Policy Assessment

Five years ago Britain produced no oil. Now we are self-sufficient. This oil provided Britain's last chance of avoiding long-term mass unemployment. It should have been used to revive our industries, restart economic growth, reduce unemployment and hold inflation at an acceptable level. Yet our national output including oil this year will be no higher than in 1976. Investment has fallen, unemployment has doubled, inflation is still above 10 per cent and for most people the tax burden is much higher. The oil has not merely been wasted, it has been used to destroy our economic base.

The reason for this appalling result lies in the policies adopted by the last government and enforced with increased vigour by the present government. These have driven up the exchange rate and imperilled industry. The government insists that its tough budget is essential to reduce inflation and secure long-term recovery. Its critics are united by the fear that the budget will cause deepening slump. Most believe that a fall in sterling is vital to help industry; many demand reflation; and a few urge protection.

This *Review* argues that, irrespective of the budget, past policies had already set up the conditions for a continuing slump. We do not see any forces which could support output even at its present level, once any benefit from a stabilisation of stocks has evaporated. On the contrary we see output then continuing to decline. Industry is now so weak that a major reflation would lead straight to huge balance of payments deficits and a collapse of sterling. Devaluation of sterling, accompanied by reflation, would accelerate inflation and could not halt growing unemployment this side of three millions.

Our impression is that most people completely mistake the scale of the problem. Reflation sufficient to halt the rise in unemployment and enlarge the area of dynamism in industry would lead to a financial deficit on the balance of payments of the order of £10 billion after a year or so. It therefore remains our view that import controls would be necessary to sustain recovery on a scale which would bring unemployment down while at the same time keeping inflationary pressures within tolerable bounds. But we are bound to add that reflation and devaluation, though hardly satisfactory, will be less dangerous than the continuation of present policies. If the economy will not turn, the government must.

The government's economic philosophy

The present government differs from all previous post-war governments not only in its priorities but also in its underlying views about how the British economy works.

As far as priorities are concerned, the government has set an unprecedentedly high value on the control of inflation. However, it does not regard the ending of inflation as something which in the end conflicts with a high level of output and employment. On the contrary, while recognising that the control of inflation is likely to have some cost in terms of temporary unemployment, the government sees such control as a necessary condition for returning to high employment in the long term. The government believes that unemployment has been caused by inflation itself, by people having priced themselves out of jobs. As a corollary, the unemployment now observable is almost all voluntary in the sense that everyone could obtain jobs if they were prepared to try hard enough and to accept 'realistic' payment for their work.

Inflation, the government believes, can only be brought down through control of the money supply and success will be achieved more rapidly if expectations can be changed in advance. This is achieved by announcing diminishing targets for monetary growth extending for years into the future.

There is, however, more to the government's policy than just reducing inflation through control of the money supply and the announcement of money targets. In addition, they believe, it is essential that the vital energies of the British people should be released by offering them incentives in the form of low taxation and interest rates. Hence the critical importance they attach to cutting government expenditure; this is a necessary condition for being able to provide such incentives. The proposition is demonstrated by the following argument. If government expenditure is not more-or-less fully covered by taxation, the result is high public borrowing. And if there is not to be a large increase in the money supply (frustrating the objective of controlling inflation), high public borrowing has to be financed by heavy sales of government bonds which will drive up interest rates. Thus the only way to keep both taxes and interest rates down may be to cut government expenditure. Moreover an increase in public spending financed by bond sales would 'crowd out' private borrowing, causing private investment to fall *pari passu* with the rise in public spending.

According to this analysis a fiscal stimulus to aggregate demand would have no lasting effect. There is one way and one way only back to full employment and prosperity. That is for individuals and groups to take advantage of the opportunities that now exist or to create new ones, threatened by the sticks of unemployment and bankruptcy and encouraged by the carrot of (post tax) monetary reward.

Critique of the government's philosophy

The above analysis has a strong political appeal to the government's supporters and generates a number of propositions, for instance about the importance (or even morality) of covering public expenditure by taxation, which present themselves, *prima facie,* as reasonable. Nevertheless the whole story, however plausible, is wrong from beginning to end.

