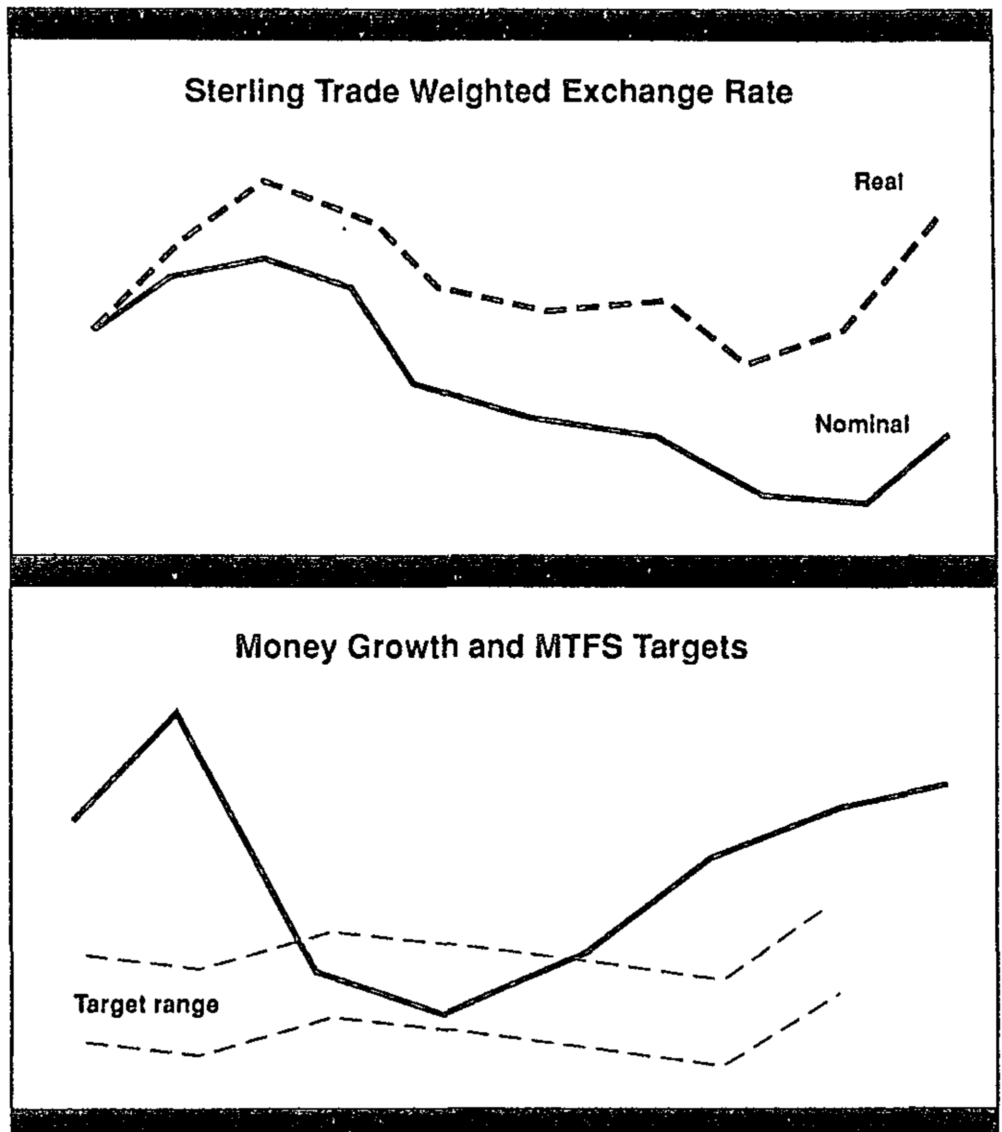
ECONOMIC RESEARCH COUNCIL

# MR LAWSON'S BOOM: A MONOGRAPH

by Brian Reading



## ECONOMIC RESEARCH COUNCIL

President Lord Ezra
Chairman Damon de Laszlo

Vice-Presidents
Lord Killearn Sir Peter Parker MVO Lord Seebohm

Hon. Secretaries James Bourlet
M.H. Cadman


## MEMBERSHIP

Membership of the Economic Research Council is open to all who are in sympathy with its declared objects. The minimum annual subscription for individual members is £12 for full members, £7 for Associate members.

Corporate membership is open to all companies and other bodies, minimum annual subscription £35 in respect of which they may send up to six nominees to any of the council's discussion meetings and lectures.


### Executive Committee

Damon de Laszlo (Chairman)
James Bourlet
M.H.Cadman
E.A. Clarke
P.L. Griffiths
J. Hatherley
Mrs D. Jenkins McKenzie
Dr P.F. Knightsfield
A. Latham-Koenig
W.A.P. Manser
Brian Reading
A.J. Street
D.R. Stuckley

## FOREWORD

Over the years the Economic Research Council, while not expressing an opinion, has supported and published papers that seek to point out the pitfalls in the financial and fiscal policy of the Government of the day.

Brian Reading's Monograph changes the perspective of the Chancellor's policy by pointing out that high interest rates are the problem, not the solution, of today's economic dilemma.

With the real exchange rate, on IMF calculations, back to its 1980–81 level, the balance of trade will continue to deteriorate. If the Government continues to run a large budget surplus and the personal sector starts saving again instead of borrowing and spending, British Industry Limited is likely to suffer a worse squeeze than in 1980–81. Changes in Corporation Tax have reduced companies' cash flow, this and the current high interest rate regime will slow down capital investment, undermining the enormous productivity gains achieved so far this decade.

Brian Reading outlines the background that leads up to the Chancellor's current economic stance and he succinctly demonstrates the consequences of sticking to the present policy.

It is important to understand the intellectual process that has led the Government into the present situation, which is in danger of undermining the revitalisation of the British economy achieved by the Government's overall philosophy.

Brian Reading's Monograph is important and should be heeded by those concerned for Britain's future as we move towards the 1990s.

**Damon de Laszlo**

**Chairman of the Economic Research Council**

## CONTENTS

Summary ........ 3

1. Introduction ........ 4
2. Three Booms Compared ........ 5
3. Money Mysteries ........ 9
4. Rival Fixations ........ 9
5. Hooked on an Overvalued Pound ........ 13
6. Interest Rates and Inflation ........ 16
7. Interest Rates and Trade ........ 19
8. Landing without Fiscal Flaps Down ........ 20
9. A Worse Squeeze than 1980-81 ........ 21
10. Beware Mr Lawson's Slump ........ 23

## CHARTS

1. Real GDP growth 1963–88 ........ 4
2. Labour force, employment and unemployment, 1963–88 ........ 5
3. Retail price inflation, 1963–88 ........ 6
4. Current account balance, % of GDP, 1963–88 ........ 7
5. PSBR, % of GDP, 1963–88 ........ 7
6. Money supply growth – M3, 1963–88 ........ 8
7. Velocity of circulation – M3, 1963–88 ........ 9
8. Nominal and real Treasury bill rates, 1963–88 ........ 10
9. Sterling exchange rates, 1979–88 ........ 13
10. Sterling trade-weighted exchange rate, 1979–88 ........ 13
11. Treasury bill rates, USA, Germany and Britain, 1979–88 ........ 13
12. Manufacturing output and productivity, 1963–88 ........ 14
13. Deviations from estimated productivity growth, 1963–88 ........ 15
14. Money growth and MTFS targets, 1980–81 to 1987–88 ........ 16
15. Nominal and real mortgage interest rates, 1963–88 ........ 17
16. Nominal and real house prices, 1963–88 ........ 17
17. Personal savings ratio, 1963–88 ........ 18
18. Personal wealth and savings, 1980–88 ........ 18
19. Sector financial surpluses and deficits, 1979–80 to 1989–90 ........ 22
20. Rates of return on capital, USA, Germany and Britain, 1980–87 ........ 23

# Mr LAWSON'S BOOM: A MONOGRAPH

## by Brian Reading

## SUMMARY

There have been three Tory booms in the past 25 years; Reggie Maudling's, Tony Barber's and Nigel Lawson's. Both earlier booms ended in disaster for the economy and electoral defeat for the Conservatives. Will Lawson's boom also end in grief?

All three booms have things in common and things which differ about them. Barber's was strongest, Lawson's is longest and Maudling's the least inflationary. All three have run Britain into deep balance of payments deficit. But Lawson's differs from its predecessors in that it is occuring against the background of greatly improved productivity performance.

Both Maudling and Barber had policy fixations which were their undoing. Maudling refused to devalue. He managed the economy under the limitations of the Bretton Woods fixed exchange rate system. Barber refused to deflate. The Heath Government, like all its postwar predecessors, thought unemployment was an evil as bad as inflation. It tried to control inflation directly, through a statutory prices and incomes policy.

Lawson's fixation is with monetary policy. He does not seem to understand the consequences of free capital movements in a world of highly integrated financial markets. In this changed world needlessly high interest rates are the problem. They attract capital inflows which increase Britain's money supply. Money becomes both plentiful and dear. This causes asset price inflation which enhances personal (but not national) wealth at a rate far beyond that possible from personal savings out of current income. Consequently people stop saving. Domestic demand booms

High interest rates caused the current account deficit. The booming economy sucked in imports while the soaring pound priced exports out of foreign markets. The economy moved into external and internal disequilibrium.

Pushing interest rates still higher will eventually stop domestic demand rising, like a brick wall stops a runaway car. But it is not likely to lead to a soft landing. A collapse in consumer spending and a run on the pound are inevitable, the only question is which happens first. On present policy company profits will be squeezed as harshly as in 1980–81 and the result, unless policy is changed, will be another sharp rise in unemployment.

Lawson's boom will be followed by Lawson's slump, unless sterling and interest rates are lowered. If they are, Britain's economic miracle will continue apace. If they are not, Britain will be condemned to yet another period of dismal economic performance under the malign effects of a persistently overvalued currency. In view of Britain's experience of the effects of an overvalued currency, both between the World Wars and since the Second War, it is remarkable that we again have a Chancellor who believes that this is the discipline necessary for the Britain's economy to thrive.

## 1. INTRODUCTION

This Monograph started as a speech given at an Economics Research Council dinner on 5th October 1988. It has developed and expanded to include arguments presented in articles published in the Sunday Times. It is critical of the present Conservative Government's management of the economy, but not of its general philosophy or of its structural reforms. It has not been written in support of any other political party. The author, who in the 1960s and early 1970s, worked successively for George Brown's Department of Economic Affairs and for Edward Heath, is not a member of any political party and has, at various times, voted for every major one of them. It therefore represents an independent though iconoclastic view of current developments in the economy. My thanks are due to the ERC for sponsoring its publication.

Twice before during the past twenty-five years Tory chancellors have engineered economic booms. Each ended in grief. Will Mr Lawson's boom be any different? The answer is the subject of this Monograph. To reach it involves a ramble through many areas of policy in which the views expressed here are controversial. But the general thesis is simple. Through a combination of good luck, good legislation and political courage, fundamental changes have been made over the past decade to the structure of the British economy. Its underlying soundness marks out the background to this boom as different from its predecessors. If properly managed, Britain is now capable of sustained rapid growth. But unfortunately the economy is being managed ineptly. In consequence a sharp, but hopefully short, recession is in sight.

Nigel Lawson deserves great credit for his contribution to the Conservatives' economic miracle. It is unlikely that any other politician would have had the guts to reduce and reform taxation the way that he has done. His name will go down in British history for it. In this respect he can be regarded as Britain's "best Chancellor" in years. But he is no all-rounder. His bungling of the day-to-day management of the economy is monumental. Provided he, or his successor, learns something from his mistakes, not too much damage need be done. Britain could be rapidly put back on the fast growth track again. Then the long term good he has done will surely outlive the short term harm he is doing.

### Tory Booms of Yore

Ever since the war, the Tory party in office has had a proclivity to go for growth, frequently as a short-term electoral expedient. "Rab" Butler's boom of 1953–54 preceded the May 1955 election. His easy April budget before that election, which the Tory's won, was reversed by a harsh October budget. There followed a sterling crisis in 1956 and the 1957 Suez crisis. Thus began a process dubbed "stop-go", which might more accurately but less euphoniously have been called "go-stop". Harold Macmillan, who became Prime Minister in the wake of Suez, continued it with a vengeance. Macmillan was particularly careless with his chancellors. He got through four of them in his six years in Number 10. His first chancellor, Peter Thorneycroft, resigned in January 1958 with his entire Treasury team (which included Enoch Powell), over a "little local difficulty" concerning the lack of control over public spending. The economy at the time was stagnant. Industrial production was unchanged throughout 1956 and 1957, and for the only 12-month period since the war, inflation was reduced to zero. Heathcote Amory followed Thorneycroft to supervise Macmillan's "you-have-never-had-it-so-good" boom which preceded the 1959 election. The strategy worked and the Tories won their third successive victory. It was Selwyn Lloyd who was left to pick up the pieces. He had to deal with the 1961 Sterling crisis. He deflated, introduced a prices and incomes policy and instituted national economic planning.

The next two Tory booms did not work out quite so well for their instigators. Reggie Maudling was responsible for the 1963–64 boom and Anthony Barber for the boom of 1973–74. Both men came to power in unfortunate circumstances. Maudling was appointed on 13th July 1962, the morrow of the "night

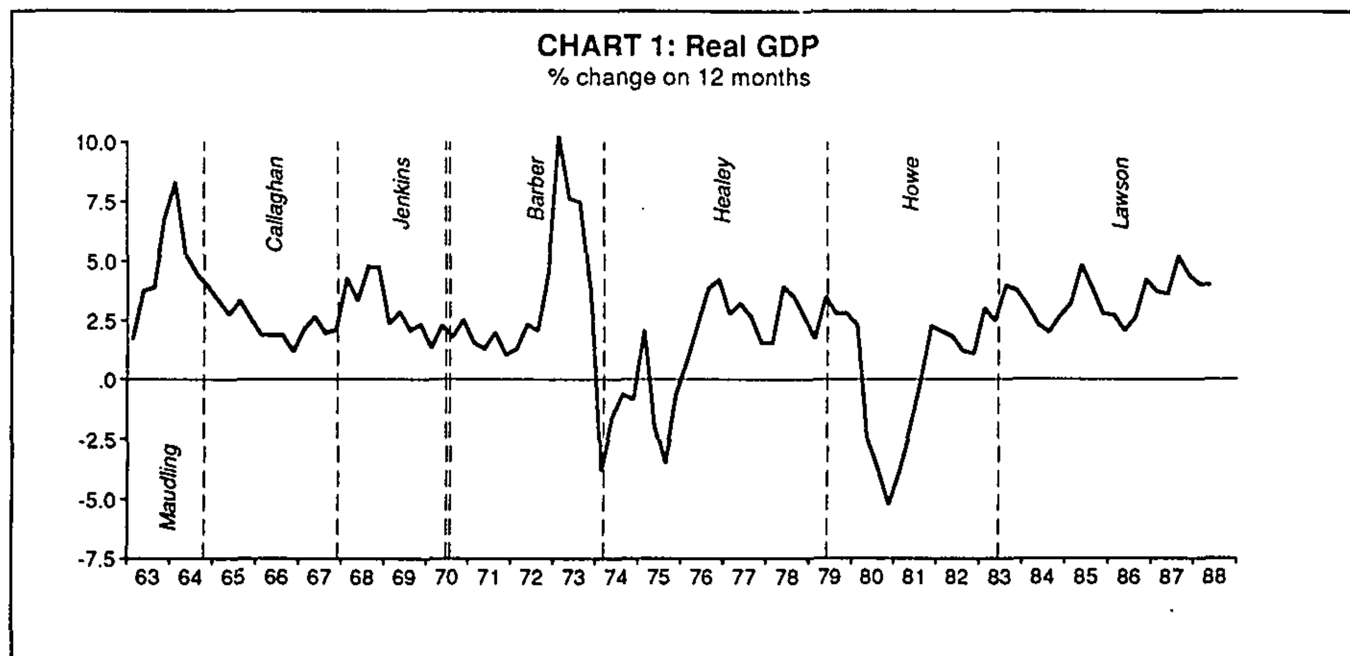


**CHART 1: Real GDP**
% change on 12 months

of the long knives", when Macmillan unexpectedly sacked seven cabinet ministers including the wretchedly-treated Selwyn Lloyd. Maudling's remit was to go for 4% a year growth within the framework of the newly-formed National Economic Development Council's economic plan. Barber was appointed by Edward Heath on 25th July 1970, following the sad and untimely death of Iain Macleod. He managed both to dig a hole in demand in 1970–71 by not reflating when he should have, and then to overfill it in 1972–73, by reflating too much when he should not have.

