UK Macroeconomic Policy since 1979

The political landscape

Government	Elections	Prime minister
Labour (45-51)	1945, 1950	Atlee
Conservative (51-64)	1951, 1955, 1959	Churchill, Eden, Macmillan, Home
Labour (64-70)	1964, 1966	Wilson
Conservative (70-74)	1970	Heath
Labour (74-79)	1974 (×2)	Wilson, Callaghan
Conservative (79-97)	1979, 1983, 1987, 1992	Thatcher, Major
Labour (97-)	1997, 2001	Blair

Government	Elections	Prime minister	Chancellor
Conservative	1979, 1983, 1987 1992	Margaret Thatcher (79-90)	Geoffrey Howe (79-83) Nigel Lawson (83-89) John Major (89-90)
		John Major (90-97)	Norman Lamont (90-93) Kenneth Clarke (93-97)
Labour	1997, 2001	Tony Blair (97-)	Gordon Brown (97-)

‘Old’ Labour’s economic legacy in 1979

2½ decades (up to about 1973) of:

- Low unemployment (although rising by the early 1970s),
- Low and stable inflation (also rising by the early 1970s),
- Growth averaging 3% per annum,
- Exchange rate stability under the Bretton Woods system (despite devaluation of sterling in 1967),

The mid- to late-1970s were a period of economic turbulence unprecedented since (at least) the 1930s.

- Persistent US trade deficit (caused partly by spending on the Vietnam War) led to the breakdown of the Bretton Woods fixed exchange rate system between 1971 and 1973.

- The ‘oil price shocks’ of 1973-4 (triggered by the Arab-Israeli War) and 1979-80 (triggered by the Iranian revolution) helped create inflation and recession simultaneously.
- ‘Tightening’ labour market conditions, workers’ increasing aspirations, and a chaotic Trade Union structure contributed to industrial unrest and inflationary pressures.

IMF loan (Autumn 1976) committed the Labour government to deflationary macro-economic policies. By 1979, some success had been achieved in reducing inflation, and re-kindling economic growth.

But unemployment remained high. A further wave of industrial unrest in the ‘Winter of Discontent’ (1978-9) paved the way for Tory success under Margaret Thatcher in the May 1979 General Election.

Two main ‘themes’ influencing the subsequent (post-1979) development of macroeconomic policy:

- Role-reversal of fiscal and monetary policy. Up to 1976, fiscal policy was used actively (growth and employment). Monetary policy had been used passively (keep interest rates steady to create a stable climate for investment).

  After 1976, monetary policy became the main macro policy instrument, in pursuit of inflationary control. Fiscal policy played a subservient role.

- Shift of emphasis away from monetary policy towards exchange rate policy during the course of the 1980s, leading up to Britain’s 1990 entry into the EU’s Exchange Rate Mechanism (ERM).

  [flexible exch, rate $\Rightarrow$ money supply controllable; fixed exch. rate $\Rightarrow$ not so]

<u>The ‘Monetarist’ phase: 1979-1985</u>

Main policy objective: control over inflation via monetary policy.

New govt set medium term (4-year) targets for growth of ‘broad’ money (M4), and subsidiary targets for the PSBR.

Abolition of exchange controls (restrictions on capital flows) confirmed the adoption of a fully flexible exchange rate regime.

Restrictive monetary and fiscal policy would be expected to cause recession in the short-term. Workers would continue to push for inflationary pay increases, and ‘price themselves out of jobs’.

But in the long-term, as people's inflationary expectations adjusted downwards, pay claims would moderate.

Market forces would push the economy back to its 'natural' levels of output and employment ⇒ there shouldn't be any significant long-term damage (??)

- As monetary policy was tightened (1979-81), interest rates and the exchange rate both rose dramatically (exch. rate partly due to North Sea Oil).
- Double squeeze on manufacturing due to
  - high borrowing costs
  - loss of competitiveness in export markets
- Unemployment rose sharply, and the economy fell into recession.

Growth in M4 failed to stay within targets ⇒ squeeze was tighter than was really necessary. From 1981 inflation fell sharply (much slower than monetary growth).

Between 1982 and 1985, exchange rate fell. By 1985 interest rates were being used to support exchange rate ⇒ exchange rate policy now more important than monetary targeting.

Lessons from the Monetarist experiment

1. Tight monetary policy (1979-81) did not achieve control over the money supply, perhaps due to:
   - distress borrowing by ailing firms,
   - financial deregulation,
   - erratic behaviour of M4 target.

2. But the Monetarist squeeze did achieve a permanent dampening of the inflationary psychology of the 1970s – at the cost of a recession that did lasting damage to the UK's manufacturing base.

3. 1982-5: the idea that monetary policy could be conducted regardless of the exchange rate was discredited. Speculative pressure against £ could not be ignored, because of its inflationary potential.

