1

INTRODUCTION

The National Institute has already produced two studies of economic policy in Britain. The first, Dow (1964), covering the fifteen years from 1945 to 1960, became a standard work of reference, as well as making a significant original contribution to the interpretation of economic behaviour. The second, Blackaby (1978), was designed to be a sequel in that it covered a similar span of years, 1960–74, but it was more ambitious in that it dealt extensively with a wider range of policies, industrial and commercial for example as well as fiscal and monetary. For that reason it was a group rather than an individual enterprise. The present volume is intended as a third in the series.

The task facing the historian of economic policy from the mid-1970s is a daunting one, more daunting surely than that which faced the authors of studies covering earlier postwar periods. It seems as if there have been more 'events' per year; and the volume of statistics and commentary referring to the period far outweighs that inviting analysis by historians of any earlier period. The task, if it is to be manageable at all, has to be narrowed down.

This is a book about macroeconomic policy, a term which is to be defined more precisely below. It is about the ways in which governments have tried to contain or reduce inflation, to influence the growth of output and employment. It concentrates on the use made, for these purposes, of monetary and fiscal policy. It has very little to say about other aspects of economic policy, such as industrial policy, trade relations, the structure of taxes and public spending; and it has relatively little to say about incomes policy under Labour and the special labour market measures used by governments of both parties to limit unemployment.

Another problem faces the author of this study more acutely than his predecessors. It has become much more difficult than it was, in the 1960s at least, to present the 'facts' of monetary and fiscal policy actions in a neutral and uncontroversial way, let alone to give an account of their consequences which would be generally acceptable to economists. Macroeconomics is not that kind of subject any more, and has not been for twenty years. For this reason alone this is not an easy book to write. It is written, however, in the strong belief that objective analysis is possible even in areas highly charged with political emotion, as well as by the value judgements of economists themselves. That said, it would be a dull book which tried only to present facts, without any new interpretation. The aim is not only to chronicle events, describe policy and the ideas which inspired it, but also to draw certain conclusions about what was achieved by policy in this particular period. What is more, the book is written in the belief that historical studies of this kind are a necessary step on the way to useful generalisations about macroeconomic policy as it can or should be conducted.

THE CHARACTER OF THE PERIOD

Not only in Britain, but in all the major industrial countries, economic performance since 1974 has been very disappointing by comparison with earlier postwar years. The growth rate of output has slowed down in almost all countries. In Britain this deceleration was very marked indeed during the later 1970s, but there was some catching up in the 1980s not seen elsewhere.

The deterioration in economic performance is even more obvious in relation to unemployment and inflation – the two variables for which macroeconomic policy is traditionally responsible. Full employment (in the proper sense of the term) was maintained continuously in Britain from the war until the early 1970s; in the period covered by this study it was *never* achieved. The 1950s and 1960s were characterised by persistent inflation, but inflation at a moderate rate that most found acceptable, if not actually desirable; the 1970s and early 1980s twice saw inflation in Britain at over 20 per cent a year, a rate at which it comes to dominate economic policy and to interfere considerably with the lives of most citizens. This book therefore must be mainly about the earnest struggles of macroeconomic policymakers, not about their triumphant successes. The best that could be said of them would be that they did well 'in the circumstances'; some did better than others, but none had much cause for satisfaction or self-congratulation.

It would be good to offer some all-embracing and cogent explanation of what went wrong, but historical studies, especially studies of economic history, seldom produce clearcut conclusions of that kind. It would in any case be necessary to extend the study to the world economy as a whole, before those features of economic performance which Britain shared with other industrial countries could be accounted for convincingly. All that can be done here is to point to some attendant circumstances which characterise the period, and may help to account for the failures of macroeconomic policy and performance.

