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# THE ECONOMIC CYCLE

*Summary of a talk by Paul Turnbull, Chief Economist at Smith New Court, to members of the Economic Research Council on Tuesday 19th April 1994*

## Introduction

Economies do not, of course, grow at steady and stable rates. Instead, we generally see marked fluctuations in the rate of economic growth, with economies growing well above their trend rates in boom periods and with economies exhibiting weakness, and with output generally falling, in bust periods.

This evening, I'm going to talk about these cycles of economic activity. Four main areas will be covered.

**Firstly,** I shall discuss the theory of the economic cycle, outlining the linkages between the basic stages of the cycle and inflation.

**Secondly,** I shall cover the economic cycle in practice. The main point here is that economies operate in practice very much according to theory. Understanding the theory of the economic cycle is therefore an important factor behind accurate economic forecasting. In fact, since 1987 to date, the UK economy has followed a classic text book cyclical path.

**Thirdly,** I shall outline how the economic cycle is linked in with the financial markets. I'll briefly outline the asset categories that one should favour at various stages of the cycle.

**Finally,** I shall outline the factors determining the economic cycle and the role of government economic policy.

This is all rather a lot to get through, but the essential messages are actually fairly straightforward. (In each section a short summary appears in the box).

## The Economic Cycle and Inflation: Theory

* **Movements in the rate of inflation are much less a function of whether the *rate* of economic growth is above or beneath trend and much more a function of whether the *level* of output is above or beneath trend.**
* **The economic cycle can be broken down into four main stages:**
  - **(i) Above trend growth and rising inflation**
  - **(ii) Beneath trend growth and rising inflation**
  - **(iii) Beneath trend growth and falling inflation**
  - **(iv) Above trend growth and falling inflation**

**Chart 1 The Economic Cycle: Theory**

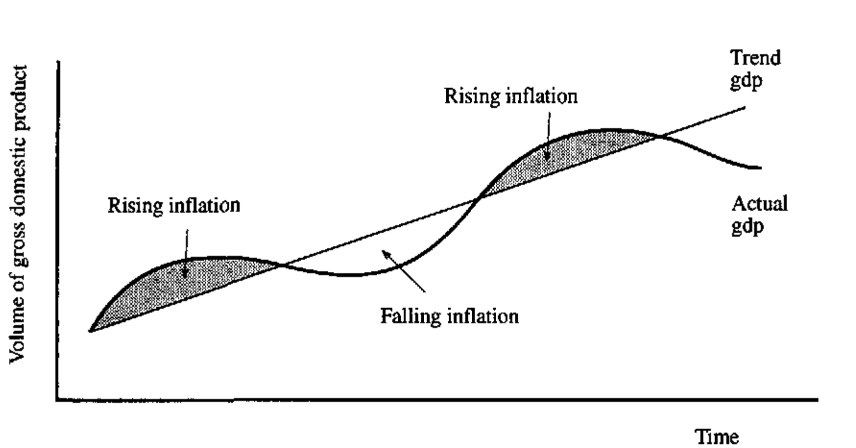



Chart 1 shows the basic theoretical position. It shows hypothetical cyclical fluctuations in the volume of gross domestic product about the longer term trend. In the chart, the wavy line shows the actual level of gdp volume and the rising straight line shows the trend, or underlying, level of gdp.

Essentially, one would expect a rising rate of inflation in the shaded periods of the graph and a falling rate of inflation when output is beneath trend. Thus, in the shaded periods the economy is operating above trend. Hence, inflation and price pressures tend to accelerate since the economy encounters capacity constraints and runs up against supply bottlenecks. Similarly, when the economy is operating beneath trend, price pressures tend to weaken since there is slack in both the labour and goods markets.

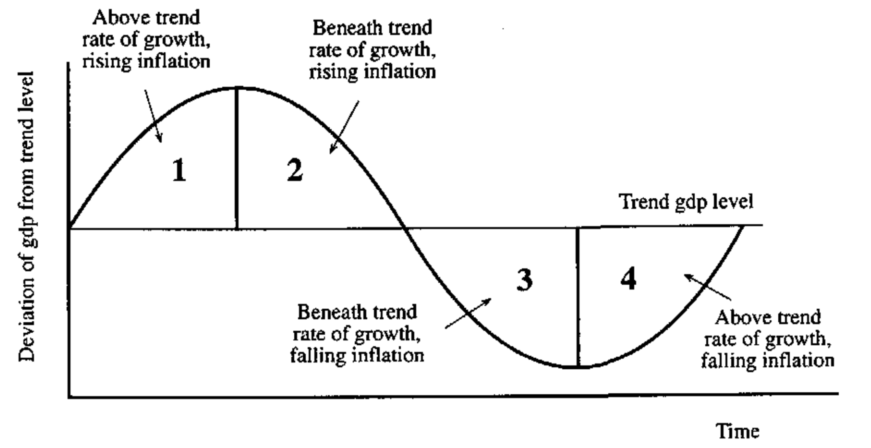
It is useful, though, to break the economic cycle down into 4 stages rather than the 2 phases – one of a rising rate of inflation and one of a falling rate of inflation – just discussed.

Chart 2 shows the stylised position where gdp fluctuations about the trend level are plotted. (The horizontal straight line in this chart represents the earlier rising straight line in chart 1.) A full cycle is shown, starting from an initial equilibrium position.

In the first phase of the cycle, the *rate* of economic growth is above trend and inflation rises since the absolute *level* of gdp is also above trend. In the second stage of the cycle, the *rate* of growth moves beneath trend. Even so, the rate of inflation continues to rise since the absolute *level* of gdp is still above trend. It is only in the third stage of the cycle, when the *level* of output moves beneath trend and when a negative output gap opens up, that inflation starts to fall. Finally, in the fourth and benign stage of the cycle the economy can combine both an above trend rate of growth with falling inflation.



**Chart 2 The Economic Cycle: Theory**




**The Economic Cycle and Inflation: Practice**

- * **Economies operate in practice very much as theory would suggest.**
- * **The experience of the UK economy from 1987 to date provides a classic example.**