Money and inflation

It used to be confidently asserted by monetarists that changes in the money supply were reflected about two years later in the inflation rate*. One of the most attractive features of this position was its simplicity. It was plausible, indeed 'obvious', that inflation was caused by excessive monetary growth — 'too much money chasing too few goods'. And the theory was testable. In the words of Milton Friedman:

> There is perhaps no empirical regularity among economic phenomena that is based on so much evidence for so wide a range of circumstances as the connection between substantial changes in the stock of money and in the level of prices. †

Unfortunately, the rather dubious statistical relationship which appeared once to exist between the chosen measure of money (M3) and inflation has now proved worthless.

In response to this breakdown there are two characteristic defences by monetarists, both of which seem to us completely untenable. First it is sometimes said that it was wrong to take M3 as the appropriate definition of money in the first place, but that instead we should look at a range of different measures. The difficulty with this is that, since the different measures of money move very differently from one another, in the absence of specific guidance there is no way in which we can reliably interpret any particular configuration of changes. We can indeed 'look at' the figures but without more to go on we can make no interpretation of them.

Another line of argument is that whatever the money supply figures show, we know that monetary policy has been tight from other indicators such as high interest rates and a high rate of exchange. But this proposition (with which we agree) concedes the whole case. The essential monetarist claim was precisely that, because of their special role in the inflationary process, monetary aggregates should be controlled in lieu of interest rates which were the traditional, Keynesian criterion for monetary policy. The new argument restores to us the freedom to ignore monetary aggregates and concentrate on interest rates and the exchange rate as such.

Another argument now used in defence of monetarism is that the speed of response of inflation to monetary growth is heavily influenced by expectations and since expectations are unstable we cannot expect to observe, *ex post,* any consistent relationship between the money supply and inflation. This argument stands in stark contrast to earlier monetarist propositions which emphasised, above all, empirical support. If governments accept this latter-day version of monetarism, the core of their economic policy rests on nothing more than faith in a theory for which there cannot *in principle* be any supporting evidence.

Interest rates and government borrowing

The proposition that increases in public expenditure have no effect on total output has no validity unless the economy is fully employed. If there are idle resources an increase in public expenditure will increase total output both directly and indirectly through multiplier effects. Higher levels of income and output will be associated with higher savings and higher demand for financial assets of all kinds including money; and if interest rates are not changed during this process the stock of money can be expected to rise with income.

The rate of interest need rise only if the stock of money is deliberately held down. If, as we believe, the stock of money does not directly affect inflation, there is no reason why the government should seek to prevent a rise in the quantity of money; and with idle resources available, higher public expenditure, current or capital, far from reducing private investment, will induce an increase in it.

The government can perfectly well finance increased borrowing and reduce interest rates simultaneously by selling as much or as little gilt-

* See Milton Friedman, *The Times,* 23 August 1976 and 3 March 1980.

† Quoted by Tylecote in *The Causes of the Present Inflation,* Macmillan, 1981, p. 119.

edged stock as the market demands at the new, lower interest rates. This may imply growth of the stock of money, but if so the reason will be, simply and solely, that the private sector's demand for money has increased. The government need never (indeed cannot) expand the stock of money in excess of private sector demand for it*.

There is a limit to the fiscal stimulus which can safely be given when the economy is underemployed but the limit has nothing to do with the money supply. It is set by the risk that (in the absence of exchange controls and import controls) the exchange rate might fall in an uncontrollable way if the fiscal stimulus caused spending on imports to exceed export earnings or if investors lost confidence in sterling and switched their funds to other currencies.

The supply side

The other component of the government's philosophy which appears implausible is the proposition that sustained recovery can occur by itself without a fiscal or monetary stimulus to demand. The idea here is that it is as open to a British entrepreneur in 1981 as it is to anyone else in the world to produce the right thing in the right place at the right price, and if he does so he will make his fortune and create jobs in the process. It is indeed possible to point to individuals who are now managing to thrive and to firms (or parts of firms) which are making successful efforts to 'trade up' as the only way of surviving in a difficult world. If some can do it why not everybody?