***Barber managed to dig a hole in demand by not reflating enough, then to overfill it by reflating too much***

Maudling and Barber also left office in the same circumstances. Both were thrown out because of general election defeats; Maudling when Harold Wilson ousted Sir Alec Douglas Home in 1964, and Barber when Wilson ousted Ted Heath in 1974. Indeed the Labour Party has won back power from the Tories only twice since the war, each time after one of these unfortunate booms. The British electorate had wised up to the cycle.

## 2. THREE BOOMS COMPARED

Butler's boom and Heathcote Amory's are ancient history now. But Maudling's and Barber's are seen by some as blueprints for the Lawson's boom. This could be wrong. The last three booms are very different. If lessons are to be learnt, they lie in these differences rather than in any similarities. Chart 1 on page 4 shows the path of Britain's real GDP growth under successive chancellors. The Maudling boom managed GDP growth of 11% over two years. The Barber boom notched up 10% growth during a single 12-month period. Lawson's performance is harder to quantify. The various measures of the real GDP, which ought to equal one another, fail to do so by unusually wide margins. In the year to the first half of 1988, the output measure (which the Treasury says is "generally considered the most reliable short-term indicator"), grew by 6%; the income measure grew by 4.5%; while the expenditure measure only grew by 2.5%. Going by the average estimate, which showed little more than 4% growth, one is entitled to ask of the Lawson boom, "What boom?"

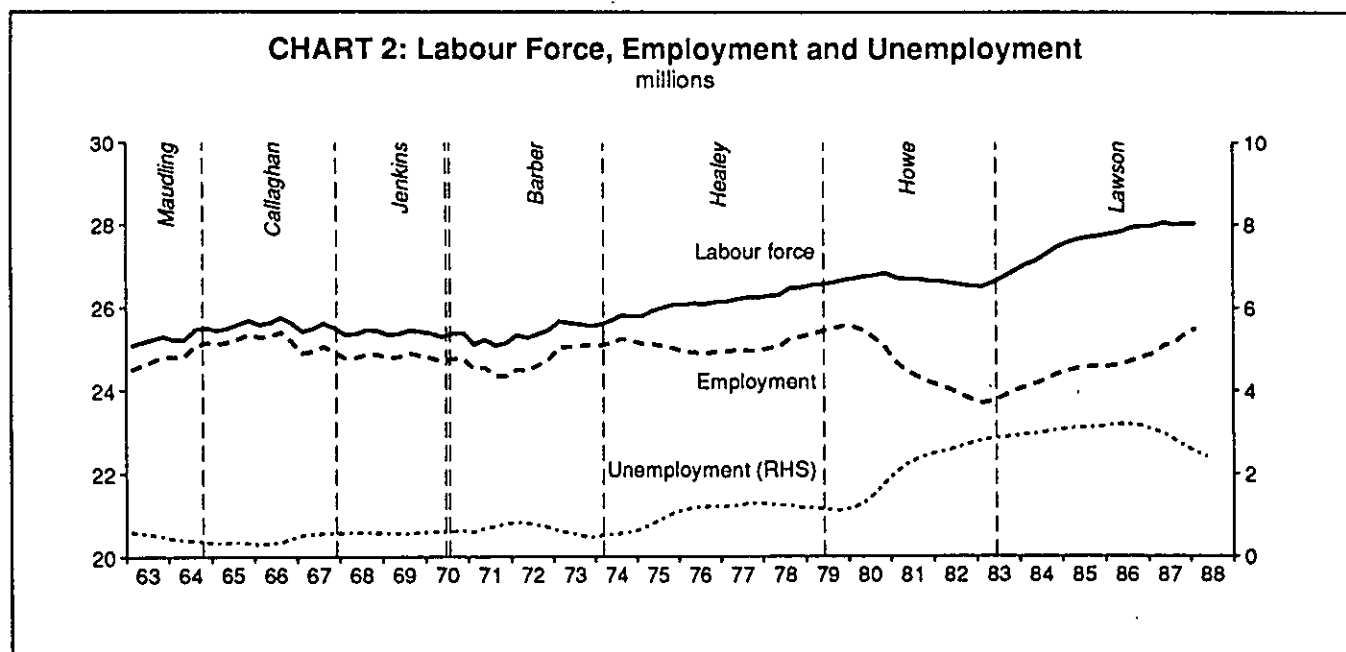
***One is entitled to ask of the Lawson boom, "What boom?"***

Lawson's boom is a boom in length rather than strength. Growth has been rapid in all of the years that he has been Chancellor. Indeed ignoring the Maudling and Barber spikes, growth has been stronger for longer under Lawson than under any other chancellor during the past quarter century. In the five years from mid-1983, when Lawson moved into Number 11, and mid-1988, Britain's real GDP rose on the average by 3.3% a year. This rate has not been bettered since before the first oil price explosion

Lawson's boom, (which started while his predecessor, Sir Geoffrey Howe, was Chancellor), was from a very low base. The recession of 1980–81 was the deepest since the interwar depression. It drove total unemployment above three million. The recovery since then has nonetheless been impressive. At first, however, the rise in employment which began early in 1983 barely kept pace with the growth in the labour force. Unemployment, as Chart 2 shows[1], did not turn down until the middle of 1986.

But the fall, when it came, was exceptionally steep. So although unemployment remains high by postwar standards, the impression that the economy is overheating has taken firm root.

1. Series used here are from the 1988 Economic Trends Annual Supplement, to which more recent data has been linked. There have been so many changes in the way that the unemployed are counted that no such long term series can be fully reliable. **Levels are a matter for controversy, but major turning points have probably not been obscured.**



## Inflation is not always a Problem

Rapid inflation is also associated in most people's minds with runaway booms. Yet in fact boom periods over the past quarter century have been ones during which, as **Chart 3** shows, inflation has been relatively moderate. The great inflations of 1974–76 and 1979–80 were caused more by outside shocks, oil and commodity price explosions, than by excessive domestic demand. Indeed it is fairer to say that in recent years rapid inflation has more often caused unemployment to rise, than that low unemployment has caused inflation to accelerate.

Britain is more prone to cost-push than demand-pull inflations. Every econometric model shows that. It explains why it has taken such high unemployment for so long to hold inflation down to what is still a fast rate compared with other major economies'. Yet it is a factor which successive Chancellors have failed to recognise. All have taken action which, by pushing up prices "at a stroke", has fuelled the inflationary spiral. Barber introduced VAT, Howe sharply increased it and Lawson has relied on unnecessarily high interest rates in a vain attempt to control money supply growth. Whenever the wage-price spiral has been wound up by higher taxes, import prices or mortgage interest rates, the cost of winding it down again, in slower growth and lost jobs, has been grievous.[1]

The Maudling boom was managed with what we would still regard as modest inflation, the rise in retail prices was 2% in 1963 and accelerated to 4.5% in 1964. Tony Barber's boom, as we all know, presaged a period of unprecedented peacetime inflation. But in fairness, it unfortunately coincided with the first of the world commodity and oil price explosions. Moreover the worst inflation occured after the Tories had lost office, when the following minority Labour Government abandoned all attempts to control wages.

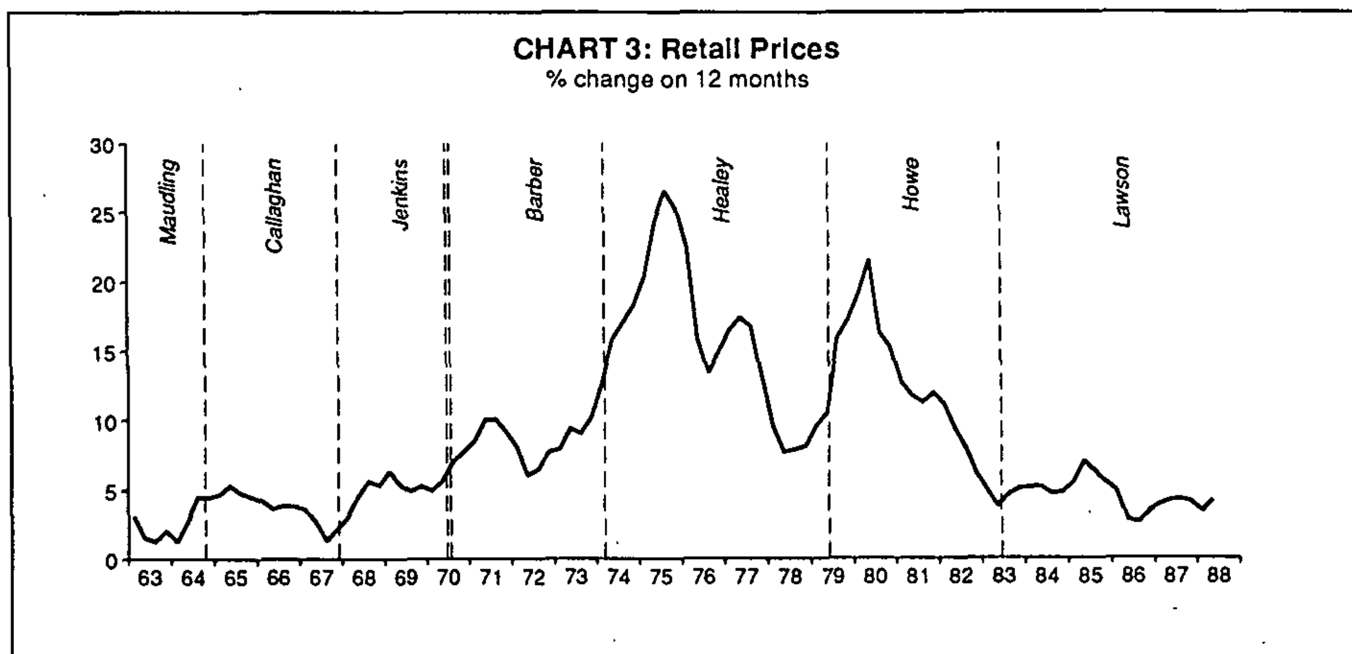
Lawson's inflation is faster in prospect than in retrospect. Retail price inflation has climbed to 6.4% in the 12 months to October. On Treasury forecasts it is set to go higher next year. They say it could peak at 7%. Private forecasters put the peak rate higher, almost back to double digits. But the precise figure hardly matters. The real issue is whether and when, and at what cost, inflation will be rolled back. This is considered in more detail below.

## All Caused Balance of Payments Deficits

All these booms have one thing very much in common. In each Britain's current account balance dives into deep deficit. Indeed this is taken as much to be a sign that the economy is overheating as the direct evidence of rising demand pressure in labour or product markets. **Chart 4** shows the current account balance since the early 1960s as a per cent of the nominal GDP. The biggest deficit, over 4% of GDP, was in 1974 following the Barber boom. This is not surprising. All major industrial economies plunged into deep deficit following the first oil price explosion. We were then, it should be recalled, dependant upon oil imports for much of our energy needs. Oil had not begun to flow in any quantity from the North Sea. Maudling's deficit, which Harold Wilson used to such devastating effect during the 1964 General Election campaign, turns out to have been rather modest. It was under 2% of GDP at its peak. Lawson's deficit is really worst of all. The Treasury says that at £13 billion in 1988 it will reach 2.75% of GDP (but over the six months to October it has been running at an annual rate of £17.5 bn). This is despite now having our own oil. Lawson's excuse, that deficits due to excess private spending do not matter, will also be considered further below.

The genesis of each boom was markedly different. Reggie Maudling's boom was spawned by old-fashioned Keynesian reflation. His giveaway 1963 budget did the trick. It raised the

1. It is therefore particularly odd that the Treasury, in its Autumn forecasts, assumes that average earnings growth, retail price inflation and unemployment will all fall in 1989. Falling unemployment, albeit at a slower rate, still means that the pressure of demand in the labour market is rising. Except when incomes policies have been operating, there is no postwar precedent for inflation coming down without unemployment going up.



public sector borrowing requirement, PSBR, to 2.5% of GDP (See Chart 5). Money supply growth under Maudling, as measured by M3, remained modest, as did inflation. Barber, however, went in with all guns blazing. Public spending and tax cuts pushed the PSBR to 6% of GDP, while M3 growth rocketed to 30%. There were plenty of excuses, then as now, for so rapid a rise in the money supply. The move under Heath to greater competition between banks and other financial institutions, deprived the money supply figures of some of their meaning. Banks expanded their share of the market so that part of the apparent money supply growth represented a shift in deposits to banks rather than an expansion in total deposits. This said, corrected figures would almost certainly still show rapid money supply growth at that time.

## Lawson's Supply-Side Tax Cuts ............

During Lawson's lesser boom, the PSBR has become the PSDR. Instead of a borrowing requirement, the public sector now makes debt repayments. It is suggested that this means fiscal policy cannot be to blame for excess spending in the economy. This need not be so. There is a two-way link between the budget deficit or surplus and the buoyancy of the economy. A bigger budget deficit may cause the economy to boom, but a booming economy will also cause the budget deficit to shrink. The final level for the PSBR or PSDR is the result of the combined effects of these two opposite forces. Thus the Government's fiscal stance cannot be determined, ex post, from the behaviour of the budget balance. It must be decided either by considering the discretionary actions taken by the Chancellor in cutting taxes and raising public spending, or though calculations which correct the actual budget deficit for cyclical changes in the economy.

