausibly argue that the relatively mild fiscal contraction of 1958 sparked the recovery. Fiscal policy was much of a muchness, and nothing like the sharp change in monetary policy. We must rest content with the weak conclusion that the case for monetary causation has to be seriously considered, but we cannot demonstrate a clear perverse reaction to fiscal policy.

To summarise this recession and recovery, we have good evidence that the monetary explanation of the 1956 downturn in activity fits the facts rather well. This is reinforced by the evidence that fiscal policy over the critical period of 1955–6 was substantially expansionary and not contractionary. This confirms the power of a contractionary monetary policy to offset an expansionary fiscal stance and to prick the bubble of a boom. For the upturn, however, the results are more equivocal, mainly because although the very sharp monetary expansion was followed, with the usual lag, by the recovery of output, fiscal policy might be construed as at least neutral and even modestly expansionary contemporaneous with the recovery. The recovery, therefore, might also, but more dubiously, be claimed as a consequence of fiscal policy.[27]

13.5.2 1974–6 recession

One may characterise this recession as one of bad luck (with the commodity and oil price rises), compounded by bad policies (those of Heath magnified by Wilson). Fortunately again for the task of separating fiscal from monetary effects, the policies which started in some sort of harmony of rampant expansion in 1971–2, diverged markedly in 1973. Then monetary policy became markedly contractionary, but fiscal policy continued to be strongly expansionist until the first months of 1976. (See Figure 13.3, where the growth rates of M0 and GDP, and the changes in the PSBR as a percent of GDP are illustrated.)

There is some doubt about the exact dates of the monetary squeeze. The M1 series is the first to turn down from its rate of growth of around 15 per cent in 1972. The early months of 1973 was the fairly clear turning point, and in the following year the annual growth rate of *real* M1 fell to zero. (The