What makes this proposition implausible is that business conditions are now, and are likely to remain, generally unfavourable (notwithstanding reductions in the taxation of high incomes and wealth). Most businesses face depression of home markets and an extremely high rate of exchange for sterling, making competition with overseas producers exceptionally difficult. For many the test of managerial ability in these conditions has been reduced to one of mere survival. There remain some areas of success but these will at most absorb and re-employ a small proportion of the resources of labour, equipment and goodwill now being put out of action by contraction of other businesses. Effective restructuring requires a large dynamic sector enjoying favourable opportunities for sustained expansion to co-exist with the sectors which are closing down. The dynamic sectors in Britain are too small to carry out this task under present conditions.

* As it happens, even if the stock of money did matter, for whatever reason, cuts in government borrowing are a bad device for holding the stock of money down. They work by deflating the whole economy, making people too poor to be able to afford to hold money in excess of the government's target. A better solution would be to reduce the yield on deposit accounts with the banks (for instance by means of the 'corset', Special Deposits or taxes on bank interest) to encourage people to hold their assets in non-money forms.

Finally, we completely reject the idea that the present level of unemployment is voluntary in the sense that substantial employment could be created if people would accept lower wages. In many parts of the country there are very few jobs for unemployed workers at any wage level at the present time. And even if average money wages were frozen from now on, it would be many years before most British exporting industries became competitive at the present rate of exchange.

An alternative philosophy

Our own model which we have for many years used to analyse and forecast economic developments is quite different from the model on which the government bases its thinking.

As far as inflation is concerned, our view is that prices are determined by costs — that is, import costs, taxes and labour costs. Labour costs are in turn the outcome of a bargaining process, an important element in which is an attempt by organised labour to maintain the real value of money wages. A government seeking to bring down inflation by tight fiscal and monetary policy may easily fail to put an end to wage bargaining pressures. Indeed it may make matters worse if higher taxes, high mortgage interest rates, increased council rents and nationalised industry prices bite into the real value of take-home pay leading to an escalation of money wage claims. At best such a policy can only succeed at great cost in terms of lost output and unemployment, and with no presumption that the reduction in inflation will survive through an economic recovery later on.

Tight fiscal and monetary policy can help to reduce inflation if it has the effect of increasing the rate of exchange for sterling, since this reduces import prices. But again there is likely to be a heavy cost in terms of lost output and employment because our industry becomes less competitive in markets abroad and at home. And any benefit to inflation is likely to be reversed if the exchange rate falls again.

As far as output and employment are concerned, a recovery can only take place if there is an increase in aggregate demand for domestically-produced goods and services. It follows from our view of inflation that an increase in demand will be met by higher production rather than higher prices since it will not in general raise costs. However increased demand is only sustainable if it does not lead to balance of payments problems. Therefore we agree with the government that fiscal and monetary expansion ('reflation') is not by itself a solution to recession. Policies are also required to ensure that exports rise and that higher demand does not 'leak' too rapidly into imports.

What policies are likely to strengthen the economy's trading performance? Certainly not tight monetary policy which reduces internal demand, induces a high exchange rate, cuts profits and investment and forces industries to close down. A low exchange rate helps, but at the cost of intensified inflationary pressures. Industrial policies may help. In our view the opportunity for improved industrial competitiveness can best be provided by a period of sustained expansion of demand. Under present conditions this would only be possible if accompanied both by devaluation and by measures to restrict the growth of imports.

Who is right?

Can experience ever determine whose model is right?

The government was initially wary of making forecasts and it is easy to see why in terms of its own logic. What does forecasting unemployment mean when the outcome inevitably depends, not directly on anything the government can do, but on the speed at which people realise that they must offer hard work for realistic wages?

