CHAPTER 1
POLICY REVIEW

In February 1972 the CEPG produced its first report on medium-term prospects for the UK economy, which argued that unless the long-term trend in our industrial performance were changed a large and growing depression would occur. At least once a year since that time we have repeated the warning with increasing emphasis.

Events have so far confirmed our worst fears. Manufacturing production is barely higher than seven years ago, while the volume of imports of finished manufactures over the same period has risen *two-and-a-half-fold;* unemployment has risen from 600,000-odd to nearly one-and-a-half million - a figure that would not have been believed ten years ago. Inflation is now at about the same rate as it was in 1970-71.

Nothing whatever has yet been done to reverse or even check the process of decline and, according to the latest analysis, which is presented in detail in later sections of this *Review,* these adverse trends will continue - why should they not do so? - unless radical changes in policy are at last made. Ten years from now unemployment will, on our estimates, be rising towards *5 million* unless mass emigration occurs in the meantime. The present prospect is insidious, because the increase in revenues from the North Sea will for a time protect real incomes, although it can only do this temporarily.

Many of the themes have been raised before; but the failure of our economy and of our economic policies together with a lack of insight on the part of our rulers and most of our influential commentators leaves us with no option but to set out the crucial issues with increased urgency.

The past 25 years of stop-go

One continuous theme of CEPG reviews has been the necessity of considering economic developments and policy over longish periods of time, so that trends can be identified and attention focused on the developing structural problems. It is instructive to consider in a succinct form the history of the economy and economic policy over the whole of the last 25 years, so as to put into perspective what seemed at the time to be major policy gestures.

Table 1.1 documents how British macroeconomic policy has responded in the postwar period to alternating internal and external pressures, without there ever being any positive or effective long-term strategy. A record as simple as this cannot do justice to the full complexity of developments, but the movement of the main economic indicators over a quarter of a century, when juxtaposed with key political events, conveys an important message.

The 25 years 1952-1977 divide fairly clearly, so far as macroeconomic developments are concerned, into *ten* periods, in each of which policy faced alternately in opposite directions.

The story may be summarised as follows:

(1) 1952-1955. We start in recession (by the standards of the time) together with a surplus on the current balance of payments. Fiscal and monetary expansion raises output faster than trend for 2-3 years.

Table 1.1. Economic policy, 1952-77

Policy	Result in year	Real output (% deviation from trend)	Unemployment at end of year (%)	Current balance of payments (£ million)
Stop	1952	−0.3	1.7	+163
Go	1955	+1.7	0.9	−155
Stop	1958	−2.4	2.1	+344
Go	1960	+0.2	1.4	−245
Stop	1962	−1.3	2.2	+128
Go	1964	+1.8	1.4	−356
Stop	1967	0.0	2.3	−300
Go	1968	+1.1	2.3	−287
Stop	1971	−1.4	3.8	+1058
Go	1973	+1.2	2.1	−992
Slow	1974	−2.9	2.8	−3565
Stop	1977	−11.0	5.9	+59