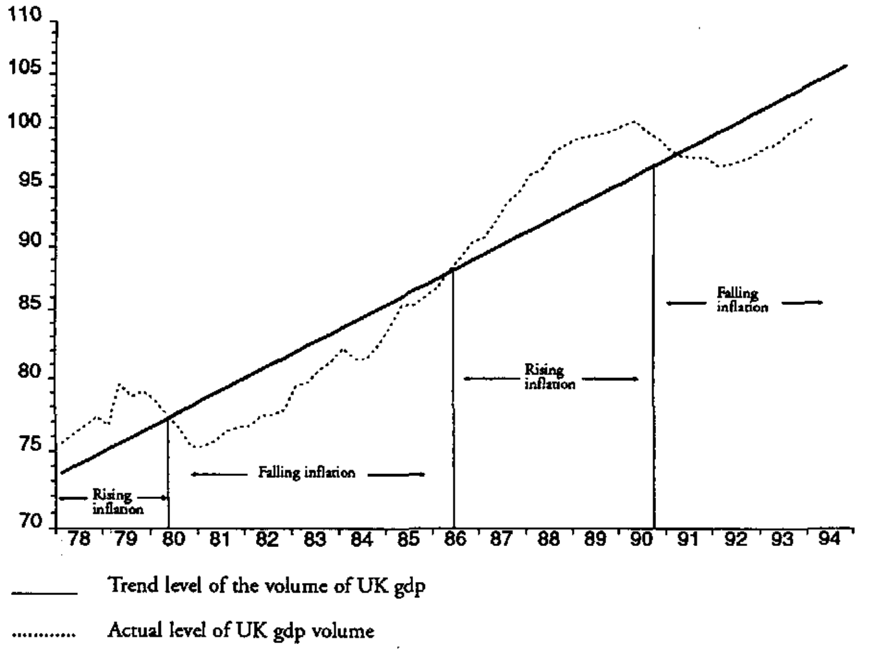
In the practical world, economic cycles vary in length and amplitude. Nevertheless, the basic theoretical model outlined above is of major relevance in the real world. (The analysis in this section focuses on recent UK experience, but it should be noted that strong relationships between the economic cycle and movements in the rate of inflation are apparent in all the major industrialised economies.)

Chart 3 is a practical illustration of the earlier chart 1. It shows the actual performance of the UK economy since 1978. In the chart the dotted line shows the actual level of UK gdp volume and the solid line is a line of best fit showing trend gdp volume. The upward slope of the solid line is around 2.25% p.a. The chart additionally shows the actual periods when UK inflation was on a rising trend and when it was on a falling trend. As can be seen, actual movements in UK inflation have closely mirrored the pattern expected according to theory.

Chart 4 is a practical illustration of the earlier chart 2. In fact, since 1987 to date, the path of the UK economy has followed the textbook economic cycle almost to perfection. Chart 4 is the same as chart 2 except that I have shown the years since 1987 when the UK economy was at the various stages of the cycle.

Thus, at the beginning of 1987 the economy, on most measures, was operating close

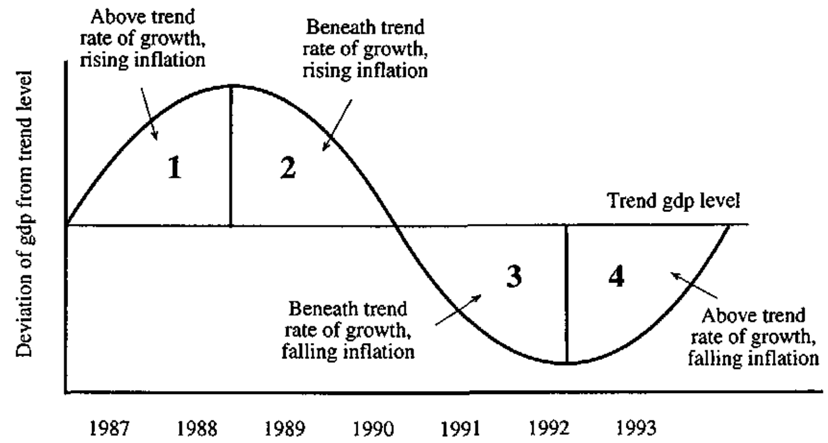
**Chart 3 The Economic Cycle: Practice**




to its trend level. However, the lax monetary stance of Mr Lawson and the low interest rates arising as a result of the shadowing of the DM led to an overheated economy. Output grew very strongly through 1987 and 1988. The level of activity moved above trend and inflation accelerated. Eventually, the clamps were put on, monetary policy was tightened and interest rates were raised dramatically. This tightening of policy necessarily led to a weak economy. Gdp rose by only 1.2% through 1989 and actually fell, by 0.7%, through 1990. Even so, the extent of the prior overheating meant that the absolute *level* of activity was still above trend. Accordingly, the rate of inflation carried on rising through 1989 and 1990. Price pressures only start to ease when activity levels moved beneath trend. And continued economic weakness through 1991 and 1992 led to a widening negative output gap and falls in the rate of inflation. Finally, UK withdrawal from the ERM allowed monetary policy to be loosened and permitted substantial falls in interest rates. In response, the economy began to recover. The rate of output growth gradually moved above trend. Gdp rose by 2.5% through 1993, slightly above the longer term trend rate of growth of 2.25% mentioned earlier. However, inflation continued to fall since the *level* of activity was beneath trend.



**Chart 4 The Economic Cycle: Practice**




## GDP and Inflation

| Stage of cycle | | GDP Growth (Q4 on Q4) % | Retail Price Inflation (excl. mortgage interest payments) (Q4 on Q4) % |
|---|---|---|---|
| 1 | 1987 | +4.5 | 4.0 |
| | 1988 | +4.3 | 5.1 |
| 2 | 1989 | +1.2 | 6.1 |
| | 1990 | –0.7 | 9.3 |
| 3 | 1991 | –1.6 | 5.7 |
| | 1992 | +0.1 | 3.7 |
| 4 | 1993 | +2.7 | 2.7 |

The preceding observations may appear pretty obvious. However, one should note that since 1987 consensus forecasts for the UK economy have been atrocious. It appears that many economists simply do not understand elementary cyclical theory. For example, most economists failed to realise that the rate of inflation would carry on rising through 1989 and 1990. They simply assumed that the weakness of the economy in these years would see the rate of inflation declining.

Big forecasting errors were also made, albeit in the opposite direction, when the UK left the ERM. The consensus view then was that the UK's exit from the ERM would be followed by a fairly rapid and significant upturn in the rate of inflation. However, it is difficult to comprehend why most economists came to this conclusion. Agreed, one cannot calculate output gaps with precision; but when the UK left the ERM there could be little doubt that the UK economy was operating well beneath trend, with plenty of spare capacity and idle resources. In such circumstances, inflationary pressures moderate and weaken. They do not intensify and strengthen.

