I

Introduction

1

British economic performance

1.1 THE STATISTICAL RECORD

Output and employment

The measure of output that we shall use is Gross Domestic Product (GDP) in 1985 prices. Figures 1.1 to 1.3 show what has happened to GDP and GDP per head since 1950. We can learn a number of things from these figures: the existence of a fairly regular cycle prior to 1973; the exceptional nature of the 1970s; and the sustained recovery of the 1980s.

- ❏ In the period leading up to 1973 we can see a marked cyclical pattern with GDP growing at over 4 per cent per annum in 1953-5, 1960, 1964, 1968 and 1973 with slower growth in the intervening years. This stands out most clearly in figure 1.3, but can also be seen from figure 1.1. After 1973 a cyclical pattern is much harder to distinguish: apart from the two major recessions discussed below, the growth rate has been between about 2 per cent and 4 per cent all the time.

- ❏ The 1970s and early 1980s were clearly exceptional: in the 1973 boom the growth rate was much faster than in any of the previous booms; and the recessions of 1974-5 and 1980-1 were much deeper than any other post-war recessions. These were the only years in the whole period when GDP and GDP per head fell substantially.

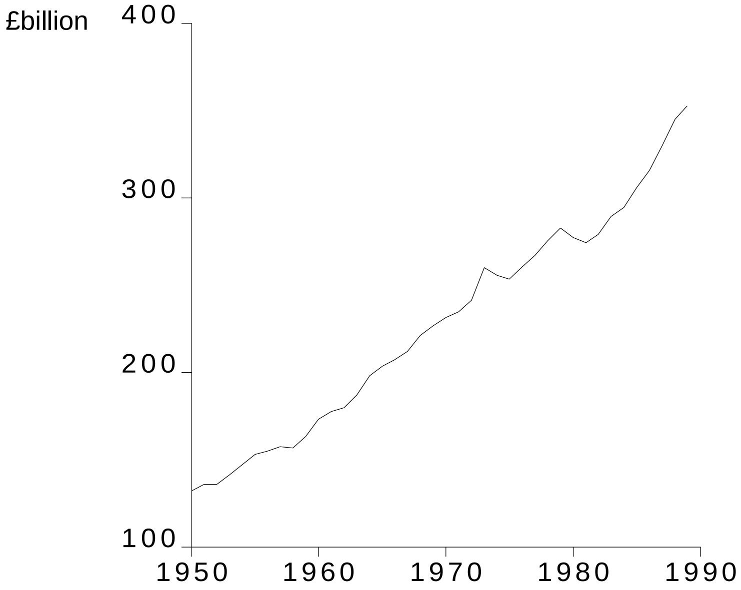

Figure 1.1 Real GDP, 1950-89

Source: Economic Trends.

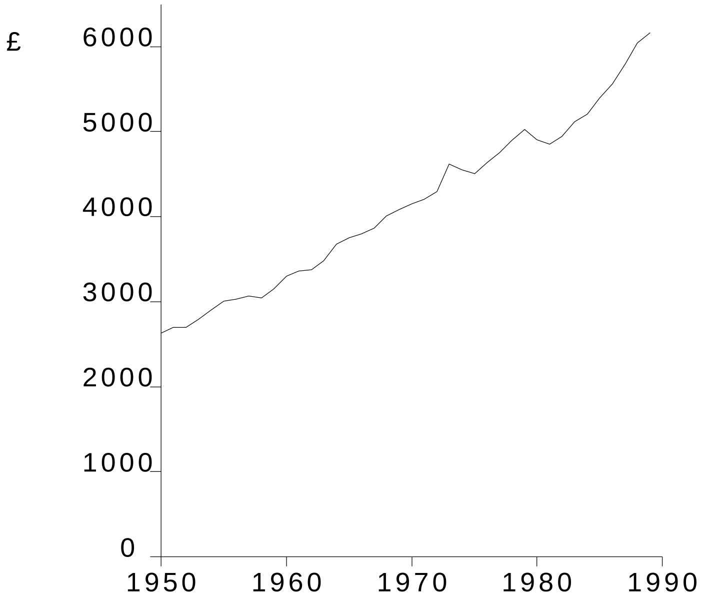

Figure 1.2 GDP per capita, 1950-89

Source: Economic Trends.