The oil price increases of 1973 and 1979 undoubtedly caused major upheavals in the world economy and were widely blamed for the ills of the industrial world. They added to inflation by raising costs, and they depressed output by cutting the real value of incomes. They created an unfamiliar pattern of payments balances between countries which may have upset financial markets. Even so it is surely too convenient an explanation for the finance ministers and central bankers of the world to say that the *main* reason for the poor performance of the world economy was the actions of oil producers. The system should have been able to cope with disturbances of this kind and scale.

A more profound change, between the 1960s and the 1970s, was the move from fixed to floating exchange rates. As later sections of this book will describe, this changed profoundly the nature of macroeconomic policy in all the major industrial countries, including Britain. At this stage we should simply note that the rules of the game had changed, making the conduct of policy altogether more difficult, at least while practitioners were trying to find out what the new rules were.

Britain was more exposed than most countries to the new international financial environment, especially after the abolition of exchange control in 1979, because of the importance of sterling as a currency in world markets, and because of the decision not to join in the exchange rate mechanism of the European Monetary System. We shall have occasion to refer to exchange rate movements in almost every section of this book.

It might be expected that the effects of Britain's entry into the European Economic Community (EEC) in 1973 would provide another recurrent theme for the study. In fact it will hardly be mentioned. In macroeconomic policy, as distinct from commercial policy, competition policy, regional policy and so on, Brussels did not have a great influence on the British authorities at this time. There were attempts to 'coordinate' policy within the Monetary Committee, but these were no more significant than the attempts to cooperate worldwide through the International Monetary Fund (IMF) and the Organisation for Economic Cooperation and Development (OECD). Indeed the views of the American authorities mattered more in London at most times than the views of Paris or Bonn. Very gradually the influence of EEC directives and laws touched more and more facets of life in Britain, so that by the end of our period the issue of sovereignty was becoming one of real political significance. But, strangely enough, macroeconomic policy was still one of the issues *least* affected by entry into the EEC.

In economics generally, and in the debate over macroeconomic policy in particular, British opinion was conditioned by events and ideas in America, not in Europe. The debate in Britain, as we shall see, was especially lively because the economic doctrine of monetarism came to be loosely identified with the Conservative Party whilst the Labour Party remained more or less faithful to Keynes. This is a crude and misleading simplification, but it is just the sort of crude and misleading simplification that often colours public debate. The period of this study was characterised in Britain by a debate over macroeconomic policy which was unusually bitter and contentious. There had been a broad agreement between political parties from the war until the early 1970s about the general lines on which macroeconomic policy should be conducted. When that consensus broke down, opinion in Britain went to extremes. The intellectual opinions adopted and the policies actually put in place on the basis of them were more dogmatic, less pragmatic, than those found in most of Continental Europe. It will be argued that the oddities of British thought and practice may have contributed to our relatively poor performance. The British are not usually thought of as volatile, argumentative or passionate people, but in matters of macroeconomic policy in the 1970s and 1980s that was the way we behaved.

The approach of the Labour government from 1974 to 1979 was broadly an attempt to keep the old style of economic policy in being (despite some important changes of tactics and despite growing doubts as to its efficacy). Government was expected still to direct the economy in all strategic, and in many particular, respects. Exchange controls remained; bank credit was rationed; industrial and regional policy was still active; above all prices and incomes policy negotiated with national trade union leaders was more crucial than ever to attempts to contain inflation.

The approach of the Conservatives after 1979 was, by contrast, revolutionary. Incomes policy was scrapped; exchange control was scrapped; direct regulation of the banks was scrapped as well. Little remained of industrial and regional policy. Firms and individual workers were told to serve their private economic interests, with no guidance from on high, and only the minimum of regulation by law. The decisions of bureaucrats were replaced by the market mechanism. The speed and thoroughness of the reforms, popularly called 'Thatcherism', were watched with awe by the outside world, mixed either with admiration or with dismay.

This book, however, is about macroeconomic policy, not about economic reform in this much broader sense. The conduct of macroeconomic policy, and of monetary policy in particular, was central to the rhetoric of Thatcherism, but it will be argued that in this area there was less discontinuity than elsewhere. The way in which the Bank of England and the Treasury set interest rates day by day or month by month was not vastly different in 1987 from the way they set them in 1974, or indeed twenty years before that. Against the background of economic upheaval and the clash of opinion, the routine work of the monetary authorities was surprisingly little affected.