### The Economic Cycle and the Financial Markets

1. **Financial market behaviour is linked to the economic cycle.**
2. **Equities and bonds generally perform poorly when output is above trend. Vice versa when output is beneath trend. Crudely speaking, bear markets begin in booms and bull markets in recessions.**
3. **"Defensive" sectors of the equity market should be favoured in the third stage of the economic cycle, when share prices are driven higher by "valuation" criteria. "Cyclical" sectors should be favoured in the fourth stage, when earnings growth provides the impetus for the stockmarket.**

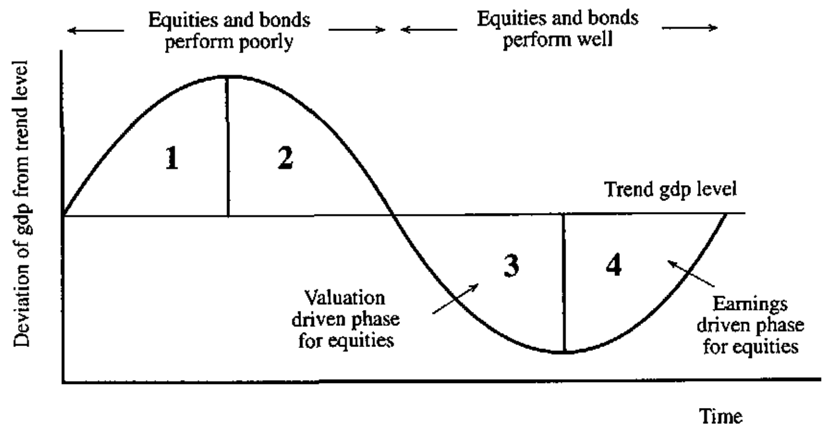
The behaviour of the financial markets is also linked to the economic cycle. The relationships here, though, are not precise, partly because the performance of equities and bonds in any given country will be influenced not just by the domestic economic backdrop but also by global financial market developments. Nevertheless, some broad observations can be made.

Chart 5 provides a crude summary of the position. Generally speaking, equities and bonds tend to perform poorly when the level of output is above trend and they tend to perform well when the level of output is beneath trend. This is because equities and bonds suffer from a rising rate of inflation in stages 1 and 2 of the cycle whereas they benefit from a falling rate of inflation in stages 3 and 4. Furthermore, the biggest gains in equity prices are normally seen in stage 3 and the early part of stage 4 of the cycle. In these phases, short-term interest rates generally fall whereas in the latter part of stage 4 monetary policy is often tightened against the backdrop of an above trend rate of growth. Monetary tightening, in turn, tends to temper equity market performance.

Referring again to actual recent UK experience for illustrative purposes, it should be noted that from the beginning of 1987 to end-1990 (i.e. during stages 1 and 2 of the cycle), UK share prices fell by 2% in real terms. (Real share prices are measured by the movement in the FTA All Share deflated by the retail prices index.) By contrast from end-1990 to end-1993 (i.e. during stage 3 and the early part of stage 4 of the cycle) real share prices rose by 42%.



**Chart 5 The Economic Cycle and the Financial Markets**




Furthermore, the economic cycle carries messages not just in terms of broad asset categories – i.e. bonds and equities versus cash – but also in relation to specific sectors of the equity market.

'Defensive' sectors of the stockmarket should be favoured in stage 3 of the cycle. This is the stage of the cycle when equities benefit from higher valuations. Thus, the biggest falls in the rate of inflation are generally seen when a negative output gap is widening. The economic backdrop in stage 3 of the cycle therefore normally sees bonds performing well and it is also usually associated with a relaxation of monetary policy (i.e. lower short term interest rates) in response to falling inflation and weakening economic activity. This combination of lower inflation, lower bond yields and a relaxation of monetary policy is necessarily helpful for the overall stockmarket and it operates to drive equities onto more demanding multiples, i.e. higher price earnings ratios and lower dividend yields.

However, stage 3 of the cycle also sees weak economic activity. The rate of economic growth is either beneath trend or negative. Corporate profits therefore come under pressure. Accordingly, 'defensive' sectors of the stockmarket (i.e. those sectors where corporate profits are not heavily geared to fluctuations in the rate of gdp growth) tend to outperform 'cyclical' sectors (i.e. those sectors where profits are heavily geared to economic activity). For example, the best performing stockmarket sector in 1991 was 'health & household', a classic defensive sector. Similarly, the worst performing sector in 1991 was 'contracting & construction', a classic cyclical sector.

Continuing with the same theme, stage 4 of the economic cycle is associated with an above trend rate of growth. The principal driving force behind the equity market becomes profits growth. Accordingly, 'cyclical' sectors tend to outperform. And just as 'contracting & construction' was the worst performing sector in 1991 so, too, it was one of the best performers in 1993. And just as 'health & household' was the best performing sector in 1991 so, too, it was one of the worst performers in 1993.

### Determinants of the Economic Cycle

> **1. The economic cycle should not be viewed as an in-built feature of the capitalist system over which governments and central banks have little control. The reality is rather the reverse. Large cyclical fluctuations are principally the by-product of macro-economic policy errors.**
>
> **2. Macro-economic policy should therefore aim at preventing large cyclical fluctuations in gdp about the secular trend. It is micro-economic policy that should be used as the tool for influencing the secular trend.**

In previous sections I have covered the economic cycle in theory and practice, and I've also discussed the linkages between the cycle and the financial markets. The obvious area that remains to be covered is a discussion of the factors determining the cycle.

The key point here is that the cycle is not an intrinsic characteristic of the capitalist system. The true position is rather the opposite. Big cyclical fluctuations in economic activity are primarily the result of official policy mismanagement. And the greater is the mismanagement the larger will be the fluctuations.

Not surprisingly, we have seen big pronounced cycles in the UK. Since 1970, the UK has been through three major boom/bust episodes – the boom of 1972 and 1973 followed by the bust of 1974 and 1975; the boom of 1978 and 1979 followed by the bust of 1980 and 1981, and the boom of 1987 and 1988 followed by the lengthy bust of 1989, 1990, 1991 and 1992.

These cycles were primarily due to errors of monetary and interest rate policy. For example, as outlined earlier, the boom of 1987 and 1988 was the result of unduly low interest rates whilst the subsequent bust period was prolonged by UK membership of the ERM which meant that interest rates had to be kept at excessively high levels in order to protect the pound.

Of course, what I have not outlined are the mechanisms through which monetary policy and interest rates impact on the economy. I do not propose to go into any detail on this here, since it could only be covered properly in a separate talk. Briefly, though, monetary policy is vitally important since not only are short-term interest rates under the direct control of the authorities but the financial behaviour of companies and individuals is also highly interest rate sensitive. For example, a decline in interest rates will raise borrowing and dampen saving in the economy. Accordingly, if interest rates are held too low for too long then the resultant changes in financial behaviour will ultimately lead to an overheated economy. Vice versa for high interest rates.



In passing, it should be noted that fiscal policy is a pretty impotent instrument for influencing demand and activity. For example, the boom of 1987 and 1988 coincided with a tight fiscal stance, the weak economy when the UK was in the ERM coincided with a dramatic loosening of the Budgetary position whilst the good growth currently being registered by the economy is taking place despite the big tax increases announced in the March 1993 and November 1993 Budgets.

### Macro-economic versus micro-economic policy

The preceding message is that macro-economic policy, and specifically monetary policy, should aim at preventing large cyclical fluctuations in gdp about the secular trend. What then is the role of micro-economic policy? Well, this should be seen as the instrument for bolstering the secular trend.