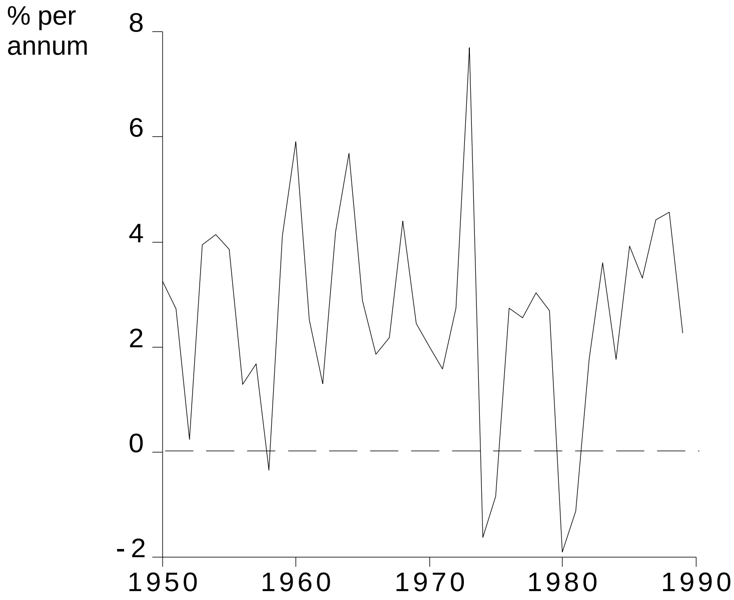

Figure 1.3 the growth rate of GDP, 1950-89

Source: Economic Trends.

Previous post-war recessions had seen low growth rates but, with the exception of 1958 when it fell *very* slightly, GDP had not actually fallen.

❑ After 1981 the boom was sustained longer than in any previous business cycle, the downturn not coming until 1989.

Though the average growth rate (not shown explicitly) is clearly different, similar remarks could be made concerning GDP per capita. The reason is that population growth is comparatively steady.

Statistics on employment and unemployment, shown in figure 1.4, paint a similar though far from identical, picture (for a discussion of this, and other, definitions of unemployment, see chapter 8). The unemployment rate fluctuated, though remaining fairly low, until the early 1970s; during the mid-1970s and early 1980s it rose dramatically; and it began to fall in the late 1980s.

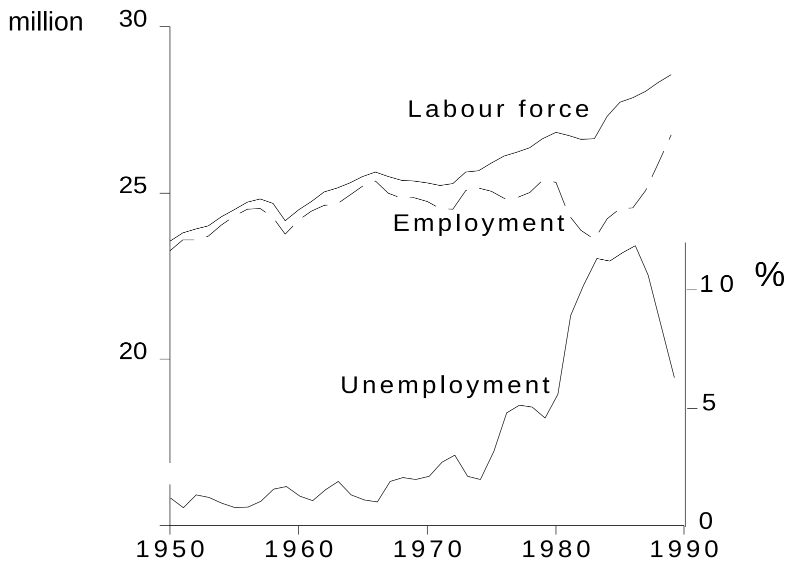

Figure 1.4 The labour market, 1950-89

Source: Economic Trends.

- ❏ Up to about 1967 the unemployment rate fluctuated around 1.5-2 per cent of the labour force. Unemployment then grew steadily from 2.3 per cent in 1967 to 3.7 per cent in 1972. In the boom year of 1973 it fell sharply to 2.6 per cent, though this was still higher than at any time during the 1960s.

- ❏ The recessions of 1974-5 and 1980-1 both produced large rises in unemployment, the unemployment rate rising to 5.8 per cent in 1977 and to 10.6 per cent in 1981.

- ❏ From 1981 to 1986 unemployment remained relatively constant at over 10 per cent, until it started to fall in 1987. By 1989 it had fallen to just over 6 per cent.

One of the most important questions in UK macroeconomics is whether or not the economy is operating below full capacity. If unemployment is high because aggregate demand is insufficient for the economy to operate at full capacity one set of policies is appropriate, whereas if the problem is low productive capacity a different set of policies is more