Unemployment falls to under 1%, but the balance of payments moves into deficit. The Chancellor (Mr Butler) resigns on 20 December 1955, after the Conservative government wins the election.
(2) 1955-1958. With a weak external position and a high pressure of demand, policy becomes restrictive. The economy responds slowly at first and a sterling crisis in 1957 leads to further restrictive measures, which cause a more severe recession (unemployment rises to about half a million) but achieve a substantial external surplus. The Chancellor (Mr Thorneycroft) resigns on 6 January 1959.
(3) 1958-1960. In view of the strong external position and high unemployment, fiscal and monetary policy become very expansionary. The economy recovers rapidly and unemployment falls; the current balance goes into heavy deficit, although it is not until the first half of 1961 that there is a substantial loss of reserves. But meanwhile, on 27 July 1960, the new Chancellor (Mr Heathcoat Amory) resigns after the Conservative government wins the election.
(4) 1960-1962. With a weak external position and low unemployment, policy becomes restrictive. Output stagnates and unemployment rises to record levels by postwar standards,[1] but the balance of payments goes into moderate surplus. The Chancellor (Mr Selwyn Lloyd) is sacked by the Prime Minister on 13 July 1962.
(5) 1962-1964. With a reasonably strong external position and high unemployment, policy is very expansionary; output rises unusually fast (by UK standards) and unemployment falls. But the current account goes into heavy deficit and this is compounded by a large capital outflow. The Chancellor (Mr Maudling) loses office with the defeat of the Conservative government on 15 October 1964.
(6) 1964-1967. The regular pattern is now interrupted. Fiscal and monetary policy are pretty neutral to start with and an attempt is made to correct the balance of payments by imposition of a surcharge on imports. The economy continues to expand (though only moderately), but the balance of payments remains in deficit and there is a big capital outflow in mid-1966. The Chancellor (Mr Callaghan) does *not* resign. In mid-1966 restrictive measures are at last imposed, causing output to stagnate and unemployment to rise. This time, however, the balance of payments remains in deficit and there is a large capital outflow leading to a devaluation of sterling. The Chancellor (Mr Callaghan) resigns on 29 November 1967.
(7) 1967-1968. Policy is not restrictive and output rises quite rapidly. Despite a large rise in exports the balance of payments remains in deficit and there is a large capital outflow.
(8) 1968-1971. Policy becomes very restrictive, causing output to stagnate for three years and unemployment to reach a new peak. But the balance of payments moves into substantial surplus and there is a huge capital inflow. The Chancellor (Mr Jenkins) loses office with the defeat of the Labour government on 18 June 1970.
(9) 1971-1973. With a very strong external position and record unemployment, fiscal and monetary policy become very expansionary; output rises fast and unemployment falls back, but only to what were considered recession levels in the fifties and sixties. The balance of payments goes into very heavy deficit - about £1000 million in 1973. The Chancellor (Mr Barber) loses office with the defeat of the Conservative government on 28 February 1974.
(10) 1973-1977. Here there is a break in pattern caused by the rise in world oil prices. The external deficit consequent on this (rather than fiscal and monetary policy) transmits a strong disinflationary impulse to the economy, causing total output to fall below trend. Capital inflows (in the form of sterling holdings by certain OPEC countries) initially mitigate the effect of the current account deficit on the reserves. The disinflationary impulse is next reinforced on a growing scale by restrictive fiscal and monetary policy, causing by far the most serious recession of the postwar period; output falls 11% or so below trend and unemployment nudges $1\frac{1}{2}$ million. The current balance of payments goes into surplus and there is a total currency flow inwards of around £7 billion. The Chancellor (Mr Healey) is still (6 March 1978) going strong.

With such a run up, it is obvious what the character of policy will be in the immediate future. With a relatively strong external position and high unemployment there will be a re-expansion of fiscal and monetary policy sufficient to generate some recovery in real income, output and employment during the next twelve months. The government is under no immediate pressure to adopt any more radical policy to deal with secular processes; and now, as throughout the last 25 years, the government's main gestures will be nothing more than a short-term response to the pressure of short-term influences.

Underlying trends

While during the past 25 years the changes in the direction of policy, at the time they were made, had come to seem inevitable, there were underlying trends of a most disturbing kind continuously at work which should have been apparent.

