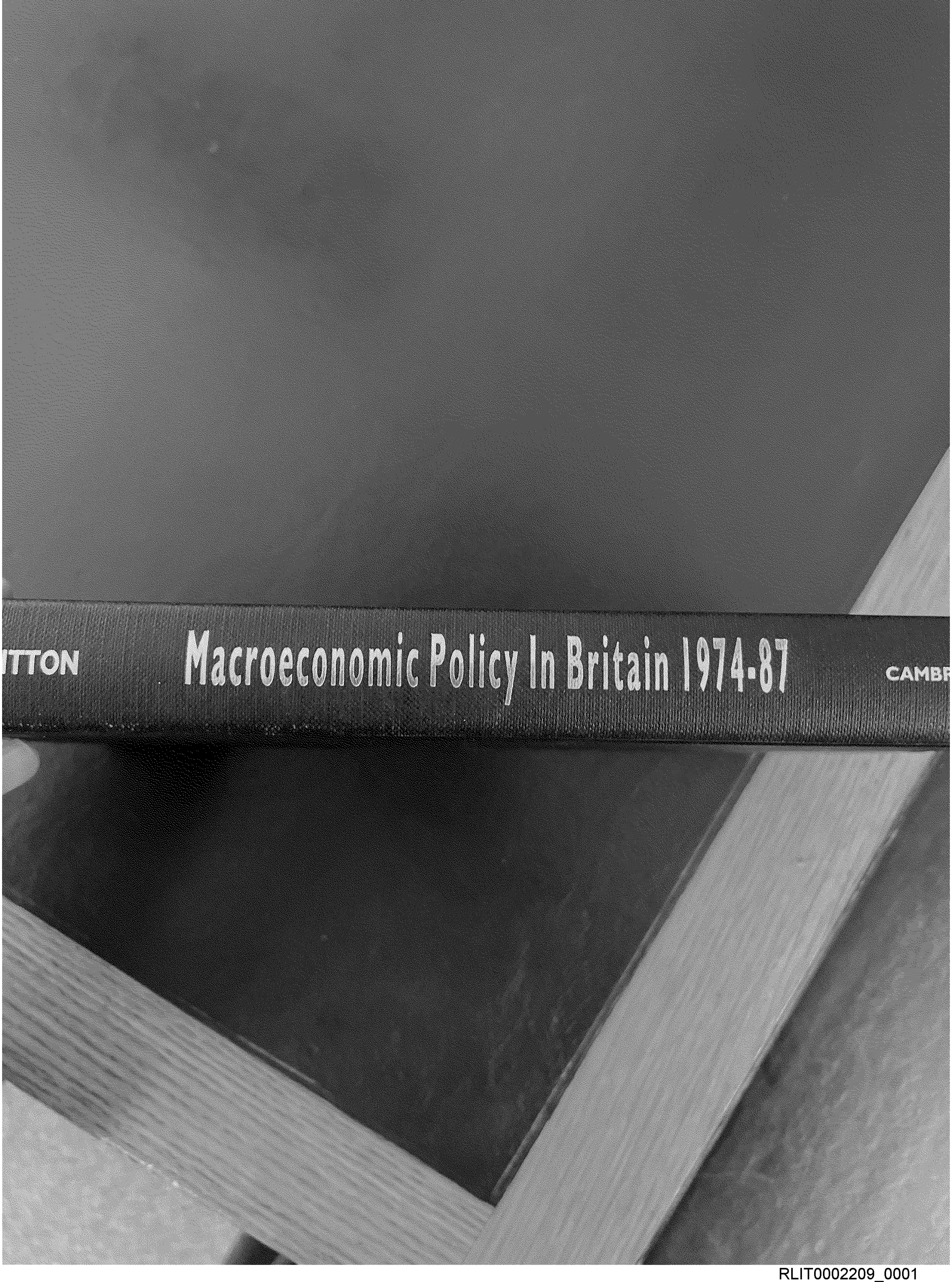
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Macroeconomic Policy In Britain 1974-87
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regain control of the money supply. Attempts had already been made to curb its growth by calling special deposits, but they had met with little success. In September the banks were asked to restrict lending to consumers and property speculators. More significantly perhaps, interest rates began to rise substantially. Minimum lending rate rose from 7½ per cent to 13 per cent between June and November. The period of expansionary monetary policy was at an end. The stock market price index, which had been drifting down gradually ever since 1972, now fell sharply in November and especially in December of 1973.

The mini-budget of 17 December 1973 was the last major act of economic policy under the Heath government, and it put into reverse the strategy of expansion that had characterised the previous two years. Further and much larger cuts in public spending were announced for 1974/5, hire purchase controls were reintroduced and a new method was adopted for the control of the banking system. By this time crisis point had already been reached for the world as a whole through the action of the oil producers, and for the United Kingdom in particular through the action of the miners. The December mini-budget, however, was not a response to OPEC or to the miners, but to the economic indicators, especially the balance of payments and the rate of inflation. The 'experiment' of the Heath government with expansion was seen to have failed. The reasons for that failure were debated again and again for much of the period with which this book is concerned.

The new method of controlling the banking system, the Supplementary Special Deposits Scheme or 'corset', was a return to direct quantitative intervention. The steep increases in interest rates had not had the desired effect of reducing bank lending and the growth of bank deposits. The scheme introduced as 'Competition and Credit Control' was shown to be technically defective. Its replacement was known as the 'corset' and it did indeed reduce the unhealthy-looking bulges in the monetary statistics.

Initially the action of Middle-Eastern oil producers threatened the availability of oil to the West, but by the end of the year this threat had been replaced by the shock of an unheard-of increase in the price of oil. The price of oil had already doubled in response to cutbacks in supply when they were redoubled by OPEC from 23 December. The effect on the world economy is described in Part 3 below. In common with other oil-importing countries the United Kingdom was faced with a change rather similar to an increase in indirect taxation. Oil was so widely used in production that the general level of prices was bound to rise. To the extent that the rise was limited, for example by price controls, company profits and liquidity would suffer; to the extent that prices did rise the real value of personal income would fall, depressing demand for consumer goods and stimulating demand for higher wage increases.

The oil crisis may also have encouraged the militancy of the coal miners and it certainly strengthened their bargaining position. Their overtime ban began on 8 November, the day after Stage 3 of the incomes policy was announced. By 13 December it was clear that coal stocks were dangerously low and a three-day working week for British industry was announced to take effect from 1 January 1974. Further meetings failed to break the deadlock. The government refused to break its own incomes policy and the miners voted by a large majority in favour of a strike. The Prime Minister then called a general election for 28 February, but the strike went ahead nonetheless.

The complete breakdown of incomes policy on this occasion was another failure of the Heath government that left its mark on subsequent events. Some drew the conclusion that incomes policies would never work and that a quite different approach was needed to the problem of inflation, and hence to economic policy generally. Others saw the miners' action as more overtly political and concluded that incomes policies might still be available but only to governments that had the political support of trade unionists. After the fall of the Heath government the debate over economic policy became much more explicitly party-political and it became much more difficult to discuss economics at all in a politically neutral way. It is quite difficult to do so even today.

3

THE LABOUR GOVERNMENT 1974–9

BETWEEN TWO ELECTIONS, MARCH–OCTOBER 1974

The result of the general election on 28 February 1974 was not decisive. The Labour Party had the largest number of seats, but no absolute majority. They were able to form a minority government, but it was clear that the political crisis was not over: there would have to be another election, and another electoral campaign, before the new government was to become fully effective. Thus the seven months from March to October 1974 were a period of transition, a period of political weakness exceptional in postwar British history. The circumstances in which the Labour government came to power further reduced their freedom of action. They owed, or seemed to owe, their electoral success, such as it was, to militant industrial action by the miners. This was an embarrassment to the new government, especially its more moderate members, and it further inhibited their actions especially in the field of economic policy.

The new government was headed by Harold Wilson, with Denis Healey as Chancellor. The new cabinet had many other members with experience of, or interest in, economic policy. The two ex-Chancellors, James Callaghan and Roy Jenkins, who were Foreign and Home Secretaries respectively, were both regarded as moderates. But there were others in the cabinet with a reputation as radicals in economic policy, such as Michael Foot at the Department of Employment and Tony Benn at the Department of Industry.

The Labour government of the 1960s had set out with the intention of recasting economic policy within the framework of a National Plan. The aim had been to increase the influence of government on economic development, and to mobilise private sector resources for a consistent set of national economic objectives. The plan had also been meant to ensure that the behaviour of government itself was consistent over time, rather than lurching from one direction of policy to another in the notorious cycle of 'stop' and 'go'. That aim had not been achieved. On the contrary, the 1967 devaluation had been followed by an exceptionally severe 'stop' period when the balance of payments proved slow to respond.

Recollection of these events of some years previously was important to the approach to economic policy adopted by Labour leaders when they regained office in 1974. They did not write another National Plan, neither did they recreate the Department of Economic Affairs. The Treasury's leading role in economic policymaking was not challenged in the same way again. On the other hand economic policy was not seen simply in traditional Treasury terms. The crucial issue in 1974 and for several years thereafter was seen as pay, and hence economic policy was seen quite largely as a process of negotiation with the leaders of the TUC. In the circumstances of 1974 it is perhaps understandable that no clear medium-term framework for policy emerged from these negotiations. It was more a matter of trying to limit the immediate damage to the economy from the critical situation in which the new government took over. Having failed, for that reason, to provide a clear framework for policy at the outset, the subsequent moves made by the Labour government during its whole term of office gave the impression of responses to short-term expediency.

The first action of the new government was to pay off the miners with an increase in wages more than double that available to them under Stage 3 of the Heath government's income policy. Full working on the coalfields was resumed. They were also quick to repeal the previous government's Industrial Relations Act and even cancelled the tax debts of the unions which had refused to register under that Act. It remained to be seen, however, whether these moves to restore good relations between government and the unions would result in a more moderate rate of wage increase.

Statutory control of pay came to an end in July with the abolition of the Pay Board and the National Industrial Relations Court. Reliance was placed instead on the voluntary agreement of unions to comply with a new 'social contract' agreed at national level by the TUC. Pay settlements were not to be more frequent than annual and they were to provide only for compensation for increases in the cost of living. There were to be special provisions for raising the pay of women and lower-paid workers. The Price Code was to remain in being, and it was expected that price moderation would ensure wage moderation in a self-reinforcing spiral of disinflation. Meanwhile the threshold agreements which were part of the 1973 Stage 3 incomes policy remained operative, and were triggered each month after April 1974.

The close linkage of pay and prices, which was a feature of both the threshold agreements and the social contract, proved disastrous. The system which was intended to produce a downward spiral of inflation in fact produced an upward spiral. One upward impetus was given by the rise in fuel prices and another by the lagged effects of the increases in the prices of other imports during the previous year. Food prices were rising particularly fast. By the second quarter of the year the retail price index was nearly 16 per cent up on a year earlier; by the third it was up about 17 per cent and still accelerating.

At the same time as inflation was spiralling upwards the economy was moving into recession. The level of output in the first quarter of 1974 was reduced by perhaps 3 per cent as a direct result of the miners' strike and the three-day week, as stocks were run down. Some bounce-back might have been expected in the second quarter to make good lost production and rebuild stocks. In the event total output was a little lower in the second quarter of 1974 than it had been in the fourth quarter of 1973. Exports did well, but consumer spending was well down, as was also fixed investment. Within fixed investment the most obvious casualty was housebuilding. By the second quarter private sector housing starts were only half as many as they had been a year before. Industrial investment in new building and works was also falling.

The labour market was also affected. At the end of 1973 unemployment was still falling fast, lagging about six to nine months behind the output cycle. In the fourth quarter the number wholly unemployed (excluding school-leavers) fell below half a million for the first time since 1968. That proved to be the lower turning point and unemployment has never again been so low. The number of unemployed rose in the first quarter of 1974, partly as a result of three-day working. Instead of falling back when normal working was resumed in March, unemployment continued to rise at an accelerating pace. Unfilled vacancies also remained well below their 1973 peak. It was evident by the summer of 1974 that the economy was in recession, but it was very difficult, in the circumstances of that year, for the government to take measures to expand demand on anything like a commensurate scale.

There was disagreement amongst Treasury ministers and amongst their advisers as to what should be done, but the main line of policymaking might, at this period and for some years thereafter, be described as 'frustrated Keynesianism'. Policymakers saw a need for counter-cyclical fiscal policy, but were inhibited from taking decisive action by fears of yet-faster inflation and yet-wider deficits on the balance of payments.

The British situation was not very different from that of most other industrial countries. The move into large balance of payments deficit resulted from the oil price increases at the end of 1973. These affected all oil-importing countries, and all, to a greater or lesser extent, saw their balance of payments position as limiting the growth of domestic demand that could reasonably be expected for the next year or two. All, moreover, experienced accelerating inflation and a downturn in output, also in part as a consequence of the same oil price increases.