Of course, the trend rate of growth will be affected by many factors outside the ambit of government economic policy, such as the rate of technological change. Even so, government does have a role to play. For example, the underlying trend rate of growth of the UK economy was considerably higher in the 1980s than the 1970s. A factor at work here was the Thatcherite supply-side micro-economic reforms enacted in the 1980s. These encompassed areas such as privatisation, trade union reforms and reductions in the share of government spending in gdp. Cumulatively, these measures were important and they served to raise the trend growth rate. Thus, productivity performance in privatised industries has been spectacular, whilst trade union reforms have helped to create a more flexible and responsive labour market. Again, the reductions in public spending as a proportion of gdp were based on the realistic premiss that the private sector is better able than the public sector to deliver efficiency and productivity gains.

Finally, I would mention that macro-economic mismanagement can easily lead to micro-economic mismanagement. This was seen during the period of UK ERM membership, when the government was forced to pursue an excessively tight monetary policy. In an attempt to offset this tight stance, the government tried to fiscally stimulate the economy via huge increases in public spending. But not only did this fiscal loosening have minimal stimulatory effect, but it also brought about the reversal of the earlier reductions, achieved under Sir Geoffrey Howe and Lord Lawson, in the share of gdp taken by public spending.

### Concluding Remarks

My talk this evening has covered many areas and as a result much of the analysis has been kept brief and simple. The basic aim, though, has been to provide a coherent framework for looking at the linkages between the economic cycle on the one hand and inflation, the financial markets and government economic policy on the other. Hopefully, it will have provided plenty of food for thought.

# OUR ENTRY INTO THE ERM – WAS IT FOLLY?

*By The Rt. Hon. Sir Peter Hordern M.P.*

It is easy now to look back and say what folly it was to join the ERM. Much better, so some say, never to have joined, never to have placed the economy, and industry especially, under such serious strain. I am not so sure.

We need to look back at the state of the economy before we joined the ERM to form a proper judgment. You very seldom find the opponents of our entry into the ERM prepared to do this. To many of them, joining the ERM was a possible prelude to a European single currency, and for that reason alone, anathema.

I am not concerned here with the European aspect of our entry into the ERM. In any case, it was certainly not John Major's motive, in October 1990, to prove our European credentials, when, as Chancellor, he took us in, with Margaret Thatcher's belated consent.

The argument for our not joining the ERM was that inflation could best be kept in check by a vigorous monetary policy. As Nigel Lawson had set out so compellingly in his Mais Lecture in June 1984, "It is the conquest of inflation, and not the pursuit of growth and employment, which is, or should be the objective of macro-economic policy". That was, of course, before the stock-market collapse in October 1987, and the subsequent easing of credit in May 1988, when Base Rate was reduced to 7.5%, to prevent a collapse of confidence.

There never was a change of policy in regard to the over-riding importance of defeating inflation. But, in part due to the international flow of funds, and in part to the liberalizing of the capital markets and the internal economy, defeating inflation was much easier said than done. Despite criticisms by Edward Heath, among others, that Nigel Lawson was pursuing a "one-club policy", meaning interest rates, there was no other form of monetary policy which the Chancellor could deploy without returning to the wholly discredited policies of controlling prices and incomes by statute, unless, that is, we were to join the ERM, which is what he wanted to do.

There was another reason for reducing Base Rate to 7.5% in May 1988, which was that sterling was extremely strong against all other currencies at that time. Against the dollar it had reached, at $1.83, the highest point since 1981, and against the DM at DM 3.14, the highest point for two years. The trade gap was beginning to worsen and, without a reduction in interest rates, which every other country had made, the CBI would soon have been up in arms, complaining that the exchange rate was too high for industry to compete.

The decision to reduce interest rates came to be known as "shadowing the DM". According to this theory, we should never have concerned ourselves about the exchange rate, but simply adjusted interest rates to the perceived risk of inflation at the time. It is very hard to guess what interest rates would have had to have been to curb the substantial increase in bank lending to the private sector in 1988, but they would have had to have been considerable, if left to work on their own. If Base Rate had remained at 10%, as it was before markets collapsed in October 1987, it is certain that sterling would have been even firmer against all other currencies, raising howls of anguish from industry. Such a decision, to keep interest rates high when interest rates everywhere else were reduced, would have been regarded by industry as deliberately perverse. Indeed, exactly the same criticisms as were later voiced about the consequences of our membership of the ERM would have been voiced then anyway.



I think it is important to stress, at this point, that, so far as some industrialists are concerned, the exchange rate can never be too low. Not only does a low rate of sterling, or as industrialists would say, a competitive rate, make exports easier, but an exchange rate which is allowed to sink actually encourages industry to "pay the going rate" of wages, whatever they may be, and defers, or makes unnecessary, tough decisions. And the golf course beckons.

But the policy of floating sterling, though in practice allowing it to sink, has its predictable consequences. Since the Government has virtually always had to borrow, overseas lenders demand a rather higher rate of interest than for other firmer currencies. And since industry also needs to borrow from the banks, the inevitable consequence of a falling exchange rate is higher interest rates. Thirty years ago, there were $2.80 to the pound, and DM11.2 to the pound. Interest rates were at 4%. When they were raised to 7% in September 1956, it was described as a crisis. That was the time of fixed exchange rates to which we belonged under Bretton Woods. Happy, halycon days!

Some people look back upon the events of 1988 as though the Chancellor abdicated all responsibility for monetary policy at that time. Nigel Lawson himself recognizes that it was a mistake to reduce interest rates to 7 ½% in May 1988, though urged on as he was by Margaret Thatcher. But, in the face of worsening evidence of a credit explosion interest rates were raised. By 6 June, Base Rate was 8.5%. By 29 June, 9.5% and by November, after six further increases, Base Rate stood at 13%. On 24 May 1989, the rate was increased to 14%, where it remained until 5 October, when it was raised to 15%, where it remained for a full year.

By any yardstick, rates of 14% and 15% are penal. Apart from the period between 1 October and 3 December 1981, when rates were briefly higher, these were the highest interest rates since 1979, and, apart from that, the highest rates since 1932. Nobody can deny that monetary policy was being applied a l'outrance. Yet bank loans to the private sector reached their highest level ever in the third quarter of 1989, even though Base Rate was at 15%, and remained at a high level until the second quarter of 1990. All this, despite some of the highest rates in our history. The policy of conducting monetary policy by high interest rates alone plainly was not working. Something had to be done.

That was when we joined the ERM, on 8 October 1990. On that very day, Base Rate was reduced by a full 1% to 14%. The banks continued to lend substantial sums until the end of 1990, but thereafter they lent less than ⅓ each year of the amount that they had lent in 1990. Accompanying the fall in lending, Base Rate was reduced to 12.5% in March 1991, to 10.5% in September, and to 10% in May 1992.

Nobody can tell how long it would have taken to reduce the volume of bank lending if we had not joined the ERM in October 1990. But it is certain that two years of high interest rates had not curbed bank lending. They may have had to be kept high for much longer outside the ERM.