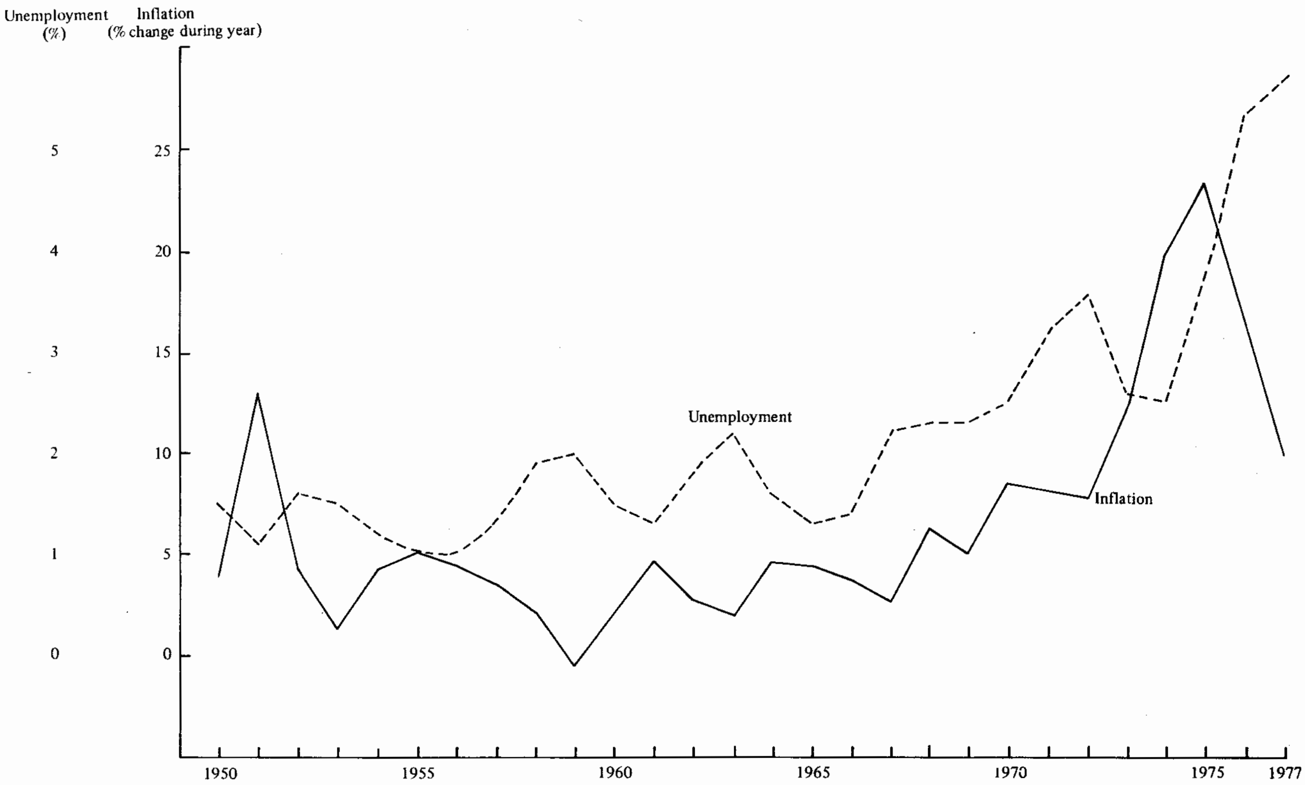
Table 1.2. Growth of exports and imports of manufactures (% per year)

	Exports of manufactures	Imports of manufactures	GDP
1951-1955	0.9	4.8	2.8
1955-1960	1.4	9.7	2.4
1960-1964	4.7	8.6	3.4
1964-1968	5.1	8.6	2.6
1968-1973	7.8	12.3	2.9
1973-1977	4.4	4.3	–0.1

Table 1.2 shows how the volume of exports and imports of manufactures has moved over the past twenty years. Since 1960 exports have risen fairly steadily at 4-8% *per annum*, whereas imports have risen at 8-12% *per annum*. Exports were so much higher at the beginning of the period than imports that for many years the absolute gap between the two was roughly constant. But the continuation of past trends of imports of manufactures relative to exports would more recently have meant that the gap would close and

[1] Excluding a freak period in the forties.

Fig. 1.1. Inflation and unemployment, 1950-77



that imports would come to exceed exports by a large margin. The necessary consequence is that growth of GDP has had to be sacrificed to hold down growth of imports and protect the balance of payments.

Fig. 1.1 shows the level of unemployment and the changing annual rates of inflation since 1950. So far as unemployment goes the picture is a clear one; after remaining nearly stable and very low until about 1965 there has been a marked, indeed sensational, turn for the worse.

There is no suggestion whatever that low unemployment is incompatible with falling inflation, since the inflation rate fell from 13% in 1951 to below zero in 1959, although unemployment averaged only 300,000 during this period. Nor is there any suggestion that high unemployment brings diminishing rates of inflation. The recent inflation has been much more like that in 1951 than seems to be generally realised. The earlier Korean war period saw a huge increase in commodity prices followed by a large consequential rise in wages, bringing the annual inflation rate to a peak of 13%. When commodity prices fell in 1952 there was a commensurate response in wages, so that inflation fell back below 5%. The important differences between the Korean inflation and the present one are that the rise in oil prices has not been reversed and that the rise in commodity prices in the recent period caused a larger and faster response of wages because of the unfortunate threshold scheme. Partly for these reasons the rate of inflation has fallen less rapidly than in the fifties.

Misleading analyses

Discussion of the problems of stagnation and unemployment has been confounded by a failure to recognise the central importance of the balance of payments as a constraint on the growth of output and loss of industrial markets as the main cause of this constraint.

Thus the monetarist school of analysis has fostered the false belief that much of the increase in unemployment has been voluntary, or has been caused by real wages being too high. These views are more pernicious than the misguided emphasis on the role of monetary policy as such, because they imply that the onus for curing unemployment and stagnation lies with workers and that there is little the government can do.