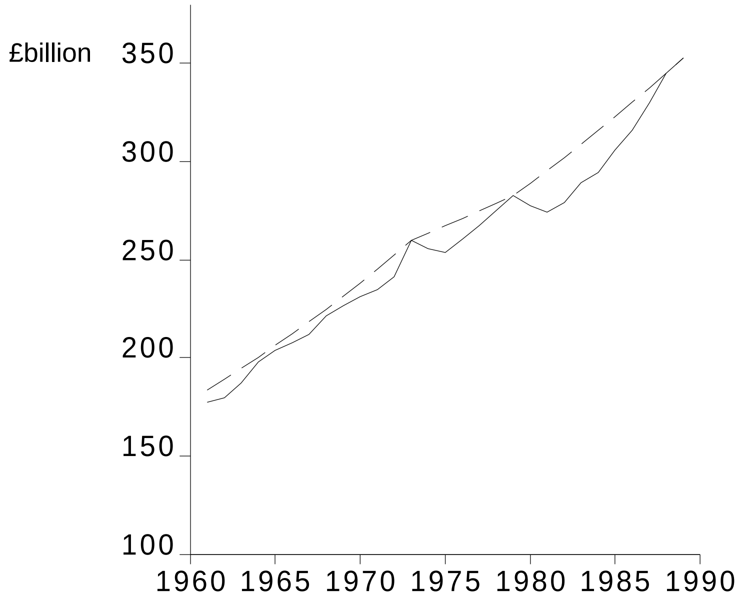

Figure 1.5 Capacity utilization, 1950-89

Source: Figure 1.1 and author's calculations discussed in chapter 6.

likely to be required. One estimate of full capacity output is shown in figure 1.5. If we believe this estimate (some of the problems involved in estimating full capacity output are discussed in chapter 6) it confirms the conclusions we drew from the GDP figures. Prior to 1973 the UK experienced a series of cycles, reaching full-capacity in most of the booms; after 1973 the cycles were much deeper and longer-lasting.

Inflation

The second major question relates to inflation. Figure 1.6 shows the behaviour of wages and prices (the retail price index) since 1949. Once again the period can be divided into two, though the dividing line would appear to be the late 1960s rather than 1973. Apart from 1951-2 when the Korean War produced a sharp rise in the inflation rate, inflation remained below 5 per cent for the 1950s and most of the 1960s. From the late 1960s inflation increased steadily, reaching over 20 per cent per annum in 1975. It then fell sharply to under 10 per cent in 1977, rising to a new peak in 1980. Since then it has fallen to around 5 per cent per annum and risen to over 10 per cent per annum.

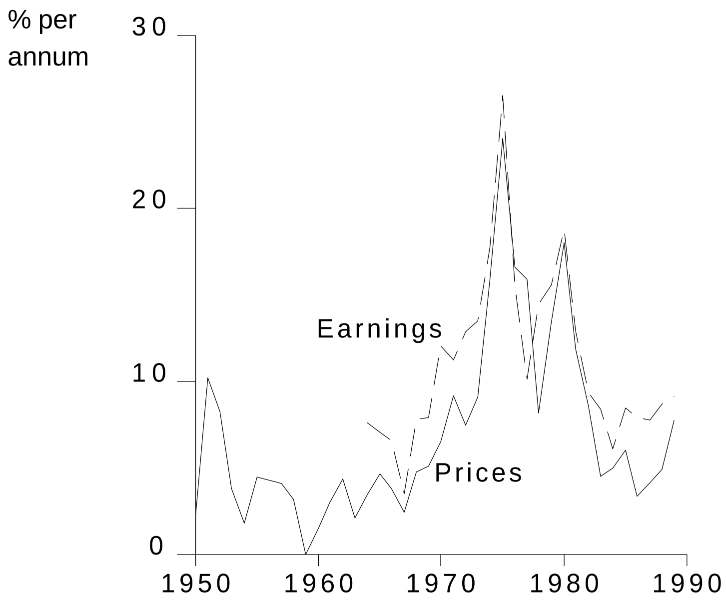

Figure 1.6 Inflation: average earnings and retail prices, 1950-89

Source: Economic Trends.

Also shown is the rate of growth of average earnings. The series only goes back to 1963 because of difficulties in obtaining comparable data; as it is, the earnings data shown in figure 1.6 are obtained by merging together one series for 1963-76 and another for 1976-89. They show that, with the exception of 1977, earnings rose faster than prices throughout the period. This means that real wages rose continuously, the only exceptions being 1976-7, when they fell, and 1980-1, when they barely changed.

1.2 INTERNATIONAL COMPARISONS

Fluctuations

Figures 1.7 and 1.8 compare British inflation and growth rates with those of the United States, France, Germany and Italy. In these graphs the solid line denotes the country indicated, with the dotted line showing comparable figures for the UK. Figure 1.8 shows that during the 1970s British inflation rates fluctuated much more than those in any country except Italy. The pattern was the same but the UK peaks of around 25 per cent and 20 per cent were much higher. The fall in