Unfortunately these alternate ways of looking at Nigel Lawson's budget stance lead to opposite conclusions. On the former basis, Lawson's five budgets have all been stimulatory, (see Table 1). His 1986 budget gave away £1bn in tax cuts after

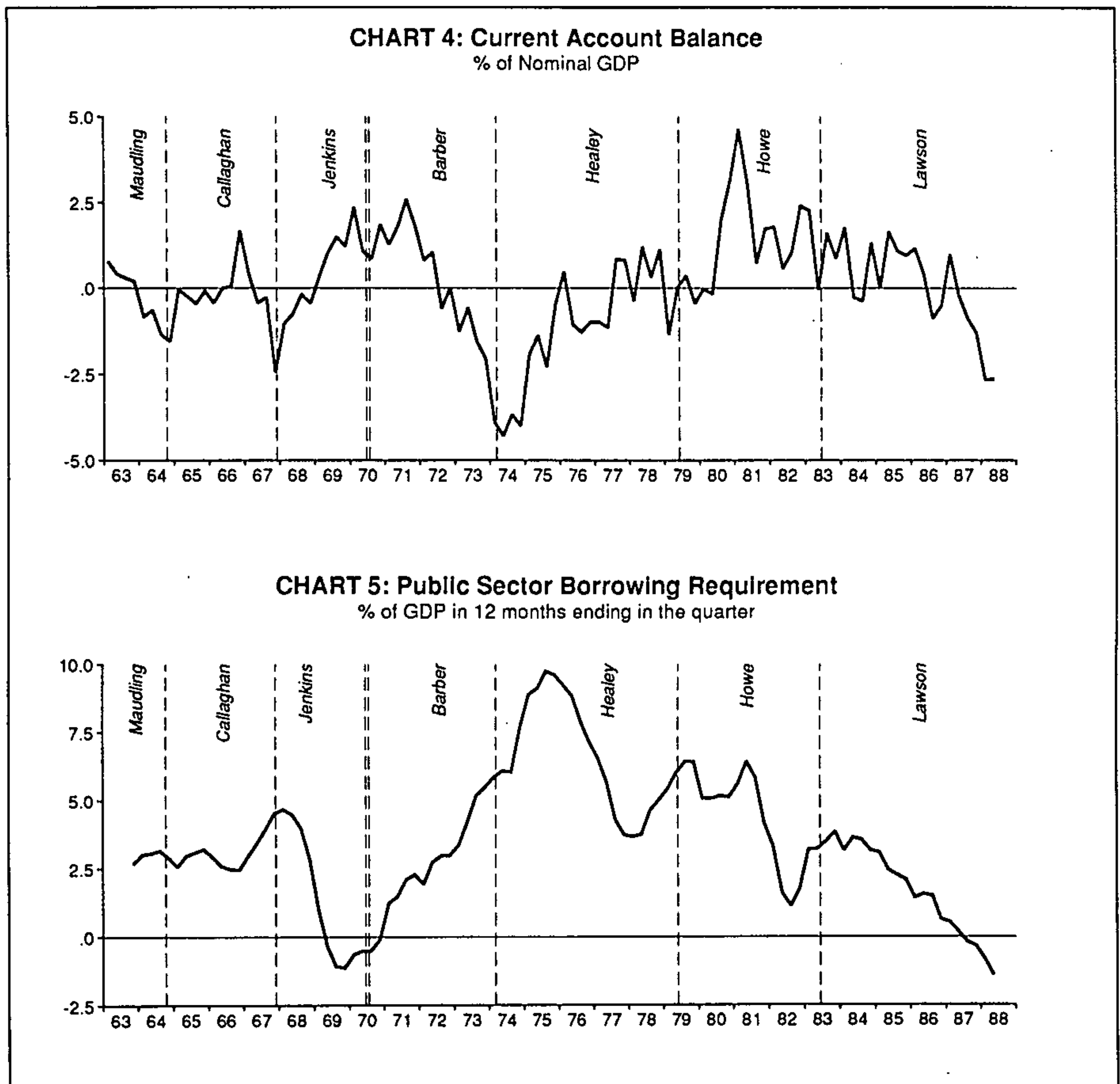


**TABLE 1**
**Treasury Estimate of Cost of Budget Measures**
Changes other than those required by indexation

| £mn | | | | | | |
|---|---|---|---|---|---|---|
| Financial years | 84-85 | 85-86 | 86-87 | 87-88 | 88-89 | 89-90 |
| Budgets | | | | | | |
| 1984 | -40 | -1,730* | | | | |
| 1985 | | -495 | -670 | | | |
| 1986 | | | -985 | -1,885 | | |
| 1987 | | | | -2,625 | -2,945 | |
| 1988 | | | | | -3,985 | -6,165 |

* Second or full year effects

| % of GDP, cumulative effect | | | | | | |
|---|---|---|---|---|---|---|
| Financial years | 84-85 | 85-86 | 86-87 | 87-88 | 88-89 | 89-90 |
| Budgets | | | | | | |
| 1984 | -0.0 | -0.5 | -0.5 | -0.5 | -0.5 | -0.5 |
| 1985 | | -0.1 | -0.2 | -0.2 | -0.2 | -0.2 |
| 1986 | | | -0.3 | -0.4 | -0.4 | -0.4 |
| 1987 | | | | -0.6 | -0.6 | -0.6 |
| 1988 | | | | | -0.8 | -1.2 |
| **TOTAL** | **-0.0** | **-0.6** | **-1.0** | **-1.7** | **-2.5** | **-2.9** |

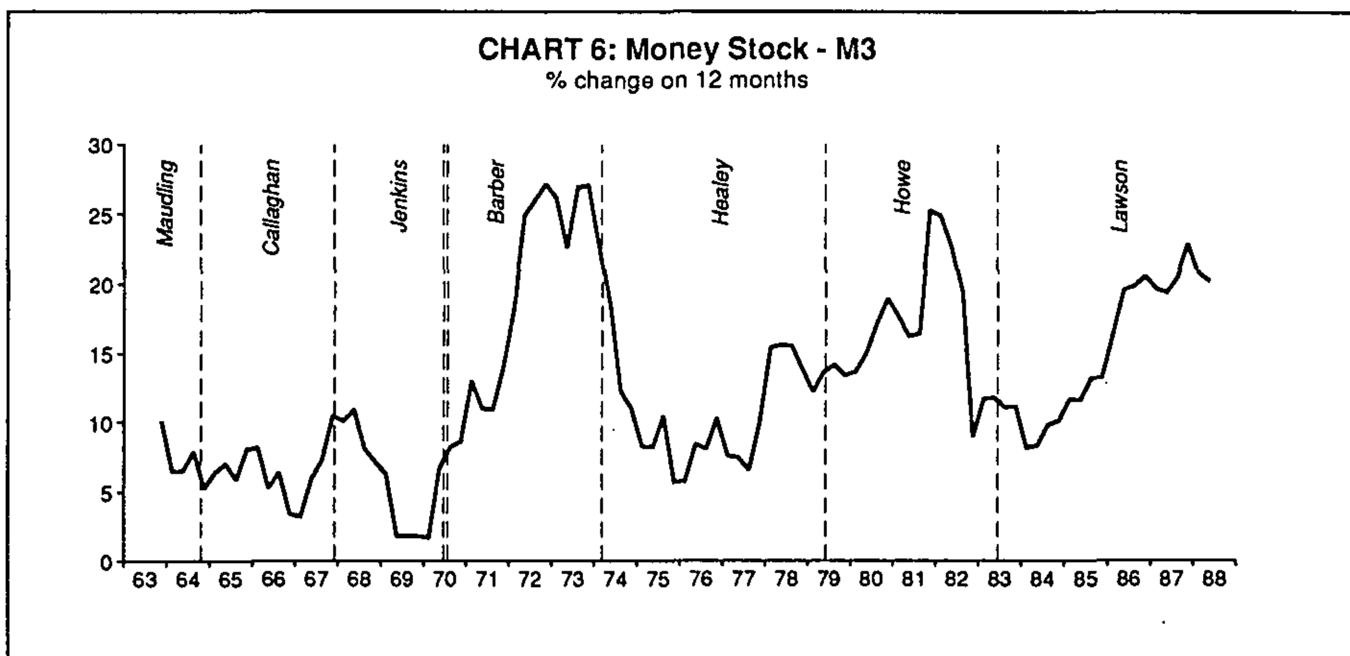
allowing for indexation; in 1987 he gave away £2.6bn in the first year, 1987–88, and £2.9bn in a full year. His 1988 budget reduced taxes, after allowing for indexation changes, by £4bn in 1988–89 rising to £6.2bn in 1989–90. But while taxes were being cut, public spending was being reigned back. Putting together both sides of this equation, the OECD, which calculates cyclically adjusted public sector balances in its half-yearly Economic Outlooks, concluded in June 1988 that British fiscal policy had been broadly neutral for the past three years. This was before it was known that the PSDR in 1988–89 was likely to run at £10bn rather than the £3bn which the Chancellor predicted at the time of his March budget.

But neither approach makes sufficient allowance for changes in the structure, as distinct from the level, of taxation. The Chancellor's coffers have been filled with a gusher of corporate tax payments since his 1984 budget decision to phase out investment allowances and lower the corporate tax rate to 35%. The yield from the income tax has equally been enhanced as a result of lowering income tax rates. Not only have lower but more efficient tax rates produced greater, not less, tax revenues, they have also contributed to the unexpected buoyancy in the economy. The Treasury, cautiously estimated that lower rates would lose revenues. So it over estimated the cost of tax cuts. The OECD allowed nothing in its calculation of the cyclical component in Britain's budgetary performance for the structural improvement in the economy's underlying growth trend. It therefore also underestimated tax revenues.

***Lawson budgets' reflationary or deflationary effects depend upon whether demand or supply potential has been increased the most***

In fact, the old language of reflationary and deflationary budgets cannot be used correctly to describe budgets which involve great changes in the system of taxation rather than in its level. Lawson's tax changes have stimulated faster economic growth. But they have also increased the economy's supply side potential to grow faster. This can be seen in the remarkable 40% improvement in manufacturing industry's productivity growth over the last 8 years (see Charts 12 and 13 on pages 14 and 15). Whether the Lawson budgets have been reflationary or deflationary depends upon whether their demand-side effects have been greater or less than their supply-side effects. Unfortunately we will not know the answer to this until enough years have elapsed for the permanent acceleration in Britain's underlying growth trend to be estimated. But as another and more obvious culprit exists to be blamed for excess demand in Britain, I would give Lawson the benefit of the doubt over his budget judgements.

Monetary excesses have fuelled the Lawson boom much as they did the Barber boom before it. M3 growth, as **Chart 6**



shows, has accelerated throughout the Lawson years to be running recently close to a 20% rate. Many of the same excuses can be made concerning structural change and the unreliability of the statistics. But among the motorway system of money stock measures, all have at one time or another shown uncomfortably rapid growth. Over the Lawson's five years as Chancellor, to the middle of 1988, both M3 and M4 have risen by annual rates of close to 15%; while M0, which mainly measures the cash we carry in our pockets has risen by 5% a year despite the increased use of plastic.

## 3. MONEY MYSTERIES

### Why has Velocity Fallen?

One mystery is why this rapid money stock growth has had so little, rather than so much, effect in accelerating the growth of nominal GDP. The velocity of circulation of M3, shown in **Chart 7**, has fallen steadily throughout the 1980s. In part this has been due to changes in the operation of the financial system. There was a short but sharp fall during the Barber boom in the early 1970s. But the velocity of circulation of M4, which includes building society deposits as well as bank deposits, has also fallen. This wider measure covers most shifts between different forms of deposits.[1] Thus there is no escaping the conclusion that under Lawson more and more money has done less and less work to increase the quantity or the price of goods and services currently produced in the British economy. A cynical description of the Conservatives monetary policy is that they have failed to control something they could not measure in order to influence something it did not affect.

1. When people take money out of building society deposits and place it in bank deposits, M3 rises faster. But M4, which includes both kinds of deposits is unaffected. Thus the broader the measure of the money supply, the less it is affected by the way in which people hold money and so it more accurately reflects how much money, overall, they want to hold. The reason for not targeting and using only broad measures is that they may be less closely correlated with changes in growth and inflation. M0 for example, which roughly measures the amount of cash we carry in our pockets, is rather well correlated with inflation. Unfortunately that does not mean that if you control the one you must inevitably affect the other. As Professor Charles Goodhart pointed out long ago, any measure of money ceases to be reliable once the Government seeks to control its growth. Controlling the growth of M0 may simply destroy the correlation between M0 and inflation.

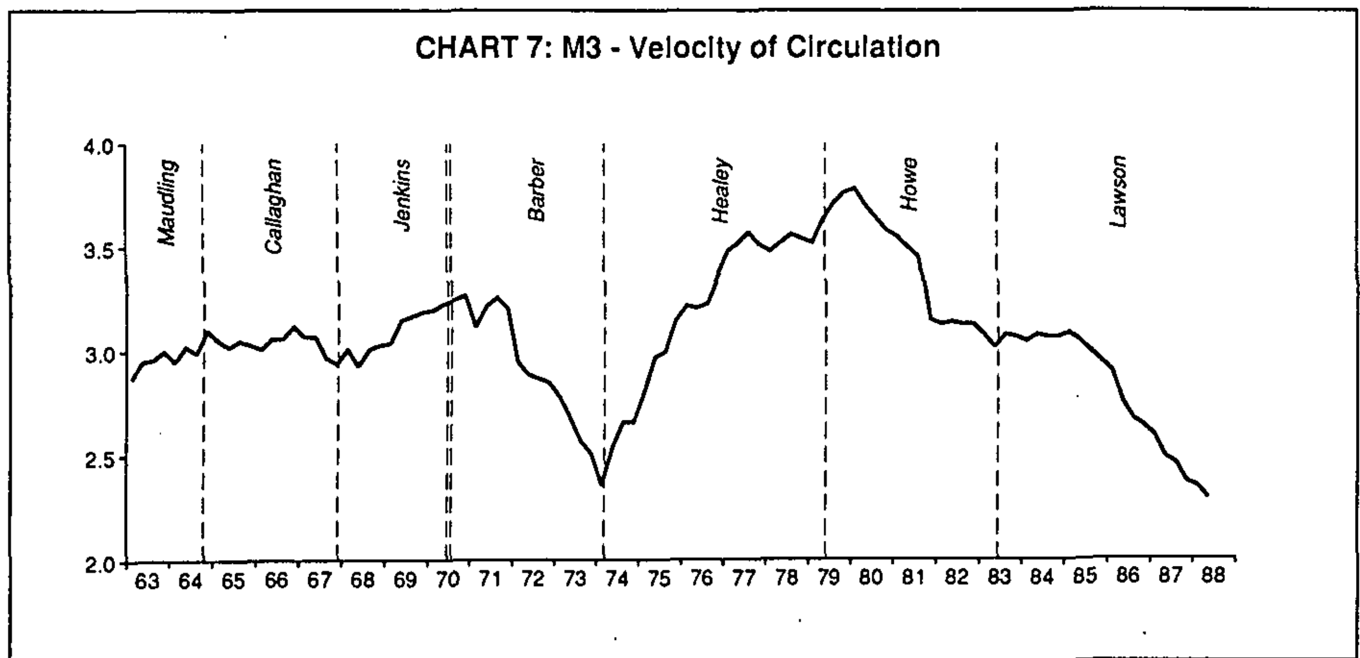
### Why have Real Interest Rates remained so High?

