

27 August 1981


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Policy Unit

PRIME MINISTER

I mentioned on Wednesday evening that we had been talking with Douglas Hague about the relevance of the lessons of 1970-74 for the country's present problems. I enclose a copy of the paper he undertook to write.

This is a first draft, but I thought you would be interested to read it. He is going to shorten in and to add further contemporary quotations from other newspapers. He will then try to place it in the Times. Whether or not it is so placed, it might be a good idea then to circulate the paper to the colleagues shortly before the Conference.



JOHN HOSKYNS

24 August 1981

MR HOSKYNS

As promised, I am now sending you the paper we discussed about 1970-72. Our suspicion that history really does repeat itself turns out to have been justified. Please make whatever use of this paper you think is most appropriate.

DOUGLAS HAGUE

1979-81: OR 1970-72 REVISITED?

1. There are similarities in the reactions of the media to the recessions of 1979-81 and 1970-72. I believe it is instructive to remind ourselves of these. I have therefore looked, especially at the Economist, to see what the media were saying in 1970-72 about the kinds of issue that are exercising the media again today. I have singled out the following five issues:

- (1) what rate of growth of GDP was feasible;
- (2) whether the Government's fiscal stance would allow this rate to be achieved;
- (3) even if it would, should further measures be taken to reduce unemployment;
- (4) what would such policies imply for inflation;
- (5) what lags were there between changes in policy and changes in the economy?

2. I have concentrated on the following five issues:

- (1) GDP growth. With hindsight, the growth rates being advocated were ludicrously high. In April 1971, the Economist noted that GDP was expected to grow at 2%, and argued for increasing it to 3%. By July, however, at the time of the mini-Budget, the Economist was pointing out that tax cuts were not being backed up by tougher monetary policy or more flexible exchange rate policy. The danger was that "Mr Barber is coming in where Mr Maudling went out in 1963-64. Those who are most warmly applauding Mr Barber's tax cuts today had better look back to what they said of Mr Maudling's cuts 8 years ago", when tax cuts equal to one-third of those of Mr Barber had led to the 1964 balance of payments crisis. There is a salutary tale here. Looking back at the Economist itself, one finds it arguing in 1963 that it would be "almost conservative" to aim at 6% or 7% growth of GDP in 1963-64, compared with the 4% target which itself led us into so much trouble.

Despite this, in December 1971 the Economist argued for 5% growth, claiming that such a growth rate would not create

bottlenecks in the economy. In January 1972, the Economist was unhappy, because "the boom is still not boomy enough". By March 1972, it reiterated its call for 5% growth. "Otherwise unemployment will not fall." Even this 5% should be achieved by giving the maximum stimulus. "The Chancellor should look at the most pessimistic forecast and then add enough to get 5% growth."

Nor was the Economist alone in taking this kind of view. The NIESR consistently favoured far bigger tax cuts than those the Government made, which themselves led to an unsustainable balance of payments deficit. Conventional wisdom overestimated the maximum feasible growth rate in the UK in 1970-73 as it had done throughout the 1960s.

- (2) Fiscal and monetary policy. In general, therefore, commentators advocated tax cuts which, on straight Keynesian arguments, would if anything have overshot the already high target rate of growth. Yet the Government itself was always favouring laxity in both fiscal and monetary policy. Tax cuts of £1.5bn in 1971 were followed by further cuts of £1.2bn in 1972.

There was no tight monetary policy to offset this. Late in 1971, the money supply had been increasing at a peak rate of 23%. It was acknowledged by the media that this laxity in monetary policy was largely responsible for the boom in house prices in an "unruly" housing market. In its comment on the 1971 Budget, when the target for monetary growth was set at 12% against an output growth of 3%, the Economist noted that this implied that the "target rate of inflation is up to 9% a year", and that the slackness in monetary policy sat badly with tax cuts of £540m in 1971-72. Yet in its comment on the 1972 Budget, by which time the money supply was increasing at around 20%, the Economist took a line favoured by many of today's press commentators. Noting that the growth of the money supply would continue "high by the standards of past years", the Economist wondered whether, even if the Chancellor knew what monetary growth he wanted, the Bank of England would be able to produce it.

The emphasis of the media throughout 1970-72 was therefore a naively Keynesian one. Indeed, perhaps the most

unfortunate legacy of Keynes was the belief that only Government action in reducing taxation or increasing expenditure could set off processes that created income and therefore jobs. Yet, as Samuel Brittan has pointed out, if this were true there would have been little or no economic development at all before the 1930s.

- (3) Unemployment. The understandable worries about unemployment led, as they are leading today, to calls for over-rapid reflation, and in 1971-72 these calls came at a time when reflation was potentially too rapid. Naturally enough, the calls were loudest when unemployment was highest - in the winter of 1971-72. The Government had already been panicked by the CBI into the reflationary mini-Budget of July 1971. In the autumn of 1971, it was panicked into bringing forward Government investment worth £185m, including "an unnecessary power station in Cheshire" and more secondary roads. This earned no praise from the TUC General Secretary, Vic Feather, who criticised the increase in Government investment as too small because it would create only 20,000 jobs. In addition, the Government provided £35m to Upper Clyde Shipbuilders.