The same might even be said of fiscal policy. The use of the budget as an instrument of macroeconomic policy never was as active in practice in the 1950s and 1960s as economic textbooks would have one believe. Throughout the 1970s and 1980s the Treasury went on making short-term economic forecasts, and using them to advise the Chancellors what they could 'afford' by way of tax cuts or public spending. The Chancellors, as always, took the advice with scepticism, but did not ignore it altogether. Here too there was some continuity between the period of this study and that of its two predecessors.

So much for the overture! It remains, before embarking on the first act of the performance, to identify rather more precisely what the title means. The word 'macroeconomic' as applied to policy is intended in a limited and rather precise sense, which must now be carefully defined.

MACROECONOMIC POLICY

Paradoxically, macroeconomic policy consists typically of *small* decisions, nudging interest rates up or down by a percentage point or so, whilst microeconomic policy includes momentous strategic choices like joining the EEC or reforming trade union law. The borderline is not always clearcut or undisputed, so it is necessary before embarking on a history of macroeconomic policy to adopt a working definition of it, and to reflect for a moment on what macroeconomic policy thus defined might reasonably be expected to achieve.

The aims of macroeconomic policy concern the behaviour of the economy as a whole, not that of particular industries, regions or social groups. Indeed, the great merit of macroeconomic policy is that it enables the government to take responsibility for some aspects of aggregate performance without needing the information, or the legal powers, to intervene in the affairs of particular parts of the economy. It can be conducted impersonally, apolitically and decisively, by means of a limited set of instruments which have a pervasive effect on the working of the entire economic system. It is common ground to economists of widely differing views that the conduct of macroeconomic policy with sufficient skill and determination is a necessary condition for the well-being of society. It provides the framework, to use a familiar metaphor, within which the private sector – and indeed the public sector as well – can take decisions about the allocation and use of resources. Suggestions have been made that macroeconomic policy should be put in some sense 'above politics', by handing it over to officials or experts who might be more farsighted, less partisan, than the government of the day. Such suggestions have not been put into practice, but the possibility of making them says something about the character of macroeconomic policy, and about the ideals of many of those involved in its conduct.

The aims of macroeconomic policy are usually said to be full employment and price stability. Few would quarrel with that as an ideal; the practical difficulty is that the two aims may be incompatible. The actual experience of the period covered by this study is one of high and rising unemployment together with persistent, volatile and often alarming inflation. If price stability was attainable at all, it was so only at the cost of yet higher unemployment, for all or much of the time. Thus a prior choice had to be made as to the rate of inflation which was considered tolerable, a choice which officials and experts on their own were hardly entitled to make, but which politicians were reluctant to make explicitly. Yet the day-to-day or year-to-year conduct of macroeconomic policy has always to be predicated on a choice of that kind.

The choice is made more difficult because we are ignorant of the 'trade-off' between unemployment and inflation. Many economists would indeed deny that such a trade-off exists in the long run; they would say that the choice is between a temporary fall in unemployment and a permanent fall in inflation – the debate continues. If politicians are reluctant to make explicit choices between inflation and unemployment it is partly because economists cannot tell them with confidence which combinations are possible, and which are not. Moreover it is possible, indeed likely, that the nature of the trade-off that exists between inflation and unemployment itself depends on the way in which macroeconomic policy is conducted.

Within any given overall strategy the routine conduct of macroeconomic policy could be described as demand management. This term, although it went out of vogue in the 1970s, still described rather well what the Treasury and the Bank of England were trying to do. They tried to prevent aggregate demand in the economy rising above, or falling below, the level compatible with the combination of inflation and unemployment which was found to be the least unacceptable. 'Management' is a better word than 'control' because the precision with which demand can be maintained and influenced has never been high – so-called fine-tuning of demand was always an unrealistic aim.