The first budget of the minority Labour government was introduced on 26 March, less than a month after the election. It was announced at the time that there would be another budget in the autumn. This March budget was described as broadly neutral in its effect on aggregate demand, if anything slightly contractionary. Both expenditure and taxation were increased, and the main effect of the changes was to redistribute to the relatively poor from companies and from the relatively well-off. Although food subsidies were substantially increased, other measures largely offset the effect of this on the general level of prices.

The second budget of the year came in July. The main change was a reduction in the rate of VAT from 10 per cent to 8 per cent, with a direct effect on retail prices calculated at 1 per cent. In a small way the British Treasury was trying to put into reverse the effects on prices and output of the OPEC oil price increases, which could themselves be likened to a tax on the rest of the world. The tax cut should also be seen in the context of the social contract which had just been agreed with the TUC. Cutting indirect taxes held back the rate of price increase, limiting the extent of the 'triggering' under the old threshold agreements, and satisfying some of the demand for increases in the real value of wages. Compared with the rate of price increase by then building up, however, it was at best only a small abatement of inflationary pressure. Compared with the mounting signs of recession, the reflationary effect of the July budget was also small. Meanwhile the Chancellor was planning his November budget in which more fundamental tax changes were to be made. That, however, had to await the achievement of a majority for Labour in Parliament after the October general election.

If minimum lending rate is used as a measure of monetary policy, that, as well as fiscal policy, was broadly neutral throughout 1974. There had been a sharp rise of interest rates in the latter half of the preceding year, and its lagged effects may have been felt during 1974, for example in the housing market. Real interest rates, as conventionally measured, on the other hand fell sharply. Nominal interest rates (on Treasury bills) fell gradually from 12¼ in the first quarter to 11¼ in the fourth, whilst inflation, measured over the preceding twelve months, rose from 13 per cent to 18 per cent. Real interest rate on this or any other likely definition became substantially negative.

The failure of interest rates to rise sufficiently to offset inflation was not an altogether new phenomenon, neither was it confined to this country. But it raises some profound questions to which we shall return at a later stage of this study. For the present, we shall simply remark that it created considerable confusion in the minds of those concerned with monetary policy as to whether that policy was very lax (as measured by real interest rates) or broadly neutral (as measured by nominal interest rates). Indeed it was also possible to argue that policy was very tight, if it was measured by the growth of the monetary aggregates.

The Supplementary Special Deposits Scheme introduced at the end of 1973 seems to have done what it was intended to do, by slowing down the growth of bank deposits and bank lending to the private sector. The broad aggregate £M3 rose by 11 per cent between the fourth quarters of 1973 and 1974, compared with 27.1 per cent over the preceding four quarters. In real terms £M3 was falling fast. The corresponding changes in the 'counterparts' to the growth of the money supply were an increase in non-bank purchases of public sector debt, a fall in sterling lending to the United Kingdom private sector and an outflow corresponding to the deficit on the balance of payments. The public sector borrowing requirement, on the other hand, rose substantially, as would be expected when the economy was moving into recession. Ironically this period of abrupt slowdown in the growth of the monetary aggregates was one of the few periods in recent history when the authorities had no declared objective for those aggregates to meet. But, given the size of the increase that had taken place over the two previous years, it may have been a case of 'closing the stable door after the horse had bolted'.

The visible trade balance was in unprecedented deficit: in 1974 almost £5½ billion, compared with £2½ billion in 1973. But this was explained, and to some extent excused, by the increase in the price of oil. The oil-producing countries had large surpluses to dispose of, and in 1974 they devoted substantial sums to the purchase of sterling assets. This was important because it helped to hold up the sterling exchange rate despite accelerating inflation and a severe imbalance of trade. Between 1974 and 1973 the exchange rate index fell by only about 3 per cent.

One reason for the relative strength of sterling in the aftermath of the oil price increase may have been the knowledge that the United Kingdom was itself potentially a rather large-scale oil producer. Certainly this factor played a part in calculations of the size of balance of payments deficit it would be (in some sense) appropriate for it to maintain. The United Kingdom, unlike other oil consuming countries, might reasonably plan to borrow on the strength of future oil revenues, even though oil production in the North Sea did not in fact get under way until 1977.

The stability of sterling in 1974 implied some loss of cost and price competitiveness vis-à-vis other industrial countries. Between the fourth quarters of 1973 and 1974 the loss was only about 3½ per cent as measured by relative export prices, but as much as nearly 10 per cent on the IMF index of relative unit labour costs. Export prices were lagging behind the acceleration of wage inflation, thus adding to the pressure on the profit margins of manufacturers.

The pressure on profit margins was a matter of wider concern as domestic prices were constrained by the Price Code. For some time a risk had been identified that inadequate company liquidity would force de-stocking and a labour shake-out, and would result in widespread bankruptcy. That would deepen the recession and prolong it into 1975. The obvious palliative was to loosen the Price Code, but that would add to inflation. The problem was put off until the General Election was out of the way.

That election was held on 10 October. The Labour Party gained eighteen seats, enough to give it a working majority, although not an overall one. This was the second defeat of the year for Edward Heath and was followed.

early the next year, by his replacement as leader of the Conservative Party by Margaret Thatcher. Even before the election of October 1974, leading Conservatives, most notably Keith Joseph, were changing quite profoundly their ideas about economic policy. They were publicly and explicitly disowning the policies of the Heath government and blaming them for the subsequent inflation. As early as 1974 the ideas which guided the next Conservative government were taking shape.

FASTER INFLATION, DEEPER RECESSION: OCTOBER 1974–DECEMBER 1975

The second general election of 1974 resolved the political crisis and provided an opportunity for a firmer and more consistent approach to economic policy. Although its majority was small and dependent on support from minor parties, the Labour Party was able to retain office for almost the maximum five-year life of a Parliament.

At the end of 1974, however, one political problem remained outstanding. The Labour Party had promised to hold a referendum on the continuation of British membership of the EEC. The Labour Party, and even the government, were divided on this central issue of foreign and economic policy. It was believed moreover that this referendum was to be interpreted as a vote of confidence by the public in the management of the economy by the Prime Minister and the Chancellor. The actual outcome was not in much doubt as most Conservative Party supporters would vote for continued membership. Nevertheless, the prospect of facing the electorate again on the issue of economic policy may have been a constraint on the government's freedom to take necessary but unpopular policy action. In the event the referendum held in June 1975 went two-thirds in favour of membership and one-third against, a sufficient endorsement of EEC membership, if not an enthusiastic one.

The economic situation confronting the government after the October election was extremely worrying, even though the subsequent depth of the recession was not foreseen at the time. Inflation was running at over 15 per cent and rising, the balance of payments was in deep deficit and unemployment had turned decisively up. The social contract negotiated with the unions in the summer was not working as intended. With wage costs accelerating and import prices still rising fast whilst output prices were constrained by the Price Code, the corporate sector was heading for financial crisis. The stock market, which had been falling gradually through 1973 and in the early part of 1973, dropped sharply at the end of the year to a low point in December, lower (in nominal terms) than at any time since the early 1950s.

Insofar as the policies followed for the next few years were not constrained by other considerations, they were governed by the cautiously Keynesian approach that had evolved in the Treasury and the Bank over the preceding 30 years. The Chancellor's principal official advisers were the Permanent Secretary, Sir Douglas Wass, and the Chief Economic Adviser, Sir Bryan Hopkin, both appointed in 1974, while the Governor of the Bank of England was advised by Kit MacMahon and Christopher Dow. All these belonged, with various degrees of qualification, to the same school of thought. A rather different tradition, which was undoubtedly Keynesian but less cautious, was represented at the Treasury by Lord Kaldor and more briefly by Wynne Godley. The monetarists were winning over the press, the city and the Conservative Party but they had as yet scarcely a toe-hold either in the Treasury or in the Bank.

In November 1974 the fourth budget within twelve months was introduced. Its main purpose was to ease the pressure on the profits and liquidity of the company sector. Relief was given from the burden of taxation on stock appreciation arising from accelerating inflation. The Price Code was eased to allow firms to pass on most of the increase in labour costs, and to pass on more if they were increasing investment. Subsidies to nationalised industries were to be limited and VAT on petrol was raised to 25 per cent. The measures may not have seemed helpful, in that they would raise prices and cut consumer demand, as well as raising public sector borrowing. They were seen, however, as a response to a crisis for the company sector, which required urgent relief. Indeed the action taken could be criticised as 'too late', delayed solely so as to get the election out of the way; it could also be criticised as 'too little' in view of the behaviour of companies the following year.

The deepening of recession in 1975 was not generally expected at the time. The average estimate of GDP now shows a fall of 0.8 per cent year-on-year. As late as Easter 1975, however, the Treasury, the National Institute and the London Business School all expected rises year-on-year of about 1–1½ per cent. The depth of the recession was unprecedented since the war, and in other ways it did not conform to the pattern of earlier downturns. Recession was not confined to the United Kingdom; one component of *our* recession therefore was the fall in exports, after a rather good year in 1974. Fixed investment, on the other hand, considering that this was the second year of a recession, held up rather well, showing only a 2 per cent fall year-on-year. The personal sector savings ratio rose to the record level of 12 per cent (compared with 11 per cent in 1974). This was variously explained by the rise in inflation, the fall in asset values and the restriction of credit.

Another major contribution to the fall in expenditure was a turn-round from positive to negative stockbuilding. It was not unexpected to see some destocking in the latter part of a recession. There was destocking, for example, in the first half of 1972, around the lower turning point of the preceding recession. But the rundown of stocks in 1975 was on a quite different scale and more widespread across industries. For manufacturing industry alone the turn-round in stocks between 1974 and 1975 amounted to over £5 billion (at 1985 prices) or 2.1 per cent of GDP. With hindsight this could be explained in a variety of ways, but one possibility must be that the pressure on company liquidity, despite the November budget, had had the feared result of prolonging and deepening the recession.

Despite the recession and the financial pressure on companies, employment held up reasonably well in 1975, falling less than ½ per cent year-on-year. That was enough, however, to produce a steep rise in unemployment. In the fourth quarter of 1974 the number wholly unemployed, excluding school-leavers and seasonally adjusted, was just under 600,000; a year later it had passed the million mark. The lower turning point of the cycle is identified by the CSO as falling in August 1975. The complete cycle, trough to trough, since February 1972, was only 3½ years in length, short compared with the typical postwar cycle and much shorter than the two cycles that followed. It was also exceptionally steep, both in the upturn and in the downturn. Between 1973 and 1975 the economy moved from euphoria to despair, from possible triumph to obvious disaster.

Despite all this the 1975 budget was mildly contractionary. Its purpose was not to 'manage' total demand, but to shift resources from domestic demand to the improvement of the balance of payments and to reduce the size of the public sector borrowing requirement. Income tax, VAT and specific duties were all raised. Public spending was cut, especially spending on subsidies. On the other hand tax relief on stock appreciation and relief from the Price Code for purposes of investment were extended. A temporary employment subsidy was announced to encourage companies to defer redundancies. The estimated overall effect of the budget was to reduce demand and employment whilst raising the price level by more than 2½ per cent. In the circumstances it was a very un-Keynesian budget. Priority was given to reducing two deficits which were seen as closely related: the fiscal deficit and the deficit on the balance of payments.

The public sector borrowing requirement (PSBR) was hardly a concern of policymakers at all until the mid-1970s. The expansionary policies of the Heath government had started from a position close to balance on the PSBR. In successive years the requirement grew, but it was the combination of recession and inflation in 1974, and especially in 1975, that produced an unplanned and unexpected figure of over £10 billion for the PSBR, about 10 per cent of GDP. It was widely feared that the finances of the public sector were out of control.

Despite this worrying development in the public sector, the growth of the money supply in 1975 slowed down. Year on year the rise in £M3 was less than 6 per cent, far less than the rate of inflation. Sales of public sector debt to the non-bank private sector rose strongly and the current account deficit contributed to another negative adjustment for external financial flows. But the most dramatic change was in bank lending to the private sector which was actually negative in 1975. The 'corset' was no longer in place, having been suspended by the Bank of England in February, so the reason for the contraction in credit may have been as much on the side of demand as of supply. But the banks may have also been wary of lending, as the recession was accompanied by a rise in bankruptcy, most notoriously amongst speculative builders. For whatever reason, it was another example of monetary restraint successfully maintained at a time when no special efforts were being made to that end.

The other worrying deficit, the deficit on the current account of the balance of payments, was reduced, but not eliminated, in 1975. This improvement was entirely in the visible balance, in which the value of imports rose year-on-year by only 4 per cent, whilst that of exports rose by 18 per cent. The volume of imports fell sharply as industry ran down its stocks of materials and as consumer spending fell. The terms of trade moved in favour of the United Kingdom because the domestic rate of price inflation was faster than that of the rest of the world. Neither of these considerations suggested that the improvement in the balance of payments would last long; on the other hand there was reason to hope that a higher level of world activity would, sooner or later, provide a better market for British goods. One aim of the budget policy was to keep resources available to meet such demand, should it emerge; another was to prevent imports from rising too fast.