The critics of our entry into the ERM say that it was wrong to join in any event, and that business and industry suffered appalling hardship through high interest rates imposed solely to maintain our position with the DM. But before we came out of the ERM in September 1992, interest rates stood at 10%, a level not seen before July 1988. The real damage to business and industry had been done by two years of penal interest rates before we joined the ERM. If we had joined the ERM some years before, it is likely that interest rates would never have been raised as high as they were.

But the real problem of the ERM was the level of German interest rates. German reunification took place on 3 October 1990. We joined the ERM on 8 October. Nobody could have foretold the effect of allowing the Ostmark to be convertible into the DM one for all. We thought we were joining the most strictly anti-inflationary economy in the Western world. We found we had joined an economy whose Central Bank was desperately worried about inflation, and raised interest rates accordingly.

Months before "Black Wednesday", it had become clear that the model economy to which we had become linked was no longer a model. That being so, and with the wisdom of hindsight, we should have come out of the ERM and rejoined it at a lower parity, say DM2.60, as the rules of the ERM have always allowed, and which were designed with just such an end in view. And there we should have stuck.

For the conclusion to be drawn from the extraordinary period from 1989–1992 is that trying to control inflation by interest rates alone simply did not work. The moment we joined the ERM, interest rates were reduced, and inflation fell further and faster than anyone could have imagined. Of course, it is argued that this was only done at enormous cost to industry and jobs, but the truth is that these costs, namely high interest rates, were already in place long before we joined the ERM. There was no painless way of curbing a high credit explosion, and certainly no panacea to be found in a policy of high interest rates and letting the exchange rate go hang.

For much of our history, the pound has been tied to gold, or, for some years after the War, to the U.S. Dollar, which was itself backed by gold. Nobody complained that we had sold our sovereignty to Californian and South African gold miners, nor that Winston Churchill had sold out to the Americans. We would not have been able to develop the sophisticated market of the City without the confidence which a stable currency gave. Without such stability, the pound has simply fallen to unimaginably low levels against other currencies. We have had to pay a heavy price for this, in paying invariably higher interest rates than, for instance, Germany and Japan. For why should foreigners lend us money only to find it constantly devalued?

If business and industry really want low interest rates, then we shall have to have a strong pound. That is why it was a good idea to join the ERM. The mistake was not to have done so years before.



## THE UNITED KINGDOM MACRO ECONOMIC SITUATION

*by Stephen Kershaw*

*Economic growth and low inflation should be given equal priority in government economic policy in order to increase British industry's competitiveness*

During the thirty year period from 1961 to 1991, which followed the basic post war recovery in Western Europe, the average rate of economic growth in the United Kingdom was lower than that of all other EC countries.

It is arguable that the UK's poor performance in economic growth is partly the result of confusion over the government's economic objectives. A strong pound, an improved balance of payments, lower inflation and a reduction in the public sector borrowing requirements, have all at different times been among the main objectives, if not the main objective of government economic policy. Economic growth has often been left lower down the list, instead of being seen as a primary objective in itself. For example, at various times during the 60s, 70s and 80s, high interest rates have been imposed over long periods to support a weak pound, a prolonged credit squeeze has been imposed in an attempt to reduce a balance of payments deficit, long periods of very high interest rates have been used to curb rising inflation and taxes have also been substantially increased to reduce a high public sector borrowing requirement.

In most of these cases, the objective of economic growth has been regarded as of secondary importance, or more recently as an objective which is not within the

**EC Countries Percentage Increase in Real Gross Domestic Product 1961–1991**

| | % increase in GDP |
|---|---|
| Belgium | 161.9 |
| Denmark | 126.1 |
| France | 182.9 |
| Germany | 146.8 |
| Greece | 251.1 |
| Ireland | 235.1 |
| Italy | 194.8 |
| Luxembourg | 157.1 |
| Netherlands | 168.6 |
| Portugal | 272.2 |
| Spain | 248.1 |
| U.K. | 96.1 |

Source: OECD *Historical Statistics*, volume indices based on 1985 government's ambit. Yet, had economic growth been given a high priority instead of a secondary one, revenue receipts would have risen, thus reducing the PSBR, higher capital investment would have increased productivity and reduced costs per unit of manufactured goods thus tending to reduce both inflation and the balance of payments deficit, while the pound would have tended to be strengthened by a stronger underlying economy.

This is not to say, of course that there is no case for anti-inflationary policies in the form of high interest rates in demand inflationary situations: it is only to say that these particular policies have been overemphasized to the long term detriment of UK economic growth. In other words, an over-cautious approach which has tended to react to all the difficulties created by sluggish economic growth, instead of aiming for a higher, yet reasonable rate of economic growth, which would either alleviate or deal with most of the difficulties concerned, has probably been one of the major factors leading to this regrettable situation.

During the recent recession, it was said by some of those concerned with UK economic policy, that our problems were insoluble. This typifies the negative approach which needs to be changed. A new, more positive approach is needed based on the twin objectives of economic growth and relatively low inflation.

The experience of a number of other developed nations has shown that it is possible to enjoy long periods of economic growth combined with acceptably low inflation and in times of difficulty, much shorter periods of very slow growth or recession than those experienced in the UK. The key to doing so lies in maintaining a good rate of capital investment in new machinery and technology, which produces the additional industrial capacity to prevent a demand inflationary problem arising.

Capital investment, particularly by smaller sized businesses, which are particularly important in maintaining employment, is not encouraged by reducing purchasing power. Such companies invest in new machinery and technology when a rising trend in sales and profit enables them to do so.

The theory that consumer spending has to be cut to allow more money to flow into capital investment is only true of a static economy. It is not true of a growing economy where additional wealth is being created, part of which will flow into capital investment. It is long periods of economic stagnation which reduce capital investment by smaller companies. It is sustained economic growth which increases capital investment by such companies. The same capital investment is the key to increasing British industry's competitiveness and therefore its share of home and export markets, thus leading to a healthy UK balance of payments.

While capital investment provides the capacity for non-inflationary economic growth, it also comes about as a result of economic growth. It is rising purchasing power that starts the ball rolling for smaller companies, not capital investment, because they cannot afford to invest during a recession. Since the maintenance of a reasonable rate of capital investment is vital to the long term strength of the UK economy, it is important not to interrupt it for too long, as has happened during the recent recession.

If demand inflation in the UK were controlled in future by a lighter touch on the brakes, economic growth leading to lower costs per unit of production would help to keep inflation under control where there is spare capacity in the economy. Such a policy would avoid bringing the UK economy to a grinding halt and then actually pushing it into reverse, as in the 1990/92 recession.