Yet it is not possible to sustain beyond a certain point the claim that this philosophy makes all forecasts irrelevant. If the government is claiming to know how the economy works (or can be made to work) it must have some idea of what is going to happen. There would have to be *some* increase in unemployment which the government would admit was inconsistent with its views about how the economy works. If 2½ million unemployed after two years is within the notion of 'small and temporary', what about 4½ million after four years?

It is quite clear that whatever the government's theories about the economy and about forecasting, events so far have been nastier than they anticipated. Sir Keith Joseph in March 1980 made an (incorrect) forecast on television that our views were 'wildly exaggerated' and the Chancellor has many times referred to the recession being 'worse than expected'.

On the other hand what has happened under previous and present policies has been quite well in accordance with our own medium-term predictions ever since the early 1970s.

After the present government's first budget we argued that its policies, if adhered to, would rapidly generate a slump and destroy a substantial part of British industry with no prospect of recovery in the long term.

This prediction followed inevitably from our model of how the economy works. The argument could be put extremely simply. To quote from an article we published in *The Observer* on 26 August 1979:

> The trend of manufactured exports has already been below that of imports for several years. The recent huge increase in the real exchange rate will accelerate this process. The resultant export-led recession, since it will cut national income and expenditure, will reduce the tax yield and tend to raise the Public Sector Borrowing Requirement. The government, committed to cut the PSBR further, will have to undertake yet more restrictions. Thus every engine of economic expansion will have been put firmly into reverse.

We could not

> establish any strong presumption, either from theory or from empirical evidence, that, with the institutions of today, monetary and fiscal restriction will moderate inflation, even in the long term.

The government has so far given no satisfactory reason as to why its policies have gone wrong; it certainly won't do to blame failure on external events since the fall in output here has been much larger than abroad despite the fact that we have oil.

The evidence so far clearly supports our model against that of the government. Yet far from relaxing its policies the government has in its recent budget reinforced them. And there have recently been explicit forecasts from government spokesmen that some recovery is now imminent.

For our part there is one and only one conclusion which we can now draw.

The heart of our argument is exactly the same as it was before. The real rate of exchange has been so high over the past eighteen months that export demand (net of import penetration) is likely to fall absolutely for some years. At the same time the government's determination to finance its expenditure by raising tax rates implies that its fiscal operations compound the impact of falling exports. Moreover, such a tight fiscal policy, by delaying any deterioration of the current balance of payments, will tend to slow the fall in sterling even though interest rates are reduced. The recession might be steadied or even briefly reversed by a fall in the rate of destocking or a fall in personal savings. But these factors could only have a once-for-all effect. After that the recession would continue to deepen.

No reader should be comforted by the fact that recessions in the past have always 'bottomed out', nor by the behaviour of 'leading indicators' compiled on the basis of past statistical correlations with no causal hypothesis to support them. Such correlations are inappropriate because the position now is quite unprecedented. For the whole post war period up to 1979 the real (inflation-adjusted) exchange rate fluctuated within a narrow band. Between 1978 and 1980 the real exchange rate appreciated by 20% and now it is considerably higher even than it was in 1980. It is the huge appreciation of sterling which has made the present prospect different in kind from anything that has happened before.

The policies of the present government have for nearly two years been perverse*. The government, in our view, has now gone so far in the wrong direction that the situation is much more intractable than it was before.

There are long time lags before changes in the exchange rate have their full effect and the main consequences of the rise in sterling are only beginning to show up in our trade performance. Because of these time lags, what happens to our export shares and import penetration over the next year or two is largely predetermined by what has already happened to the exchange rate.

Is there an alternative?

In earlier *Reviews* we always tried to illustrate what would happen if the government 'continued with conventional policies'. This used to mean keeping the real exchange rate roughly constant and operating fiscal and monetary policy so as to meet a reasonable target for the balance of payments. We concluded that such policies would result in a gradually worsening recession, and went on to show that either devaluation or protection, if they could be used on a large enough scale, could alleviate or even solve the problem (although there were serious difficulties in implementing either policy).