It may seem odd to equate the routine of macroeconomic policy with demand management when the presentation of policy for many years was in terms of monetary control. But the difference in theory is not as great as the heat of controversy between monetarists and Keynesians would suggest; and the difference in practice is even less. In theory monetary control ensures control of inflation because an excess or deficiency of money adds to or substracts from demand for goods and services. The precise mechanism is open to question, but most theoretical accounts of a monetarist regime imply some sort of automatic regulation of aggregate demand. The way monetary control was attempted in Britain was extraordinarily similar to demand management, since the operational decisions were about the level of interest rates and the size of budget deficit necessary to hit the monetary target. There was no attempt to control the money supply *directly*; what the authorities tried to manage was the demand for money, a close relation, as it happens, of aggregate demand for goods and services, expressed at current prices.

Nevertheless, to talk of demand management in the 1970s and 1980s without qualification *would* be somewhat anachronistic, because the floating of the exchange rate introduced a new and very important element into the calculations of policymakers. Monetary policy was dominated by exchange market pressures for much of the period covered by this book. On occasion fiscal policy had to be used as well to 'defend the pound'. The first requirement to be met by a set of macroeconomic policy measures often was that it should be well-received by international bankers, not that it should be appropriate to the pressure of demand in the domestic economy.

Sir Peter Middleton (1989) has suggested that the need to keep the confidence of financial markets was recognised by the Treasury as the essential first requirement of a sound macroeconomic policy some time in the 1970s. 'Confidence and expectations in financial markets are crucial to policymaking in today's world of global markets. It is no use thinking that those involved in financial transactions will take the trouble to understand the nuances of domestic economic policy'. The chronicle of events in Part 1 will include many events which serve well to illustrate that text. It may not give a complete account of the substance of macroeconomic policy, but it is a necessary corrective to those who think that demand management can continue unchanged in exactly the same way as it was conducted when Butler or Gaitskell was Chancellor of the Exchequer.

Even under the new rules of the game appropriate to a world of floating exchange rates, however, the old, hard choice between inflation and unemployment still had to be made. The authorities had to decide what level of the exchange rate they would try to defend: a high exchange rate helps reduce inflation, but a low exchange rate makes industry more competitive. There is still a trade-off, although its nature may not be the same as that available in a closed economy.

To achieve their preferred combination of output and inflation the Treasury and the Bank of England have two instruments at their disposal. They can, within limits, decide the rate of interest at the short end of the market, day by day and month by month. That is the main way in which monetary policy operates. The government can also decide year by year roughly what the level of public sector borrowing shall be. That for present purposes summarises fiscal policy.

The system is a good deal more complicated in practice, so that the two levers of macroeconomic policy could easily be described as two dozen. In the case of monetary policy, decisions have also to be taken about operations in gilt-edged markets, about purchases and sales of foreign exchange, about regulation of the banking system, in the past, about hire purchase control and about a host of other things. In the case of fiscal policy the mix between different kinds of public spending matters as well as its overall level; the rates of taxation matter for their effects on private sector behaviour as well as for the revenue they raise.

The choice between fiscal and monetary measures, when it is thought necessary to expand or contract demand, was not always taken in a systematic way. In the Spring action might be in the budget, at other times of year it was interest rates that changed. In an emergency, such as characterised much of the 1970s, action had to be taken on both fronts, even at the 'wrong' time of year. The possibility of using the two arms of policy in a more constructive way than this was often discussed. It is an issue we shall take up later in this study.

The hint was dropped a few pages back that the nature of the trade-off between inflation and unemployment might be changed by the way in which macroeconomic policy is conducted. If that is true, it is obviously a consideration of the first importance. The routine of macroeconomic policy may be aptly described as demand management even in the 1970s and 1980s, but the term does much less than justice to the ambitions of governments in that period, and it gives much too narrow an account of the issues covered by the concurrent debate about the way in which macroeconomic policy should be conducted.