The exchange rate for sterling was weak throughout 1975 and the fall, year-on-year, was about 8 per cent. However, given the rate of inflation actually being experienced in the United Kingdom, relative to inflation abroad, it should be said rather that the exchange rate was strong. The real exchange rate, that is the ratio of producer prices in the United Kingdom to those of major competitors converted into sterling, rose by about 3 per cent. The index of relative export price competitiveness showed a change of similar magnitude. This development threatened to reduce the share that British industry could actually win of world markets, when the upturn in the world economy eventually came.

The relative strength of sterling in 1975 may have owed something to the movement of interest rates abroad. The three-month eurodollar deposit rate fell abruptly at the beginning of the year from about 10 per cent to about 7½ per cent and for the rest of the year fluctuated at about that level, or rather below. Sterling interest rates also eased, but less sharply. The uncovered differential on three-month deposits favoured sterling against the dollar throughout the year by a margin of about 3 percentage points. This differential may not, however, have been wide enough to compensate for the expected depreciation of the pound or for differences in the expected rates of inflation in Britain and the United States. Sterling was also helped by the traditions of some Middle East oil producers who were accustomed to keep their financial wealth in London. Moreover the United States was regarded as an ally of Israel, so the alternative of placing the new oil wealth in dollars seemed less attractive.

In 1975 most countries experienced rapid inflation, but inflation at a slower rate than in the preceding year. In the United States for example the inflation rate fell from 11 per cent to about 9 per cent, whilst in Japan it fell from nearly 25 per cent to nearly 12 per cent. The United Kingdom was an exception, in that inflation rose, and rose markedly, from 16 per cent in 1974 to over 24 per cent in 1975. At the beginning of 1975 the retail prices index was 20 per cent up on a year earlier. That percentage continued to climb through the spring and the summer, helped by the budget changes, reaching a peak of 26.9 per cent in August.

The British public had no experience of rates of inflation like this and they were not well-prepared to cope with them. Insurance contracts for example were not indexed, neither were many private pension schemes. Inflation, therefore, had a redistributive effect between individuals which was arbitrary and inequitable. Lenders generally lost and borrowers, especially the public sector, gained. The experience of the mid-1970s led, over the years that followed, to a much wider adoption of index-linking in a variety of contracts and other financial arrangements. The government itself acknowledged the problem as early as January 1975 by introducing index-linked National Savings contracts, although they were at first restricted to small savers and those over pensionable age. The Sandilands Committee prepared a report on the inflation adjustment of company accounts which was published in September.

Few countries had experienced inflation continuing for more than a year at around 20 per cent. The main precedents were for 'creeping' inflation, about 5 or 10 per cent a year, on the one hand and 'hyper inflation' on the other. There was therefore a real fear at the time that inflation would rise explosively. This influenced even those who would have been quite prepared to tolerate inflation at 5 or even 10 per cent in perpetuity. It made trade unionists in particular more ready to accept, even to welcome, the substitution of a much tighter form of incomes policy for the social contract which had failed in its purpose.

On 11 July the government published a White Paper, 'The Attack on Inflation'. This set a maximum pay rise of £6 per week, with no increase at all for those earning more than £8,500 a year. The flat-rate limit was deliberately chosen to favour the lower paid, narrowing differentials and making for a more equal distribution of earned income. This helped to win the support of some large trade unions, and was welcomed by many in the Labour Party. Its effect on incentives and the efficiency of the labour market was relatively little discussed at the time. The policy was backed up by reserve powers making it illegal for employers to exceed the pay limit.

The growth rate of average earnings did indeed slow down markedly after this new policy was introduced. The earnings index compiled at that time for all production industries and some services showed a rise of 26½ per cent in the year to the third quarter of 1975, but only 13½ per cent in the next twelve months. The rate of price inflation also gradually began to abate. By the end of the year it was below 25 per cent and falling significantly each month. Those who feared hyper-inflation could begin to hope that the country was pulling back from the brink.

As soon as inflation began to abate, or perhaps even before, the focus of attention shifted to the alarming rise in the level of unemployment. The 'headline total', not seasonally adjusted, first exceeded a million when the school-leavers joined the register at the end of the summer. Little could be given by way of conventional demand stimulus, although the Chancellor, in yet another package of measures just before Christmas, eased the restrictions on consumer credit. For the time being at least the policy response was directed rather to measures which would now be called microeconomic.

These were of two kinds. The first was characterised by the Industry Act which became law in November. This introduced a mild form of indicative planning and established the National Enterprise Board to take a public stake in industry and help to turn round ailing businesses. There was provision for direct help to firms on a variety of grounds or pretexts and in subsequent years quite significant sums of public money were spent.

The other kind of initiative was a more direct response to unemployment and consisted of special measures designed to create or preserve jobs at a cost to the exchequer far lower than that of a conventional reflation. In August the Temporary Employment Subsidy came into effect, giving help to employers for up to six months if they would reverse or delay plans to make workers redundant. The extent of employment subsidies was widened by further measures announced in September and again in the December package.

This was the beginning of an approach to employment policy that proved far from temporary. It was the result of a political and social need for government to do something about unemployment, even though its hands were tied for the present on macroeconomic policy. But this turned out to be a continuing, or at least a recurrent, situation and the need for special measures became greater, not less. They were never designed as a coherent strategy; they rather emerged as a series of stop-gaps, more or less hastily conceived and put in place. In the event they were to become a major element, even *the* major instrument, of policy to promote employment. At the end of 1975, however, the issue was not seen that way. It was still a question of waiting for the appropriate moment to bring in the general reflation, the major reflation, that would restore full employment in the sense of the 1950s and 1960s. This was the prelude to the dramatic events of 1976.

THE YEAR OF STERLING CRISIS, JANUARY–DECEMBER 1976

The economic recovery which began in the latter half of 1975, continued quite briskly through 1976. Year-on-year the rise in the average estimate of

GDP was 2½–3 per cent. Through the year, fourth quarter to fourth quarter, the rise in the output estimate, the best for short-term comparisons, was over 4 per cent.

Stockbuilding became positive during the year, reversing some of the heavy destocking that had deepened and prolonged the recession. This could be seen as part of a normal bounce-back in the recovery stage of the trade cycle. Exports also made an important contribution to the recovery; the volume of goods and services combined rose by 10 per cent fourth quarter on fourth quarter. The personal sector savings ratio fell back a little.

This rise in output was enough to hold back the increase in unemployment, but not to reverse its trend. This was disappointing, since vacancies turned up again from their low point in the first quarter of the year and were rising quite sharply by the end. Moreover, the fall in employment also came to an end in the second quarter, to be followed by a slow recovery.

The rate of inflation was still very high at the beginning of the year, but falling significantly each month. From 23.4 per cent in January it came right down to 12.9 per cent in July before turning up again, for reasons to be discussed below. The £6 pay policy worked well, and the virtuous circle of disinflation that had proved impossible to initiate since the days of the Heath government seemed at last to be getting under way. The current account of the balance of payments was actually in surplus in the first quarter of the year, a very welcome improvement from the yawning deficits that had followed the oil price increase at the end of 1973. Later in the year there were deficits to follow, but they were on quite a modest scale, such as one might well expect to be financed easily enough by a country now preparing to be a significant producer of oil.

Another encouraging sign was the reduction in public sector borrowing, although that admittedly was slower than had been hoped. The PSBR in 1976 was £9 billion compared with £10 billion the year before. This fall in public sector borrowing was nevertheless accompanied by a recovery in the growth of £M3 to about 9 per cent in 1976, although even that figure was well below the rate of inflation, implying a fall in the real value of the stock of monetary assets outstanding.

This acceleration of monetary growth was made possible by the absence of any direct controls on bank lending, the Supplementary Special Deposits Scheme having been suspended in the early months of 1975. Interest rates were being continuously reduced at the beginning of 1976. By a succession of quarter and half-point reductions, minimum lending rate crept down from its high point of 12 per cent in October 1975 to 9 per cent in March the following year. Eurodollar rates meanwhile were much lower, about 5½ per cent and also falling a little. Looking at all these indicators many years after the event it is not at all obvious why this was to be the year of the great sterling crisis.

The Labour government up to this point had been wary of adding to the level of domestic demand and activity, because inflation was so fast and because the balance of payments was in large deficit. Now in the early part of 1976, for the first time, the opportunity seemed to be there to revert to something like the policies of 1972. Although output was now recovering, and although unemployment was hardly rising any more, the case for expansion was bound to be considered seriously. The level of unemployment, well over a million, still seemed inexcusably high. The Keynesian tradition, to which most ministers and officials still subscribed, told them that their duty was to seize the first opportunity to reflate. The policies of 1972 did not just involve tax cuts; they also meant allowing the exchange rate to fall so that the current account would correct itself, and so that export demand could add to the growth of output. (It was reasonable to hope, by 1976, that the fall in the exchange rate need only be quite modest, since the prospect for the balance of payments in the late 1970s would be much better when North Sea oil production came on stream.) To contain the inflationary effects of depreciation and demand pressure in the domestic economy the package had also to include restraint on pay.

Policies of this sort might appeal to the government, but they had lost any appeal they might once have had in the City or in other international financial centres. The press would also be unsympathetic. Most of the ills that had fallen on the economy since 1972 were widely attributed to the rashness of the Heath government. Similar policies followed by a Labour government would be met with even more scepticism and suspicion. The government did not actually need to do or say very much to produce a financial crisis. The level of mutual trust was so low between the authorities, the press and the markets that a crisis could arise on almost any pretext.

In February the Chancellor announced extra public spending mainly designed to increase employment. The package included several of the ingredients already becoming familiar: more assistance for industrial investment, more training places, more job creation, an extension of the Temporary Employment Subsidy. The public spending plans for 1975/6 and 1976/7 were both being exceeded, but cuts were announced in the February White Paper affecting plans for subsequent years and proposing that the total volume of spending be held flat for several years.

The budget introduced in April proposed quite substantial cuts in income tax, but made them conditional on agreement by the TUC to a low pay norm for the next stage of incomes policy. This made explicit the idea of a macroeconomic bargain that was already implicit in earlier attempts to combine incomes policies with reflation. The government's contribution to the deal could be interpreted either as the creation of extra employment or as higher take-home pay for the workers. Whatever the political implications of allowing the unions to influence taxation in this way, the economic effects of the deal seemed to benefit everyone.

There was another way of looking at the proposed deal, however, which made it look much less attractive. The Chancellor's approach to reducing inflation involved increasing the pressure of demand in the domestic economy and hence, presumably, increasing the deficit in the balance of payments. It also involved raising public sector borrowing and hence, presumably, the growth of the money supply. This did not look like orthodox economics to the city, the press or foreign bankers, least of all to those recently converted to the ideas of the monetarists.

This was not the only problem with the proposed deal over the budget. The TUC failed to deliver their side of the bargain. The Chancellor had over-played his hand. Scarcely a week after the budget was presented, the TUC leaders rejected his proposal of a 3 per cent norm, although they said they would continue their discussions with the government. The Incomes Policy White Paper, which was published in June, set out a 5 per cent norm but gave less to higher paid workers and more to lower paid. There were also modifications to the Price Code allowing prices to rise a little faster. In the event, the rise in the earnings index slowed down to under 10 per cent over the next twelve months, compared with nearly 14 per cent in the twelve months before.

Meanwhile sterling was showing signs of serious weakness. Early in March its value fell below two dollars for the first time. The authorities did little or nothing to stop its fall. On the contrary minimum lending rate edged down to 9 per cent and the yield on three-month inter-bank deposits suggested that a further fall was expected. Later in the same month the French effectively devalued the franc by leaving the 'snake', that is the joint EEC currency alignment against the dollar. There was a suspicion in the markets that the British authorities would welcome a similar depreciation of the pound. That suspicion was indeed well-founded, although it would be wrong to say that a definite decision had been taken in the Treasury that the pound should be devalued.

Between the first and second quarters of the year the effective sterling exchange rate index fell by 9 per cent. The dollar rate, which was still much more widely quoted, fell to $1.81, down nearly 10 per cent in the quarter. The authorities' attempts to limit the fall of the pound were soon reflected in the balance of payments statistics. In the first quarter the reserves actually increased, although this was made possible only by drawing on IMF loan facilities. In the second quarter, large-scale official borrowing was not enough to prevent a fall in the reserves.

Interest rates were raised sharply in April and again in May. There then followed a period of relative calm in the foreign exchange markets. About the same time, however, the stock market turned down. It had recovered well from the very depressed levels reached at the end of 1974. For much of the subsequent year it was on an upward trend, which accelerated as interest rates came down towards the end of 1975 and in the early months of 1976. When interest rates were raised again in March the stock market turned down.

The markets, and the press, were not to be satisfied by increases in interest rates. They believed that the government's whole strategy was rash and ill-conceived. In particular they thought that it paid too little attention to the size of the PSBR, and they were worried that public spending was out of control. In July, partly in response to this pressure, public spending cuts of £1 billion for 1977/8 were announced. It was impossible at this stage to get ministerial agreement to a larger package. At the same time the Chancellor gave a forecast of the money supply growth for the current financial year. It was a forecast, not a target, but still represented a significant concession to public demand for a new way of conducting and presenting monetary policy.