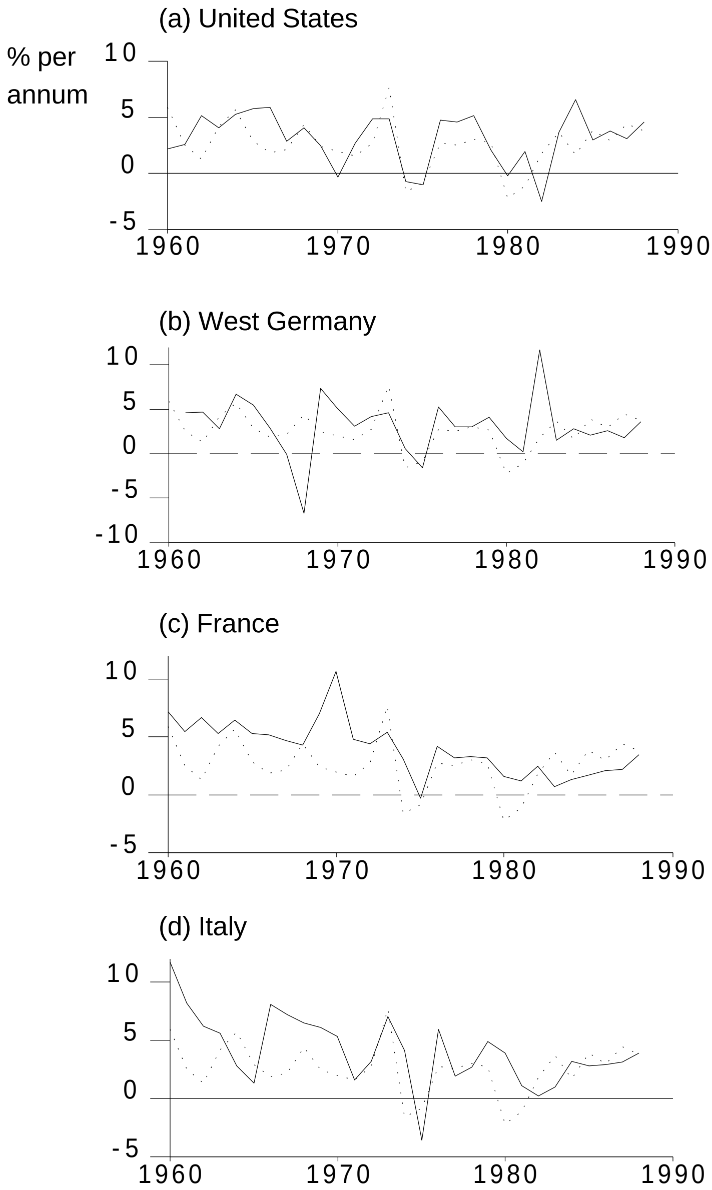

Figure 1.7 Growth rates of GDP, 1960-88

Source: International Financial Statistics Yearbook, updated from *Datastream*.

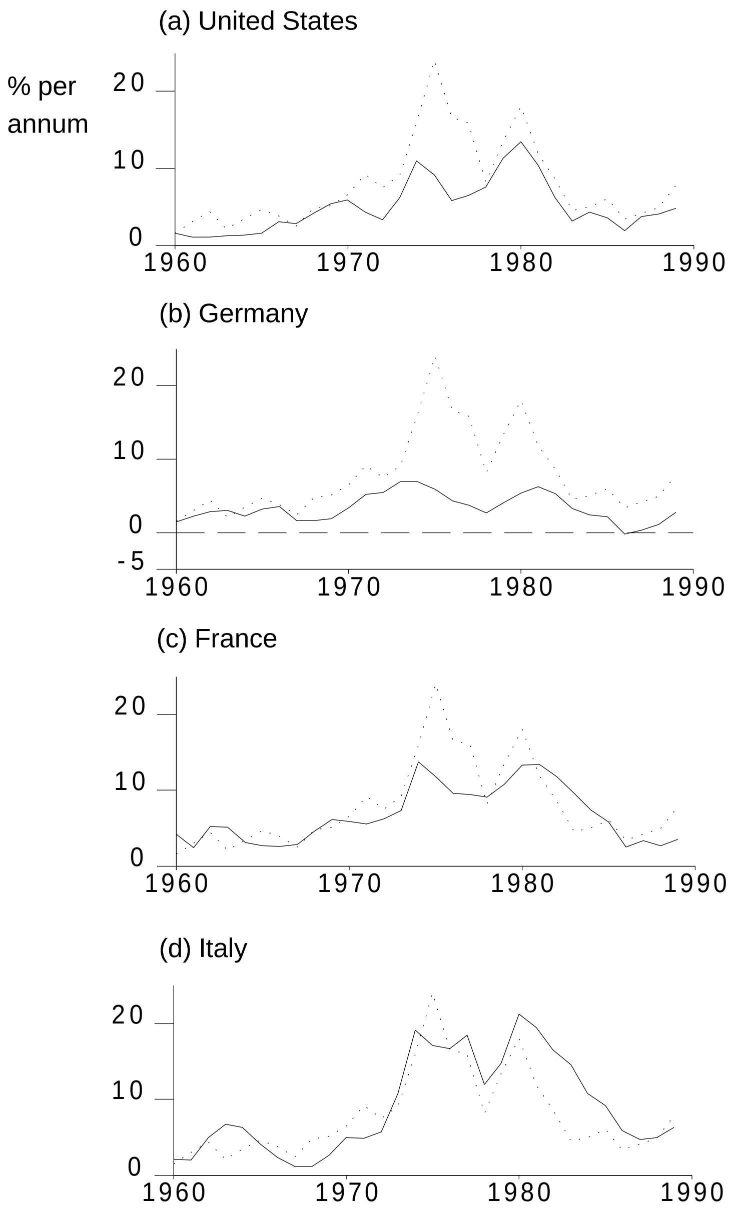

Figure 1.8 Inflation rates, 1960-89

Source: International Financial Statistics Yearbook, updated from *Datastream*.