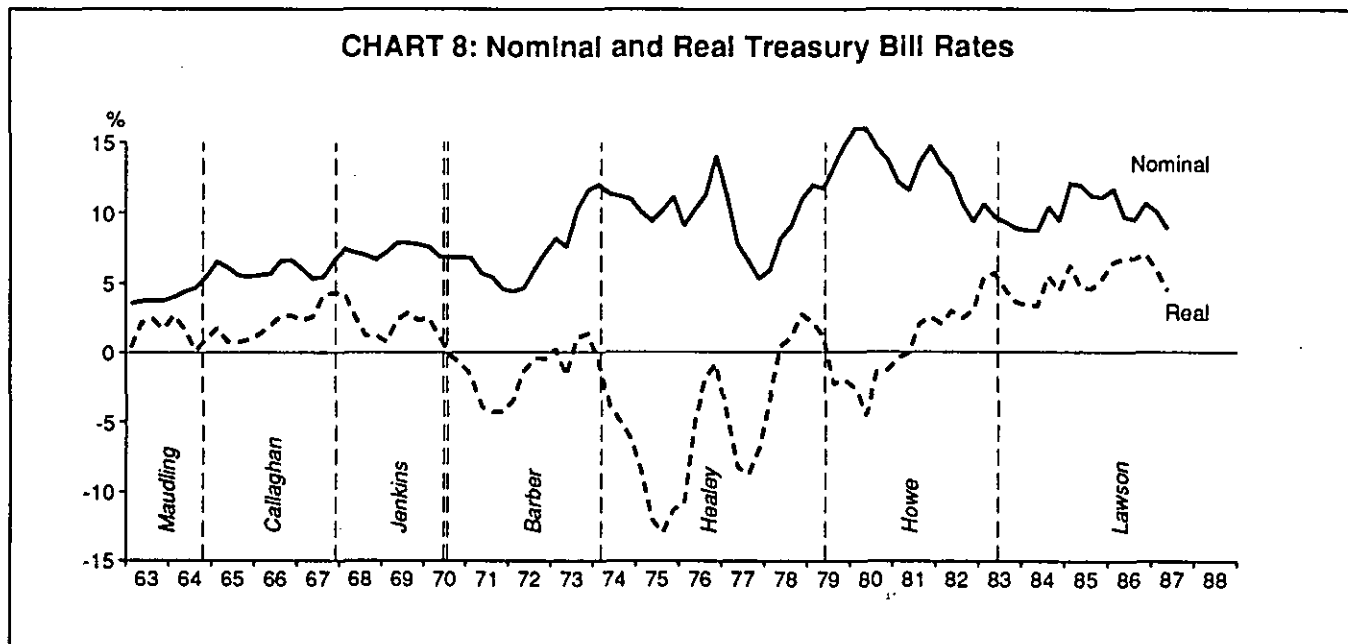
A second mystery is that while money has been exceptionally plentiful, it has not at the same time been exceptionally cheap. It has been and remains remarkably expensive. Nominal interest rates have been higher, as **Chart 8** shows, but only in periods when inflation has also been faster. Real interest rates have been positive and historically high throughout the Lawson years. Indeed it is puzzling why the present boom has happened at all against the drag of such high real interest rates. Most forecasters did not see it coming.

## 4. RIVAL FIXATIONS

One thing which all three booms have had in common is that, on every occasion, the chancellors and governments of the day have politically ruled out specific policy options for dealing with the problems that have confronted them. The disasters which have followed have been in large measure the result of such fixations. The Maudling boom occured in the days of the old Bretton Woods fixed exchange rate system, to which in turn the Macmillan, Home and Wilson Governments were utterly committed. Sterling was uncompetitive, but it was an article of faith that it could never be devalued. Before November 1967, when the Labour Government was finally forced to capitulate and devalue, Harold Wilson even banned the use of the word "devaluation" in Whitehall.

The Maudling boom was a deliberate "dash for growth". It was believed that a lack of capacity limited the economy's ability






to expand. This was why imports surged and inflation accelerated every time the economy put on a spurt. The lack of capacity was blamed on inadequate capital investment[1].

Investment was inhibited by uncertainty. Stop-go caused that uncertainty. So if industry could be convinced that a period of sustained growth was coming, it would invest to meet that growth. If it did invest, sustained growth could be achieved. This was the bootstraps theory which lay behind indicative planning of the variety which the National Economic Development Council was established to provide. In February 1963, NEDC published its 4% a year plan for the "Growth of the UK Economy to 1966". The Government, industry and unions were all supposed to be committed to it. The Government played its part by going for that growth. But since the pound remained uncompetitive, it was accepted that it had to ride out a temporary period of payments deficit. This made it vital that foreign investors' remained confident that sterling would not be devalued[2].

## Maudling would not Devalue

The Tories 1960s "deathbed" conversion to planning and growth came too late to have a realistic hope of success. The opposition, under Harold Wilson, made the most of the mounting trade deficit, undermining the foreign investors' confidence in the process. This helped the Labour Party to victory in October 1964, but since Wilson had the same hang-up over devaluation, it also tied their own hands thereafter when they continued with an abortive National Plan for 25% growth between 1964 and 1970.

By the time Barber's boom began, the Bretton Woods fixed exchange rate system had collapsed. Sterling was floating. Many people believed that the balance of payments constraint had been eliminated. Changes in the exchange rate would look after the external balance, freeing the Government to pursue faster growth at home. Barber did not plan on sending the growth soaring to 10%, he aimed at 5% a year for two years but got it all in one. He and the Government over reacted to the recession they inherited and which their earlier policies did little to alleviate. That recession was partly the product of the former Labour Chancellor's, Roy Jenkins, remarkable austerity. To make the 1967 devaluation work and with IMF prompting, Jenkins turned a public sector borrowing requirement of 4% of GDP in early 1968 into a PSDR of 1% by late 1969. This represented a greater turn around in the public sector's finances than anything Nigel Lawson has achieved, and it was profoundly deflationary. Worse still, it coincided with the first, post-Bretton Woods synchronised world economic downturn.

***In 1968–69 Labour's Roy Jenkins engineered a greater turn around in the public sector's finances than anything Nigel Lawson has ever achieved.***

In 1970, the new Conservative Government was slow to see what was happening and to respond to it. Treasury forecasters were largely to blame. The Treasury did not see the 1970–72 recession coming. To have done so would have been to admit that their 1970 budget advice to Roy Jenkins had been wildly

1. This view is hard to sustain. Britain's capital stock per worker was not particularly low, although our machines were often older than our competitors'. The problem was rather the inefficient use that we made of them. Productivity per unit capital is probably still worse, relative to our rivals, than productivity per worker. The Bank of England estimates that the service life of equipment in British manufacturing industry is 28 years, compared with 23 years in Germany, 18 in the USA and 11 in Japan. Net value added as a per cent of the net capital stock, ie., capital productivity, was 43.7% in Britain in 1987 against 55.8% in the USA and 56.8 in Germany. In 1973 the figures were 40.2%, 68.9% and 62.1% respectively. (Bank of England Bulletin August 1988.)

2. Nigel Lawson was a special adviser and speech writer to the Prime Minister, Sir Alec Douglas-Home in February 1964 when Home, in response to the record bad January 1964 trade figures, claimed that "the economy has seldom been stronger". Full 24 years later, in response to the record bad July 1988 trade figures, Nigel Lawson himself claimed that the economy was doing "exceptionally well".

wrong. Their forecasts in the summer of 1970, which were official State secrets at the time, said that unemployment would continue to fall, the trade balance would deteriorate and inflation accelerate. But instead growth slowed, unemployment climbed and the current account moved into larger surplus. Nonetheless these erroneous forecasts frightened Tony Barber enough for him to reject the "at a stroke" policy which the late Iain Macleod planned to pursue. Despite private advice to the contrary and his own misgivings, Heath (unlike Thatcher) would not overrule the Chancellor and his Treasury Mandarins[1]. It was only when unemployment climbed rapidly towards the one million mark through 1971 and early 1972, that the Government panicked. Its reflation, when it came, was far too late and far too great.

## Barber would not Deflate

The Heath's Government's fixation was with unemployment. It believed that, above a certain level, unemployment was not only political suicide, but evil, wasteful and socially divisive. The former conviction has been proved fallacious. The latter part remains, to my mind, indisputably correct. The Government's solution to growth without inflation was incomes policy. Heath hoped to persuade union leaders and senior industrialists, out of their duty to the nation, voluntarily to restrain wage and price inflation so that the economy could safely be expanded at a 5% a year rate during 1973 and 1974. When union leaders duly rejected his overtures, a statutory incomes policy was imposed. It was bad luck that this coincided to the week, in November 1972, with the start of the 1972–73 world commodity price explosion. When this was capped by the 1973–74 oil price explosion, all hopes were destroyed of containing inflation in Britain without recourse to rising unemployment.

Had Ted Heath been re-elected in early 1974, it is highly unlikely that wages and prices would have been allowed to rise so far and so fast as they did under Labour. Had the miners been put in their place 10 years sooner, Britain's economic miracle would now be a decade older. Heath pioneered the supply side revolution. Mrs Thatcher has continued the process which he began, but for which he now receives scant credit. Barber and Heath are still blamed for their handling of the economy in the early 1970s. Originally and understandably, it suited their former Conservative colleagues as well as their Labour opponents to pillory them. This was part of the struggle within the Tory Party during its opposition days by which Mrs Margaret Thatcher and her naive monetarist supporters won power. But history, I believe, would by now have produced a fairer judgement of both men had not Heath complained so long and so loud about his fate.

## Unemployment becomes the Solution

Mrs Thatcher's arrival in Number 10 Downing Street marked the beginning of a new era. *Inter alia*, she was the first Prime Minister born after the end of the First World War, (in 1925). Consequently she was only a child during the depression. She was the first to treat unemployment as a solution instead of a problem, the solution to inflation, overmaning, trade union pushfulness, and low productivity. Every previous government since the war knew that you could control inflation by creating unemployment, but all saw this as exchanging one evil for another. The problem had always been to control inflation while maintaining full employment; and it must be admitted that this was something nobody had managed to do.

Mrs Thatcher and her colleagues did not actively plan to create three million unemployed. Rather they did so accidentally. They believed that inflation could be painlessly controlled through monetary restraint. They thought that if people knew the Government would not print the money to validate wage and price increases, no such increases would be forthcoming. Rational unions and employers would see that the result must be plant closures and higher unemployment and would therefore voluntarily exercise restraint[2]. Nonetheless, when the incoming Conservatives accidentally triggered the severe recession of 1980–82, they did not flinch from its unemployment consequences. Distasteful as it may be to those who share my background and views, they were probably right. Curing inflation without causing unemployment may have been impossible, and the choice of higher unemployment in the short term could be correct for the longer term.

Growing North Sea oil production deeply affected developments in the early 1980s. It prevented the second 1979–80 oil price explosion from plunging Britain's current account into deep deficit as the first one had done. It caused sterling to go up rather than go down, which moderated the inflationary shock to the British economy. (But having a strong currency in a world recession caused a worse slump in Britain.) The 1979–81 inflation explosion, when the rise in the retail price index peaked at 21.9% in the 12 months to May 1980, more than double the rise of 10.3% to May 1979, Labour's last year in office, was mainly the result of Tory tax hikes and excessive public sector pay settlements. But perhaps most important, North Sea oil bolstered tax revenues at a time when the recession would otherwise have caused the PSBR to go through the roof. But for North Sea oil revenues, larger public spending cuts or tax hikes would have been needed to meet the Conservative's budget commitments. Some of these would inevitable have fallen on the growing number of unemployed, making the jobless rise more of a political liability than it turned out to be. To this extent North Sea oil, which also helped to cause higher industrial unemployment, made it more palatable. If it was necessary for unemployment to rise to over three million, it was indeed fortunate that this occured at a time when unemployment relief could remain relatively generous.

---

1. Throughout his years in office, Heath made the mistake of supposing that the most senior officials necessarily spoke the most sense. It did not dawn on him that they had reached their positions of eminence by dint of creating the mess the economy was in. They were the last people to consult over how to clear it up. Mrs Thatcher, to her credit, has never made this mistake.

2. Whereas Heath believed union leaders and captains of industry could be persuaded to do their national duty, Thatcher believed they would act out of enlightened self-interest. They were both wrong. Union leaders and industrialists have little power to deliver on promises which are not in the self interests of their members. Self-interest works, but only at the level of the individual self.

## Mr Two-and-a-Half Per Cent.

Treasury has published its forecast for the British economy twice a year since Parliament forced it to do so through an amendment o the 1975 Industry Act (which forced big companies to tell the Government their forecasts). Its forecasting record is claimed to be good, but so it should be. The Treasury has more information about Government policy on which to base its forecasts, and greater resources, than private forecasters. But as in 1970, it did not see a recession coming. Ever since the Government gave up fiscal fine tuning, it has given up publishing serious forecasts, contenting itself with projections of what it would like to see happen. The following table shows forecasts published with each year's budget since 1979. It cannot be an accident that the prospective growth rate, looking to the first half of the following year, has always been 2.5% while Nigel Lawson has been Chancellor.

| Budget | Real GDP, year to 1st half of following year, % growth. | | Retail Prices, year to 2nd quarter of following year, % increase. | | Current Account 1st half of following year, £bn annual rate | |
|---|---|---|---|---|---|---|
| | Forecast | Actual | Forecast | Actual | Forecast | Actual |
| 1979 | -1.0 | -0.2 | 13.5 * | 16.3 * | 0.0 | -0.2 |
| 1980 | -1.5 | -3.0 | 13.5 | 11.7 | -2.0 | 10.0 |
| 1981 | 1.0 | 1.9 | 8.0 | 9.4 | 0.0 | 4.1 |
| 1982 | 2.0 | 2.7 | 7.5 | 3.8 | 3.0 | 3.8 |
| 1983 | 2.5 | 2.2 | 6.0 | 5.2 | 2.0 | 2.4 |
| 1984 | 2.5 | 3.7 | 4.0 | 7.0 | 1.0 | 2.8 |
| 1985 | 2.5 | 2.9 | 4.5 | 2.8 | 3.0 | 2.8 |
| 1986 | 2.5 | 3.6 | 3.5 | 4.2 | 1.5 | 1.0 |
| 1987 | 2.5 | 4.3 | 4.0 | 4.2 | -2.0 | -11.5 |
| 1988 | 2.5 | | 4.0 | | -4.0 | |

* Year to 3rd quarter deliberately used in 1979 to lower forecast inflation. This excluded the rise between the second and third quarters, which was blamed on the previous labour government.

### Mr Lawson's Fixation: Needlessly High Interest Rates.

Lawson's fixation is with monetary policy. He rejects all means of controlling the economy other than through interest rate changes. Yet excessively high interest rates are the cause, not the cure, of our present problems. They have worked to destabilise the economy over the past two years. By chance Britain in 1986 was in a state of exceptional economic health. Spending and savings in the domestic economy were close to equilibrium, a moderately small and falling public sector deficit matched a moderately small private sector surplus. Externally the economy was in equilibrium. The current account showed a small surplus. GDP growth was rapid, faster than in any other major economy. Unemployment peaked in mid-year and started to fall. Retail price inflation, although faster than our competitors', fell to its lowest level for 20 years. The rise in the 12 months to June 1986 was only 2.4%. Indeed Britain in 1986 enjoyed a unique and felicitous combination of fast growth, low inflation, falling unemployment and external payments balance, the simultaneous achievement of which had eluded all previous postwar governments. It was the economic *Annus Mirabilis* of the second Elizabethan age.