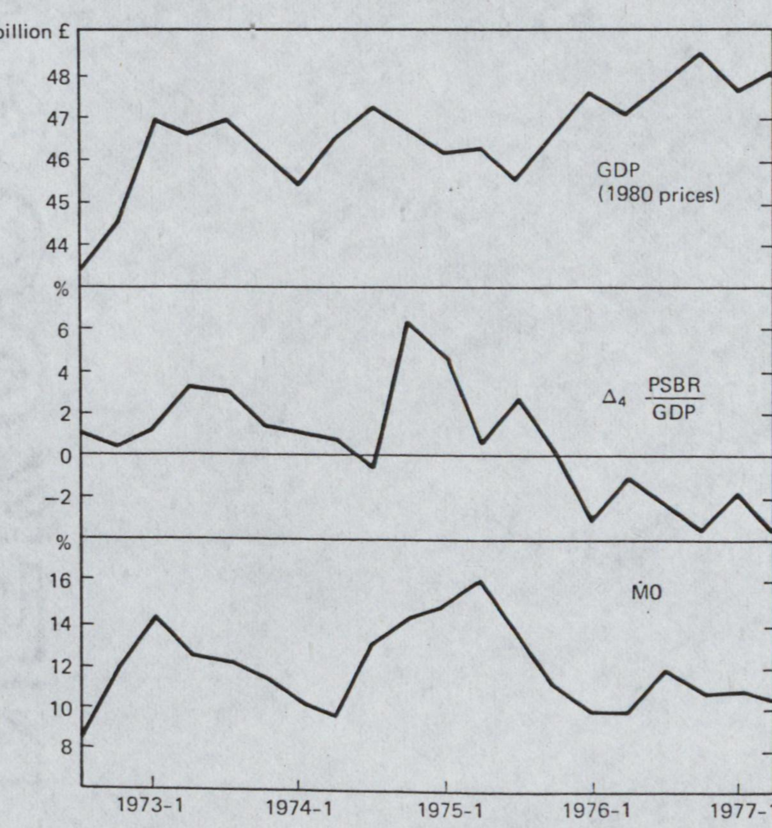


Figure 13.3

first sight it appears that there is a good fiscal explanation for the upturn. Over 1974 to 1975 there was a record increase in the PSBR (in nominal terms) from 6.4 bn to 10.2 bn (with a similar increase in the financial deficit), an increase of about 3.6 per cent of GDP. There a fiscalist might be tempted to rest his case, and claim the upturn as his own. But, alas, one must explain why the fiscal stimuli during the previous two years – of about equal magnitude measured in terms of the increase in the deficit (or PSBR) as a percentage of GDP – did not work.[33] Furthermore, if one adjusts to exclude the cyclical effects, the adjusted deficit shows that the fiscal stance was *very sharply contractionary from the first quarter of 1975*.[34] Similarly, weighting and adjusting for inflation gives the same pattern of a sharp squeeze in fiscal policy in the months before the upturn of activity. Clearly there is no case for attributing the recovery to fiscal policy; on the contrary, the recovery took off in spite of the reduction in fiscal stimulus.

The role of monetary policy in the recovery appears to be more convincing. Monetary growth (M1) had stopped in the second quarter of 1974. Monetary expansion started again in the last quarter of 1974 and by the first quarter of 1975 there was a 19 per cent growth and it remained well above 16 per cent for six quarters, that is to say to mid-1976.[35] A money-output causal interpretation would suggest that the lag is at least six months and probably nine to twelve months is the appropriate range. This is broadly consistent with the lag which has emerged from previous studies of the effects of money on output.

On this deep recession of the mid-1970s, the conclusion on the relative roles of monetary and fiscal policy are similar to those of the recession of the 1950s. There is, however, a significant difference. In the 1950s the attribution of recovery to monetary as distinct from fiscal policy was clearly equivocal. In the 1970s, however, we can be more confident that the recovery was stimulated by monetary expansion which dominated the supposed contractionary effects of a reduction in the fiscal deficit.

13.5.3 1979–82 recession

This was the deepest and most persistent recession since the Second World War.[36] Perhaps its most distinctive and painful feature was the rise in unemployment and the persistence of such joblessness at very high levels, until it started to decline from 1986. (Note, however, that employment started expanding from late 1982.) Indeed, many left-inclined intellectuals would argue that the recession was really a prolonged slump from 1980 with no foreseeable end in sight. In this chapter I have taken output, not unemployment, as the indicator for the cyclical movements, and this will be used in interpreting this recession. The upturn in output began in mid-1981 and growth has continued unabated for the period 1981–7 (see Figure 13.5).