inflation which has taken place since 1980 has been common to all the countries shown here. From figure 1.7 we can see that the UK experienced a cycle similar to that of most of the other countries shown, with major recessions in 1974-5 and 1980-81. The 1980-1 recession was, however, much more severe in Britain than in any of the other countries shown here.

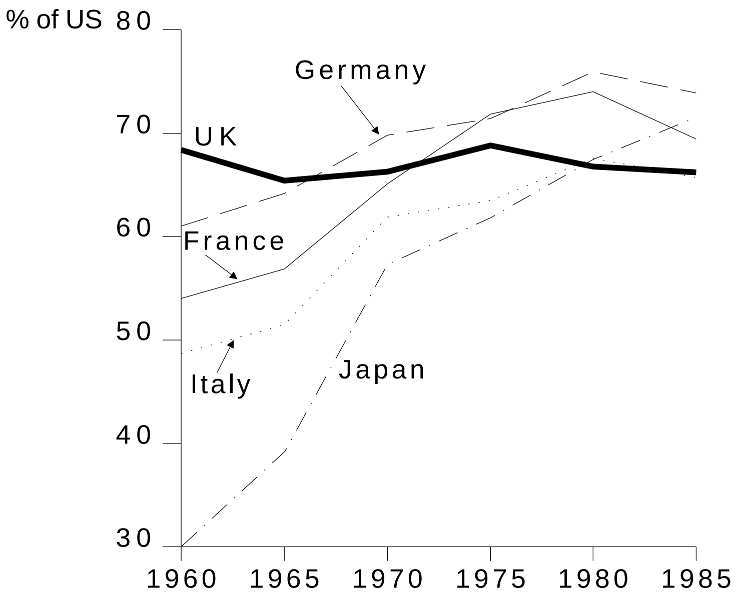

Figure 1.9 International living standards, 1960-85

Source: OECD National Accounts, supplement on purchasing power parities.

Growth

Since the end of the nineteenth century Britain has been growing more slowly than its main European rivals, notably France, Germany and Italy. In the nineteenth century British living standards were on average much higher than those in continental Europe, but more recently the position has been reversed. It is, however, difficult to compare national income and living standards across countries when different countries use different currencies. One way is to convert incomes into a common currency using market exchange rates. Such comparisons are misleading because exchange rates do not reflect relative prices in different countries: exchange rates fluctuate, sometimes by large amounts, without there being any corresponding change in living standards (prices do not fluctuate by the same amount). To get round this problem it is better to use *purchasing power parities*. The purchasing power parity (PPP) between two currencies is the exchange rate at which prices of goods are the same in both countries (see chapter 11 for a more detailed discussion).

Figure 1.9 provides a comparison of GDP per head in several countries based on PPP data. The two main conclusions to be drawn from this are that between 1966 and 1980 the UK was overtaken by West Germany, France and Japan, and that the UK's relative decline slowed down during the 1970s.

❑ The UK was overtaken, in terms of GDP per head, by West Germany in 1966, France in 1972 and Japan in 1980. The equivalent dates based on earlier, non-PPP comparisons were 1959, 1965 and 1972 respectively. The use of of PPPs rather than exchange rates to make the comparisons makes Britain's position look better compared with other countries.

❑ Britain's relative decline slowed down during the 1970s. The greatest improvement was relative to the European Community, because of the slowdown of the European economies. This might be for a number of reasons: the discovery of oil, which was particularly important during the 1974-9 upswing; rising productivity since 1979 (discussed in chapter 6); or simply that the UK

Table 1.1 UK Governments since 1945

	Party	Prime Minister(s)
1945-51	Labour	Atlee
1951-64	Conservative	Churchill/Eden/Macmillan/Home
1964-70	Labour	Wilson
1970-74	Conservative	Heath
1974-79	Labour	Wilson/Callaghan
1979-	Conservative	Thatcher