The greatest achievement of the period was, however, something which the Government only grudgingly accepted. The pound fell in 1986 against all other major currencies. Moreover it did so without causing inflation to accelerate, since the fall coincided with a worldwide decline in commodity prices and an oil price implosion. Britain received on a plate the gift of an undervalued currency, while being spared the inflationary consequences of obtaining it. Seldom if ever has the economy been better poised for sustained rapid and non-inflationary growth, which its most prized possession, a competitively undervalued currency, would have allowed. No economy has ever sustained an economic miracle without one.

**TABLE 2: 1986 Britain's Annus Mirabilis**

| | USA | Japan | Germany | Britain |
|---|---|---|---|---|
| **% year on year** | | | | |
| GDP growth | 2.9 | 2.4 | 2.5 | 3.3 |
| Inflation | 1.9 | 0.4 | -0.2 | 3.4 |
| **% of GDP** | | | | |
| Current Account | -3.3 | 4.4 | 4.2 | 0.0 |
| Government Financial Deficit | 3.5 | 1.1 | 1.2 | 2.7 |

The contrast between Britain at that time and America on the one hand and Germany and Japan on the other was striking. Americans were spending too much and saving too little. Their economy was in external and internal disequilibrium. The US was suffering from the twin deficit problem. (It still is). The Japanese and Germans were saving too much and spending too little. Their economies were in also external and internal disequilibrium. They had (and have) over large current account surpluses. It was clear at the time that part of the process by

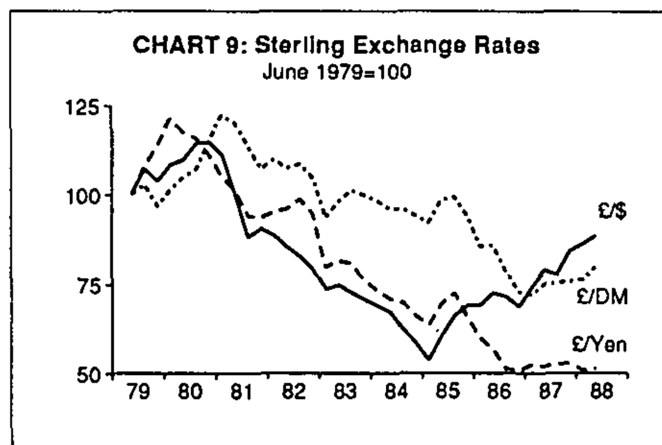
which these disequilibria would be eliminated would have to be a change in the dollar's exchange rate vis-a-vis the yen and the deutschmark. The dollar would have to go down and the deutschmark and yen would have to go up, as indeed they did.

The pound ought to have sat this one out. Our economy was in equilibrium. It did not need to adjust. So the pound clearly should not go down all the way with the dollar. If it did, it would become seriously undervalued. British exports would soar and imports decline. Our current account surplus would become excessive, and the economy would overheat. But equally the pound should not go up all the way with the deutschmark and yen. If it did, it would become overvalued and we would slide into deficit and debt. In order to remain in domestic and international equilibrium, the pound had to remain in the middle.

***A competitively undervalued currency ought to be our most cherished possession. No economic miracle has ever been sustained without one.***

## 5. HOOKED ON AN OVERVALUED POUND

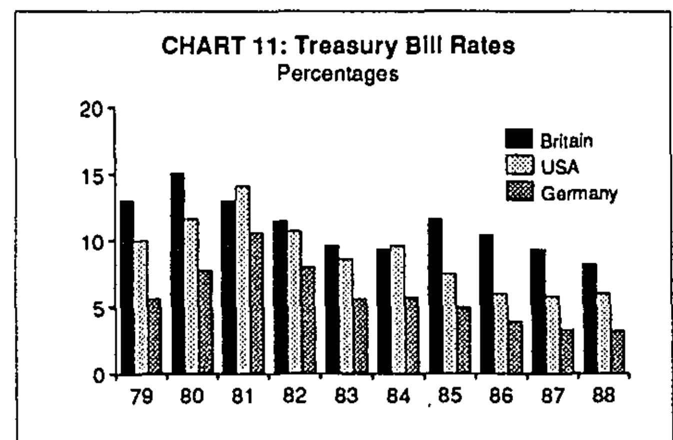
The pound did not stay in the middle. From the end of 1986, as Chart 9 shows, it went up all the way with yen and rose even more than the deutschmark. Chart 10 shows the consequences. It is based on new IMF figures, first published in the July issue of International Financial Statistics, for real trade-weighted exchange rates. These are obtained by adjusting the familiar nominal trade-weighted exchange rates by relative changes in unit labour costs[1]. A rise in a country's real trade weighted exchange rate shows that its manufacturing industry is becoming less competitive internationally. By the middle of this year, the latest period for which these figures are available, Britain had lost almost all the competitive advantage it had so fortunately gained by 1986. The pound is now as uncompetitive as it was in the great 1980–81 recession, only this time there are no rising oil prices or exports to bail out our balance of payments.




1. The IMF also now publishes real trade-weighted exchange rates deflated by relative wholesale prices, export unit values and consumer prices. These show a similar pattern.

The pound has gone up for one simple reason. British interest rates have remained persistently too high . As the conviction spread amongst international fund managers that the British economy was uniquely robust and healthy, so the need to offer premium interest rates to prop up the pound disappeared. Instead, Britain's continued high interest rates attracted funds from the four corners of the world. Thus was set in motion a process which the Chancellor not only did not control but also, it seems, did not understand.

Chart 11 compares Treasury bill rates in Britain, Germany and the USA. British rates have been persistently the highest, significantly higher than those the USA, with its twin deficit problem, found it necessary to employ. British Government bonds have also persistently yielded more than American, German or Japanese bonds. It is fair to ask why a country which had a sound balance of payment position in the mid-1980s and whose Government spending and borrowing was under full control, needed to offer such high rates to foreign investors? Government apologists will be quick to point out that these comparisons are between nominal interest rates. The gap between British and foreign real rates was narrower and even negative. So what? Britain's domestic rate of inflation is not directly relevant to the foreign investor, who is primarily concerned with what his money will be worth when converted back into his own currency (which he will ultimately spend in his own shops and not ours). The only worry he has is that rapid British inflation will cause the pound to depreciate. Provided he is confident that it will not, nominal interest rate levels will determine whether he wants to lend to us. Since there is now little evidence that exchange rates are determined by purchas-



ing power parities – see page 19 – comparisons between nominal interest rate levels are the relevant ones for international capital flows.

Why were British rates kept so high in 1986 and thereafter? There seem to be three answers.

- Although inflation was low by British standards in 1986, it was high by the standards of our competitors. Moreover, *given continued rapid earnings growth, resurgent inflation* was still feared.
- High interest rates were thought to be a way of limiting money supply growth, which was running persistently above its Medium Term Financial Strategy target rate.
- The Chancellor was deliberately shadowing the deutschmark.

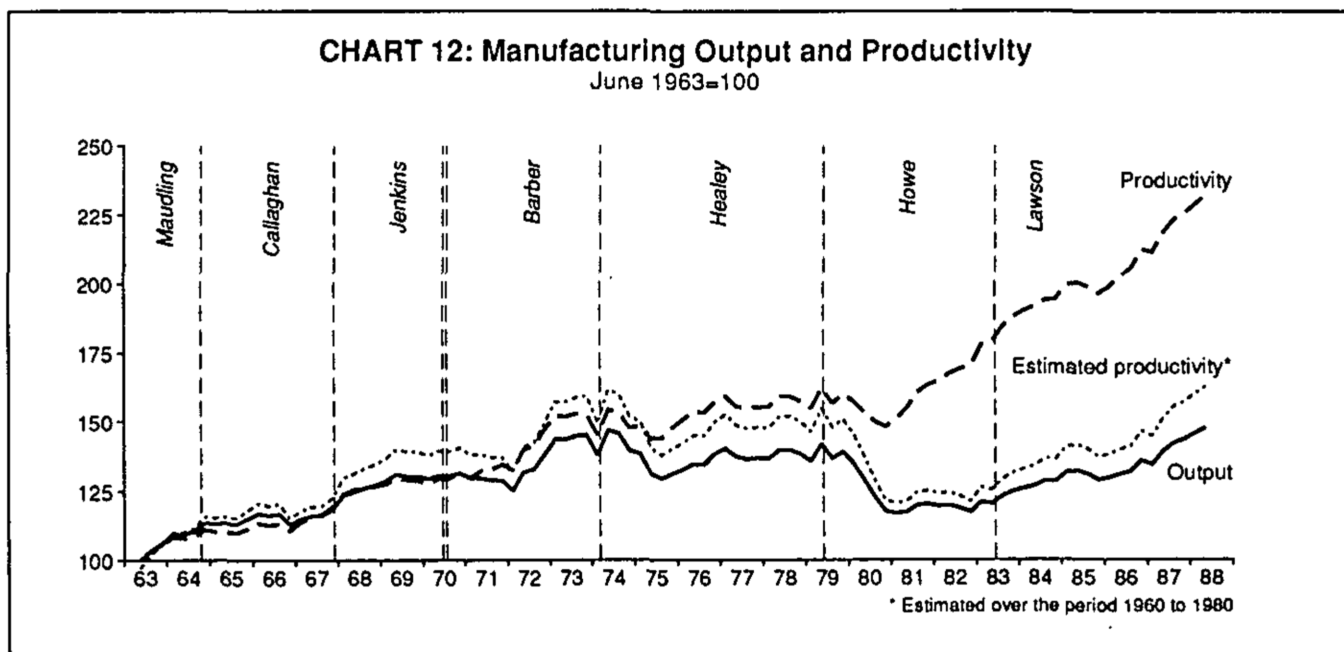
## A Paranoiac Fear of Inflation

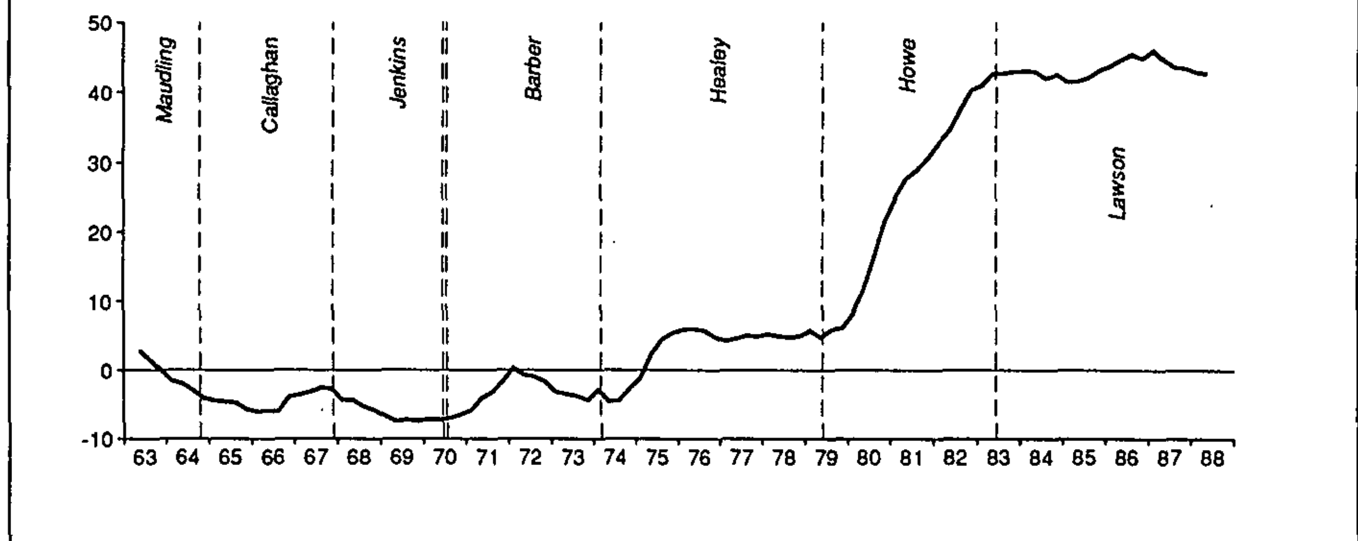
Each of these reasons is deeply flawed. The Conservative approach to inflation is both simplistic and selective. Inflation, to the Thatcher Government, is selectively defined as changes in wages and in product prices. Such inflation is bad because it redistributes incomes, making some people demonstrably better off while other people become demonstrable worse off. The economy's growth may have to be checked, making everybody poorer. Yet the Government shows no such concern for asset price inflation, and indeed almost welcomes it when the assets mainly involved are the homes of owner occupiers. Higher prices for existing houses in no way increases the wealth of the country as a whole. Wealth is merely redistributed it in favour of one section of society. Such asset price inflation is not merely tolerated, it is even encouraged. It makes home owners identifiably and quantifiably better off without making anyone else demonstrably worse off. The Conservatives regard inflation which redistributes income to workers from rentiers to be evil, but seem less concerned with inflation which redistributes wealth from young to old or poor to rich. It has been no part of their policy to limit house price increases to the general level of inflation in labour and product markets.

On the simplistic level, the Government has not grasped the implications for relative prices which a major improvement in productivity growth necessarily entails. Nowhere is the improved performance of the economy more striking than in the accelerated growth in manufacturing productivity. **Chart 12** shows what has happened in recent years. In the short term, productivity growth is closely correlated with the cyclical path which output follows. Employment cannot be increased or reduced as rapidly as sales rise or fall. The effect of falling output is thus to lower output per employee, the effect of rising output is to increase it. Thus to judge how far productivity performance may have improved, the effects of changing output growth must be eliminated. Chart 12 shows estimated productivity growth calculated from the relationship between productivity and output over the years 1960 to 1980. **Chart 13** shows deviations in actual productivity growth from its estimated growth. Manufacturing productivity in the first half of 1988 was fully 40% higher in relation to output, than would have been expected from the experience of 1960 to 1980. Unfortunately output growth had not accelerated to the same extent, with the result that we are now producing not a lot more manufactured goods but with many fewer workers. Thus if the fullest benefits are to be obtained from Britain's economic miracle, it is essential that output growth continues to be run flat out. If not, the main benefit becomes the dubious one of having fewer jobs for Britons to do.

***Manufacturing productivity in the first half of 1988 was fully 40% higher in relation to output, than would have been expected from the experience of 1960 to 1980.***

Accelerating manufacturing productivity growth reduces production costs and increases profits. It is understandable and desirable that a part of this benefit should go to those employed in manufacturing. A rapid rise in earnings in manufacturing industry is therefore the corollary to an accelerated rise in productivity. It is something to be desired. So it is indicative of the Government muddled thinking that it simultaneously de-






lights in the productivity improvement while deploring the accelerated earnings growth.

Rapid earnings growth in manufacturing causes benign inflation. Workers in services and distribution seek and frequently obtain similar wage increases. But here there is a problem. Statistically, the scope for productivity increases in service sectors is limited, if only because output in such activities is frequently measured indirectly by labour input – the number of nurses measuring the provision of nursing services. So whereas higher productivity, output per employee, in manufacturing cancels out higher earnings per head to leave wage costs per unit output little changed, there is no similar offset in other sectors. The higher earnings feed directly through to higher wage costs and thence prices. In effect, therefore, instead of there being a change in relative earnings between manufacturing and services, there is a change in relative prices. Service and distribution industry prices go up relative to manufactured goods prices, and in this way the gains from productivity improvements in manufacturing are shared more widely amongst workers generally.