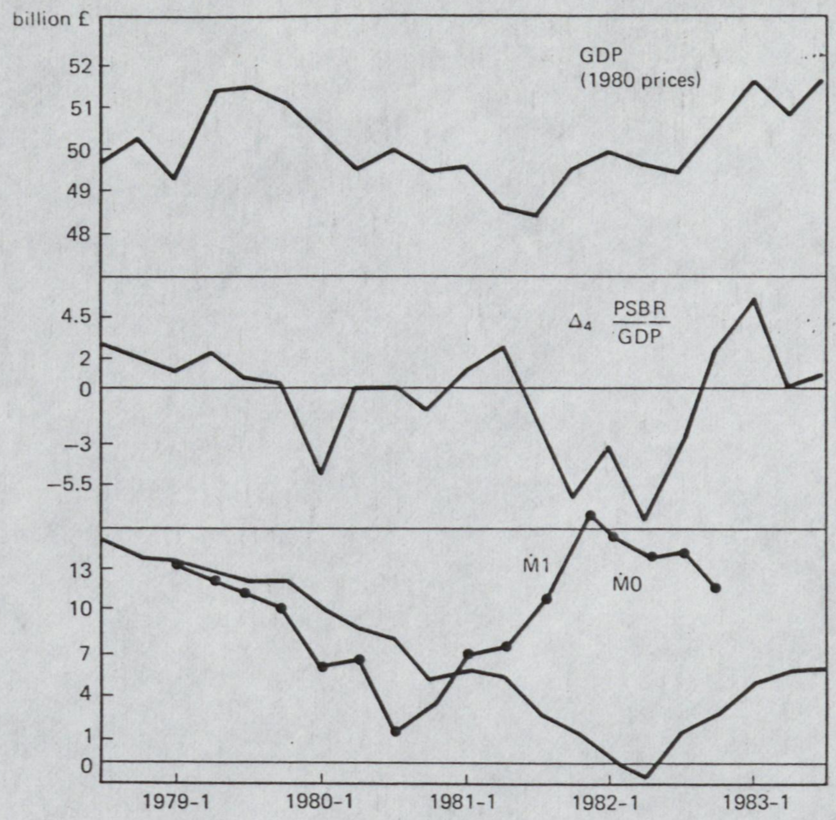


Figure 13.5

First we examine the causes of the downturn in 1979. After a sustained rise for more than three and a half years, the output index surged in the spring and peaked in the second quarter of 1979. If a fiscal squeeze were to be the cause of this relapse, one would expect to find evidence of fiscal tightening during the financial year 1978–9. Yet on all the fiscal measures reported in the NIESR study of David Savage (1982), there was an *expansionary* fiscal policy in operation during FY 1978/9.[37] As far as fiscal policy is concerned, the economy behaved perversely.

Monetary (M1) growth had reached a peak of 25 per cent in the first quarter of 1978. In the subsequent five quarters, that is to the second quarter of 1979, it fell to 12.5 per cent. (The fall in real M1 growth was even steeper.) This monetary squeeze is confirmed by the rise of the Minimum Lending Rate from 6.5 per cent in the first quarter of 1978 to 14 per cent by the first quarter of 1979. All this evidence leads to the conclusion that there was a severe monetary contraction in the course of 1978. And, as can be seen from Figure 13.5, this contraction continued throughout 1979. (As a matter of fact, in terms of the growth rate of M1, it continued until the third quarter of 1980.)

Yet again for the upper cyclical turning point, we observe the precursors of fiscal ease and monetary squeeze. Of course, in this case the fiscal stimulus was modest and the monetary contraction severe.[38] For analytic purposes it would have been nice if the policies had been more evenly matched; then we could have made more confident judgements about the relative efficacy. We have to make do with what evidence we have. Fortunately, in the following recovery there occurred a combination of a severely contractionary fiscal policy with a monetary policy which was decisively (and deliberately) stimulative.

The fall in the rate of growth of M1 ceased in the third quarter of 1980. By the first quarter of 1981, the growth rate had increased from its low of 2.5 per cent to 7.5 per cent. The fall in interest rates had been only slightly less dramatic than the previous rise. From a peak of 17 per cent in the first half of 1980, MLR was reduced to 14 per cent in November and was brought down to 12 per cent in March 1981. Both monetary growth and interest rates are consistent with expansionary monetary policies from the third quarter of 1980.[39]

The fiscal contraction began modestly in the Autumn Statement (November 1980) with both small cuts in public expenditure (about 700 million) and an increase in National Insurance Contributions and oil taxes. But the draconian squeeze came with the budget of 11 March 1981. The financial deficit for FY 1981–2 was reduced by 2.6 percentage points of GDP compared with the 1980–81 outturn (see Figure 13.5). Cyclically adjusted the percentage reduction in the deficit was an astonishing 4.1 per cent. Certainly it is the largest budgetary squeeze recorded in the post-war years and, war years apart, probably the largest ever in the United Kingdom.

In spite of this massive fiscal contraction, the economy turned decisively by the third quarter of 1981 from the precipitous downward plunge of 1980. And to date (September 1987) there has been no cyclical contraction in subsequent years.

The experience of the 1981 recovery is important because, first, it provides some evidence that monetary policy is not 'pushing on a string'; the economy did appear to respond strongly to the easier monetary conditions, contrary to the NK view.[40] Secondly, the effect of fiscal conditions cannot be interpreted in terms such as the change in the public sector deficit or indeed any of the complex variations of that original concept, to produce an expansionary fiscal indicator.[41] But our immediate purpose is to point out the domination of a moderate monetary expansion over the draconian budgetary squeeze – surely one of the important examples of the effects of modern macroeconomic management. The failure of the 1981 fiscal contraction to produce the dire effects so confidently predicted by both academic economists and

(retired) chief economic advisers appears to have excited little critical re-examination of the phenomenon.[42]

13.6 REFLECTIONS ON THE RECESSIONS

The evidence from the three recessions, although equivocal in some respects, does suggest that monetary conditions were important determinants of activity with results which were consistent with what have come to be called monetarist predictions. As for fiscal policy, one cannot in truth say that it was not important; on the contrary it was on occasion, as in 1981, very important, but not in the way portrayed in the Keynesian or NK framework.[43]