Demand management was once seen by economists as an essentially technical exercise, what used to be called 'steering the economy'. But all the theory of macroeconomic policy was rewritten in the 1970s to take account of the way in which expectations are influenced by the conduct of policy. (The fact that floating exchange rates respond to expectations very sensitively may be of importance to the timing of this intellectual revolution.) Macroeconomic policy is a matter of political leadership, credibility and reputation as well as a technical matter of economic forecasting and modelbuilding. Politicians may feel that they have known this all along, but since the 1970s economists have incorporated a more rigorous use of this language into their debate and policy recommendations. The interesting policy choices were not seen so much in terms of one year's budget or one week's interest rate change, but in terms of alternative rules or regimes that might be put into operation and govern policy responses for the foreseeable future.

The attempt to influence expectations was one way of addressing the central problem of economic policy, that of combining an 'acceptable' rate of inflation with an 'acceptable' rate of unemployment. The other way was to call in aid additional arms of policy which could as easily be called microeconomic as macroeconomic, and which *did* involve detailed intervention by government in the working of the economy.

Prices and incomes policies were intended to act on inflation directly – to suppress it, rather than to cure it, a critic would say. A more sophisticated way of putting it would be that they were an attempt to reduce the level of unemployment that was compatible with constant inflation. Special employment measures tackle the same problem from the other end. They act directly on unemployment – to disguise it, a critic would say, not to eliminate it. They too may shift the trade-off between unemployment and inflation. Less obviously and directly many kinds of economic policy initiatives may have an influence, for good or ill, on the sustainable level of economic activity and the degree to which the system is prone to inflation. A case could be made, for example, for including trade union legislation and competition policy in a book on macroeconomic policy; but a line must be drawn somewhere.

OUTLINE OF THE BOOK

The earlier parts of the book are mainly descriptive, the later parts more analytical. There are no footnotes, but each part is provided with bibliographic notes and a list of references at the end of the book. Part 1 is a chronological account of macroeconomic policy actions and their setting. The topics covered during the periods of Labour and Conservative governments necessarily differ a little: for example the description of successive phases of incomes policy from 1974 to 1979 has no parallel in the later sections. A calendar of events is provided at the end of the book, as well as charts of the main economic indicators.

This is followed in Part 2 by a history of ideas about macroeconomic policy and its effects. This describes some of the most influential writings of economists in Britain during the period, throwing light on the reasons given for policy actions by ministers and by officials. Given the intellectual ferment of this period, it is not possible to include all the significant ideas that have been given an airing. It is hoped that the themes which are developed are reasonably representative.

The influence of the world economy on Britain was not the subject of special attention by Dow or by Blackaby, but it has now become so pervasive that it calls for a Part of its own. Part 3 gives a necessarily brief account of the developments in the major economies and compares their experience with that of Britain.

Part 4 contains the main analysis of monetary and fiscal policy. This is of broadly two kinds. The first considers how policy instruments were used in response to different indicators, such as inflation, unemployment, the exchange rate or interest rates abroad. In the case of interest rate movements econometric estimation is possible, showing for example how the reactions of the authorities differed before and after 1979. The second kind of analysis uses the National Institute's macroeconomic model of the United Kingdom economy, and compares the course of events with what might have happened if macroeconomic policy had been different in several carefully defined ways.

Part 5 is concerned with the consequences of macroeconomic policy, that is with what actually happened to inflation, unemployment, the external balance and the rate of growth. The issues addressed include the following: the consequences of a floating exchange rate; the reasons for the upward trend in unemployment; the relationship between inflation and the pressure of demand; and the effects of demand management on growth potential in the long run.

The conclusions drawn in Part 6 contrast the rhetoric of policy with what was actually done, and the claims made for policy with what was in fact achieved. We try to give a brief summary of 'what actually happened'. After that we try to draw out some lessons from history. It is necessary to come to terms with the events and ideas of the past before prescribing policies for the future.