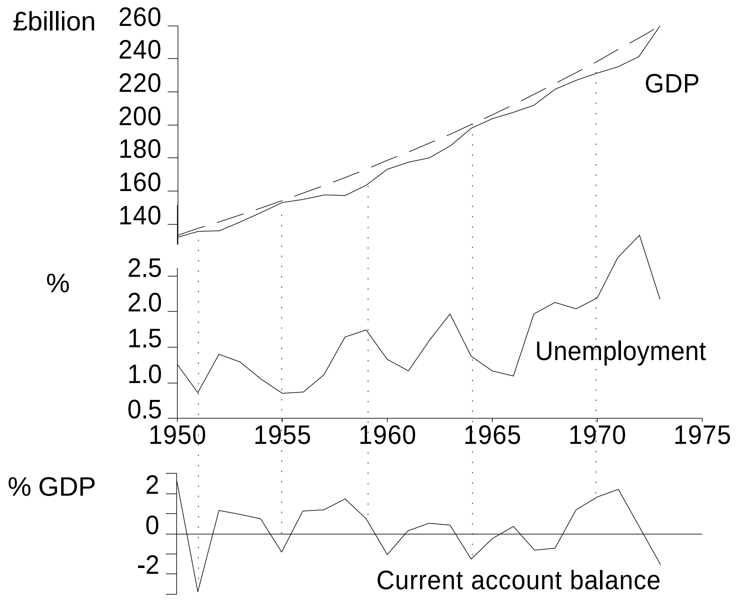

Figure 1.10 The business cycle, 1950-73

Source: Economic Trends.

performs relatively well in recessions, and poorly in times of rapid growth. A world recovery or a British recession might make the picture look much worse.

1.3 POLITICS AND ECONOMIC POLICY

Introduction

The natural way to divide up the period is according to the political party in power, which gives us the periods shown in table 1.1. Our starting point will be the period from 1951 to 1964. The period of the previous Labour government was dominated by problems of reconstruction after the war with the result that, though there are certainly interesting things to say about the macroeconomic policies pursued then, there are so many special problems that we will neglect it.

1951-1964: the period of 'stop-go'

This period was dominated by Keynesian ideas, in particular the use of fiscal policy to achieve a high level of demand, low unemployment and a high growth rate. Policy would be used to stabilize the economy, expanding and contracting the economy in order to smooth out booms and slumps. Very little importance was attached to monetary policy, though controls on credit (in particular hire-purchase regulations and quantitative restrictions on the amount banks were allowed to lend to different types of customer) were used to help regulate consumer demand. Little interest was shown in the 'money supply' and figures for it were not even constructed. The exchange rate was fixed throughout the period under the Bretton Woods system, at a rate of \$2.80 to £1. Governments were committed to maintaining this exchange rate.

The main problem facing policy-makers was the balance of payments: if the economy grew too fast the balance of payments would deteriorate and put pressure on the exchange rate. The Bank of England's gold and foreign currency reserves would fall. In order to put such a situation right there would have to be deflation, reducing imports and freeing resources for exports. What actually happened, therefore, was not continuous high employment and rapid growth, but a period of 'stop-go', the timing of which was, arguably, linked to general elections. In the run up to an election the economy would be expanded, using mainly fiscal policy plus a relaxation of credit controls. After the election a balance of payments crisis would emerge, leading to the imposition of a contractionary fiscal policy and a tightening of credit controls. When the balance of payments had turned round the economy would be expanded again, prior to the next general election.

Some of the evidence for this is shown in figure 1.10. The exception to the pattern is 1959, for the peak of the boom did not come till after the election. But then this was the election that everyone expected Labour (under Gaitskell) to win. Three comments are worth making.

- ❑ Causation could run both ways: to or from politics. It could be that governments called elections when the economy was doing well, or that they ran the economy with a view to the election.

- ❑ It has been disputed whether policy succeeded in stabilizing the economy. It has been argued that the timing of policy was frequently wrong and that this made fluctuations worse.

- ❑ Inflation was seen as part of the balance of payments problem, various types of price and wage policies being introduced in order to maintain competitiveness. Remember that, although economists argued that excess demand could cause inflation, policy was not thought of in terms of a trade-off between inflation and unemployment. With the exception of the Korean war years, the inflation rate was always low by modern standards.

1964-1970: the balance of payments and the failure of planning

In many ways this period was similar to the previous one, but with balance of payments problems being much more dominant.

- ❏ There was an attempt to introduce a 'National Plan', the idea underlying this being to plan for a higher rate of growth in the hope that firms would do the same and a higher growth rate would result. This was not a new idea, for the Conservatives had attempted to introduce some elements of planning a few years earlier, but it was on a much larger scale. Planning came to nothing because the government found itself having to introduce restrictive policies, inconsistent with the plan's targets. There were other problems, such as an over-optimistic target for productivity growth.

- ❏ The government inherited a balance of payments deficit from its predecessor, but this time it seemed to be larger and more persistent than after previous booms. According to the Pink Book for 1967, the current account deficit was £402m. in 1964, £110m. in 1965 and £59m. in 1966. Restrictive measures were taken to improve the current account and support sterling. Later figures, incidentally, showed that the deficit was much smaller: the problem was on the capital account.

- ❏ There was a greater emphasis on controlling prices in order to restore competitiveness. The National Board for Prices and Incomes was used to control prices and wages. There was a complete wage freeze in the second half of 1966. Unemployment rose and inflation fell.