These concessions were not enough. As sterling continued to fall the range of options open to the government narrowed. The scale of the depreciation was already affecting the rate of inflation: from its low point of 12.9 per cent in July the rate (measured over the preceding twelve months) was rising again, to reach 15 per cent by November. The exchange rate could not simply be left to find its own level.

In October alone sterling fell by more than 5 per cent on the effective exchange rate index. By then it was 23 per cent down on the same period of the preceding year. Official intervention continued on a considerable scale and minimum lending rate was raised, to 13 per cent in September, and to 15 per cent in October. It was all in vain. There seemed to be no limit to the fall in sterling that the market might dictate.

The pressure from the press and in the markets could be satisfied if the government applied to the IMF for a loan. The loan itself would provide funds to continue intervention in the foreign exchange markets. More importantly the terms on which a loan could be made available would require a change in the direction of economic policy. It would limit the freedom of action of the government, and that was precisely what the markets and the press needed as reassurance.

The only other option open to the government was to cut itself off from dependence on financial opinion altogether. To do this it would have to impose tighter exchange control and probably restrict trade as well. Some saw a strategy of this kind, if only for a short period, as the only way of pursuing an independent economic policy, and the only way of managing the level of output or employment in the domestic economy. Perhaps British industry would only flourish under protection. The new Prime Minister, James Callaghan, who had succeeded Harold Wilson earlier in the year, presided over a very divided Cabinet at this stage.

The terms proposed by the IMF, when negotiations for a loan were eventually completed, were not as onerous as might have been feared. As with all loans of this kind they required a commitment to a target path for Domestic Credit Expansion (DCE). This hybrid was neither a monetary aggregate nor a measure of fiscal policy, but it was convenient from the IMF's point of view as it put pressure on borrowing countries both to slow down the growth of the money supply and to improve their balance of payments position. By accounting identities, to which British financial experts were now getting accustomed, DCE was approximately equal to the growth of £M3 plus official financing of the balance of payments. The numbers chosen for the Letter of Intent signed by the British government were not intended to be very difficult to achieve, but they were a binding commitment. There were further commitments to a progressive reduction in the PSBR and cuts were made in public spending plans both for 1977/8 and 1978/9. An increase was also made in rates of indirect taxation on tobacco and alcohol. The credibility of these commitments had been increased in November by the reimposition of direct controls on bank lending to the private sector by means of the SSD scheme (the corset). The government undertook to keep the scheme in being at least for the immediate future.

The market response to the negotiation of an IMF loan on these terms was immediate and favourable. Sterling stabilised at $1.65 and soon the authorities were intervening to rebuild their foreign exchange reserves. The questions in the following year were to be whether the exchange rate should be allowed to rise again and how far interest rates should fall. The turn-round of sentiment seems out of proportion to the policy measures actually announced. But more had changed than the public spending plans for the late 1970s. The plans for a protectionist strategy had been decisively rejected. Moreover the 'cautious' Keynesians themselves had also suffered a severe setback. The combination of reflation and incomes policy with a permissive attitude to depreciation had been shown to be potentially unstable, at least if it was rejected by market sentiment and the press.

The 'cautious' Keynesians, both ministers and officials, remained in power for a few years yet, and the approach to economic policy which they supported was not altogether abandoned. But their intellectual position was much weakened by the events of 1976 and quite different ideas about the aims and instruments of policy were becoming influential even in the Treasury and the Bank. Moreover, so long as the country was in debt to the IMF the intellectual position of the Fund staff (and of the governments of the member countries which ultimately controlled the IMF) mattered as much as the views of ministers and officials in London.

FOLLOWING THE LETTER OF INTENT, JANUARY–DECEMBER 1977

The economic policies recommended to the British government by the staff of the IMF centred on the achievement of export-led growth. In this they were not very different from the policies recommended to other member countries who found it necessary to borrow from the Fund. The first priority was that the borrowers should put themselves in a position to repay the Fund; the second was that the level of domestic activity in the borrowing country should not be made to suffer unnecessarily. Since direct controls on imports were anathematised, the only way to reconcile these requirements was export-led growth. Happily from this point of view in the case of the United Kingdom at the end of 1976, the exchange rate had fallen so low that the prospects for an increasing share in world trade seemed very good.

On the IMF's index of normalised relative unit labour costs (1985=100) in the fourth quarter of 1976 the United Kingdom stood at 68.1, the lowest level recorded since the series began in 1963. It was lower, for example, than it had been in the aftermath of the 1967 devaluation, when at its low point it was still 75.1 on the same scale, or after the Heath government let sterling float in 1972 when it fell to 75.8 at the end of the subsequent year. The aim of policy in 1977 was to maintain that competitive advantage by preventing the exchange rate from rising, whilst keeping down the growth of domestic costs.

The policies of 1977 were not Keynesian, in that domestic demand was constrained by the need to meet a DCE objective, and specifically by the need to cut public spending. On the other hand they were also very different from the policies followed later under the Conservatives, in that the exchange rate was kept low to help exports even though this meant that import price rises were adding to the rate of inflation. Moreover, incomes policy retained its central place in the strategy, as the published Letter of Intent itself required.

Keeping the exchange rate down proved no easy task. International confidence in Britain returned with a rush. In January the Bank of England was able to sign the Basle Agreement with the BIS under which the official sterling balances held in London by members of the old sterling area were protected by a medium-term credit facility. These balances were seen as a source of embarrassment, not a source of strength, to the authorities in the management of sterling. The return of confidence in sterling was to be used as the occasion for an orderly running down of the balances, not for their rebuilding.

On the other hand the official foreign currency reserves were themselves severely depleted and the Bank was relieved in the early months of 1977 to be able to rebuild them by selling sterling in the market. It was also a relief to be able to reduce short-term interest rates from the very high levels (up to 15 per cent for MLR) seen in the last quarter of 1976. By the end of March 1977 MLR was down to 9½ per cent.

Meanwhile the events of 1976 were having their effect on the state of the economy. Inflation (measured over the preceding twelve months) had turned up in the latter half of 1976 as the exchange rate fell. This acceleration, at a time when inflation was abating in most other countries, continued until the summer of 1977 peaking at 17.7 per cent in June. Had the exchange rate been allowed to rise as confidence returned the rate of inflation presumably would have come down rather sooner.

The path of output through the early part of 1977 is also of some interest. All three measures of GDP show a sharp rise in the fourth quarter of 1976, followed by slower growth or even a fall in the first half of 1977. The fall in the expenditure measure is quite marked, reflecting falls in most categories, including both public and private consumption. This would be in line with the strategy of the Letter of Intent and also a natural consequence of the deterioration in the terms of trade as the exchange rate fell. The CSO index of coincident cyclical indicators shows an unusual pause in the midst of an upswing, lasting about a year, from late 1976 to early 1978. Meanwhile the labour market indicators gave an uncertain or ambiguous reading with unemployment almost flat in the first quarter of 1977 and unfilled vacancies still rising.

It soon became clear that the painfully negotiated figures for DCE in the Letter of Intent were even less of a constraint on fiscal policy than had been expected, or intended. The figures for government borrowing in 1976/7 were revised down significantly, as often happens to these notoriously unreliable estimates. Moreover the return of market confidence and the expectation of falling interest rates made it very easy indeed to sell government debt outside the banking system. The risk of rapid money supply growth arose from the external component, that is from official intervention to hold down the pound in the foreign exchange market. But that intervention did not raise DCE.

The background to the 1977 budget therefore was not quite as worrying as it seemed likely to be six months earlier. Even so the Chancellor could not afford to relax as long as inflation continued at such an alarming rate. Consistently with the strategy agreed with the IMF, his main aim in the budget was the same in 1977 as in the preceding year: he wanted to use such tax concessions as he could afford to 'buy' the agreement of the TUC to another year of wage restraint. This time he overplayed his hand more seriously. He proposed a cut in the basic rate of income tax from 35 to 33 per cent, but that proposal was made conditional on agreement to a new pay limit. That agreement was impossible to obtain.

The pay limits agreed in 1975 and 1976 had been reasonably well observed and had had a visible effect on the rate of price inflation. The consequence, in 1976 and 1977, was that the growth of wages slowed down sharply. In 1976 up to the third quarter this involved little change in the real value of earnings, as price inflation slowed down more or less in line. In 1977, however, as inflation reaccelerated, real wages fell sharply. Between the third quarters of 1976 and 1977 the index of basic wage rates rose only 5 per cent, in line with Stage 2 of the incomes policy, and the old earnings index rose 8.7 per cent. The rise in the retail price index over the same period was over 16 per cent. Some re-acceleration of earnings was surely unavoidable.

What eventually emerged from negotiation was a norm of 10 per cent for wage increases and a renewed commitment to annual settlements. This was a weak form of incomes policy and it did not command much support from individual unions. Over the next twelve months the rise in both wages and earnings was in fact over 16 per cent. The strain put on the incomes policy framework following the substantial exchange rate depreciation of 1976 and the subsequent price inflation proved too great. The system of cooperation which had worked well for about two years broke down; it has not been repaired since. The Chancellor partly acknowledged his failure when he announced that only 1p of the proposed 2p cut in the basic rate of income tax was to be implemented.

The budget ran into some difficulty on other fronts as well. The government lacked a clear majority in the Commons and was obliged to change its proposals in response to backbench pressure. A proposed increase in petrol duty had to be abandoned. Of more lasting significance was the Rooker-Wise Amendment which required governments to raise personal tax allowances each year in line with inflation, except when specific exceptions are made in the Finance Act.

Despite the government's problems in relation to Parliament and to the trade unions, confidence in sterling remained strong; indeed the strength of sterling was becoming a source of considerable embarrassment to the monetary authorities. Throughout the first half of 1977 the exchange rate was held below $1.72 which was only a little above its low point in the fourth quarter of 1976. The official reserves, which had fallen to only a little over $4 billion at the end of 1976, were rebuilt to over $11 billion by June 1977 and over $20 billion by December.

Concern was being expressed that official intervention in the foreign exchange markets was adding to the growth of the domestic money supply. In the first quarter of the year DCE (seasonally adjusted) was negative for the first time in five years. Despite a positive external adjustment M3 rose quite slowly. In the second quarter, however, less debt was sold to the non-banking sector at home and, as the external adjustment was still adding to monetary growth, the increase in M3 looked more threatening. In the third quarter the external adjustment became very large indeed and M3 growth was again substantial, although DCE was again negative.

Even so the growth of M3 was still well below the rate of inflation and slower than it had been in 1976. In August the Bank of England suspended the Supplementary Special Deposits Scheme, which had been reactivated at the time of the IMF agreement and renewed in May. Clearly the growth of M3 was not a matter of overriding concern to the authorities. Interest rates continued to fall.

Minimum lending rate (MLR) had been reduced in easy stages from 15 per cent to 9½ per cent by March. The falls continued for most of the year in an attempt to stem the unwanted inflow of foreign money. By October MLR was as low as 5 per cent, the lowest level since 1964, having fallen 10 percentage points in twelve months. It was very difficult to see how a fall of this magnitude could be appropriate to domestic economic conditions, especially as inflation was about 14 per cent both in October 1976 and in October 1977. One did not need to take 'new-fangled' monetary statistics like M3 altogether seriously to believe that the attempt to hold down the pound was leading the authorities to behave in an otherwise inappropriate way.

The purpose of holding down the pound was to preserve relative cost competitiveness and promote export-led growth. Relative inflation rates, even at a constant exchange rate, were eroding that cost advantage. Between the fourth quarters of 1976 and 1977 the IMF index for normalised relative unit labour costs in the United Kingdom rose by 10 per cent, of which about half was due to exchange rate movements and about a half to relative inflation rates. Meanwhile the growth rate of exports of goods and services was actually slowing down. This may seem to show that the strategy for export-led growth was unsuccessful, but it did not mean that the gain in competitiveness was ineffective. World trade growth in 1977 slowed down from 11 per cent to under 5 per cent; exports of goods and services from the United Kingdom slowed down from 9 per cent to 7 per cent. Our performance certainly improved relative to that of other exporters, and in the year after the exchange rate fell our share of world trade rose.

This export performance, coupled with the slow growth in spending on imports (and improving terms of trade), turned the current account of the balance of payments from deficit in the first half of the year to surplus in the second. Thus one of the principal aims of the strategy agreed with the IMF was satisfactorily achieved. But it was achieved more by curtailing the growth of output, less by transferring resources to meet external demand, than had been hoped at the beginning of the year.

The extraction of oil and gas from the North Sea fields was, in 1977, for the first time making a useful contribution to the trade balance. The value of production in 1976 (mainly gas) was £0.6 billion; in 1977 it was £2.1 billion. Almost all of that increment could be seen as a direct contribution to the improvement of the trade balance. Meanwhile the slow growth of, or even stagnation in, output was having a perceptible effect on the labour market. The vacancy statistics still showed a slight rise, but this may have been due to an increase in the proportion of vacancies covered. Unemployment, which had been almost unchanged for nine months, began to rise worryingly again in the latter part of 1977.