The results of our analysis now are qualitatively different. The government is notorious for reiterating that 'there is no alternative'. The destruction already caused is so great that this proposition is becoming true, not in the intended sense that present policies alone will restore prosperity, but in the sense that neither these policies nor others can succeed in doing so. Some idea of the scale of destruction is conveyed by the following calculation deriving from simulations of our model. Consider on the one hand what output could have been over the next three years had the real exchange rate remained at its 1979 level and on the other hand what output would be if the real exchange rate, having appreciated up to now, returned *forthwith* to its 1979 level. The comparison illustrates the consequences for output of the loss of competitiveness which has already taken place but whose effects will take time to appear. *The result is a loss of future output equal to about 5% of GDP in each of the years from now to 1983.*

Our impression is that most people who oppose the budget are completely mistaking the scale of the problem they should now be facing up to. Reflation sufficient to halt the rise in unemployment would lead to a financial deficit on the balance of payments (allowing for long-term capital and direct investment) approaching *£10 billion* next year. On the other hand if devaluation were to be the instrument of recovery it would now have to be of the order of 40%. Quite apart from the extraordinary risks involved in bringing about such a large fall in the exchange rate, inflation would probably bounce quickly back to 20% and more. There is no alternative which would rescue the economy other than import controls and exchange controls as a way of holding the balance of payments situation while some new momentum is given to domestic industry.

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* Before the present government came to power, we showed what would be the effect of pursuing fiscal and monetary policies so tightly as to generate a 25% appreciation of the real exchange rate. The purpose of this was, of course, to demonstrate just how disastrous the consequences would be. The passage we wrote two years ago still reads quite well:

> For any given relativity between domestic and foreign prices, the government can maintain a higher exchange rate for sterling by fiscal restriction, which deflates internal demand and reduces imports, and by monetary restriction, which raises interest rates and attracts capital inflows. A higher sterling exchange rate reduces the sterling cost of imported inputs and reduces prices of foreign producers, measured in sterling, whose competition in home and overseas markets may influence prices charged by domestic producers. This complex of relationships means that fiscal and monetary restriction designed to maintain a high exchange rate can reduce inflation, but at the cost of output and jobs.

The numerical simulation (CEPR, 1979, No. 5, p. 35, Table 3.3) showed that such a policy might get 7% off the inflation rate at a cost of 5½% to the level of GDP.

A formal model of fiscal policy

It is important to be clear how fiscal policy and Britain's external trade performance interact and jointly determine the level of GDP. The following notes set a formal representation of this interaction which stands at the core of our analysis. They show in particular why we attach a crucial role to trade performance, why monetary policy is only of subsidiary importance, why full-employment policy became unsustainable and how present policies lock the economy into a vicious circle of decline.

SYMBOLS

(a) Money flows in real purchasing power†

Y	GDP at market prices
G	Government spending
PX	Private spending
X	Exports
M	Imports
T	Tax revenue
PSBR	Government borrowing
NAFA	Private net acquisition of financial assets
B	Balance of payments surplus (+) or deficit (−)

Target values are denoted by asterisks.

(b) Ratios

t average tax rate
m ratio of imports to GDP
b NAFA as a share of GDP

IDENTITIES

Government accounts	PSBR = G−T
Private sector accounts	NAFA = (Y−T)−PX
Balance of payments	B = X−M
National accounts	Y = G+PX+X−M
Flow of funds	NAFA = PSBR+B

ASSUMPTIONS

(a) Trade performance
M = mY
X, m are formally exogenous variables.

Note that exports, X, and the import propensity, m, depend in part on the exchange rate and are therefore indirectly influenced by fiscal policy and interest rates.

(b) Fiscal policy
T = tY
G, t are policy instruments.

†Cash flows at current prices divided by a single price index (e.g. the deflator for total domestic expenditure).

(c) Private sector asset formation
NAFA = bY
b is formally an exogenous variable.

Note that the share of NAFA in GDP is influenced by interest rates and the rate of growth of money income. In a static equilibrium with constant money income and fully adjusted portfolios b would be zero at any rate of interest. Under conditions of rising money income b is almost always small but positive as the private sector sets aside part of its income to increase its net stock of financial assets.