- ❏ Despite these measures devaluation came in November 1967, sterling falling from $2.80 to $2.40. This was followed by a further period of deflationary policy to provide resources for exports, and to ensure that inflation did not erode the competitive advantage given by devaluation. The policy worked: growth remained low and unemployment remained high, but exports grew rapidly and the current account went into surplus at the beginning of 1969.

1970-1974: U-turn and dash for growth

The period was one of rising inflation (see figure 1.6). The causes of this are too complicated to go into here, but note that this was a worldwide phenomenon which started in the late 1960s (though inflation did rise more in Britain than in most similar economies). Policy falls into two phases.

- ❑ A period of *laissez-faire*. The government came into office committed to a policy of *laissez-faire* and stimulating enterprise. Fiscal policy was neutral, and there was an attempt to reduce government intervention in industry. There was a slight change in policy in 1971 when expansionary fiscal policy was introduced to deal with rising unemployment, and attempts were made to keep prices down (an agreement with the CBI).

- ❑ Early in 1972 unemployment rose to nearly a million (4 per cent), prompting a change in policy. The aim became to expand output at 5 per cent a year in order to reduce unemployment to 500,000 by the end of 1973. Inflation was to be kept down first by TUC/CBI negotiations and later by statutory incomes policy. The output and unemployment targets were met (nearly enough).

One significant aspect of this policy was the exchange rate. Previous booms had come to an end because of balance of payments problems, so this time the government decided that if balance of payments problems occurred the exchange rate would be allowed to fall: they announced this policy as part of their attempt to persuade people that growth would be sustained.

The policy's main problems concerned inflation.

- ❑ Inflation was never controlled, partly because of the world commodity price boom from 1972-3 and partly because by 1973 the economy was operating at full capacity, growing at an unsustainably high rate. Many western economies were expanding rapidly and US spending in Vietnam was high.

- ❑ War between Israel and Egypt in 1973 reduced oil supplies to the west.

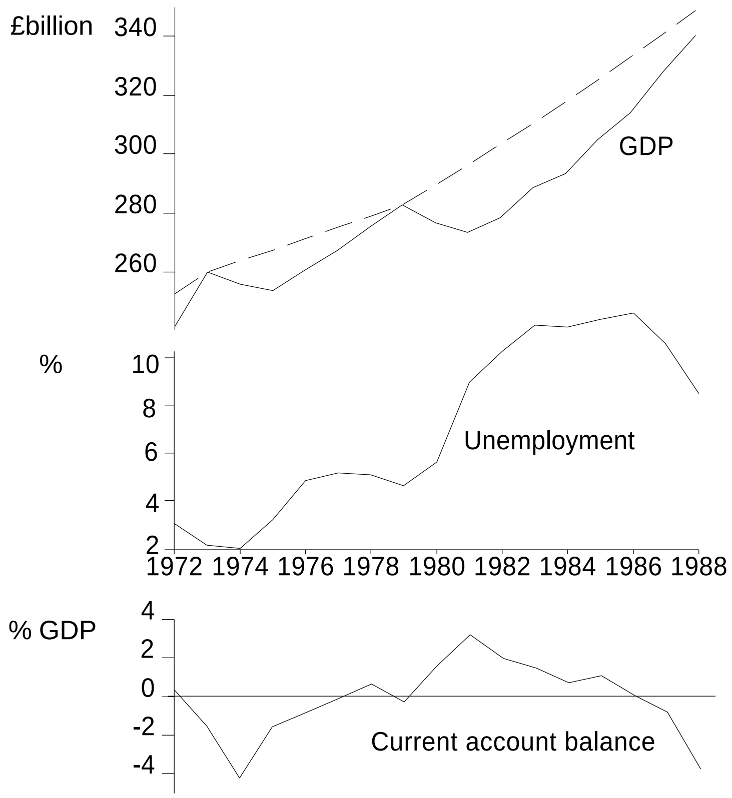

Figure 1.11 The business cycle, 1973-88

Source: Economic Trends.

- ❏ OPEC raised the price of oil by 66 per cent in October 1973 and a further 100 per cent in January 1974.

- ❏ There was a series of strikes with unions refusing to accept the statutory incomes policy. Particularly important was the miners' strike at the end of 1973. This together with the oil shortage led to the imposition of a 3-day working week to save energy. This was when speed limits were introduced on motorways.

The boom came to a very abrupt end.

1974-1979: responding to the oil crisis

The government elected in 1974 faced a number of severe problems that needed to be resolved:

- the miners' strike;
- high and rising inflation;
- rising unemployment;
- the effects of the oil price rise. These included a rise in inflation, a fall in real income and a large balance of payments deficit (see figure 1.11).

The main problem was that the rise in unemployment and the rise in inflation called for different policies: the supply shock was both 'deflationary' and 'inflationary'. Contractionary fiscal and monetary policy would have made unemployment worse, whilst expansion would have made inflation worse.