Special attention was being paid by government to the problem of youth unemployment, which had risen disproportionately. The youth opportunities programme (YOP) was approved at the end of June. Although relatively cheap in terms of gross public spending (and even cheaper in terms of net effect on the exchequer) it was designed to help almost ¼ million young people. It was an important further step in the slow evolution of special employment measures, which were to play an increasing part in the response of successive governments to unemployment.

With the total register well over the million mark, however, it was still believed by many economists that the pressure of demand in the economy was low, giving ample room for macroeconomic expansion, if the situation on the balance of payments and inflation made it possible. The mini-budget of October could be seen as a modest step in that direction. There were further income tax cuts, backdated to April; pensioners got a Christmas bonus; there were additions to public spending concentrated on construction. The effect on the PSBR was comparable in scale to that of the package agreed with the IMF a year earlier, but in the opposite direction.

So long as the authorities were intervening energetically to hold sterling down, the market was willing to buy apparently unlimited amounts of the currency. This was especially true after July when the Bank of England switched its tactics from stabilising the sterling–dollar rate to stabilising the effective exchange rate index. The markets believed throughout the year that the policy would sooner or later be abandoned, that sterling would then rise and that they could then sell it back to the Bank of England at a profit.

They were right, eventually, on the first count. At the end of October the Bank announced that the rate would be allowed 'for the time being' to find its own level; the 'cap' was removed, and the expectation was that the rate would gush up like oil from a well. In the event it hardly rose at all. Once the one-way option was removed the speculators lost interest and so, as a group, they made little profit.

The experience of exchange market policy in 1977 was important for the future. It was widely perceived as unsuccessful, in that the authorities had to abandon it by the end of the year, and it was said to have undermined monetary control. Two further lessons drawn were that the strategy necessitated too sharp a fall in interest rates, and that the cost of its success was faster inflation at a crucial time for the development of incomes policy.

At the end of the year the Chancellor wrote another letter to the IMF. This time there was no need for protracted negotiation or Cabinet room confrontations. The promises made this time were (like most international agreements on economic policy) promises to do what he had intended to do anyway. The United Kingdom was in a strong position. It was being asked not to draw as much credit from the IMF as it was entitled to, because the IMF needed all its own resources for other purposes elsewhere in the world. So far as the IMF was concerned the problems of the British economy were, for the present at least, solved. So far as the United Kingdom was concerned, however, that was far from the case, as subsequent events were to show.

THE LAST STAGE OF THE LABOUR GOVERNMENT, JANUARY 1978–APRIL 1979

The aims of macroeconomic policy, and its basis in an understanding of the way the economy works, were particularly unclear in the final phase of the

Labour government. The immediate need to follow the lead given by the IMF had receded during 1977. There could, however, be no explicit going back to traditional Keynesian policies of reflation as exemplified by the later Heath years; the experience of 1976 was still very recent and very chastening. On the other hand ministers and top officials at the Treasury and the Bank were not intellectually converted to the approach of the monetarists. They now treated it with far more respect than they would have done a year or two previously, but with the detached respect of non-believers. It was a period of intellectual confusion, or perhaps of transition, which some of the official publications of the period betray. Most of the senior officials were still unsympathetic to monetarism: Sir Douglas Wass was still Permanent Secretary and the new Chief Economic Adviser, Sir Fred Atkinson, was another 'cautious' Keynesian. Others in influential positions, like Ken Couzens, Peter Middleton and Geoffrey Maynard at the Treasury, were not precommitted; Charles Goodhart and others at the Bank were closely in touch with monetarist economists outside the official institutions and helped to promote the exchange of ideas.

Increasingly the conduct of policy was affected by the difficulty of maintaining a Parliamentary majority. Proposals for tax changes during 1978 had to be modified several times in order to keep the support of Liberal MPs. (Support from the Scottish and Welsh Nationalists depended mainly on the preparations for legislation and constitutional change.) The possibility of an early general election was given increasing weight in the conduct of economic policy and the way it was discussed. In this context the most difficult problem was the negotiation of an acceptable deal with the trade unions on pay and prices.

In one respect at least 1978 might be deemed a satisfactory year: a good rate of economic growth was resumed after the 'pause' of 1977. Year on year the average of the three measures of GDP shows a rise of 3 per cent. The main demand stimulus came from consumer spending, which rose by as much as 5½ per cent year on year. This in turn was the result of resumed, and rapid, growth in real personal incomes, especially real wages. The savings ratio actually rose. The later stages of incomes policy under Labour allowed, or failed to stop, wage increases far in excess of the current rate of inflation. The sacrifice of real incomes in Phases 1 and 2 was swiftly reversed. Tax cuts reinforced the stimulus. The result was a consumer boom. Government current spending on goods and services was up by 2.3 per cent roughly reversing the fall of the previous year. Fixed investment also recovered and stockbuilding remained substantial. Export growth, however, was slowing down and resources were shifting out of the balance of payments.

Unemployment which had risen to 1.2 million in the fourth quarter of 1977 fell steadily, if slowly, through 1978 to 1.1 million a year later. The Conservatives might claim in the 1979 election campaign that 'Labour isn't working' but this was in fact the last time that a fall in unemployment was to be recorded for eight years.

Unemployment certainly remained very high relative to the experience of previous upturns, but unfilled vacancies had risen to over a quarter of a million, a level higher than the peak in 1969, although still some way below the exceptional level of 1973. It had become very difficult to read the indicators of aggregate pressure of demand and the margin left for further expansion was much disputed.

The budget of April 1978 was moderately expansionary, adding to the stimulus already given in the previous October. The main innovation was the introduction of a lower rate of tax, 25 per cent on an initial tranche of taxable income. An opposition amendment forced a cut of 1p in the standard rate as well. The problems faced by government are even better illustrated by events that followed. Market concern about the loss of revenue during the progress of the Finance Bill obliged the government to announce an increase of 2½ percentage points in the National Insurance Surcharge. Political pressure from the Liberals then forced the government to cut that increase back to 1½ percentage points. It is difficult to say whose views were really effective in the conduct of fiscal policy at this stage.

The conduct of monetary policy was also running into difficulties, but of a different kind. Towards the end of the preceding year interest rates had risen again when the 'cap' was taken off the exchange rate, but they remained relatively low. 1978 was a year of continuous rise in interest rates with minimum lending rate at 6½ per cent in January, but 12½ per cent in November. Thus the long decline of 1977 was largely reversed. This was reflected in share prices which had risen strongly in 1977 but showed no change between January and December of 1978.

The progressive rise in interest rates through the year was not only the result of concern about the exchange rate. There was a period of weakness in the second quarter, but the sterling index in the first quarter of 1979 was back to the level at which intervention had been abandoned more than a year previously. The rise in interest rates was rather the result of growing concern about the accelerating increase in the money supply, M3, caused by expansionary fiscal measures, and a lower level of debt sales to the non-banks, which prompted talk in the summer months of a 'gilts strike' by the institutions. On the other hand the Bank no longer needed to finance foreign exchange market intervention on anything like the same scale as in the preceding year. Thus DCE rose much more sharply between 1977 and 1978 than did the growth of the money supply.

The progress of M3 was now being monitored against official projections for its growth. The 9–10 per cent range given in the 1977 Budget Statement for the year to April 1978 had been called an 'estimate' not a 'target'. In the event it was exceeded by 3 percentage points. In the 1978 Budget Statement the range was lowered to 8–12 per cent for the following year, starting from the new base, and the word 'target' was used. The targets were to be reassessed every six months.

In order to control the money supply it was necessary to sell gilts to the non-banks, and in order to sell gilts it was necessary to demonstrate that the money supply was under control. So that the authorities should have a greater assurance of hitting their targets the 'corset' or Supplementary Special Deposits Scheme was reactivated in June. The rise in interest rates which continued throughout the year was believed to help on both fronts, selling gilts and restraining the demand for credit. For the present all turned out well enough. The growth of M3 from April 1978 to April 1979 was 11 per cent, happily inside the target range.

The adoption of six-monthly 'rolling' targets for M3 was one momentous decision in the field of monetary policy taken by the Labour government in its closing stages. An equally important choice was made when the United Kingdom decided not to become a full member of the new European Monetary System. Thus two of the main elements of the so-called 'Thatcher experiment' were inherited from her predecessor.

Jim Callaghan and Denis Healey were not averse to international cooperation in economic policy as such. On the contrary they were enthusiastic supporters of the strategy of coordinated expansion adopted at the Bonn Summit meeting in July 1978, after extensive discussion at many meetings of the OECD. The central idea was that those countries with strong balance of payments positions should expand domestic demand and thus act as 'locomotives' pulling along their less fortunate neighbours and stimulating economic growth everywhere. Coordinated economic expansion is an idea with perennial appeal to 'cautious' or 'frustrated' Keynesians in this country.

Close cooperation with France and Germany in the EMS was less appealing. A Green Paper, published by the Treasury in November 1978, gave some of the pros and cons. To do so with clarity would have required an unambiguous statement of the government's attitude to the exchange rate as an instrument of policy and of the priority to be given to money supply targets. The paper is a good example of the difficulty the monetary authorities had at this time in formulating or describing their monetary policy at all. The great majority of economists in the United Kingdom came out against the EMS for a variety of mutually contradictory reasons. It would have required a very strong lead from the government to overcome public suspicion. Another set of arguments about EMS membership, not elaborated in the Green Paper, related to politics rather than economics. The attitude of the Labour Party to Europe was still (at best) ambivalent, and there was no enthusiasm in the British electorate for a commitment which might restrict the freedom of action of British governments.

There was also some real disagreement as to the design of the EMS. The British authorities wanted a system in which the obligations of surplus and deficit countries, lenders and borrowers, were symmetrical. This was not just a disinterested preference, as experience suggested that sterling would be weak most of the time against the mark, if not against the franc or the lira. They did not want to join a DM zone, in which it would have been their responsibility alone to keep sterling in line. It proved difficult enough to get agreement on this, and related points, between the rest of Europe whilst Britain remained on the periphery of the EMS. The time for full United Kingdom membership, it was said, was not ripe. The case for procrastination was to be argued again and again, in good times and bad, for the next decade.

The assumption sometimes made, tacitly or openly, in the debate about EMS membership in 1978 was that sterling would soon be weak again, and that a fall could not, or should not, be resisted. Continuing inflation was again eroding the competitive position of British industry; the level of the index of relative unit labour costs at the end of 1978 was in fact much the same as it had been towards the end of 1975, in the run up to the last great sterling crisis. Export growth was slowing down and Britain's share of world trade was again being reduced. Imports on the other hand were growing fast thanks to the very rapid rise in consumer spending. The balance of payments on current account was close to balance, but that was thanks to rising oil production in the North Sea and an improvement in the terms of trade. Unless inflation could swiftly be brought under control it was difficult to see how another sterling crisis could be avoided.

This was the background to the last act in the drama of incomes policy in the 1970s. The policy, as we have seen, was already in severe trouble in 1977; indeed it is hard to say whether the Phase 3 norms, in operation from July 1977 to July 1978, actually held back earnings growth at all. There were, however, innumerable groups, many of them relatively well-paid, many of them in the public sector, who believed that they had been unfairly treated and who now wanted 'catching up' settlements. The TUC did not want to be committed to any kind of Phase 4 which it knew it would be unable to enforce.

The government nevertheless went ahead in July 1978 and published a White Paper called 'Winning The Battle Against Inflation' which included a 'guideline' of just 5 per cent. Inflation at that time was running at about 7½ per cent, so it appeared that another cut in real wages was being demanded. There were to be exceptions, it is true, but they were meant, in the main, to be self-financing. It may well be true that a level of settlements of this kind was what was necessary to secure a further reduction in inflation, but the framework of incomes policy was not strong enough to secure it. Like the Heath government before it, the Callaghan government was drawn into a conflict it could not win. Wages in the twelve months from July 1978 rose over 12½ per cent, earnings by 16½ per cent. Inflation was up to 15½ per cent. The conflict this time was of two kinds. One was with firms who accepted pay deals outside the pay limits and who were supposed to be penalised in a variety of ways. The other kind of conflict, which was more damaging politically, was with public sector unions that called strikes or took other forms of industrial action. The months prior to the general election of 1979 were called the 'Winter of Discontent', a time of troubles, when the news was all of disruption or of inflationary wage settlements; often of both. It did not perhaps feel as dangerous to society as the events that precipitated the fall of the Heath government five years earlier, but there were similarities nevertheless.

Another parallel with 1974 was the behaviour of oil prices. Early in 1978 the prospect seemed to be for a fall in oil prices rather than a rise, but by November OPEC members reached an agreement to restrict production and in December they announced a series of phased price increases for the next year. Also in December oil exports from Iran came to a standstill during the agitation against the Shah. In the early part of 1979 a steep rise in prices began which was ultimately to increase the cost to oil importers by as much as had the first price 'hike' of 1973 and 1974. That, amongst other things, falsified all expectations that sterling would be weak in 1979. This process, however, was only just beginning at the time of the general election in Britain, so its effects belong to the next chapter.

The Labour Party surrendered power in economic circumstances rather similar to those in which it had gained it five years earlier. The cycle in output and employment in May 1979 was not as far advanced as it had been in February 1974, but even in the first quarter of 1979 growth was faltering and the fall in unemployment was levelling off. Inflation in the second quarter of 1979 was 10½ per cent and rising, compared to nearly 13 per cent and rising in the first quarter of 1974.