Another misleading view is that recovery of output can be led by services rather than by industry. It is argued that since the trend of demand in a growing economy is towards services rather than industry, the decline of UK industries does not really matter, and it is sometimes even claimed that services could provide an adequate source of increased foreign exchange earnings to finance rising imports. As will be demonstrated in Chapter 3, this view is totally unrealistic. A much improved performance in industrial trade is in fact essential to alleviate the balance-of-payments constraint on growth of GDP.

Policies to reverse industrial decline

The key to improved prospects for the economy as a whole is a reversal of the trend loss of industrial markets which has persisted throughout the postwar period. There is now some temptation to shift the blame for the depression in the UK onto excessively disinflationary fiscal and monetary policies in other countries. But according to our calculations the UK's trade performance looks like being so poor that even with a rapid growth of world trade it would still be impossible to restore full employment without radically new policies.

Indicative planning and sectoral consultation, such as that embodied in former National Plans and the present Industrial Strategy, have had no visible effect on industrial performance. Nor have adverse trends been checked by general tax reliefs and grants to industry, provided in various forms for the past two decades. The most successful policy to date, in terms of measurable efects, has been real devaluation (i.e. depreciation of the exchange rate in excess of inflation in the UK relative to competitors). But real devaluation conflicts with the aims of financial management, because it intensifies inflation. It has never been maintained for more than a few years at a time. Estimates in Chapter 2 of the scale of real devaluation needed to prevent rising unemployment in the 1980s imply a sustained rate of depreciation which seems quite infeasible, not least because it would involve a massive rise in the share of profits in income at the expense of wages.

The basic necessity is to secure high investment in new or expanded manufacturing facilities, which displace foreign suppliers in home and overseas markets at least as much as they replace existing home production. The calculations in Chapter 2 imply that at least a 50% increase in manufacturing investment, maintained for a decade, will be necessary in order to prevent very high unemployment in the 1990s. In our view there is no possibility of carrying through such a programme without extensive protection by means of import controls or other means of discrimination in favour of home industries, because this alone will provide an assurance that new capacity can be operated at a high level of utilisation and that it adds to, rather than replaces, existing production.

The international perspective

The strongest argument against using protection as an instrument for restoring full employment is that this is contrary to the system of alliances and agreements in which we have become engaged. It is also argued more generally that we are in an interdependent world in which there is only very limited scope for unilateral action.

The system of alliances and agreements is certainly there, but their manifest objective has always been to increase our prosperity and protect employment and living standards, as indeed the opening paragraphs of the GATT clearly point out.

It is our contention that there is no solution to the problems of structural trade imbalance through free trade unless it were really to be accepted that whole countries and whole regions of individual countries should be permitted to become impoverished and derelict.

A genuine international solution to the problem of the progressive divergence between countries in their economic growth and living standards would have an altogether different character from anything which now exists. In outline it might have to undertake on an international scale something like the implementation of the regional policies which our own governments have with some limited success pursued within the UK. In other words the relatively successful and rich countries. subject to appropriate conditions, should positively assist the others by budgetary transfers or other means in discriminating against themselves. Lest this should sound fantastic, it should be recalled that this is in essence precisely the policy which was followed by the USA with remarkable foresight, generosity and success in the early postwar period, and on which the postwar recovery of all industrialised countries has been based.

Official views

It is very disconcerting that the major statements made recently by the Chancellor, by the Permanent Secretary of the Treasury and by the Governor of the Bank of England[2] contain no significant references to the alarming present predicament and future prospect; nor do they give the slightest indication of what policies would change these trends, let alone how these would work.

> 'So getting unemployment down depends on sticking to the policies which have paid off so well in the last twelve months. First, we must keep the balance we have achieved between the main components of demand. Second, we must make sure that we do as well in the rest of this wage round as we have so far in keeping settlements within the guidelines. Third, we must maintain control of the monetary aggregates.'

Thus, our Chancellor in a speech to LEFTA on 17 February 1978. But neither this nor anything else in the three speeches mentioned above gives any indication of the mechanism whereby monetary targets or the manipulation of conventional policy instruments, or anything else whatever, could have the slightest bearing on our industrial performance and on the grim prospect of substantially worse depression and unemployment over the next decade.

[2]Addresses by D. Healey to the Labour Economics Finance and Taxation Association, 7 February 1978, by D. Waas to the Johnian Society, 15 February 1978, and by R. Rishardson at the City University, 9 February 1978.