Such benign productivity-driven inflation has a distinctive effect on international competitiveness. International trade is more heavily concentrated on manufactured goods than on services. Thus the slower rise in manufactured goods prices relative to prices generally, means that purchasing power parity comparisons based on consumer price movements are misleading. It is possible for an economy, which is enjoying rapid productivity-driven inflation, to suffer larger consumer price increases than its competitors while enjoying lower export price increases. Its currency, if fixed, will then become increasingly undervalued despite the country's deteriorating position on a consumer price purchasing power parities.

This is what happened to Japan during the heyday of its economic miracle. Between 1950 and 1970 the yen was pegged at ¥360 to the US dollar. Japanese consumer prices rose by 160%, against an 80% rise on average in all industrial countries. But whereas industrial countries' export prices rose by 35%, Japan's went up only 8%. Japan thus suffered faster inflation while the yen became increasingly undervalued.

***Any nation clever enough to obtain productivity-driven inflation, ought to be wise enough to relax and enjoy it.***

Any attempt to reduce benign productivity-driven inflation by restraining the growth in output, simply causes malign consequences. It is easier to cut output and hence productivity growth, than to slow wage growth. Costs then rise rather than fall, and inflation accelerates. But if productivity growth is sustained despite the slower output growth, jobs will inevitably be lost. Benign inflation can be "cured", but only at the expense of malign unemployment. Any nation clever enough to obtain productivity-driven inflation, ought to be wise enough to relax and enjoy it.

But if actual inflation need not have frightened the Government into a high interest rate policy, prospective inflation certainly did. In 1980 the Government adopted a Medium Term Financial Strategy designed by Nigel Lawson. The strategy set out to reduce inflation, (with the ultimate objective of stable prices), and to create the conditions for a sustainable growth in output and employment. Under the MTFS the Treasury committed itself to a precise target range, looking several years ahead, for the progressive reduction in the growth in the money supply. Sterling M3 was the money stock measure originally chosen as the Government's target variable. At the same time the Government set a path for the reduction in its PSBR arguing that, although there was no precise connection between the growth in sterling M3 and the size of the PSBR, the bigger the Government's deficit, the higher nominal interest rates needed to be to hit any given money growth target. It was therefore essential that the Government's deficit be reduced to manageable proportions so that money supply growth could be controlled with an acceptable level of interest rates.

## 6. INTEREST RATES AND INFLATION

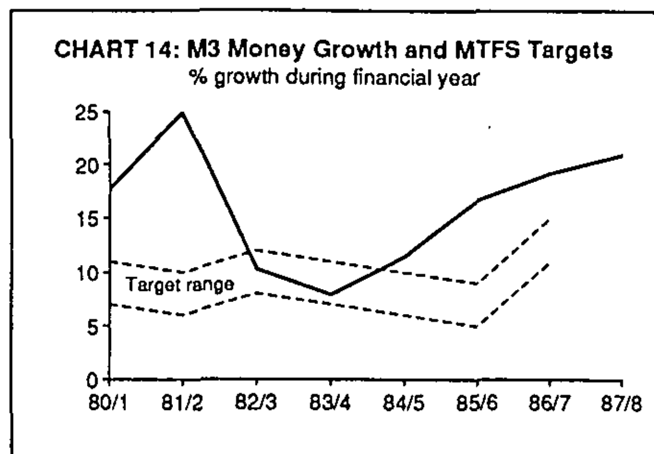
### High Interest Rates cause Faster Money Stock Growth

In the event, and after some initial failure, the Government succeeded brilliantly in cutting the PSBR, not only faster than originally planned, but to the extent of creating the present £10bn PSDR. But after some initial success, (thanks to moving the goal posts), the Government failed dismally to contain sterling M3 growth within its target range.(See **Chart 14.**) It was finally forced to abandon this measure and target the better behaved but less relevant narrow monetary aggregate, M0, in its place. The persistence of high nominal interest rates after 1985, despite the Government's success in eliminating its budget deficit, was in large measure due to futile efforts to check broad money supply growth. Unfortunately, high interest rates were the cause of fast money supply growth, not the cure. So the more the Government kept nominal rates up, the less success it had in bringing money growth down, and the more it was tempted to push interest rates higher.

When exchange controls were removed in October 1979 the workings of the British monetary system were fundamentally changed. Hitherto the British money supply was contained in a seperate box from the rest of the world's, with flows into and out of that box under control. Henceforth people in Britain were free to borrow and lend what they liked, however much they liked, to and from whom they liked, in whatever currency they liked, anywhere in the world. Moreover, with the spread of international banking and improved communications they are now able to do so easily, cheaply, speedily and knowledgeably. Britain's national money supply, as a wholly seperate entity, ceased to exist. Instead we now occupy a corner of the world's money supply and only inertia and friction gives the Government the ability to affect to any significant degree what happens in that corner.

### How Money became Plentiful and Dear......

The internationalism of Britain's money supply had consequences which the Government failed to foresee. Money used to be either plentiful-and-cheap or scarce-and-dear. Now it can also be plentiful-and-dear or scarce-and-cheap. When foreign




investors have confidence in the British economy and sterling, as they had with abundance from 1986 onwards, unnecessarily high British interest rates encourage them to lend excessively to Britain and encourages Britons to borrow excessively abroad. A capital inflow results. The supply of money in the British corner of the world money system increases when the price of money in Britain rises. Money here becomes more plentiful when it is made dearer.

### *Do higher interest rates do more to reduce borrowing than the easier credit does to put it up?*

This novel situation creates new problems. Will higher British interest rates do more to reduce borrowing and spending than the easier availability of money does to put them up? The answer depends on the type of borrowing and the extent to which it is interest-rate sensitive. Corporate borrowing, to finance investment in plant and equipment, is more likely to be deterred by higher interest rates than encouraged by more plentiful money. Consumer borrowing, on balance, is probably little changed. The main area in which more plentiful credit increases borrowing is to finance the purchase of financial and real assets, the price of which in large measure depends on the availability of finance for their purchase. Unnecessarily high interest rates cause supply-driven money stock growth, whose main result is an increase in the price of existing real and financial assets. High interest rates in Britain in 1986–87 drove

**TABLE 3: MTFS Money Growth Targets**
M3, Growth during Financial Years

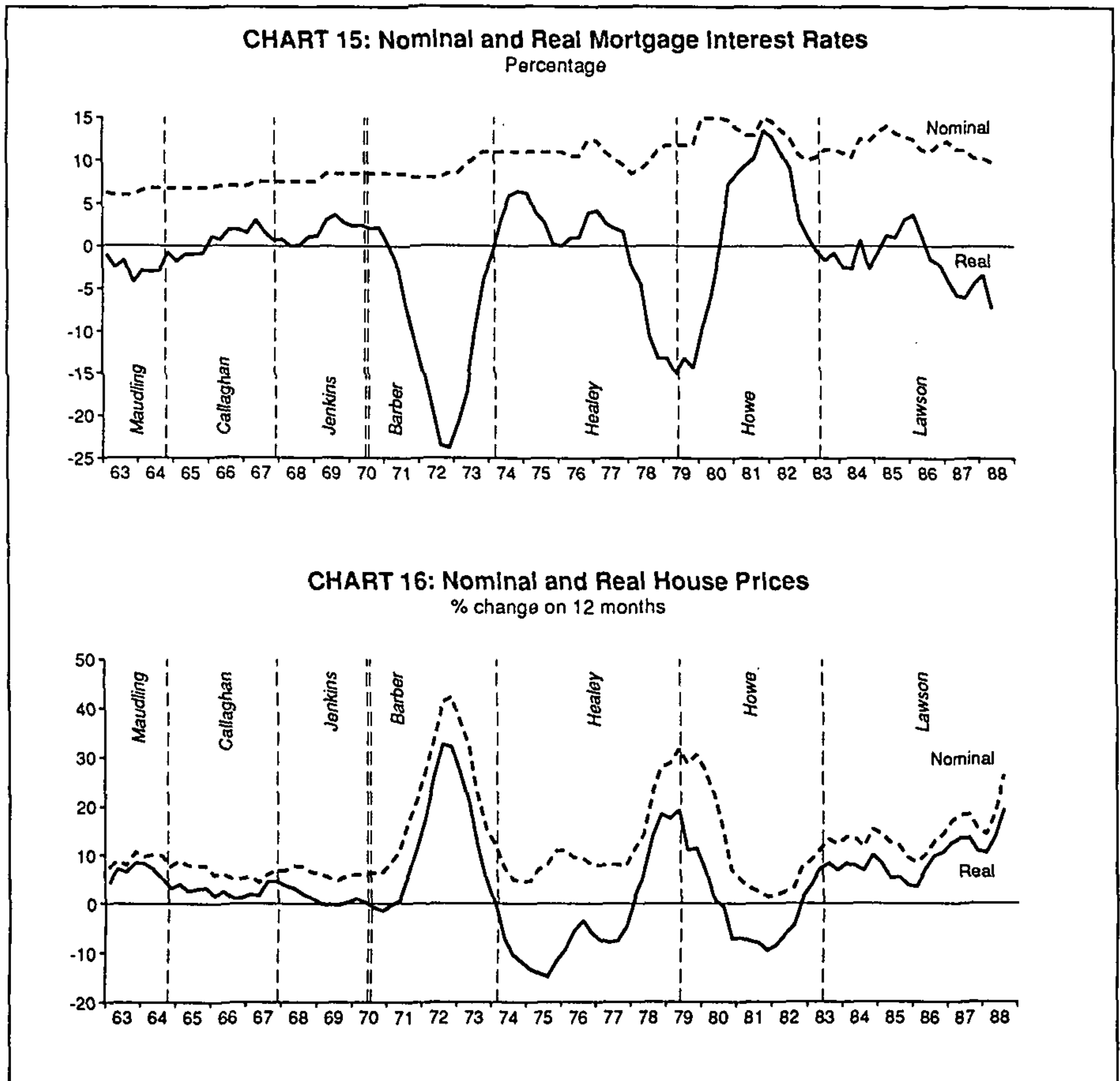
| Budgets | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | Actual |
|---|---|---|---|---|---|---|---|---|
| Financial years | | | | | | | | |
| 1980-81 | 7-11 | | | | | | | 17.7 |
| 1981-82 | 6-10 | 6-10 | | | | | | 24.9 |
| 1982-83 | 5-9 | 5-9 | 8-12 | | | | | 10.3 |
| 1983-84 | 4-8 | 4-8 | 7-11 | 7-11 | | | | 7.9 |
| 1984-85 | | | 6-10 | 6-10 | 6-10 | | | 11.5 |
| 1985-86 | | | | 5-9 | 5-9 | 5-9 | | 16.7 |
| 1986-87 | | | | | 4-8 | 4-8 | 11-15 | 19.2 |
| 1987-88 | | | | | 3.7 | 3-7 | | 20.9 |
| 1988-89 | | | | | 2-6 | 2-6 | | |

the stock exchange bull market and the house price explosion. After the London stockmarket crashed in October 1987, in sympathy with New York, savers switched funds from unit trusts to building societies, driving house prices even higher.

This explains the first mystery identified above. Borrowing to finance investment and consumption increases the demand for newly produced goods and services, whose production or prices then rise. The resultant money supply growth is therefore associated with an increase in the nominal GDP and the velocity of circulation remains stable. But borrowing to finance the acquisition of existing assets does not directly increase demand for newly produced goods and services, it merely forces up the price of things which have either always existed – like land – or whose production was part of some earlier year's real GDP – like houses. Money supply rises without any concomitant rise in nominal GDP. The velocity of circulation inevitably falls. Monetarists, fearing future wage and product price inflation, overlook the inflationary effect that the money supply growth has already had, in driving asset prices higher.

## .....causing the House Price Explosion .....

The second mystery is solved by **Chart 15**. This shows nominal and real mortgage interest rates, where real rates are nominal rates deflated by the rise in house prices. Paradoxically most people calculate real interest rates from the lenders' perspective. They deflate nominal rates by the rise in consumer prices, which determines how much interest receipts and capital repayments will be worth when the lender comes to spend them. But there is never any problem finding people willing to lend when real interest rates are high. The problem is to explain why people continue to borrow. This depends on the use to which they put the money which they borrow. The demand for mortgage loans remains high when nominal interest rates rise, if house prices are rising even faster. As Chart 15 shows, real mortgage interest rates have been negative, even



without allowing for the favourable tax treatment which mortgage borrowers receive.

Chart 16 shows nominal and real house price inflation. The present house price explosion has not been as strong as earlier ones, but it lasted longer and affected a greater number of owner-occupiers, producing more widely dispersed effects. A third mystery can now be solved. Chart 17 shows the behaviour of the personal saving ratio, as a per cent of personal disposable income. Despite persistently high real and nominal interest rates offered to British savers and lenders, personal savings have persistently declined throughout the 1980s. This should surely have caused the exponents of a high interest rate strategy pause for thought long before now. The fall in personal savings could be seen as the reason why interest rates have had to be kept so high. But high interest rates are rather the cause of low savings, through their effect on personal wealth.

## ....which led to a Collapse in Personal Savings

Between 1979 and 1987, personal net wealth rose by £942bn or 156% to £1,545bn. The aggregate total of personal savings over 1980–87 was £168bn. Thus for every £1 which people saved out of income in the Thatcher years to add to their personal wealth, they gained a further £4.60 from the appreciation of the assets which they already owned. Dwellings accounted for £271bn of personal net wealth in 1979. By 1987 dwellings were worth £739bn or 48% of net wealth. The increase in the value of personal dwellings was £468bn, yet borrowing for house purchase rose only £140bn to £184bn. Over the whole period asset price inflation increased personal wealth by an average of 45% of each year's total personal disposable income. It is hardly surprising then that people, becoming thus effortlessly richer, would see little reason to struggle to save out of current income. (See Chart 18). Moreover, with an ample supply of credit available, thanks to Mr Lawson's high interest rate policy, they were easily able to monetise part of their increasing net wealth to support consumer spending growth in excess of income growth.