A transitional phase: 1985-1990

Under ‘pure’ Monetarism, the exchange rate was irrelevant for the conduct of macro policy. But after 1985 this view was untenable; Monetarism was ‘dead’.

In October 1990, the UK entered the EU’s Exchange Rate Mechanism, committing the UK to an exchange rate within a 6% margin on either side of £1=DM2.95.

Exchange rate management was now the centrepiece of macroeconomic policy.

The process of transition (1985-1990) was politically acrimonious and economically damaging.

The arguments are still largely unresolved today – but have now transferred to the debate about the UK’s membership of the euro.

Main economic issue: would ERM membership be helpful or harmful in the fight against inflation?

Pro-ERM case: If UK inflation increased within a fixed exchange rate system, UK goods would become uncompetitive

⇒ *current account deficit*

⇒ central bank intervention to buy £’s
or rise in interest rates (to attract mobile capital)

⇒ automatic tightening of monetary policy, and reduction of inflationary pressure

Anti-ERM case: If UK inflation increased within a fixed exchange rate system, investors would anticipate a rise in UK interest rates, and move mobile capital into sterling

⇒ *capital account surplus*

⇒ central bank intervention to sell £’s *or* cut in interest rates (to deter mobile capital)

⇒ loosening of monetary policy, and acceleration of inflationary pressure

The debate was really about whether the *current account* or *capital account* adjustment tended to dominate.

Current account dominance ⇒ ERM membership would be stabilising
Capital account dominance ⇒ ERM membership would be destabilising

In 1985, the anti-ERM faction (led by PM Thatcher) won the debate about membership, and the UK stayed out.

But the pro-ERM faction (led by Chancellor Lawson and Foreign Secretary Howe) continued to argue the case.

By 1987, Lawson was running an unofficial strategy of 'shadowing the DM'

(intervening on the currency markets to keep the exchange rate within the range £1=DM2.80 to £1=DM3.00).

Meanwhile the economy was booming unsustainably due to:

- Substantial income tax cuts (basic rate was cut from 30% to 25% 1986-8),
- More financial deregulation,
- Housing market boom ⇒ increased consumer spending.

Against this inflationary background, 'shadowing the DM' provided a test case for pro- and anti-ERM arguments.

What happened?

Speculative pressure in favour of sterling (1987-8) ⇒ relaxation of monetary policy (cut interest rates) to prevent £ exceeding its upper limit ⇒ inflation ↑↑

Spring 1988:

- interest rates were increased sharply,
- 'shadowing the DM' was abandoned and £ rose sharply.

⇒ validation of the anti-ERM case?

Perhaps, but pro-ERM faction argued shadowing failed because it had been attempted without *convergence* between UK and European economies.

John Major (new Chancellor) announced entry in Oct 1990, still before convergence had been achieved.

PM Thatcher was replaced by Major in Nov 1990.

ERM membership: 1990-1992

Entry at a central parity of £1=DM2.95 (with a 6% margin on either side permitted).

By 1990, economy was in deep recession, due to policy responses to the 'Lawson Boom'.

Underlying theme of the 2-year period of membership – conflict between:

- Need to cut interest rates (recession),
- Need to maintain interest rates to prevent £ from falling.

£ was below its ERM central parity (1991). Then a brief improvement, due to:

- Maastricht Treaty (Dec 1991) ⇒ timetable for European Monetary Union (UK & Denmark could opt out),
- 4th Conservative election win (April 1992).

Then, a 'No' vote in Danish Maastricht referendum (June 1992) unsettled the currency markets.

Speculation against £ (& the lire) increased (summer 1992).

UK raised interest rates from 10% to 12%, then 15%. But £ still fell below its lower ERM bound on 'Black Wednesday' (Sept 16 1992).

£3bn of foreign currency reserves were lost in the attempt to stay in the ERM.

Summer 1993: further currency market turbulence forced a widening of all ERM bands to 15% (much looser arrangement).

What went wrong? Reasons for the ERM's failure

1. *Weakness* of the German economy in the early 1990s, following monetary unification of West/East Germany (July 1990).

   Guaranteed parity between DM and Ostmarks (public subsidy from west to east) ⇒ high interest rates required to curb inflationary pressure.

   High German interest rates attracted mobile capital into DM, away from currencies such as £.

   Downward pressure on £ ⇒ UK had to keep interest rates high, despite recession.

   Also – 'textbook' argument against fixed exchange rates: a 'shock' affecting one country strains the entire system, forcing exchange rates apart.

ERM crisis emphasised a contradiction between the Bundesbank's duty to keep German inflation low, and its responsibility for stability of ERM.

2. Other factors included:
   - The UK's parity was too high. At the time, £1= DM2.95 did not reflect true purchasing parities.
   - Difficulties in establishing the credibility of commitment to ERM, due to the UK's poor track record, & anti-European rhetoric.

No realignments within the ERM had taken place since 1987, so pressures were building up anyway.