Like the Conservatives before them, the Labour Party left office convinced that it was a failure of economic policy above all that had secured their defeat. In opposition they were also to change leaders and to disown the policies they had pursued in power. The divisions within the Labour Party after 1979, however, were deeper than those in the Conservative Party after 1974 and were not confined to economic policy. They had therefore to wait longer for another chance to govern.

4

THE CONSERVATIVE GOVERNMENT 1979–83

A NEW BEGINNING, APRIL–DECEMBER 1979

The Conservatives won the general election of May 1979 with a majority of 43 seats. The new government, unlike its predecessor, had no need to bargain with other parties in order to secure the passage of legislation. It was also, especially in the area of economic policy, a government that knew its own mind, and was prepared to take decisive action. On occasion it chose to highlight the elements of continuity between its policies and those of the Callaghan government post-1976, and this was indeed justified to some degree, as has already been suggested above. Nevertheless, there was a fresh start after the election, as the new Chancellor claimed in his first budget speech. 'The British people are convinced', he said, 'that it is time for a new beginning'.

The 1979 election campaign did not take the form of a contest between monetarism and Keynesianism. The Conservative party itself was still divided on economic policy between those who wholeheartedly embraced the new philosophy and those who merely respected it, whilst retaining the party's traditional scepticism concerning dogmatic beliefs of any kind. The new Prime Minister was undoubtedly an enthusiast, and the new Chancellor, Sir Geoffrey Howe, in his quieter way, was also prepared to make radical changes. A wide range of opinion was represented in the Cabinet, from Sir Keith Joseph, the most zealous champion of monetarism, as Secretary of State for Industry, to Jim Prior, well-known as a moderate, as Secretary of State for Employment. Dissent within the ranks of the Cabinet did influence the conduct of policy under this, as most other governments, but it was of least influence in precisely those areas where the monetarists wished above all to see changes, that is the conduct of monetary policy and the budget judgement. So far as monetary policy was concerned the attitude of the Bank of England, the necessary instrument of policy, mattered more than that of any minister. At no time could the philosophy of the Bank possibly be described as monetarist (in the same sense as that of the government) although its officials no doubt were loyal, at all times, to the government and tried to be as sympathetic as they could. The Governor, Sir Gordon Richardson, and others at the Bank, were attracted to a much more pragmatic version of monetarism of the kind long familiar to most central banks – but that was not the same species of monetarism at all.

The proposition that 'money matters' was by this time common ground for most commentators, for the Treasury, the Bank and backbench MPs. But for the first twelve or fifteen months of the new government, economic policy was governed by the far stronger proposition that 'only money matters'. Incomes policy was abandoned, not just because it was counter-productive or unenforceable, but because it was redundant. The recommendations of the Clegg Commission on Pay Comparability for the public sector, set up by the previous government, were to be honoured in full. This was done to fulfil a pledge made during the election campaign, but it was defended on the grounds that inflation was a monetary disorder which would be treated by monetary means. One of the first acts of the new government was to abolish the Price Commission.

The budget was introduced little more than a month after the election. The principal changes in taxation were a cut in the basic rate of income tax from 33p to 30p in the pound and an increase in the rates of Value Added Tax from 8 and 12½ per cent to a unified rate of 15 per cent. The effect of this tax-switch on the retail prices index was estimated at 3½ per cent.

The case for raising indirect taxes and cutting direct taxes rests either on their different incidence, or on their different effects on incentives. So far as macroeconomic policy is concerned the main danger of such a reform must be that of setting off an inflationary spiral. Workers may perceive a need to compensate for rises in prices however caused, but take little or no account of their income tax position. The new government consciously ignored this argument on the grounds that inflation depends on the growth of the money supply, not (except briefly) on changes in the rate of indirect taxes. Few commentators supported the tax-switch; it was strongly criticised, for example, by the international monetarists at the London Business School.

At the time of the general election the rate of inflation (measured over the preceding twelve months) was 10.3 per cent and rising. It went on rising until the following May, by which time it had reached nearly 22 per cent. Throughout the latter part of 1979 the policies of the new government were making no demonstrable improvement, although they had identified the control of inflation as their main, their overriding, priority. Success in this campaign was to be much slower in coming, and more costly than they, or the economists whose advice they followed, had expected.

Measured by its effect on public sector borrowing the 1979 budget was moderately contractionary. Cuts amounting to almost £1½ billion were announced in public spending for the year ahead. They were concentrated on industrial support, energy and the Department of the Environment. The aim from now on was to be to 'roll back the boundaries of the public sector'. One means of doing this was privatisation and the sale of public sector assets. The PSBR for the coming financial year was estimated at £8¼ billion, compared to £9¼ billion in the preceding year. The target range for £M3 was reduced from 8–12 per cent to 7–11 per cent, a modest reduction but an ambitious one given the acceleration of inflation already under way. The main onus for achieving this monetary target fell on interest rates and the SSD scheme which had already been in operation for nearly a year. At the time of the budget, minimum lending rate was raised from 12 to 14 per cent and it was announced that the SSD scheme would remain in operation for the time being.

In the second quarter of 1979, the target monetary aggregate was 13 per cent up on a year earlier, the increase in the second quarter itself (seasonally adjusted) being particularly large. The increases in the third and fourth quarters added about 6 per cent, which (at an annual rate) was just above the top end of the target range. Even a small overshoot was thought to threaten the credibility of the government's economic strategy. No effort was to be spared therefore to demonstrate the authorities' determination and ability to exercise monetary control.

The main difficulty arose from the growth of bank lending to the private sector, which was rising rapidly throughout 1979 despite successive increases in interest rates. Sales of public sector debt were running at a very high level in the first half of the year, but moderated in the third quarter. The difficulty may have been that the June increase in minimum lending rate came to be seen as insufficient, and the market for gilt-edged securities went quiet as investors waited for the authorities to make the next move. Operations in the gilts markets did not provide a system of monetary control which could be used with any precision.

In order to be sure of reviving the market for debt, and also in the hope of reining back the demand for bank lending, the authorities decided to give a clear, even a dramatic, signal. On 15 November minimum lending rate was raised by 3 percentage points to 17 per cent. This was the largest one-day rise on record and it produced the highest level ever of short-term interest rates in this country. It produced a sharp fall in the stock market. It did not, however, stop, or even much slow down, the growth of £M3.

The increase in interest rates during 1979 was not confined to the United Kingdom. In June, Eurodollar deposits paid 10½ per cent, well below the return on similar sterling deposits after the budget day increase in MLR. The United States authorities, however, were also concerned about monetary growth and began experimenting with a new approach to the setting of interest rates, allowing them to be more volatile in the hope of thereby achieving better control of the monetary aggregates. As a result Eurodollar deposits in October were paying more than 15 per cent, nearly 1 per cent more than sterling certificates of deposit. The United Kingdom authorities at this time had no explicit objective for the exchange rate, so there was, strictly, no need to follow the lead set by the United States. There can be little doubt, however, that they would have been very worried by anything that threatened to precipitate a sharp fall in sterling.

Sterling had in fact strengthened considerably in the early months of 1979. In the second quarter the exchange rate index was about 9 per cent up on the same quarter of 1978. This was believed to result from the Conservative election victory and the prospect of a tough anti-inflationary stand, as well as the increases in the price of oil. (We shall try to provide our own explanation in Parts 4 and 5 of this study). The cost of this appreciation was a loss of competitiveness which industry found very worrying.

In the second quarter of 1979 (about the time of the election), the IMF index of relative unit labour costs was 17 per cent up on the preceding year. The new government thus inherited an exchange rate which was already well out of line with domestic costs. Since domestic costs were rising at a fast, even an accelerating, pace, the misalignment could only get worse if sterling did not depreciate. The new government chose to turn a blind eye to this problem and followed a monetary policy determined exclusively by their target for £M3. Foreign exchange intervention was foresworn and interest rates, as we have seen, were dramatically raised. The immediate effect on the exchange rate was not great, partly because interest rates were rising in other countries as well. Sterling rose significantly in the third quarter, but then fell back a little in the fourth. The effect of the November rise was to be felt in 1980, rather than in 1979.

The strength of sterling provided the right environment for a major reform, the abolition of exchange control. Since the war the Bank of England had operated a set of restrictions on the foreign exchange transactions of United Kingdom residents, which, despite some easing over the years, still had an important effect on the market for sterling. The magnitude of that effect was necessarily unknown before the event, so the total abolition of control in a few months was itself an act of faith. It was clear, from the experience of 1976 for example, that exchange control could not prevent a run on sterling in the right circumstances. 'Leading and lagging' trade-related payments was enough to outweigh the scale of the market intervention that the authorities could command. Controls were more effective in determining the composition of assets held by large British institutions, especially pension funds. The extent to which they would diversify into foreign assets if permitted was unknown before the event. It was assumed that 'long-term' capital flows of this kind would result in some downward pressure on sterling, perhaps over a protracted period, as portfolios were adjusted. Such downward pressure was, on balance, thought to be welcome at the time. In the event there was a quite substantial effect on capital flows, especially portfolio outflows, in subsequent years, but no discernible downward pressure on sterling at the time that the controls were removed.

The other effect of exchange control abolition was to undermine the SSD scheme as a method of monetary control. The scheme was already somewhat discredited by the growing practice of 'disintermediation'. This involved banks acting, in effect, as agents arranging borrowing and lending between their customers, without recording assets or liabilities on their own balance sheets. Freedom for United Kingdom banks to operate in the euromarkets provided them with another back door through which to conduct business for their customers that the SSD scheme did not restrict. This was not regarded as a serious argument for retaining exchange controls. The SSD scheme was in any case being retained only as a temporary expedient until a better method of effective monetary control could be devised. The November announcements included the promise of a consultative document on monetary control early in the new year.

Meanwhile the strength of sterling relative to domestic costs was contributing to a pause in the growth of output and to mounting pressure on the finances of the company sector. In the Financial Statement issued at budget time, the Treasury for the first time published an official forecast that output would fall. 'The prospect is for economic activity to decline slightly over the next year or so.' This view, which was proved substantially correct, was rather more pessimistic than that of most independent forecasters, including those at the National Institute. In his budget speech the Chancellor, with less candour, spoke of a period of 'no growth' and expressed doubts as to the reliability of the forecasts he was obliged by law to publish. He added however that an easier stance of fiscal policy would make matters worse, not better.

As the year progressed it became clear that the rise in output was over. The upper turning point in the cycle is identified by the CSO as May 1979. From the second quarter peak (caused by anticipation of a higher rate of VAT), consumer spending fell back in the third and remained roughly constant thereafter. There was a rise in the savings ratio, possibly resulting from the higher rate of inflation. Public expenditure also levelled off, thanks in part to more effective control by central government. As is common at the top of the cycle, fixed investment continued to rise for a few more quarters and stockbuilding remained positive up to the end of the year. There was a sharp burst of growth in imports, possibly as a result of capacity constraints in some sectors of British industry at a time when consumer spending was still buoyant. There were signs that export volume was beginning to suffer from the loss of international competitiveness.

The fall in unemployment continued until the autumn, bringing the total (seasonally adjusted and excluding school-leavers) down to just under 1.1 million. The rise in employment also levelled off and vacancies began to fall. The signs of a downturn were easy to read, and evident to commentators at the time. What was not so evident was the scale of the recession that was to follow.

The economic situation was in some respects similar to that of 1974. Output growth was faltering; oil prices had been raised very sharply and wages were accelerating. As in 1974, the pressure was quickly felt by the company sector, unable to pass on its costs in full. This time the restraint on prices was not the price code, but international competition and a firm exchange rate. The rise in interest rates in 1979 (which had no parallel in 1974) added to the financial pressure on the sector. Industrial and commercial companies in aggregate (including oil companies) were roughly in financial balance in the first half of 1979, after recording healthy surpluses in the preceding two years. In the latter half of 1979 the sector moved into deficit, a position which prevailing conditions made difficult to finance.

The Chief Economic Adviser to the Treasury, Sir Fred Atkinson, was due to retire at the end of 1979. The question of the succession was naturally regarded as an important one and was widely discussed beforehand in the press. The job could only be done effectively by someone who sympathised with the new beginning initiated after the election, but who at the same time understood the methods used by the large team of macroeconomists at the Treasury and could command their respect. Fortunately such a person was found in Terry Burns of the London Business School, whose relative youth was decided to be, in these special circumstances, no disqualification.

TWO MILLION UNEMPLOYED, JANUARY – DECEMBER 1980

The recession began in earnest in the first quarter of 1980 and continued throughout the year. The output measure of gross domestic product, usually regarded as the most reliable, at least for short-period comparisons, fell by nearly 6 per cent between the fourth quarters of 1979 and 1980; manufacturing output, which was especially hard-hit in this recession, fell by 15 per cent over the same period. Unemployment, which was 1.3 million at the end of 1979 (seasonally adjusted and on the definition then in use) had risen by the end of 1980 to over 2.1 million.