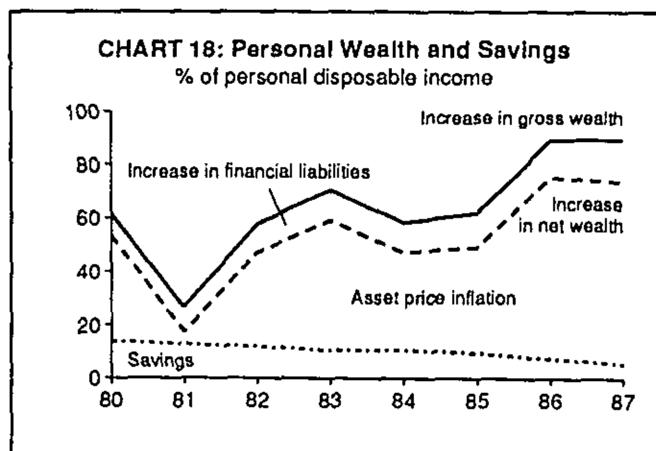
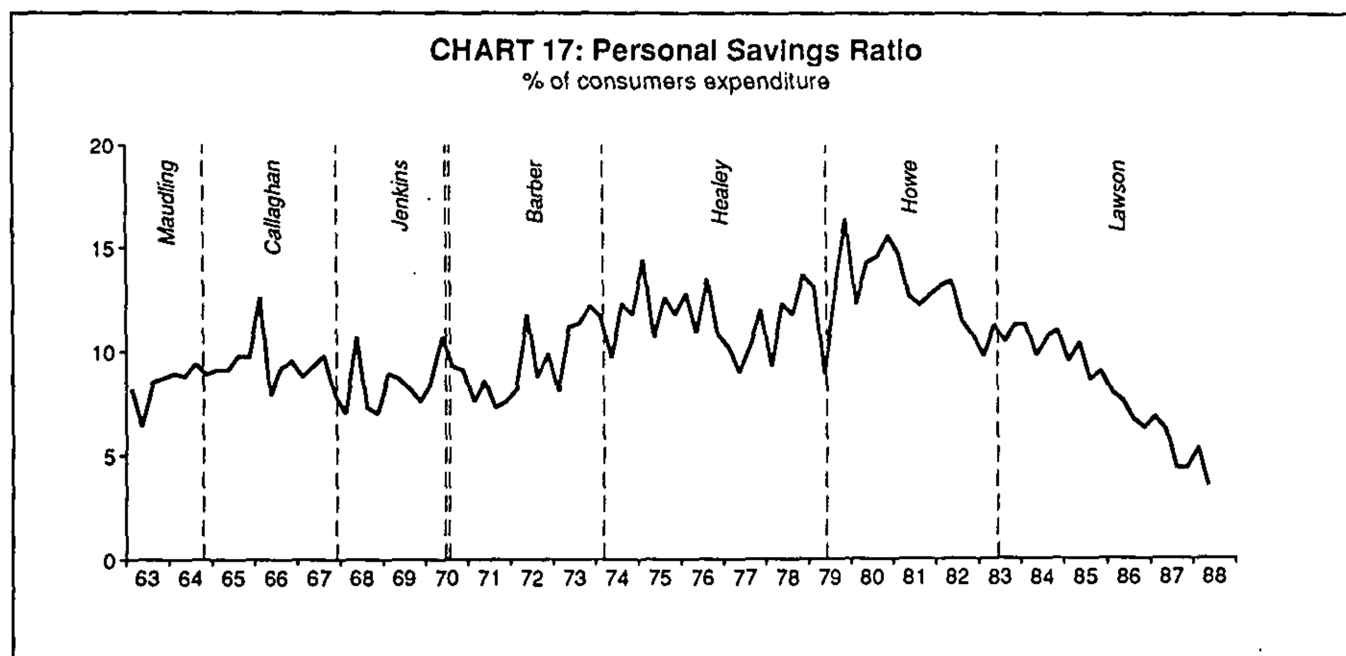



**TABLE 4: Personal Wealth and Savings**

| | End-1979 £bn | End-1987 £bn | Change £bn | Change % |
|---|---|---|---|---|
| Gross wealth | 681 | 1,828 | 1,147 | 168 |
| Financial liabilities | 78 | 283 | 205 | 262 |
| Net wealth | 603 | 1,545 | 942 | 156 |
| *Of which dwellings* | | | | |
| Gross worth | 271 | 739 | 468 | 173 |
| Mortgage borrowing | 45 | 184 | 138 | 306 |
| Net worth | 225 | 555 | 330 | 146 |

| | £bn | % of TPDY |
|---|---|---|
| Total personal disposable income, 1980–87 | 1,721 | 100.0 |
| Increase in gross wealth | 1,147 | 66.7 |
| *Less* increase in financial liabilities | -205 | 11.9 |
| *Equals*, increase in net wealth | 942 | 54.7 |
| *Less* personal savings in 1980–87 | 168 | 9.8 |
| *Equals*, gain from asset price inflation | 774 | 44.9 |

Plentiful if dear money, by generating asset price inflation, caused personal savings to slide. Needlessly high interest rates in 1986 and 1987 caused Mr Lawson's boom and the economy



to overheat. But the more they had this effect, the more he refused to lower them.

## 7. INTEREST RATES AND TRADE

### Capital Inflows cause Current Account Deficits

What was the effect of high interest rates on Britain's external situation? Again the Chancellor seemed unable to comprehend what was happening. Throughout most of the postwar years, and particularly during the Bretton Woods fixed exchange rate period, trade in goods between countries was relatively free. But capital movements were severely restricted. The majority of foreign exchange transactions were therefore trade-related. Trade deficits put downward pressure on currencies. Relatively rapid inflation (if concentrated upon the traded goods sector) caused trade deficits. Exchange rates came under pressure, and if allowed to fall helped to correct external disequilibria. But, rather than see the exchange rate fall, governments often raised interest rates, attracting capital from abroad to finance that deficit. Equilibrium was then restored by slower domestic demand growth.

The shift to floating exchange rates, in a world of relatively free capital movements, has changed all this. Foreign exchange markets are now dominated by capital movements. Exchange rates no longer move to equate purchasing (or spending) power parities between countries. They now move to equate lending power parities. Currencies move to equalise the perceived cost of borrowing and return on lending between rival centres. Moreover perceived costs and returns include expectations concerning future currency movements. Since a falling currency is often expected to continue to fall, exchange rate movements become self reinforcing.

***Current account deficits no longer cause exchange rates to fall, rising exchange rates now cause current account deficits.***

The old rules have been turned upside down. The Government of a country suffering accelerating inflation is tempted to raise interest rates. The Government of a country suffering from a recession is tempted to cut them. The higher rates cause the inflation-prone economies currencies to rise, and lower rates cause the deflation-prone countries currencies to fall.[1]

The result is that exchange rate movements now exacerbate, rather than correct, trade imbalances. Instead of current account deficits causing exchange rates to fall, rising exchange rates cause current accounts to move into deficit.

1. Foreign exchange markets nowadays do not even wait for governments to act. News of accelerating growth, falling unemployment and rising inflation, sends a currency up in anticipation of higher interest rates to come. News of weakening demand, falling employment, lower inflation sends a currency down. Newspaper reports almost every day confirm this. The Financial Times, for example, ran a frontpage headline on 27th October saying "Lower US growth hits $."

### High Interest Rates attract Capital Inflows

It is axiomatic that a capital account surplus must be matched by a precisely equal current account deficit. A country cannot spend more than it earns without simultaneously borrowing more than it lends. But now it is the inflow of capital which causes the current account deficit, not the deficit which causes the inflow. When Lawson persistently held British interest rates too high, thereby attracting an excessive capital inflow into the pound, he caused Britain's current account balance to move into deficit. The only way the deficit could have been avoided was if foreigners had been dissuaded from wanting to lend us too much money despite our high interest rates. I therefore advocated a policy of controlled irresponsibility to this end. Unfortunately, Nigel Lawson was firmly convinced that his actions were prudent, and rarely missed an opportunity to say so. Foreigners were thereby encouraged to lend Britain money to take advantage of the high interest rates we offered. Having generated such a capital inflow, a current account deficit was sure to follow. The only issue was, how would the Chancellor like his deficit, with or without inflation?

It is worth repeating and stressing the premises underlying the arguments.

- The current account always equals the capital account with the sign changed.
- A non-trade-related capital inflow must cause a current account deficit.
- The resultant current account deficit cannot be reduced or eliminated unless the capital account inflow is reduced and eliminated.
- There are only two ways in which a country's trade balance can be changed.
  (1) Through relative price changes, so that everyone buys fewer of its dearer goods and more of foreigners' cheaper ones; *or*
  (2) through relative activity rate changes, so that more (or less) spending in the country increases (or reduces) its purchases of both its own and of foreign goods.

If the authorities in the country attracting an excessive inflow of capital do nothing about it, the exchange rate rises. The higher rate persuades some people to sell more of its currency and some foreigners to buy less. The capital inflow is choked off by the rise in the price of the currency, but given expectations, the exchange rate may have to overshoot a long way on the upside before this happens. If the exchange rate is allowed to rise, relative price changes cause the current account to deteriorate. Exports are priced out of foreign markets. Imports become cheap and replace home produced goods on domestic markets. Industry stagnates. The deterioration in the trade balance is then achieved without inflation.

Alternately the authorities may resist the rise in the exchange rate, which their high interest rate policy induces. They will then intervene to buy foreign currencies in exchange for their own. The Bank of England has done so on an heroic scale since the February 1987 Louvre Accord to support the dollar. Between February 1987 and July 1988 Britain's reserves of convertible currencies rose from £14bn to £40bn. This extra

£26bn, used to buy a mountain of foreign currencies, mostly US dollars and German deutschmarks, had to be borrowed. So while the Chancellor was cutting the amount he needed to borrow to finance public spending, and indeed moving into surplus, the Bank of England on the Government's behalf was having to borrow like crazy to finance foreign exchange market support. The nutty situation thus arose in which high nominal interest rates caused the Government borrowing which kept them high.

***The nutty situation arose in which high nominal interest rates caused the Government borrowing which kept them high.***

The effects on the domestic money supply from borrowing to buy a mountain of dollars and deutschmarks is little different from the effect of borrowing to buy a battleship. If the money is raised through the banking system, ie if the exchange market intervention is unsterilised, it increases the ability of the banks to create deposits. The resultant growth in the money supply boosts domestic demand and increases imports. The trade balance, prevented from deteriorating due to relative price changes due to the Bank's intervention to hold sterling down, deteriorates instead as a result of a change in relative activity rates. This is the inflationary route to a trade deficit.

### Sterilised Intervention has no effect on the Exchange Rate

There are some people who believe that this result can be avoided if the Bank's borrowing is sterilised. By this they mean that the extra Government debt is sold to the non-bank private sector instead of to banks. But there is a minor snag. In order to sell more of anything, you have to make it cheaper. The way you make Government bonds cheaper is to raise the interest you pay on them. This (ultimately) increases private demand for gilts. The money supply need not then be increased. Unfortunately, however, the even higher interest rates attract even more money from abroad. Efforts to sterilise the domestic consequences of intervention thus exacerbate the upward pressure on the currency in the foreign exchange markets, which the intervention was originally designed to counter.

Totally sterilised foreign exchange market intervention, which does absolutely nothing to increase the money supply or the growth in domestic demand, can do absolutely nothing to prevent the pound from rising. Since sterilised intervention does not stop high interest rates attracting a capital inflow, it cannot stop this inflow causing the current account to deteriorate. If, then, sterilised intervention does not effect relative activity rates, it can have no effect in changing relative prices. The only way to stop the current account from deteriorating is to stop foreigners wanting to lend Britain money. Intervention, whether sterilised or unsterilised, does not do that. Every £1bn which the Bank of England spends buying dollars through sterilised intervention simply attracts another £1bn worth of dollars to Britain

Some commentators believe that sterilised intervention can stop the pound rising without having any domestic effects, provided the Bank of England simply sells to foreigners the additional Government bonds they wish to buy. But sterilised intervention is rather the loopy situation in which the Bank of England puts up interest rates, in order to borrow billions of pounds to buy billions of dollars, which foreigners would not have wanted to sell if the Bank had not put up interest rates.

## 8. LANDING WITHOUT THE FISCAL FLAPS DOWN

### Heading for a Consumer Slump ......

If high interest rates are the cause of the trouble, and Nigel Lawson keeps putting them up, where will it all end? There are two possibilities. Either the rise in interest rates will finally deter Britons from borrowing; or the rise in the trade deficit will finally deter foreigners from lending. Whichever happens first, the other must follow a close second. Britons cannot stop borrowing without foreigners stopping lending, and vice-versa.

Rising interest rates increase the burden of servicing debt, as mortgage borrowers know to their cost. While as long as debt grows faster than income, the proportion of income required to service and repay it also rises. Even if real interest rates to the borrower remain negative, the rise in the ratio of debt service payments to income sets a limit on how much he is willing and able to borrow. Unfortunately, in order for asset prices to rise at a constant rate, the amount borrowed to finance their purchase must increase at a constant pace. Once borrowing slows down, asset prices stop rising and then borrowers' real interest rates become cripplingly positive. Asset price inflation promptly unwinds.

Nigel Lawson has argued that Britain's current account deficit is not a problem because its counterpart is low private savings, not a large budget deficit. In some ways he is right. The Government can always borrow what it chooses to spend; the personal sector can only spend what it is able to borrow. But there is another difference. When Governments go into deficit to finance large public spending programmes, or when companies borrow to pay for major capital investment projects, the borrowing and spending takes years to turn off. But the personal sector can turn on a sixpence. People can stop further borrowing overnight. When they do so, the personal savings ratio rebounds, but to a higher level than before. The past borrowing spree commits people to a higher rate of repayments when the borrowing has to stop.

One thing is certain to stop people borrowing and to make them save again, falling house prices.[1] Net wealth no longer effortlessly increases. Higher mortgage payment demands on the

1. Gordon Pepper, senior adviser to Midland Montagu, argues that house prices could fall by as much as 20%. He says that the market is no longer as sticky as it was, because many of the new lenders are more trigger-happy on foreclosures than the stable old building societies. Moreover more loans are more fragile to higher interest rates.

doormat, unsold houses down the street (and for British Rail commuters 9% to 21% fare increases) can bust the spending boom in a trice. Britons will then stop borrowing however plentiful money may be. New borrowing and house price increases have already slowed down. Consumer spending is holding up still on official figures, but there has been fine weather on successive Saturdays. Watch what the shoppers do when winter weather sets in. High interest rates are finally working to take the heat out of the consumer boom at home.

### .........and a Run of the Pound

If Britons stop borrowing and the consumer spending boom collapses, foreigners will conclude that interest rates here will have to be lowered. They will then stop lending. But with the pound as uncompetitive as it was in 1980–81, there is no reason to suppose that British industry will be able to sell abroad what it can no longer sell at home. The British consumer is more likely to buy fewer expensive homemade goods than to reduce demand for cheap imported goods. The current account deficit will then continue to yawn wide, after Britons have stopped borrowing and foreigners have stop lending. Private capital inflows will decline. Then either the pound will crash or have to be supported. But any support, be it by exchange market intervention or through even higher interest rates, will merely intensify or extend the recession. When capital inflows dry up, the current account deficit can only be reduced by a relative change in prices (ie, a lower pound) or a relative change in activity (ie, a more depressed domestic economy.) So if the Government prevents the pound from falling it must condemn the economy to a deeper and longer recession.

The events described above could occur in a different order. Instead of a fall in consumers' spending causing a run on the pound, the run may come first and the fall in consumption second. The lending power parity theory does not entirely divorce currency movements from balance of payments problems. The current account deficit can yawn so wide that foreigners lose confidence in the Government's ability to finance and correct it without an exchange rate fall. They then stop lending regardless of the level of interest rates. This, in turn, makes money at home scarce as well as dear. The supply of funds for house purchase then dries up before the demand for them falls. But the result is the same. House price inflation ends and consumers stops spending.

An end to rising house prices, a collapse in the consumer boom and a run on the pound are all inevitable. But despite the awful October trade figures it still seems more likely that the slow-down at home will come first and the run out of sterling second.