The crucial ingredient which can serve to explain the strange effects of fiscal policy can be summed up in the word 'credibility'. Both 1976 and 1980 were situations where continuation of, let alone expansion of, the large running fiscal deficits and borrowing requirements were simply inconsistent with the rest of the government's policy. And in a real sense the budget is the main instrument over which the government has more or less complete control. (With price and wage controls or guidelines etc., the public has self-justified scepticism. The absurd case of the 'six pounds' (a week) wage increase under Mr Callaghan was a prime example.) A borrowing requirement does have implications for the nexus of interest rates, inflation and foreign borrowings. The point was that, notwithstanding the condition of the real economy in 1980, anything but a tight fiscal squeeze would have destroyed credibility in the feasibility of the Thatcher programme. Scepticism about the political will would have quickly ensued. In my judgement, there would have followed a financial crisis as the markets passed speedy judgement on the borrowing and the implications. Interest rates would have soared instead of sinking. The 1976 period is very similar in its sequence of severe fiscal tightening followed by lower interest rates and monetary expansion and recovery.

This suggests that the tightening of fiscal policy was a necessary, but not sufficient, condition for the easing of monetary policy and the onset of the recovery. This is a very different 'harmony' of fiscal and monetary policy from that which is usually promoted.

Notes

1. In 1968/69, the Labour Chancellor Roy Jenkins promised the IMF that domestic credit expansion (DCE) would be less than £900 million per year. But this was *not* the same as controlling the money stock (see A. A. Walters, *Money in Boom and Slump* (Institute of Economic Affairs, London, 2nd ed., 1969).

2. It will be noted that only the monetary base is net wealth to the private sector. Commercial bank deposits, on the other hand, are *liabilities* of the bank as well as assets to the depositors, so they net out.
3. See, for example, David K. Sheppard, *The Growth and Role of UK Financial Institutions, 1880–1962* (Methuen, London, 1971).
4. John Fforde, 'Setting Monetary Objectives', *Bank of England Quarterly Bulletin*, vol. 23(2) (June 1983) p. 203.
5. To avoid dispute, it should be noted that I am not discussing the subtleties of assignment theory of Tinbergen, Meade and Mundell. An interesting historical aside, relevant to this issue, was the theory put forward by the New Cambridge School in the early 1970s. The policy consequencies of this theory was that the exchange rate should be used to ensure full employment and that the financial deficit of the public sector should determine the deficit on the current balance of payments. I do not think that the New Cambridge School had any discernible effects on policy, largely because the assumption on which their theory was based, namely a constant financial surplus of the private sector, was clearly discredited by the data from 1972 onwards.
6. See Alan S. Blinder, 'Keynes, Lucas, and Scientific Progress', *American Economic Review*, Papers and Proceedings, vol. 77(2) (May 1987) pp. 130–36. Professor Blinder argues that it is more 'scientific' to base macroeconomics on broad empirical generalisations rather than a fully articulated micro-foundation of the underlying co-operative arrangements through market processes. And if the broad empirical generalisations are inconsistent with the elementary market behaviour, it is best to turn a blind eye to the fundamentals of the markets and rely on the broad brushes of the macro-artist.
7. This is suggested in B. Greenwald and J. E. Stiglitz, 'Keynesian, New Keynesian and Classical Economics', *Oxford Economic Papers*, vol. (39) (1987) p. 119. The authors discuss New Classical economics as though the NCs meant it to be a description of reality. I doubt whether any NC author thought of the models in such terms. For the most part the NC movement was calling attention to aspects of micro-adjustment which, in terms of the caricature of such models, might serve to explain some of the disappointment with conventional Keynesian models.
8. I would still at this late day continue to urge that 'consistent' expectations is a much better description than 'rational' expectations. I so described it in what I believe was the first application to macroeconomic phenomena in 'Consistent Expectations, Distributed Lags and the Quantity Theory', *Economic Journal*, 1971, vol. 81, pp. 273–81. Expectations are consistent with both the information set and the model; rationality is another and much more far-reaching matter.
9. This 'ineffectiveness' result, however, was established only for the Sargent and Wallace Keynesian type of model (with a Phillips adjustment) when RE were substituted for adaptive expectations.
10. Much depends on the speed with which the private sector acquires information. The original formulations (by Sargent and Wallace) assumed that in period t the rate of interest was known only for period $t-1$. If, however, the private sector know the current rate of interest, *any* optimum rule is very difficult to disentangle and the results become volatile and dependent on the particular values of the model. See M. B. Canzoneri, D. A. Henderson, and K. S. Rogoff, 'The Information Content of the Interest Rate and Optimal Monetary Policy', *Quarterly Journal of Economics*, vol. 98(4) (Nov. 1983) pp. 545–66.