It is not the use of high interest rates themselves which has been the main cause of the UK's slow rate of growth, but their over-zealous use by its government. Other European nations have used high interest rates and credit squeezes but usually for shorter periods. A balance has to be struck and economic growth needs to be given a higher priority. More attention needs to be paid to the views of industry, which forecast recession long before the government did. In future, when government forecasts on economic growth are substantially at variance with the forecast of industry, I would urge that more weight should be given to the latter.

Another cause for concern has been the assumption that inflation caused by factors other than excess demand can be corrected in the same way as demand inflation. For example, demand inflation responds to a reduction in purchasing power. However, a substantial increase in VAT will lead to higher inflation, but the cause of the inflation, in this case, has nothing to do with purchasing power or the money supply. Therefore, to reduce purchasing power in the second case is not a rational response by government.

I have not dealt upon the constraint of the ERM on UK interest rate policy, because having taken care to negotiate the right to do so, the United Kingdom was entitled to reduce interest rates and to realign sterling against other ERM currencies if necessary.

The strength of sterling ultimately depends on the strength of the UK economy, which in turn depends upon the twin objective of a reasonable rate of economic growth and relatively low inflation. Sustained capital investment will both follow and help to maintain these twin objectives. If, on the other hand, the UK economy is weak, sterling will also tend to be weak and will not be held up for ever by long periods of high interest rates which make the economy even weaker.

## BILL JAMIESON, SHIGETO TSURU AND THE LABOUR PARTY

*By Jim Bourlet*

i) *Britain Beyond Europe* by Bill Jamieson. Duckworth £17.99
ii) *Japan's Capitalism* by Shigeto Tsuru. Cambridge University Press £24.95
iii) *Europe has Faults* ... by David Smith. The Sunday Times 29/5/94

Compare for a moment, the post-war economic development of Britain with Japan. Both are island, crowded nations and both are at a mature stage in capitalist/industrial development. Both have to find an economic role within the international order of things – neither can turn inwards and be self-sufficient. From 1945 to 1972 Japan's economy raced ahead at growth rates often over 10% a year. Japan was catching up with new technology and her government nurtured industrial growth with policies to hold down interest rates and maintain an undervalued currency. Britain could have done much the same but chose to be an exporter of technology and pursue policies involving relatively expensive credit and an overvalued pound. Britain chose to nurture instead the slumbering nationalised industries and the misdirected state-run health and education systems. All the same, we both went forward down the route of *industrial* growth, relying on increases in industrial productivity to pull us along at our varying speeds.

From 1972 to the present time – close on a quarter of a century – both countries have stalled. Both now realise that somehow "more of the same" will lead, not to a crisis, but to a dull and socially uncomfortable stagnation. Both need a fresh understanding of the opportunities ahead – and both have socialist parties ready and able to listen.

Bill Jamieson's truly remarkable new book "Britain Beyond Europe" sets out the record and analyses the role which EU membership has played in frustrating Britain's aspirations since – well, since Suez really. He points out that Britain's overseas investments almost ignore the "European" link. During 1987-91, for example, only 16% of profits from overseas investments came from EU countries – the rest came from "Beyond Europe". He points towards the astonishing costs which Britain has paid over the years for EU membership and demands – rightly – to be told the reason why no British government since 1965 (when the Labour government ordered an official assessment of the costs to Britain of joining the CAP) has allowed an audit of membership costs to be published. If such a reckoning (which is inevitable sooner or later) confirms the damage which this well qualified author has patiently and logically listed in terms of direct costs, protectionism, legal enmeshment and political enfeeblement, then Britain's absolute industrial decline, her relatively poor growth rate and her maintenance of shameful unemployment rates during this last quarter century are more than explained. The picture is of a Britain burdened unnecessarily, and with leadership abilities, such as they are, diverted from the tasks of solving the problems of finding a productive role, a wealth creating role and a fully employed role for *all* people of the country.

Reaction to the "Jamieson assessment" from Euro-apologists are about as close as one can get to economic comedy. Take, for example, David Smith's 50 column inches in The Sunday Times of 29th May. The whole of his "Economic Outlook" article was devoted to "Britain Beyond Europe".

Smith begins by reminding his readers that Europe represents, for many U.K. businessmen, their main market. (Sure, that is where we sell our oil and where 25% of British exports went anyway, before 1972. But despite EU trade diversion effects, half of Britain's exports still go elsewhere.) He then asserts that the 1989 Euro-election results showed that the British public thought we could do even better by being more closely integrated with Europe. (Whoops ... the low turn-out and comment following the latest elections has upset that one.) Turning to Jamieson's book he quotes the book as attacking "the myth of economic benefit through membership of the EC" and as suggesting that "Britain's salvation lies in rediscovering and building on its own past as a trading post for all the world, and not throwing in its lot with a socialist and



mercantilist regional bloc". He then takes up Jamieson's reasons for saying that the economic benefits are a myth.

One economic benefit was supposed to be that we joined a high growth club and could expect increased growth if we tagged along. Jamieson points out that E.C. growth rates have collapsed since 1972 – and anyway, high growth in a competitor country may simply mean that it enjoys newer investment and thus higher productivity and lower costs – to your disadvantage. Smith says that things are about to get better and perhaps it was Britain which caused European growth rates to halve after 1972. (Right ... now tell me another ...)

Another economic benefit was supposed to be that we would have a vast market of customers – perhaps 350 million or more – to enable British exports to soar and relieve us of constraints arising from balance of trade deficits. Jamieson points out that we also joined a group of very effective producers who have, in the event, managed to turn a pre-1972 annual trade surplus with Europe into a huge deficit – £4.2bn last year. Smith comments, "I find it hard to be persuaded by this argument, which is another way of saying we were better off with protectionism". (Hey, wait a minute – Britain in 1972 enjoyed free trade in food, had the highest penetration rates in Europe for Far Eastern products, was a member of EFTA and had generally low GATT based industrial tariffs.)

A third economic benefit was supposed to be the great investment opportunities which would open up for British companies in Europe. Jamieson shows that British investment seems to be everywhere *except* Europe which provides opportunities for only about 19½% of direct foreign investment. Smith says this is just a response to "geographical necessity" (which ranks, I suppose, with Marx's "historical imperative" as the greatest non-explainer of all time).

Shigeto Tsuru's contemporary book "Japan's Capitalism – Creative Defeat and Beyond" (with Foreword by J.K. Galbraith) is the most frank and effective explanation of Japan's post war economic growth that I have ever read. J.K. Galbraith describes Tsuru as his friend, instructor and guide to the Japanese economy – and he can be ours as well. The book details and admits the Japanese government's success in maintaining a low valued Yen and accepts openly the extent to which the Japanese government has protected and cossetted Japanese business. The tricks and chicanery which enabled Japanese firms to acquire foreign technology and maintain a stranglehold on the Japanese market are openly acknowledged. The methods used to hold down the cost of capital are listed and the value to Japan of the American market, the Korean war and American monetarism are all accepted.