Inflation increased during 1974-5, reaching 25-30 per cent per annum (the exact figure depends on what price index and what period is taken). Unemployment rose and output fell, this leading to an improvement in the balance of payments. The real adjustment to the oil shock came in 1976-7, especially following the sterling crisis of 1976.

- A severe incomes policy (year 2 of the 'social contract', the agreement between the government and the TUC) led to reduced wage inflation and a *fall* in real wages (see figure 1.6). This was needed to adjust to the fall in real income caused by the oil price rise.
- Restrictive fiscal and monetary policies were imposed, with targets for both the public sector borrowing requirement (PSBR) and the growth rate of the money supply.

These measures were largely successful: inflation fell; the balance of payments increased; and sterling appreciated in 1977.

From 1978 to 1979 wages and output rose, output reaching a new peak in 1979. The incomes policy had broken down, causing rising consumer spending, and controls on public spending were no longer so tight.

This episode is important, because it shows that 'monetarist' policies did not come in with Mrs Thatcher. The Labour government introduced monetary targets and managed greater reductions in government spending than the Conservatives were able to achieve. They were a response of the Labour government, in common with many other western governments of the period, to a new and unfamiliar set of economic problems.

1979-1988: the 'Thatcher experiment'

Whereas the Labour government turned to 'monetarist' ideas as a response to a specific policy problem, the Conservative government elected in 1979 committed itself to such ideas much more wholeheartedly, offering what it called a 'Medium term financial strategy.' This was a 5-year plan involving targets for the growth of the money supply and the PSBR. The idea was gradually to reduce monetary growth, and hence the rate of inflation over the period. The results were rather different, for although inflation was gradually reduced, the result was an exceptionally severe recession. This period of economic policy is discussed in greater detail in later chapters.

1.4 CONCLUSIONS

- There was a clear break in the problems faced in the early 1970s.

- The main features of UK economic performance were shared by other countries: the rise in inflation in 1973-5, the recession of 1974-5, the inflation of 1979, the recession of 1980 and the subsequent recovery, and the fall in inflation during the 1980s.

- British performance differed from that of similar economies in a number of ways: (a) the recession of 1974-5 was longer lasting; (b) inflation was much higher in the UK than in most similar economies; (c) the recession of 1980-1 was much more severe than elsewhere, because of the behaviour of sterling in 1979-80; (d) the recovery since 1981 has been relatively fast, but it is not clear how far this is simply because of the depth of the recession.

- The links between politics, economic policy and economic performance are not clear-cut. There was a change in ideology after 1979, but the movement towards monetarism came earlier and was a response to urgent economic problems. It is not clear that policy has always had the effects claimed for it: either that Keynesian stabilization policies were the cause of high employment in the 1950s and early 60s, or that monetarist policies were the cause of the fall in inflation during the 1980s.

FURTHER READING

One of the best introductions to UK macroeconomics is Christopher Johnson *Measuring the Economy: A Guide to Understanding Official Statistics* (London: Penguin Books, 1988), which provides a very thorough discussion of how the main macroeconomic statistics are constructed and what they mean. The most useful statistical source is probably *Economic Trends* (London: Central Statistical Office, monthly) and *Economic Trends Annual Supplement* (usually published between January and March).

A short survey of post-war macroeconomic policy is contained in the chapter on the UK, by M. J. C. Surrey, in *The European Economy: Growth and Crisis* (Oxford: Oxford University Press, 1982). More detailed discussions of specific periods can be found in: J. C. R. Dow *The Management of the British Economy, 1945-60* (Cambridge: Cambridge University Press, 1964); F. T. Blackaby (ed.) *British Economic Policy, 1960-74* (Cambridge: Cambridge University Press, 1978); R. E. Caves *et al. Britain's Economic Performance* (Washington DC: Brookings Institution); and Rudiger Dornbusch and Richard Layard (eds.) *The Performance of the British Economy* (Oxford: Oxford University Press, 1987). A very clear account of the major policy issues as seen from around 1980 is found in R. C. O. Matthews and J. R. Sargent (eds.) *Contemporary Problems of Economic Policy* (London: Methuen, 1983) which contains reprints of articles published in the *Midland Bank Review* between 1977 and 1982. More detailed references on recent policy can be found at the end of chapter 13. Regular analysis of macroeconomic policy and current events in the UK and the world economy is contained in *OECD Economic Surveys: United Kingdom* (annual); in the *National Institute Economic Review* (quarterly); and the *Bank of England Quarterly Bulletin*. Chapter 13 contains more detailed references on the 1980s.

An accessible discussion of long-run economic performance in the UK is provided in *Oxford Review of Economic Policy* 4(1), 1988, in which general surveys of economic growth are provided by Nick Crafts, Geoffrey Meen and Charles Feinstein, with other articles discussing more specialized problems.