11. One might wonder, however, why monetary policy should be employed in eliminating deviations of output and employment that arise from contractual or informational lacunae. Surely would it not be best to concentrate on the contractual and information nexus as such. Of course this would require that the precise non-price elements be specified and a joint theory of contracts, monitoring, compliance, sanctions, and information be developed. As is well known, excess monetary expansion would generate long-run persistent inflation and much reduce the information content in the price system, which must give rise to further 'stickiness' and costs.
12. The seminal paper is by Robert Barro, 'Are Government Bonds Net Wealth?', *Journal of Political Economy*, vol. 82(6) (Nov.–Dec. 1974) pp. 1095–117. There has been much dispute on the applicability of this 'irrelevance of tax and bond finance' proposition. As I understand it, the evidence does suggest that the form of financing does have real effects, but less than those which arise from simply adding the deficit to aggregate demand. For a survey of the empirical studies on Barro's proposition, see Giancarlo Perasso, 'The Ricardian Equivalence Theorem and the Consumption Function: a Survey of the Literature', *Rivista Internazionale di Scienze Economiche e Commerciali*, forthcoming.
13. See Chapter 2 of my *Britain's Economic Renaissance* (Oxford University Press, 1986).
14. Because I am thought to be unsympathetic to various varieties of Keynesians (though I hope not to Keynes himself), I restrict this review largely to the account of Greenwald and Stiglitz (1987). It may well be argued that their account differs considerably from that of James Tobin, Robert Eisner and many other distinguished Keynesians. Perhaps so, but I doubt if the differences in the effects of monetary and fiscal policy are so large as to limit the critique that follows to this one clique of New Keynesians. Besides, the debate about 'what Keynes really meant' is alive and well among Keynesians and an agreement looks far from being within reach.
15. It must be recognised that Keynes himself was very much aware of the importance of monetary policy in determining real output (via the real rate of interest). On the topic of Keynes and monetary policy, see John F. Brothwell, 'The General Theory After Fifty Years: Why Are We Not All Keynesians Now?', *Journal of Post Keynesian Economics* (Summer 1986) pp. 531–47.
16. It must here be noted that other distinguished NKs would tend to put their trust in variations in tax rates rather than in government spending. Thus they fully reject the 'irrelevance of finance' argument of Robert Barro.
17. The normal NIESR assumption for this period was a trend rate of growth of potential GDP of 2.5 per cent per annum – the same as that actually experienced between the peaks of 1973 and 1979. But if one adopted a definition based on unemployment, then the period would be much longer.
18. *Bank of England Quarterly Bulletin*, vol. 23, no. 2 (June 1983) p. 205.
19. *Economic Trends*, October 1983, pp. 8, 16. These figures are for the whole of the private sector and include houses as well as the investment of non-corporate businesses. The investment of public corporations fell about £500 m, but government investment fell by about £2.5 bn – all over the period 1978/9 to 1981/2.
20. Note also that borrowing from the capital markets also approximately doubled from 1978 to 1981. (*Bank of England Quarterly Bulletin*, vol. 23, no. 2 (June 1983) p. 205).
21. If the NK view is simply that in a recession investment is low – then, of course, that is neither new nor interesting.