Japan has channelled her economic energy not into a high standard of living and a high level of general prosperity, but rather into a superb *industrial* sector based on astonishing levels of investment and productivity geared to a history of outstanding export success. Japan's factories are superb and her product success almost without rival. Amongst the developed nations Japan and Germany have the highest proportion of workers in the industrial sector.

This was an "all systems go" approach – until around 1972. Thereafter growth rates turned downwards and now threaten to be negative. Inexorably the Yen has climbed upwards in a delayed attempt to balance the books. High oil prices helped for a while and then in the 1980s, capital outflow, though in essence a haemorrhage of national seed corn, offset the export surplus. Now nothing seems available to save the country from the need to restructure, import more, export less, and enjoy itself.

Just like Britain. Inexorably the Pound has fallen in a delayed attempt to balance our books. High oil prices helped for a while and then, in the 1980s, capital inflow, though in essence a blood transfusion of investment, made up for the export deficit. Now nothing seems available to save the country from the need to restructure, export more, import less and get down to work.

On the subject of importing less, exporting more and getting down to work, Jamieson's book has much to tell us. On the subject of restructuring, Tsuru has advice for Japan (Chapter 8, Whither Japan?) that – by golly – is far more appropriate for us!

Importing less and exporting more has little to do with paternalistic government in Jamieson's world, and everything to do with exchange rates. Our ERM experience has demonstrated the point nicely though it is a pity that we had to pay so much for the lesson. Beyond the economics though lies the question of social and welfare policies, of taxation and subsidy. Jamieson demonstrates – or rather illustrates the point – with a thorough going critique of Britain's "dependency culture". His list of available "benefits" in this country is a shock for all. His claim that these need all be reduced is open to debate because some benefits, such as tax relief on mortgage payments, bring positive results such as better housing, more jobs in construction, and an incentive to young people to take the first step towards being capital asset owners. Nobody is *discouraged* from work by this. Other benefits such as unemployment pay, whilst having a social purpose, have the negative economic effect of making people less willing to take low paying jobs. But this point is a side-track.

Key to Jamieson's analysis is the question of our having the right to make new decisions and the crucial importance of *not* having some outside power with the right to influence or simply give its backing to policies which we would not otherwise adopt. Policies that are right for this country will emerge out of the gestative system of Britain's body politic – the party workers, the courts, the journalists, the activists, the pressure groups, the meetings and TV shows and all else. That is a delicately balanced mechanism. Money from outside (as the Brussels Commission is said to have funded the European Movement prior to 1975,) an opinion of Jaques Delors that Mrs Thatcher should go, or a "social chapter" in the Maastrict Treaty are all ways in which this balance can be unhinged. The result is disgust, disillusionment and abstention – all of which endanger a previously healthy democracy. This is what "loss of sovereignty" is all about – and Jamieson's treatment of this question is first rate and his diversion into the economics of our "dependency culture" is a very fine way to illustrate the point in detail.

So Jamieson would bid us to look to our roots, to our past and to our own resources to find our way forward and our role in the world. "Never say the die is cast for the British people" is his final conclusion. This is fine, but for some specific ideas we can turn at last to chapter 8, by Tsuru.

He starts by saying "It is proposed in this chapter to discuss the direction in which Japanese capitalism might hopefully evolve with positive programs of nation-building", and continues "A Japan that takes the lead in pressing for world disarmament, is assiduous in the fight against disease by making the country the health-care centre of the world, lays emphasis on tourist facilities at sites of scenic beauty, is active in international exchange in the fields of cultural and ascetic life, is willing radically to increase the country's contribution to the United Nations University, and works hard, through both aid and trade, to wipe out the poverty which plagues the Third World, would be a Japan where the people would feel assured of holding in common positive values worth defending. Such a prospect, I am certain, will have a sobering as well as vitalising effect on the spirits of Japan's younger generation."

So Japan should be the best place for foreigners to go for health care. Fine, but with the Yen at 150 to the pound, prohibitively expensive. So Japan should develop her excellent opportunities for providing holidays in hot spring areas and scenic beauty spots. A dream for us all, but, with the Yen ... So Japan should promote international exchange and invite the world to spend time studying in Japan. That would certainly be worthwhile but with the Yen ... So Japan should raise the level of its financial facilities. That would be international indeed but what does it cost to place foreign executives in Tokyo?

In fact Tsuru's inspiring vision is at present unattainable simply because Japan has been too successful in manufacturing and exporting. All that electronic gear and all those motorcars have forced up the value of the Yen and have *crowded out the opportunities for service sector international specialisation.*

But Jamieson's Britain could – blindly already is – embracing this vision. Britain's service sector is the un-crowned king of the past decade. Coffee shops and boutiques in Covent Garden, endless tourist places of interest in the West Country (starting perhaps with Lord Montague's car museum), a booming growth of college courses for foreign students to learn real English, the phenomenal success of private hospitals, the success of the City. It is Britain with its relatively low pound, its language and history, its wealth of education (mostly, but not entirely, thanks to the private sector) and its mild recuperative climate, that stands able to fulfil this promise. It is Britain that could become "The world's educator, the world's financier, the world's hospital and the world's playground". The students will come here if they can afford it, the money will pass through London if London can be free from EU regulations, the wealthy sick can come here provided the NHS will relinquish its claim on facilities, and the tourists will tire of the Sun and seek the pleasures of country lanes and theatre if they can afford it.

Leadership means encouraging these possibilities, rejecting outside regulation, resisting EU clamour for an artificially overvalued currency. Leadership then means using the wealth created to improve our world, resist entanglement in superstate ambitions and inspire the young towards a worthwhile future.

One last point. Tsuru talks of the "convergence of capitalism and socialism" and shows, very credibly, the futility and outdatedness of conflict between the two. Today we all talk of the "social market economy", and the modern Labour party, uncluttered by power in recent years, is well placed to learn both from Shigeto Tsuru's perception of change and from Bill Jamieson's emphasis on the crucial importance of sovereignty.

## PLANNING FOR CHANGE

*"Industrial Policy and Japanese Economic Development 1945–1990"*
*by James Vestal. Oxford University Press, £25.00*

This author, chief economist at Barclays de Zoete Wedd Securities (Japan), and visiting lecturer at Keio University, provides us with a beautifully written, cogent and well informed account of post war Japanese government industrial policy. This is an account given from the perspective of an economist rather than that of a political commentator – and therein lies both its strength and its weakness.

The aim of the book is to review industrial policy in the context of macro-economic circumstances and assess, at each stage, policy rationality and efficacy – with a view towards suggesting lessons for developing countries, for countries in the former Soviet Union, and for other advanced OECD members.

Thus the account naturally divides into a number of time periods starting with the immediate post-war period from 1945 until the Korean war, followed by the 20 years of high growth through to the first oil crisis, followed by a look at the 1970s decade and then the 1980s. The author sets out to account for government actions under occupation reforms, then over an economy hell-bent on expansion, then during a period of dislocation and finally within current constraints only too familiar in other countries.