The fall in output was considerably sharper than that experienced in 1975 and the effect on unemployment was more pronounced. The initial level of output, relative to the potential of the economy, was probably lower in 1979 than it had been after the boom of 1973; certainly the starting level of unemployment at the end of 1979, before the second great recession, was far higher than that in 1973 or 1974 when the first great recession began. The upward trend of unemployment through the 1970s and much of the 1980s, however, is difficult to interpret and it would probably be wrong to regard it as a straightforward indicator of the slack in the labour market. The issue was naturally a crucial one for the design of macroeconomic policy throughout the period covered by this study. (It is addressed again in Part 5 below). However that trend is interpreted, there can be no doubt that the economy suffered a major setback in 1980, from which it took many years to recover.

If the path of output is to be explained by that of the different categories of expenditure, then the origin of the 1980 recession is to be found principally in the course of stockbuilding. There was an abrupt turnround from positive stockbuilding worth some 1¼ per cent of gross domestic product in 1979, to negative stockbuilding of similar, or a little greater, magnitude in 1980. This is a pattern familiar from previous cycles, although not previously seen on the same scale. It is possible that firms, on this occasion, concluded that output would not be sustained as it had been sometimes in the past by a deliberately counter-cyclical use of macroeconomic policy, and accordingly cut back their level of stocks to one more appropriate to a permanently lower level of production and sales. It is clear that some firms at least had little choice in the matter, but shed stocks as fast as they could to stave off bankruptcy. For similar reasons fixed investment in the private sector turned down in the course of the year.

Public sector investment had been falling for some years, as the previous government found it easier to cut capital budgets than to hold back the growth of current spending. This trend continued after the election with a fall in general government fixed investment (excluding sales of existing assets) of 6 per cent in 1980 alone. The volume of government current spending on goods and services, however, showed a small rise.

Private consumption fell fractionally in 1980, as the savings ratio remained at the high level reached in the latter part of the preceding year. At nearly 14 per cent, the savings ratio in 1980 is the highest recorded for any year, attributable perhaps to rapid inflation and an exceptionally high level of interest rates.

Both imports and exports of goods and services were falling for most of the year. The fall in imports reflected the fall in output, the rising production of North Sea oil and negative stockbuilding. The fall in exports may be explained by the very high exchange rate of the pound relative to domestic costs. The world economy was still expanding, although at a much reduced pace compared with 1979. The onset of the 1980 recession cannot credibly be blamed in any large part on the slowdown in world economic activity following the second oil price shock, although clearly this was one of the many contributory factors.

The scale of the recession was not foreseen, still less intended, by policymakers at the time. As we have seen in the previous section, the origins of the recession can be traced back to the situation inherited by the Conservatives when they came into office in May 1979: the consumer-led upswing had already spent its force, inflation was already dangerously high and the real exchange rate was already misaligned. The measures taken by the new government, however – public spending cuts, an increase in indirect taxation, and two sharp increases in interest rates – must have contributed substantially to the scale of the fall in output which followed. As the extent of that fall became evident during the course of the year, the stance of policy was, gradually and reluctantly, changed. Having begun by making a virtue of inflexibility, the government learnt from the experience of 1980 that some degree of pragmatism was indispensable.

In the Financial Statement and Budget Report presented in March, the Chancellor set out a Medium-Term Financial Strategy (MTFS). This was intended to provide a framework within which macroeconomic policy would be conducted over a period of four years. The conduct of both fiscal and monetary policy in the past was criticised, with some justice, as being a matter of short-term expediency, lacking a clear vision of objectives and of the constraints to be overcome. By making its plans public the government was seeking to guide expectations and in this way to influence economic behaviour. The conquest of inflation would be swifter and less painful if all concerned, particularly perhaps those involved in wage bargaining, believed that the government would and could play its part. It was a change of 'regime' in the sense that we have used that word in the introduction to this study (page 8 above).

The centrepiece of the MTFS was a four-year path for the growth of the money supply, defined as £M3. A firm commitment was made to 'a progressive deceleration over the period' although the deceleration actually shown in the accompanying table was a very gradual one. The aim was to achieve this by a progressive reduction in the scale of public sector borrowing, not by maintaining a very high level of interest rates. A distinction was drawn, however, between the 'projection' of the PSBR, which was not intended as a target, and the deceleration in monetary growth on which a deliberately firm pledge was made.

> To maintain a progressive reduction in monetary growth in these circumstances it may be necessary to change policy in ways not reflected in the above projections. The Government would face a number of options for policy changes to achieve this aim, including changes in interest rates, taxes and public expenditure. But there would be no question of departing from the money supply policy, which is essential to the success of any anti-inflationary strategy.

This last sentence did not quite say that money supply growth would decelerate year-by-year, come what may, over the next few years, although it came very close indeed. Within a matter of months the Chancellor had cause to be grateful for the slight ambiguity which could be read into this apparently inflexible declaration of intent.

The incipient recession was inevitably raising public sector borrowing, by reducing revenue and by increasing spending especially on benefits for the unemployed. Nevertheless the Chancellor was able to forecast a small reduction in the PSBR for 1980–81, compared with 1979–80. The budget measures themselves were estimated to cut the PSBR directly by £0.8 billion. There was another tax switch, raising specific duties and cutting income tax, but on a much smaller scale than that of the previous year. The lower rate of income tax at 25 per cent was abolished. Some further cuts in public spending were announced.

The White Paper on public spending was published at the same time as the budget, and completed the survey of expenditure undertaken by the government in its first year of office. The main aim was clearly stated: 'The government intend to reduce public expenditure progressively in volume terms over the next four years.' The scale of the reduction was to be about 4 per cent, comparing 1983–4 with 1979–80. As compared with the last White Paper of the Labour government the level of spending proposed for 1982–3 was down by 11½ per cent. There were to be increases in spending on defence, law and order, health and social security; the programmes to be cut back most were those concerned with industry, energy, trade and employment, housing, education and support for the nationalised industries. The costs of EEC membership were still being negotiated at the time when the White Paper was published. An agreement was reached at the end of May, under which Britain was given favourable treatment, because of our exceptionally heavy net contributions to the Common Agricultural Policy.

At the time of the budget, the Chancellor also announced that the SSD scheme for controlling the liabilities of the banking system would not be extended beyond mid-June. He had presented a Green Paper to Parliament a few days earlier on the subject of monetary control. This began from the premise that the SSD scheme had 'come virtually to the end of its useful life' and sought to find a better alternative. The paper, written jointly by the Treasury and the Bank of England, illustrates well the problems with which the authorities were wrestling as they sought to devise an operational means of achieving the objectives of monetary control to which the government attached such overriding importance.

The government declared itself satisfied with fiscal policy and interest rates as instruments for controlling the money supply in the medium term. This confidence, which in the event proved altogether misplaced, limited the scope of the consultation to tactics rather than grand strategy. The government further circumscribed the agenda by declaring its intention of retaining £M3 as the sole aggregate for which a target range would be set. The question posed was what means should be adopted for keeping that aggregate close to a predetermined path and keeping its 'short-term fluctuations' in moderate bounds.

The disagreements amongst the monetarists, and between the monetarists and the Bank of England, which lay behind the Green Paper are discussed in Part 2 below. For present purposes it is enough to say that the Green Paper signalled the success of the Bank in averting radical changes to the banking system, such as would have been required if an attempt was made to operate a system of monetary base control. Such a system would, according to its advocates, have made much more direct and reliable control of the money supply possible. It would, on the other hand, have meant such profound changes during a period of transition that the stability of the relationships between the monetary aggregates and the rest of the economy (such as it was) would have been upset to an unknown extent for an unknown period into the future. Having abandoned the SSD scheme, and having failed to replace it with any other direct control, the authorities were left with little influence over the growth of £M3. The situation was reminiscent of that following the publication of 'Competition and Credit Control' in 1971, so reminiscent that it is perhaps surprising that the same conditions were allowed to recur.

The SSD 'corset' was removed in June. In the following month £M3 (seasonally adjusted) rose by nearly £3 billion, or nearly 5 per cent. This was a far greater rise than had been expected, and there seemed no way in which it could possibly be accommodated within the target range announced at budget time. The next month there was another large increase and, after a pause in September, the spate continued unchecked. In retrospect we can see that the removal of the corset had a far greater effect on monetary growth than was expected at the time. It made possible a sustained and rapid increase in banks' balance sheets for many years to come.

This was the end of the brief phase of macroeconomic policy when it could be said that 'only money matters'. It is not easy to say what steps the authorities might have taken to stem, or reverse, the excess of monetary growth over the target. Some monetarist diehards wanted a massive auction of gilt-edged securities, but events were taking the decisions out of their hands. In fact the decision was taken in July (after the corset had been removed, but before its full implications were known) to cut minimum lending rate from 17 to 16 per cent, thus signalling that the authorities had other concerns in mind as well as their monetary target when setting the level of domestic interest rates. The retreat from monetarism had begun.

The rise in interest rates at the end of 1979 had made little perceptible difference to the growth of £M3, but it had stopped altogether the growth of the narrower aggregate M1. Apart from the bulge in July, when the 'corset' was removed, M1 was lower in the summer of 1980 than it had been the previous autumn. (In real terms it was more than 20 per cent down.)

Another indicator suggesting monetary tightness was the exchange rate, which was rising throughout 1980. By the fourth quarter the exchange rate index was 13 per cent up on a year earlier; over two years the appreciation was 24 per cent. This was at a time when inflation in Britain was running at about 20 per cent, some 5 per cent a year faster than the OECD average. The IMF index of relative unit labour costs for the United Kingdom was about 25 per cent higher in the fourth quarter of 1980 than a year earlier, nearly 50 per cent higher than two years earlier (and actually 70 per cent above its low point in the fourth quarter of 1976.) In terms of relative export prices the loss of competitiveness was, as might be expected, rather less, but the loss of profitability on exports was damaging to industry as well as the loss of markets.

The reasons for the buoyancy of sterling were much debated at the time, and it was not easy to sort out the effects of such factors as the price of oil, relative interest rates and market confidence following publication of the medium-term financial strategy. Britain at this time was roughly self-sufficient in oil, so the doubling of oil prices during 1979 and 1980 had little net effect on our balance of payments. The same was not true of our main competitors, especially Germany and Japan. Thus the markets tended to mark sterling up relative to other currencies every time oil prices rose, during the turbulent course of events leading up to the war between Iran and Iraq. Some commentators argued that this was inevitable, and that a consequential fall in manufacturing output was a necessary adjustment of the economy to its oil wealth.

Another factor helping to raise sterling must have been the high level of interest rates maintained in the United Kingdom for most of the year. Dollar interest rates by contrast were extraordinarily volatile, rising to a peak of virtually 20 per cent (on 3-month Eurodollar deposits in London) in March, but falling to below 10 per cent two months later. After staying below sterling rates for most of the summer, dollar rates shot back up to over 18 per cent in the autumn, by which time British rates were well down.

The strength of sterling, and perhaps also the fall in output, were beginning to have an effect on inflation. The measure most often quoted, the 12-month rise in the retail prices index, peaked at 21.9 per cent in May. It then moved down quite gradually, but further falls could be confidently predicted from the month-to-month changes. The old wage rate index in the third quarter showed a rise of about 19 per cent on a year earlier; the settlements being made in the latter part of the year resulted in a rise over the twelve months ahead from the third quarter of 1980 of just 9½ per cent. Possibly these signs of moderation in the rate of inflation contributed to the more moderate macroeconomic policies pursued by the government from about this time.

The November measures included some public spending increases, as well as further cuts. External finance for the nationalised industries, for example, was raised to cushion the blow of the recession. The main relaxation was a cut in the minimum lending rate from 16 to 14 per cent, and the budget monetary target for the year was in effect abandoned. Some relatively small changes were announced to the operating methods of the Bank of England, but the proposal to move to monetary base control was postponed indefinitely.

The next day it was announced that unemployment was over 2 millions and still rising fast. At this stage 'the new beginning' introduced by the Conservative government seemed an almost unmitigated failure.

THE RECESSION PROLONGED, JANUARY – DECEMBER 1981

On 24 February, 1981 the Treasury and Civil Service Committee (TCSC) of the House of Commons published the report of an enquiry into the government's monetary policy and the basis of the MTFS. This had become a major exercise, occupying the committee for most of the preceding year. Evidence, written and oral, had been taken from the Treasury and the Bank of England, from foreign central banks, from the CBI and the TUC and from a wide range of academic economists and other interested parties. Some of the views expressed to the Committee will be featured in the discussion of the history of ideas in Part 2 below. For present purposes it is enough to outline the Committee's conclusions, which were of some importance to the subsequent course of policy. The Committee had a Conservative majority and a Conservative chairman, but it was nevertheless highly critical of the way in which monetary policy had been conducted over the eighteen months since the election.

The report concluded that 'the Medium-Term Financial Strategy was not soundly based'. It found no evidence of a direct link between the growth of the money supply and price inflation of the kind presupposed by a monetarist strategy. It was unhappy with the exclusive reliance on £M3 and argued that the exchange rate should also be taken into account when setting interest rates. It wanted more use made of econometric evidence, and it wanted less dogmatism. There should be more scope to modify the tactics of policy in the light of developments in the economy. As we have seen in the previous section, this was the direction in which events were already pushing monetary policy by the time the report came out.