GENERAL SOLUTION

$$Y = \frac{X+G}{m+t+b}$$

The level of GDP is jointly determined by trade performance, fiscal policy and private sector asset formation. In the short run variations in b may be important. But in the medium term changes in X/m and G/t will be far larger and will dominate the outcome. Note that monetary policy can *only* influence the solution for GDP via its effects on b or on trade performance.

FULL EMPLOYMENT FISCAL POLICY

The full-employment level of GDP is taken as a target. On the assumption that trade will balance at full employment, taxation and public expenditure are adjusted such that

$$t = \frac{G}{Y^*} - b$$

Thus public borrowing compensates for variations in b. The problem arises that, with a weak trade performance in terms of X and m, the full-employment trade balance,

$$B(Y^*) = X - mY^*$$

may move into ever-increasing deficit. At the same time the actual level of GDP, given by

$$Y = Y^* + \frac{B(Y^*)}{m+t+b}$$

will fall below the full employment level. Moreover unless fiscal policy is changed the actual trade balance, given by

$$B = \frac{t+b}{m+t+b} B(Y^*)$$

will be in chronic deficit, making it impossible for the authorities to hold the exchange rate at a reasonable level. Worse still, the large and rapid falls in the exchange rate which must result may accelerate inflation without improving trade performance enough to restore full employment.

FISCAL POLICY WITH A BALANCE OF PAYMENTS CONSTRAINT

There will be a certain trade balance, B^*, consistent with exchange rate objectives (e.g. a small target deficit if it is desired to secure a gradual fall in the exchange rate). The target for B will depend also on monetary policy (whether interest rates are so high as to attract financial inflows or low enough to discourage them) and short-run variations in B can be compensated by building up or running down official exchange reserves. Fiscal policy may be adjusted to aim at a given target for B by setting taxation and public expenditure such that

$$t = \frac{G+B^*}{Y} - b$$

The level of GDP will then be entirely determined by trade performance and the trade target:

$$Y = \frac{X-B^*}{m}$$

The problem remains that if trade performance is weak (yielding a full employment balance $B(Y^*)$ below the target balance, B^*), the level of GDP will be below the full employment level:

$$Y = Y^* - \frac{(B^* - B(Y^*))}{m}$$

Fiscal policy will have to be deflationary to keep the trade balance at its target level and the price paid for balance of payments equilibrium may be permanent unemployment.

IMPLICATIONS OF A PSBR TARGET

To achieve a given PSBR target fiscal policy must be adjusted such that

$$t = \frac{G-PSBR^*}{Y}$$

and the level of GDP will then be

$$Y = \frac{X+PSBR^*}{m+b}$$

In the medium term GDP growth will still be dominated by trade performance and this will constrain the choice of the levels of G and t.

If the PSBR target is tight (less than NAFA) the trade balance will be pushed into surplus and unless interest rates are very low the exchange rate will tend to become over-valued, causing trade performance to deteriorate. There will then be a vicious circle of declining GDP, rising tax rates, cuts in government spending and a worsening trade performance — the balance of payments remaining in surplus throughout, as long as the PSBR is kept down.

FISCAL POLICY WITH IMPORT CONTROLS

To achieve targets for GDP and the balance of payments, the import propensity must be adjusted such that

$$m = \frac{X-B^*}{Y^*}$$

Fiscal policy must simultaneously be adjusted to be consistent with GDP and balance of payments targets, i.e.

$$t = \frac{G+B^*}{Y^*} - b$$

In principle GDP growth can be sustained along a target path with balance of payments equilibrium and an appropriate exchange rate. The main difficulty which may arise is that if exports continually rise more slowly than GDP, the import propensity will have to be reduced progressively until scarcity of goods and services not produced domestically becomes a significant bottleneck. Thus in the long run the question is whether import controls and sustained growth of GDP will assist (or at least be compatible with) a reasonable export performance.