The conceptual framework is perhaps of even greater interest than the historical account. 'Anti-growth' and 'pro-growth' policies are examined. 'Anti-growth' policies are such things as agricultural subsidies, laws to prevent the development of supermarkets, and import restrictions – in other words policies which deliberately enable employment levels to be maintained in sectors which would otherwise contract sharply if exposed to competitive market forces. These policies are defended quite simply on grounds of political necessity – to avoid massive unemployment and civil unrest. They are to be justified in terms of slowing the pace of change to a pace consistent with social tolerance. These policies have indeed succeeded in maintaining employment levels and it would not be easy to argue that any sensible alternative way of providing a basic livelihood to a large proportion of the Japanese (especially during the early years) existed.

'Pro-growth' policies depend heavily on infant industry notions about reaching scale economies, achieving 'critical mass' and enabling Japanese firms to become internationally competitive. Vestal argues fairly convincingly that such policies work, not because they over-ride or negate market forces but precisely because the Japanese government accepts the benefit of market mechanisms and sees its role in terms of preparing firms for the moment when free market conditions can be allowed. 'Infant' industries have been succoured by the full range of tricks from tax breaks, subsidies, advice and public contracts through to import controls, restrictions on inward investment, assistance with technology procurement and loan subsidies from both public and private sources. No country, it seems, could have been more ruthless, especially during the 1950s and 1960s in identifying its own (producer) interests and securing advantage for them. And when an industrial sector faced decline, the Ministry (usually the Ministry of International Trade and Industry -'MITI') was seldom slow to allow cartels to be formed to arrange 'orderly' reductions in capacity.

It would be unfair however to suggest that 'pro-growth' policies are based *solely* on infant industry notions. The author takes care to brief the reader on a whole range of notions (familiar enough to students of French indicative economic planning) claiming that government intervention can lead to higher levels of investment – notions based on information, security and consistency. And it is precisely here that both the author and the reader face the greatest difficulties. It is a matter of looking at performance, evidence, claims and theories in whatever is the most informed light possible having discarded, so far as possible, one's own preconceptions.

Thus this reviewer approached both the overall account and the industry specific accounts in the text with some scepticism. At each turn of the debate, Vestal seeks to assess whether or not there was 'policy efficacy'. We are treated to his judgment on point after point as to whether the policy move was 'rational' – or not.

This reviewer developed considerable respect for the author's knowledge, clarity of thinking and ability to assess events. The overall impression given – that the Japanese have done a pretty good job in industrial intervention, is convincing.

Yet the worry remains that somehow 'rationality' has become confused with 'rationale' so that whatever can be explained can thus be held acceptable – which it clearly is not. And somehow the author has missed, in his lengthy bibliography, many of the texts so critical of Japanese industrial policy-making. There is no mention of Karel Van Wolferen or Jon Woronoff or Marvin Wolfe. Where is the argument that political cynicism as demonstrated by Van Wolferon, or business interests as demonstrated by Woronoff, or nationalist ambition as claimed by Wolfe, might have been far stronger factors in determining policy outcomes than economic rationality? But perhaps this is to stray from economics to political analysis and this is perhaps unfair given the economic brief the author sets himself – a brief he has fulfilled and thus provided one of the most valuable books currently available on the Japanese economy.

**J.B.**

## LETTERS

### A response to "The Economic Cycle" by Paul Turnbull

Dear Sir

May I congratulate the speaker on 19 April 1994 on his excellent presentation. The relation between above trend growth in GDP and inflation does appear very convincing.

What is less clear is whether, in either direction, the one is causing the other; or whether alternatively the two have a common third matter as a cause. If anything, the very closeness of timing of the peaks probably suggests the latter.

If I may inject my opinion that inflation is a direct consequence of how fast the government turns the handle on the printing press producing the money, it follows that what the speaker demonstrated was a relationship between how fast that handle is turned, and G.D.P.. But in which direction does that relationship operate? I do not possess the figures for money supply over the years; perhaps someone who does would like to plot growth of money supply, and see how the graph compares with the other two. I should be surprised if there are not corresponding peaks above the trend line, etc., but the exact timing would be fascinating.

Mark C. Daniel
Park Avenue
25 High Street
Stagsden
Bedfordshire

### A response to "Risk and Reward" by Damon de Laszlo

Dear Sir

I was delighted to read the piece on risk and reward.

Let me comment on the point that "the performances of stock markets in the last few years and the decline in interest rates have got to the point where linear extrapolation is no longer valid". Amen! I can't believe the number of youngsters in the business world today that look at the economic trend as though it were some sort of straight line headed upward. Nonsense! Economic growth has always been cyclical, and each upward cycle has invariably had some new development driving it. In the 19th century the building of our national railway system was the dominant force; and, when the last spike was driven at Promontory Point, Utah, in 1869 and the building came to an end, we enjoyed almost three decades of deflation.

Then came the automobile and a flood of inventions, including the phenumatic tyre, the radio, the telephone, kitchen appliances, and chemicals; and the stock market that was earlier dominated by the rails became dominated by "industrials". That burst of activity reached its zenith in the twenties and was followed by another decline and another dose of deflation. Following World War II, there was social legislation, the computer, defence spending, the phenomenon of the international corporation, and space exploration and, again, it all came to an end. Interestingly, interest rates have followed these cyclical developments up and down, reaching highs in 1871, the 1920s and the late 1970s and early 1980s. Lows were reached in 1898, the late 1940s, and – if history is any guide – should reach the next low in about 2005 or 2006.

My prediction is that NAFTA and GAAT are the harbingers of the future and that the next surge forward will be the opening of free world markets, and that it will feature a boom of unprecedented proportions. In the meantime, it's going to be like the bankruptcies among the railroads that marked the late 19th century. We have a lot of fiscal house straightening to do, and things are going to drag a bit as this is done.

John Russell Holmes
790 Huntingdon Garden Drive
Pasadena
California 91108

### A Comment on the National Debt

Dear Sir

Increased taxes to fund unemployment are unnecessary if Government supporters follow Conservative Prime Minister Baldwin's example.

In 1922, when First Secretary of the Treasury, he donated through a letter to The Times, 25% of his personal fortune to the Treasury on condition an equivalent amount of the national debt be retired.

Today's National Debt, one of the most rapidly rising items in the budget, approximates £120 billion: a 25% reduction eliminating interest and capital repayment thereon should be more than adequate.

It is constructive to recall Thomas Jefferson's views of "Funding" (Jefferson like many of the Founding Fathers was a qualified member of the Temple Bar in London): "Making future generations pay for services incurred by their ancestors is, in my opinion, Robbery"!

Yours truly
Malise L Graham
40 Morris Road
Lewes
East Sussex
BN7 2AT

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iii) To explore with other bodies the fields of monetary and economic thought in order progressively to secure a maximum of common ground for purposes of public enlightenment.

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