22. Bruce Greenwald and Joseph E. Stiglitz, 'Keynesian, New Keynesian and New Classical Economics', Working Paper 2160, *National Bureau of Economic Research* (Cambridge, Mass., Feb. 1987) p. 31.
23. Indeed it was widely thought that, during the depths of the recession, increases in interest rates *increased* rather than decreased the demand for credit, since the corporations were so desperate that they would have to finance the increased interest charge by borrowing more. For obvious reasons this had to be a fleeting transitory phenomenon. Ultimately changes in interest rates do affect the demand for loans in the traditional way.
24. There is the problem that the data will not reveal the *true* underlying relationship. In fact although one may find that the money supply is a prime determinant of real output some six months or so later, this observation could come from a system where the oscillations in activity are due *only* to unexpected monetary variations. See Thomas J. Sargent, 'The Observational Equivalence of Natural and Unnatural Rate Theories of Macroeconomics', *Journal of Political Economy*, vol. 84 (1976) pp. 31–40. In the comparison here I do not need to take issue on the nature of the expectations, but I would concede that, from the circumstantial evidence, in the last two deep recessions, the monetary movements were largely a surprise.
25. *Economic Trends*, 1985, table 153. If one adjusted for cyclical variations in unemployment, there would be virtually no difference to the figures. Unemployment did not start increasing until 1957–5 (see *ibid.* table 103). Furthermore, it is noteworthy that in an OECD study for the period 1955–65, the UK central government automatic stabilisers were *negative*, that is they were *destabilisers*. See Bent Hansen, *Fiscal Policy in Seven Countries 1955–1965* OECD, Paris 1969) table 2.6, p. 69.
26. The 'net money supply' (roughly M1) reported by Sheppard (*The Growth and Role of UK Financial Institutions, 1880–1962*) was (in billions of pounds sterling):

1951	1952	1953	1954	1955	1956	1957	1958
8.45	8.65	8.98	9.35	9.05	9.19	9.52	9.84

Thus it took three years to restore the nominal stock of money to its 1954 level. Similarly Bank rate peaked at 7 per cent in September 1957 and was brought down sharply in 1958 to 4 per cent.
27. This recession was the backdrop to the deliberations of the Radcliffe Committee (1959) and no doubt had much to do with the general conclusion that quantitative monetary controls were ineffective in managing the economy. But in one sense Radcliffe was correct. The reduction in the money supply had little effect on inflation until the latter half of 1957 – when at last prices stabilised, and the retail price index remained more or less constant through to the first half of 1960. The lag was indeed long – at least two years, perhaps three – before the effect of monetary contraction on prices could conceivably be claimed as a manifestation of a monetarist prediction. The decline of inflation coincided with the decline in interest rates. This period is also worthy of note because it has some claim to being the first (very mild) case of stagflation.
28. Thereafter MLR was relaxed to a low of 7.5 per cent in mid-1973.
29. Note also the 'weighting' items of the government accounts to reflect the degree of 'kick' expected in fiscal stimulus makes little difference to this assessment. Similarly, calculating the 'real' surplus by taking account of the inflationary erosion of public debt will not affect much the *differences* in the public sector deficits or PSBRs. See my *Britain's Economic Renaissance*, Chapter 4.

30. It must also be borne in mind that M3 was much affected by the changes instituted under CCC. The rapid increase in the rate of growth in 1972, especially in interest-bearing assets, was partly a consequence of the new freedom. One might take the point much further and argue that the *acceleration* in the growth rate of M3 ceased in the first quarter of 1973.
31. There remains the question: did the economy simply hit the 'full employment ceiling' as described by Sir John Hicks in his *Contribution to the Theory of the Trade Cycle* (Oxford, 1951), and would not this have occurred, as a consequence of such previous expansionary policies, whether or not there was a monetary squeeze? The ramifications of such a question are many; but it is worth noting that the economy did not expand along a 2 or 3 per cent path marking the 'potential' growth of the economy. Instead, there was a sharp *contraction*.
32. Note, however, that using the production index, *Economic Trends* table 82, one would strictly date it as the third quarter of 1975.
33. The data, representing changes from one calendar year to another in percentages of GDP at market prices, are:

	1971–2	1972–3	1973–4	1974–5	1975–6	1976–7
PSBR	0.8	2.6	1.9	2.2	−2.6	−3.1
PSFD	1.9	1.4	1.9	1.6	−0.7	−2.5

A psotive value indicates an expansionary fiscal policy, and a negative value a contractionary policy.
34. See David Savage, 'Fiscal Policy 1974/5–1980/1: Description and Measurement', *National Institute Economic Review*, vol. 99 (Feb. 1982).
35. If one uses the monthly rates of change of M1 and smooths these values with a 12-monthly moving average, the turning point in the smoothed series comes early in 1974. This timing is consistent with the movement of nominal interest rates.
36. I have discussed this recession and the role of monetary and fiscal policy at some length in *Britain's Economic Renaissance*, so the account in this chapter will be brief.
37. The *increase* in the financial deficit as a percentage of GDP at market prices compared with FY 1977/8 was:

Unadjusted	0.81
Cyclically adjusted	1.06
Weighted	0.44
Weighted and cyclically adjusted	0.58

The increase in the PSBR as a percentage of GDP is of a similar order. It will be noted that the financial deficit for 1977/8 decreased, as a percentage of GDP, from that of 1976/7. But the whole thrust of fiscal policy in the Keynesian and NK context is that the economy will react in months not years. So we can dismiss the earlier squeeze as the NK cause of the 1979 downturn.
38. In analysing the downturn, many economists have argued that, with much more fiscal stimulus in 1979, perhaps even late in 1979, the downturn could have been dampened if not reversed. For reasons set out in my *Britain's Economic Renaissance*, I think that such fiscal expansionism would have exacerbated the downturn because it would have created deficits which would be seen by the markets to imply massive retrenchment in the near future. Not the stuff on which to build offsets to a recession or a confident recovery.

39. Note that the growth rate of M1 continued to rise until it reached a plateau of about 15 per cent per annum, where it rested for about four years. The monetary expansion was, as it were, a permanent phenomenon – and I think was seen to be so by the market.
40. One important feature of the recovery is the apparent divergence in timing of the M1 and M0 indicators. The growth rate of M0 declined to the second quarter of 1982, and lagged the change in the growth rate of M1 by about 20 months. There are many plausible explanations such as deregulation and the payment of interest on checking balances – but it does cast doubt on using such indicators for short-run purposes.
41. For additional reflections on the problem, see my *Britain's Economic Renaissance*, Chapters 4 and 5.
42. So far as I am aware, there have been few considered accounts of the outcome by any of the 364 economists who signed the famous 31 March letter to *The Times* which predicted that 'present policies will deepen the depression, erode the industrial base of our economy and threaten its social and political stability'. The reactions might be generally classified into first those who say that, since unemployment continued to grow, there was no recovery, and second, those who argue that in 1982–3 and in subsequent years fiscal policy (particularly in terms of the public sector financial deficit) became modestly expansionary and so ensured expansion. A possible sophistication on this latter theme is to suggest that the 1981 budget was seen to lay the foundations for subsequent expansionary fiscal policy. And it was the *anticipation* of future budget relaxation that sparked the recovery in the latter half of 1981. Of course such an argument, for which there is much to be said, makes nonsense of conventional fiscal policy. It may be thought that the fiscal squeeze in 1981 had its main effects on inflation rather than on real output. Certainly inflation fell steeply in 1981 and 1982 – but it had been falling since the middle of 1980. And what many believe to have been the main ingredient in disinflation, the exchange rates peaked in the first quarter of 1981 and then sterling steadily depreciated as monetary policy was eased. The timing of the fall in inflation was broadly in line with the monetary contraction of 1978–9 – roughly a two-year lag.
43. An example of Keynesian views in 1985 of the effects of the budget squeeze is illuminating. James Tobin wrote of the 1981 policies: 'While Reagan and Volcker were converting cyclical deficits into structural deficits, their counterparts in Britain ... were converting cyclical deficits into structural surpluses. Their tax increases and spending cuts hit their economies while they were down ... contractionary fiscal policies prolonged recession and retarded recovery, even as spillover of American demands into foreign markets provided some relief.' 'The Fiscal Revolution: Disturbing Prospects', *Challenge* (Jan./Feb. 1985), p. 15. Yet later in that article, Tobin argues for a reduction of the US federal deficit because of crowding-out and unnecessarily high interest rates. He recommends (in more or less full employment) a combination of lower deficits and more expansionary monetary policy – indeed shades of British policy in 1980–81, except that there was massive unemployment.