Vic Feather would have been on firmer ground had he pointed out that the jobs created by extra Government investment would come only in mid-1972 when unemployment would already be falling because of the lagged effect of measures already taken.

The Treasury had "never envisaged anything but gloom for investment in 1971 and 1972". On top of the high unemployment figure, however, the fact that private sector investment was falling was more than politicians felt able to stand for. The increase in public sector investment was made in the hope that it would stimulate private investment, but as has typically been the case in post-War Britain, the timing of this counter-cyclical Government investment was wrong. It was destined to stoke up the next boom, not to smooth the recession.

Another aspect of unemployment was perhaps more important and more familiar to us today. In the way that John Biffen has done recently, the Economist saw advantages in the shake-out

of labour. At the beginning of 1972, many people in Britain were influenced by the views of Bill Allen, consultant, who branded Britain as a "half-time country". He claimed that the British GDP could be produced from the existing machinery with about half of the labour force and that the other half could then be redeployed. While any practical degree of redeployment was likely to be much smaller than this, redeployment could only come if labour was first shaken out of existing jobs into unemployment and later into new jobs. The Economist took the view that such a shake-out "would probably come only by political muddle so that it was important that it should not be greeted by the sort of political panic in which Governments insist on trying to shake all the redundant labour straight back into their previously unnecessary jobs".

There was, however, no shortage of those who wanted to do precisely the opposite. With total predictability, Harold Wilson did precisely this. He urged on Parliament: more subsidies to lame ducks; the re-establishment of the Industrial Reorganisation Corporation to help shipbuilding and other declining industries; "nationalisation of the investment responsibilities", providing Government finance for all investment; subsidisation of local authorities in areas of high unemployment, so that they could "employ more people than their ratepayers wanted to pay for".

As today, there were also many who saw nothing in the future but massive structural unemployment and called for the UK to go straight to a 35-hour week. They did this despite the fact that "there was no evidence to support them". Nor did the events of the next decade support them.

Nevertheless, the near-panic induced by the spectacle of high and rising unemployment meant that the unemployed were indeed shaken back, and that they largely went into their previous occupations. The more recent shake-out in 1979-81 has therefore been bigger than it need have been. In December 1971, the Economist pointed out that one of its reasons for welcoming a Heath Government was that it "would not panic in response to political breezes. He and his Ministers should remember that".

(4) Inflation. Just as there was over-optimism about the feasible rate of growth of GDP, so there was about inflation. In October 1971, the Economist argued that 5% growth of GDP over the next 2 years would not add to inflation. At the time of the 1972 Budget it said: "So long as unemployment remains near to its socially sickening winter million, the danger of more inflation by giving men jobs should rate lower than the threat of continuing stagnation in investment". Similarly, the NIESR, which wanted to cut taxes in the 1972 Budget by £2.5bn, did not think that this would necessarily lead to demand-pull inflation.

(5) Lags. The most important cause of alarm over the economy, and therefore of panic reflation, was a failure to appreciate the length of the lags operating in any economy, and especially in the UK economy.

Although the two Budgets of 1971, together with lax monetary policy, meant that there was strong reflation, the near-panic of late 1971 and early 1972 was accentuated by a belief among many people that reflation could come quickly after a policy change. For example, some Ministers had been predicting that the rise in unemployment would quickly be influenced by the July 1971 mini-Budget. By the winter, it was clear that this would not happen and the pressure was for further action. Similarly, the CBI and TUC, both of which failed to recognise how strongly demand would increase in 1971 and 1973, pressed hard for increases in public investment. Even after the increases of November 1971, press comments suggest that a third reflationary Budget for 1971 was being discussed in Whitehall in December.

The pressures for further reflation, with all the problems this was to cause, stemmed from a failure to recognise how much reflation was already being generated by the measures which had already been taken.

Although it is important to recognise that lags in the economy are long, it is also important to note the rapidity with which, once the lags have worked themselves out, apparently irreversible trends can reverse themselves. In November 1971, there was "bewildered debate" on unemployment in Parliament

and violent demonstrations against unemployment outside it. In the next few months, the crude unemployment total reached 1 million and debate in the media concentrated on the "moan about the million". Yet, very soon, in May 1972, there was the biggest ever monthly drop in the crude unemployment figures - a fall of 100,000 in one month. And unemployment continued to fall during 1972 and 1973.

Similarly, in May 1972, low industrial investment was still "a worry". Only a year later, however, a CBI survey showed business confidence at unprecedented levels. And within a further 6 months, the price of oil had rocketed, the balance of payments was in unprecedented deficit, and the boom was over.