This did not mean, however, that the government was about to make a U-turn and adopt Keynesian policies of reflation – far from it. It might be necessary to modify the exclusive emphasis on the money supply, but the aim of reducing public sector borrowing remained as important as ever to the Chancellor and the Prime Minister. In fact it may have been thought even more important to achieve that aim, given the failure to control the money supply. Something had to be done to demonstrate that the counter-inflation strategy had not been abandoned, or even seriously compromised. There was also a need to demonstrate to some members of the Cabinet that excessive public spending would result, not in extra borrowing, but in politically painful increases in taxation. The report of the TCSC had argued that public sector borrowing might need to rise in a recession and that the 'automatic stabilisers' of lower tax revenue and higher social security spending should not be overridden. The Chancellor did not take this advice in preparing his 1981 budget. He presented a deflationary budget in the depths of the recession.

The direct effect of the budget proposals was to raise revenue by £3.6 billion in 1981–2 or £2.7 billion in a full year. Measured relative to the effects of 'revalorising' both direct and indirect taxes in line with inflation, the budget proposals raised revenue in 1981–2 by £4.3 billion. Personal income tax allowances were not raised at all and excise duties were raised more than in line with inflation. Both these decisions had the effect of reducing real personal disposable incomes, and hence presumably consumer spending. These measures were, on any conventional calculation, directly deflationary. The economic effects of the other major tax increases were, and still are, difficult to judge. A supplementary duty was raised from oil producers, whose profits had exceeded their original expectations since the second oil price shock of 1979–80. A special tax on bank deposits was also introduced for one year only, on the grounds that high interest rates produced a windfall gain for the banks, which the exchequer ought to share. It is arguable that the effects of both these latter taxes on economic activity would be small, or even negligible.

The budget measures as a whole were a good deal tougher than expected. They were accompanied by a restatement of the MTFS in words which made only the minimum concessions unavoidable in the light of experience over the previous twelve months. It was stated more than once that something described as the 'thrust' of the strategy would be 'maintained'. It was recognised that £M3 had been giving a misleading signal and that the conduct of monetary policy required attention to a variety of indicators, including M1 as well as £M3, not forgetting the exchange rate and interest rates. Even house prices got a mention as a possible guide to financial conditions. Nevertheless a three-year path for the growth of £M3 was again given prominence, and its virtues as a medium-term guide to policy were again catalogued.

The target range set for £M3 in 1981/2 was the same, 6–10 per cent, as that shown in the Financial Statement of the previous year. Since, however, growth over the preceding twelve months was 20 per cent, well outside the range of 7 – 11 per cent set for 1980/81, the starting point was now far in excess of that originally intended. The MTFS, therefore, in all seriousness, discussed the possibility of clawing-back the excess growth already conceded. This too was very tough talking.

Talking apart, the main monetary policy measure at the time of the 1981 budget was a *reduction* of 2 per cent in the minimum lending rate. At 12 per cent, this was now 5 percentage points lower than it had been at the peak in November 1979, and lower than it had been at any time since the Autumn of 1978. Monetary policy (thus measured) had now become relatively easy. The MTFS reiterated the wish to use tight fiscal policy, rather than high interest rates, as the means of slowing down the growth of the money supply and hence inflation. The tax increases and the MLR cut in the budget were an attempt to change the 'mix' of policy in that direction. Events later in the year were to show how difficult it could be to make such a change in an open economy like that of the United Kingdom.

The hope was expressed in the MTFS that public spending would be cut back (it would be given 'the most serious attention') so that the tax burden in later years could be reduced. That also was a difficult wish to fulfil, as events later in the year were to prove. In the budget speech itself the Chancellor had to announce a few minor *additions* to spending plans for the forthcoming year.

About the time of the 1981 budget (coincidentally, one must assume), the fall in output came to an end. The lower turning point of the cycle is put at January 1981. The rise in output was, for some time, barely perceptible, in contrast with the brisk recovery from recession in 1972 and 1975. The output measure for GDP rose about 1½ per cent between the fourth quarters of 1980 and 1981. Employment continued to fall throughout the year and unemployment rose from 2 to 2½ million. Unfilled vacancies, however, showed a slight rise, from a very low base at the end of 1980.

Consumer spending rose in the first quarter of the year, but fell back a little thereafter as real incomes were cut by the budget. The savings ratio, which had been exceptionally high in 1980, was lower in 1981, as it usually is when real income growth slows down. The slight rise in total real expenditure during 1981 is accounted for by a slower rate of de-stocking – stockbuilding remained negative throughout the year, but to a decreasing extent. This is a typical pattern at the lower turning point of the cycle, reinforced on this occasion, as indeed on others, by a fall in interest rates.

The reduction in interest rates may also have contributed to the weakening of the exchange rate. The long period of sterling appreciation, almost uninterrupted from early 1977 to early 1981, was over. The trend changed even though the United Kingdon was now in exceptionally large current account surplus on the balance of payments. From now on the general trend was down, although the slide was intermittent and not very fast. Between the fourth quarters of 1980 and 1981 the effective exchange rate index fell by about 9½ per cent.

Inflation in the United Kingdom at this time was broadly similar to average inflation in the industrial world. Thus an exchange depreciation of 9½ per cent translated into roughly the same size of improvement in relative cost competitiveness. This began to reverse the unprecedented, and traumatic, loss of competitiveness which had taken place whilst the exchange rate was appreciating. As always, exchange rate depreciation brought its cost as well as its benefit. The rate of inflation, which had been brought down sharply during 1980, levelled off. The twelve month change in the RPI which was 13 per cent in January 1981, was still 12 per cent in January 1982. This pause in the process of disinflation was unexpected and unwelcome. It must have owed something to the rise in excise duties in the budget and to a sharp increase in local authority rates about the same time, but the path of the exchange rate was another major contributory factor.

In the course of the year it was felt necessary to tighten monetary policy again, that is to raise interest rates, reversing the budget-day cut. The disappointment over inflation would probably be thought of as an underlying reason for this change, although, at this time, official pronouncements would not have made a direct connection of that kind. The high level of interest rates in the world at large may have been another unacknowledged cause. Certainly MLR at 12 per cent was well out of line with eurodollar deposits yielding 17 per cent in April. The United States under President Reagan was embarking on a programme of fiscal expansion and monetary tightness which effectively set the going rate for real interest rates world-wide. The United Kingdom, in trying to combine a tightening of fiscal policy with a cut in interest rates, was moving in a diametrically opposite direction. As a result we had, for a few years, *both* a tight fiscal stance *and* historically high real interest rates.

Another reason for the rise in United Kingdom interest rates in the latter half of 1981 was the failure, again, to control £M3. The trouble, as in the preceding year, arose from the rapid growth of bank lending to the private sector. The authorities had no effective means of controlling this, since it did not respond in any predictable way to the level of short-term interest rates. They could, in principle, have offset the growth of private sector bank lending by reducing the other counterparts to the growth of £M3, that is bank lending to the public sector. They did cut the PSBR as far as seemed prudent in a recession (or indeed further than seemed prudent). They might have reinforced that by selling more debt outside the banking system, although it was not proving easy to guarantee as large sales of debt as might be required. To safeguard, and perhaps expand, opportunities for funding government debt, the Chancellor announced, when presenting the 1981 budget, the first issue of index-linked gilt-edged securities. At the time this was a bold step, which was thought to have far-reaching implications. In the event the fall in inflation in later years, and the good yeild to be had on conventional gilts, limited the market for index-linked debt. When it was first issued the authorities were worried that it would be *too* attractive, for example to overseas buyers, and it was therefore restricted to the United Kingdom pension funds. In subsequent years these restrictions were lifted, but no great demand was forthcoming.

It might seem that the authorities could always meet their monetary targets by selling a sufficiently large quantity of debt, sufficiently cheap, outside the banking sector. In practice the authorities were at this period very reluctant to force the pace of funding, for example by substituting auctions for the traditional tap system as a method of selling debt. Long-term debt sells, at least in part, by offering the prospect of capital gain, so it was thought that a fall in price could actually be counterproductive in some circumstances since the market would be worried that the fall would continue. The alternative of selling large quantities of short-dated debt outside the banking system was also unattractive, as the debt instruments would be almost indistinguishable from some of the bank liabilities that were included in the definition of £M3. Control by that means might be dismissed as merely cosmetic.

The search for an effective means of controlling £M3 continued through 1981, the alternative of monetary base control having been by this time effectively excluded. Some procedural changes were announced in August. Publication of minimum lending rate was to stop. This did not mean, however, that the authorities had really abandoned responsibility for the level of short-term interest rates. The Bank of England's operations day by day in the short-term money markets would set a rate somewhere in a band agreed from time to time with government. That band would not be disclosed, but market operators would obviously know roughly what it was. The guiding hand of the Bank would be less visible, but not necessarily less effective. One advantage of being less visible might be that increases in interest rates attracted less public criticism, and the authorities were subject to less political pressure to keep them low.

The reserve asset ratio requirement, which meant that banks had to hold a minimum proportion of their total balance sheet in a liquid form was abolished. This had not been an effective brake on the expansion of banking business and was inequitable as between banks and other deposit-taking institutions. Another requirement to be abolished was that applied to the clearing banks under which they had to place non-interest-bearing deposits at the Bank of England. The main purpose of this requirement was to provide an independent income for the Bank. Under the new arrangements a smaller percentage contribution was required from all banks or licensed deposit-takers. Most of these changes had been foreshadowed in the November statement of the preceding year. None of them made it any easier to control £M3.

A new monetary aggregate, M2, had now been added to the menu. It consisted only of the retail deposits of the banking system and was thought likely, for that reason, to be a better measure of money as a transactions medium. Potentially it was a rival to £M3, but it woud be some years before its behaviour, for example its seasonal pattern, was sufficiently well understood for it to be considered as a target aggregate. In the event, enthusiasm for *any* monetary aggregate ebbed away before M2 had had a chance to prove itself. Even at this stage the argument was gaining ground within government that the logical next step was full membership of the European monetary system. It was many years, however, before that idea was allowed to emerge in public.

The design of monetary policy in the early years of the Conservative government owed much to the then Financial Secretary to the Treasury, Nigel Lawson. He was rewarded by appointment as Secretary of State for Energy in a September reshuffle. This also translated Sir Keith Joseph from Industry to Education and put Norman Tebbit in charge of Employment.

Labour-market issues were now quite as important to economic policy as questions of monetary control. A package of measures was announced in July to support employment in the face of a continuing fall in the demand for labour. In contrast to earlier special employment measures under the Labour government one condition applied to the new employment subsidies was a limit on the earnings of the workers in respect of whom they were paid. In December a more ambitious programme, costing £1 billion a year, was launched to improve training opportunities, especially for the young unemployed. The new Youth Training Scheme (YTS) began as a one-year scheme for school-leavers combining work experience with some further education. The spur for this reform may have been the high level of unemployment amongst the young, but it was not just a way of reducing the embarrasingly high unemployment numbers. From the start it was intended also to meet a real worry that industry was neglecting training, because of financial difficulties and doubts about the future viability of many firms. Should demand pick up again, it was feared that shortages of skilled labour could hold back production. There was growing concern that standards of vocational training in the United Kingdom were much lower than those of her industrial competitors.

Another reason often given for the relatively poor performance of British industry was poor industrial relations. The effect of the recession was to reduce the frequency of strikes and other disputes because workers feared the loss of their jobs. This was reinforced by legislation proposed in a November White Paper. Broadly, the effect was to limit the industrial action that was immune from the civil law, rather than to use the criminal law as had been attempted in the past.

At the end of the year the problems of implementing the government's economic strategy was still more evident than its successes. Nevertheless what the Chancellor had called its 'thrust' had been 'maintained'. Financial confidence had survived the disarray over monetary control, and the exchange rate had fallen in an orderly fashion from its unnatural height at the beginning of the year. Inflation *was* coming down, if only slowly. The recession had been prolonged, but in fact the prospect for output growth was better than anyone knew at the time. The worst was over.

INFLATION SUBDUED, JANUARY 1982 – JUNE 1983

The next eighteen months take the story up to the General Election of June 1983, won by the Conservatives with an increased majority. That election result is sometimes attributed to the afterglow of the Falklands campaign, sometimes to the divisions amongst and within the Opposition parties. It was also helped by an improved performance of the economy, with inflation at last subdued and with a stronger recovery of activity at last in sight.

In the restatement of the MTFS at the time of the 1982 budget the aim of economic policy was clearly stated and even, very roughly, quantified. 'Government policies are directed at achieving a rate of inflation that is well into single figures.' At that time the increase in the RPI over the preceding twelve months was still just over 10 per cent. The Treasury forecast showed a rise over the next twelve months (from the second quarter of 1982 to the second quarter of 1983) of 7½ per cent. This proved far too pessimistic. When the election came in the second quarter of 1983 the rate of inflation was not 7½ per cent but under 4 per cent.