### A Soft Landing is highly Improbable

The Chancellor, in forecasts published with his Autumn public spending statement, assumed that the British economy will achieve a soft landing from its present boom. His single-minded reliance on interest rate policy makes such an outcome highly improbable. When landing an aeroplane, all controls must be used. A pilot who decided just to rely on closing the throttles would probably stall and crash. But this, in economic terms, is what Nigel Lawson is attempting. He is landing without the fiscal flaps down.

High interest rates will ultimately cause domestic demand to decline. But they also cause the pound to rise. It would be remarkable if the level of interest rates which achieves precisely the right rate of growth in domestic demand simultaneously achieves precisely the right level for the pound. It is far more likely that too high rates will cause a recession at home combined with an overvalued currency and thus a continued external trade deficit. British industry, which currently is unable to make what it can sell, will then be unable to sell what it can make.

Fiscal policy works in a different way. Higher taxes or lower public spending directly deflate domestic demand. As such they reduce the need for high interest rates. Tighter fiscal policy therefore weakens both domestic demand and the pound. This means that production is more likely to be switched from home sales to exports, rather than factories becoming idle and workers unemployed. This is why a sensible Government, set on achieving both internal and external balance in the economy, uses both fiscal and monetary policy to achieve its aim.

## 9. A WORSE SQUEEZE THAN 1980–81

The Treasury's own forecasts indicate what is in store if the Chancellor does not change his policies. The answer lies hidden in tables for sector financial surpluses and deficits which the Treasury does not publish. But they can be reasonably deduced from what it does say. From these it is clear that, on present policy, British industry faces a profit squeeze every bit as awful as that which sent unemployment soaring to over three million in the early 1980s.

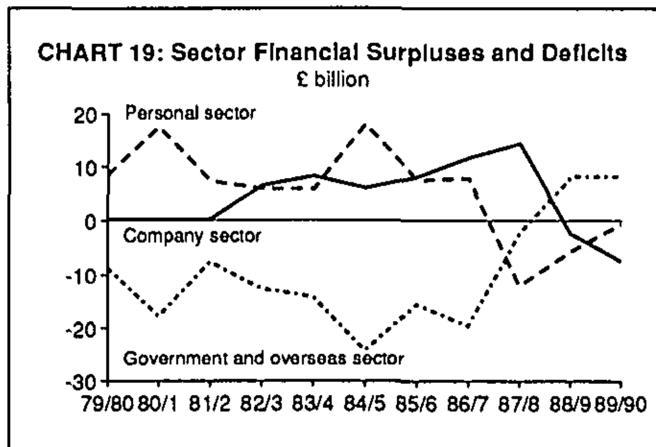
The economy can be divided into four sectors, the Government, companies, people and foreigners. Each sector earns, saves and spends, borrows or lends. The total of its income less the total of its spending, current and capital, measures the amount of cash it has left over to lend or needs to borrow. These cash excesses and shortages are called financial surpluses and deficits. They measure the extent to which a sector increases its financial claims and pays off old debts, or increases its financial liabilities or sells off old assets. For every borrower there must be a lender, for every asset sale an asset purchase. The financial surpluses and deficits of the four sectors should therefore sum to zero. They don't, of course. There is an horrendous black hole of errors and omissions in all our national income and balance of payments accounts, which should balance but never do. Details are given in the table on page 22. In it, the overall errors and omissions are divided between those that appear as the "balancing item" in the balance of payments statistics, which measures the statistical discrepancy between the current and capital accounts, and the remaining errors and omissions which can be attributed to the domestic economy.

But even horrendous errors and omissions cannot hide what is happening. The Government's financial deficit or surplus is equal to the better-known public sector borrowing requirement

(PSBR) or debt repayment (PSDR) less extraneous items such as the proceeds from privatisation asset sales. The Government, we are told, has moved to a PSDR of £10 bn this year and a similar surplus is assumed for 1989–90. Excluding privatisation proceeds, these translate into financial surpluses of £4 bn then £5 bn. Foreigners', or overseas sector's surplus, is better known as the deficit on the current account of Britain's balance of payments. This is optimistically forecast to be £13 bn in calendar 1988 and £11 billion in 1989 (in the six months to October the deficit was at an annual rate of £17.5 bn). The personal sector's financial surplus or deficit is the total of personal savings less what we invest in buying new houses and other capital items. It is the declared object of policy to force us to spend less and save more out of our income. So the personal sector must be forecast to show a meaningful improvement in its financial health. in the table it is assumed that the personal sector deficit will fall from £10bn in 1988–89 to £5bn in 1989–90.

### *If everyone else is running bigger surpluses or smaller deficits, companies must catch a cold*

The public sector surplus is set to stay large or grow larger. The overseas sector surplus is likewise likely to remain large. The personal sector deficit is due to come down. This only leaves the company sector. If everyone else is running bigger surpluses or smaller deficits, companies must carry the can. Chart 19 illustrates how bad things could be. In it the balancing item in the balance of payments accounts is treated as exaggerating the size of our current account deficit, and all remaining errors and omissions as due to miscounting personal sector transactions. (Errors and omissions over the next two years are assumed to equal their average over the past four years). One line in Chart 19 shows the combined position of the Government and overseas sectors as forecast by the Treasury. A second line shows what could happen to the personal sector if the Government's policies are assumed to work and personal savings recover. The final line shows what's left for companies.




On any reasonable assumption about the personal sector's savings, the company sector's financial position becomes worse in 1989–90 than it was in the early 1980s.

A recession is in sight. But it need not be anything like as long or as severe as these forecasts imply. If, however, such a disaster is to be avoided, both the Chancellor's understanding of the British economy and his policies to manage it will have to improve. He will have to learn that interest rates can safely be cut and sterling sensibly be lowered. To this end the spectre of inflation, which so haunts him, must be exorcised. . This is not the simple point that higher mortgage interest rates are included in, and therefore raise, the retail price index. The wider measure of inflation, the GDP deflator, which does not include mortgage rates, is also surging. It rose by 6% in the year to the second quarter of 1988 against a 4.3% rise in the RPI. The best way to stop worrying about inflation is to understand what causes it.

## Higher Profits cause Higher Prices

It is generally assumed that wage cost increases are to blame for accelerating inflation. But even allowing for benign productivity-driven inflation outside the manufacturing sector, this is not

**TABLE 5: Sector Financial Surpluses and Deficits – £ billion**

| | Public Sector | Overseas Sector | Balancing Item | Personal Sector | Remaining Errors and Omissions | Company Sector |
|---|---|---|---|---|---|---|
| 1979-80 | -8.0 | 0.0 | 0.8 | 8.6 | -0.0 | 0.2 |
| 1980-81 | -11.6 | -5.8 | 0.5 | 15.1 | 2.5 | 0.2 |
| 1981-82 | -5.0 | -4.7 | -2.1 | 12.5 | -5.1 | 0.2 |
| 1982-83 | -8.8 | -4.5 | -0.6 | 9.5 | -3.5 | 6.6 |
| 1983-84 | -11.3 | -2.9 | -0.1 | 9.0 | -3.1 | 8.3 |
| 1984-85 | -13.6 | -0.5 | 10.1 | 9.2 | 8.9 | 6.1 |
| 1985-86 | -7.9 | -4.5 | 3.3 | 6.6 | 1.0 | 8.1 |
| 1986-87 | -9.1 | 0.4 | 11.0 | -0.9 | 8.8 | 11.7 |
| 1987-88 | -1.6 | 6.2 | 6.9 | -10.4 | -1.6 | 14.4 |
| 1988-89 | 4.0[1] | 12.0[2] | 7.8[3] | -10.0[4] | 4.3[3] | -2.4[5] |
| 1989-90 | 5.0[1] | 11.0[2] | 7.8[3] | -5.0[4] | 4.3[3] | -7.4[5] |

1. Treasury forecast; 2. Derived from Treasury calendar year forecasts; 3. Average of previous 4 years:
4. Assuming some reasonable reduction in personal sector borrowing and spending; 5. Residual.

the case. The following table disaggregates factors causing the GDP deflator to rise over recent years. Average earnings in the whole economy rose by a little over 8% in the year to the second quarter of 1988, although the rise since then has accelerated. But productivity growth was 3.8%, so that wage costs per unit output rose by 4.4%. With wages accounting for about 63% of GDP, wage cost increases added only some 2.7% to the GDP deflator during the latest 12 months. This was less than in the previous year. With sterling somewhat stronger, import price inflation was also negligible. The "cause" of accelerating inflation between the middle of 1987 and 1988 was "other" factors.

**TABLE 6: Factors causing inflation**
How they contributed to the overall rate

| | Changes by year, to second quarters | | | | | |
|---|---|---|---|---|---|---|
| | **1983** | **1984** | **1985** | **1986** | **1987** | **1988** |
| Wage costs | 2.9 | 2.0 | 3.0 | 4.2 | 2.8 | 2.7 |
| Import prices | 1.3 | 0.6 | 3.3 | -1.9 | 0.9 | -0.3 |
| Indirect taxes | 0.0 | -1.3 | 0.3 | 1.0 | -0.2 | 0.5 |
| Other | 0.4 | 4.2 | -1.4 | 0.4 | 1.1 | 3.1 |
| **GDP deflator** | **4.6** | **5.5** | **5.2** | **3.7** | **3.9** | **6.0** |
| Mortgage interest | -0.5 | 0.5 | 2.3 | -0.3 | 0.5 | 0.0 |
| Other differences | -0.3 | -0.8 | -0.6 | -0.6 | -0.1 | -1.7 |
| **Retail Price Index** | **3.8** | **5.2** | **6.9** | **2.8** | **4.3** | **4.3** |

This conclusion is supported by the Treasury's own figures for manufacturing industry's wage costs, published with the Autumn forecasts. This table is as follows:-

**Table 7: Cost in Manufacturing**

| | Percentage changes on previous year | | | |
|---|---|---|---|---|
| | **Unit Labour costs** | **Costs of Materials and fuel** | **Estimated total unit costs** | **Output prices** |
| 1986 | 5 | -10.5 | 2.25 | 4 |
| 1987 | 0.25 | 5 | 1.5 | 4.25 |
| 1988, part forecast | 0.75 | 4 | 1.25 | 4.75 |
| 1989 Forecast | 2.5 | 1.5 | 3.25 | 4.25 |

The Treasury itself says that the rise in costs in manufacturing industry has slowed down during the boom. But it forecasts that costs will rise faster when it succeeds in slowing down GDP growth. While the rise in output prices, which has accelerated during the boom, is forecast to slow down. But so far the acceleration in inflation is not due to wage costs but to "other" factors.

What could these other factors be? The answer is to be found in the Bank of England's November 1988 Bulletin. Its paragraph headlines tell the story. They say,

*There are indications of a further* **tightening in the labour market ...**

*...but* **labour costs** *remain subdued because of rapid* **productivity growth.**

**Inflationary pressures** *have intensified, however, and* **retail prices** *have accelerated....*

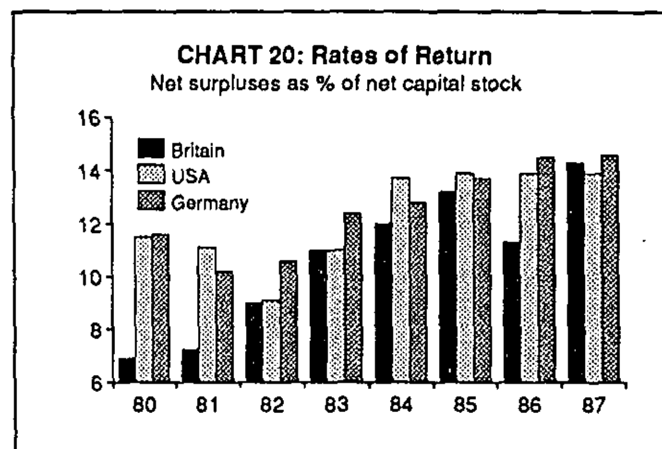
*...as* **Margins** *have widened.*

The recent acceleration in inflation has been primarily due to companies taking advantage of strong demand to increase their profit margins. According to the Bank of England, the real pretax rate of return on capital for non-North Sea oil industrial and commercial companies has risen from around 2% in early 1981 to almost 12% in early 1988. In the year to the second quarter of 1988 such profits rose by 16.8%, twice the rate of growth in average earnings.

## but British Profits are not too High

This growth in profit is not a cause for concern. Like benign productivity-driven inflation, it is a necessary condition for the British economic miracle. The rise in the real return on capital in Britain has merely brought it into line with returns in other countries – see **Chart 20.** This is the corollary of the abolition of exchange controls over capital movements. It does not mean that British industry is now flush with cash. On the contrary, the net liquidity of industrial and commercial companies, as a proportion of their capital base, is now lower than it was during the great squeeze of 1980–81. Instead, British industrial investment is now booming.

**CHART 20: Rates of Return**
Net surpluses as % of net capital stock




## 10. BEWARE MR LAWSON'S SLUMP

The Chancellor may believe that the present rise in inflation, whatever its source, can be painlessly reversed by slower growth in domestic demand. If his aim is to lower prices by squeezing company profits by way of a strong pound, he has embarked upon a fool's errand. So long as there is no control over the movement of capital between Britain and the rest of the world, the rate of return on capital in Britain will remain on a par with that available elsewhere. Efforts to reduce profits will not primarily lead to sharply narrower profit margins. They will lead instead to a shakeout of companies and plants which make subnormal profit.

To negate benign inflation is worse than to validate malign inflation. Without satisfactory earnings and profit growth there can be no economic miracle. To run a high performance vehicle too slowly causes as much damage as to run a low performance vehicle too fast. The Tories have put a new engine into the British economy. But Lawson is driving it into the nearest ditch.

## He has no Alibi

No Chancellor has had fewer excuses for things going wrong. Nigel Lawson did not inherit an inflationary explosion. He has not had to steer Britain through a world recession. He has not been saddled with a fixed absurdly unrealistic exchange rate. Nor has he had to deal with a world commodity or oil price explosion. He has not even had to raise taxes. He has been a very lucky Chancellor. But consequently the problems which have arisen for the British economy have been of his own making. He has nothing else and nobody else to blame. It is to be hoped that he can be brought to understand this. If the coming recession is to be mild, and the interruption to rapid growth brief, interest rates and sterling must both be brought down to more reasonable levels.

For six years between the Wars and for thirty-five years after the Second War, Britain suffered from a fixed and over-valued pound. Throughout these years, Governments struggled to force the British economy to become competitive. They all failed. The price was to place Britain last in the International growth league. After Britain left the Gold Standard in 1931 and from the time the Bretton Woods fixed exchange rate system was abandoned, Britain's international performance improved. It defies reason that anyone should want to put the clock back. Yet seemingly, the Chancellor does. If he persists, then Mr Lawson's slump will inevitably follow Mr Lawson's boom, and Labour will have an unexpected third chance to win back power.

**Layout and Design:**
Philip Armstrong, 60 Warwick Street, Oxford OX4 1SX

**Printed by:**
RBP, 20 Manor Road North, Hinchley Wood, Esher,
Surrey KT10 0AX

**Additional copies, price £3.00, may be obtained from:**
Economic Research Council, 55 St James's Street,
London SW1A 1LA
Tel: (01) 437 1982