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SURVEY OF BRITISH ECONOMIC POLICY
FROM 1920 TO THE 1980s

PART II: FROM CIRCA 1949 TO THE 1980s

BY

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SURVEY OF BRITISH ECONOMIC POLICY FROM 1920 TO THE 1980s

PART II

FROM CIRCA 1949 TO THE 1980s

Submitted in Fulfilment Of Contract For

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By

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June 1991

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For helpful comments on earlier drafts, thanks are due to my colleagues James Heslin, Cormac Ó Gráda and Gerard Quinn, and to Thomas Szira of the Hungarian Academy of Sciences.
As background to the present Part II (on policy over the period from around 1949 until the 1980s) it is assumed that the reader is already familiar with the material covered in Part I (1920 to 1949), a separate monograph. The format for Part II is similar. Thus, this part of the survey opens with balance of payments and exchange rate policy. Section II is on the postwar resort to activist employment policies implemented until the 1970s and their subsequent partial demise. This is followed by a section on economic growth, including regional development, as a policy objective. Counterinflation policies are discussed in Section IV. The main text of the monograph closes with a very brief overview of the recent record followed by a short summary and some conclusions. An appendix is provided to illustrate some issues raised in the text.

1. BALANCE OF PAYMENTS AND EXCHANGE RATE POLICY

1.1. Balance of Payments Problems in the 1950s and 1960s

The countries of the Sterling Area were individually listed in a schedule to the Exchange Control Act of 1947, and for this reason they became officially known as the 'Scheduled Territories'. They then consisted of the British Commonwealth (except Canada), a few Middle East countries, Iceland and Ireland. The Sterling Area remained the basis of British exchange control for several years after the war. As applied to sterling holdings of countries outside the Area, exchange control went through a series of changes until December 1958, when general convertibility of sterling (as well as of several other European currencies) for current account transactions was restored. In regard to the capital account, there were practically no limitations on British foreign investment within the Sterling Area until 1966-72, when investment in the white Commonwealth Sterling Area was made subject to some restrictions. But foreign investment in the rest of the world was strictly limited by exchange control until 1969, when there was some liberalisation. Entry by Britain to the European Community in 1973 brought further liberalisation, and finally in 1979 all exchange controls limiting British foreign investment were removed.
In 1959 the Radcliffe Committee's Report (Chap. II) on the UK monetary system elaborated on two key objectives of British balance of payments policy. One was some contribution to the economic development of less developed countries via long-term capital outflows, implying surpluses on the current account; the other a strengthening of London's reserves, implying further surpluses on current account. Although the first objective was seen by the Committee as part of Britain's contribution to development in British Commonwealth countries, it was also based on the view that prosperity in Britain depended on growth in the less developed world. The second objective was seen as crucial in maintaining the exchange rate in the face of periodic sterling crises. The years 1951 and 1955 excepted, Britain did succeed in attaining current account surpluses throughout the 1950s. But such surpluses were dissipated by net long-term lending, while government (military and other) expenditures abroad made them substantially smaller than they would otherwise have been. These in turn reflected attempts by Britain to maintain unsustainable economic and political roles abroad.

The shrinking share of British exports on world markets was a striking feature of the post-war decades. Britain's share of world exports of manufactures, which had been 21% in 1937, fell from 25% in 1950 to 11% in 1970 and 9% in 1981. The structure of Britain's balance of payments on current account in the post-war years until the 1980s was as follows: For the private sector, the visible balance of trade was generally in deficit, while the invisible balance (ie. net earnings on shipping, tourism, insurance, banking and brokerage services, interest and dividends on foreign investments, etc.) was consistently in surplus. The net effect was that the private sector's current account was usually large in surplus. But the government sector's balance on current account was in large deficit. Thus, although the private sector maintained generally large surpluses available for reserve accumulation or foreign investment, Britain had persistent balance of payments problems for about three decades after the second world war. Policy responses to those payments problems had an almost continuous effect in stifling British economic growth.

There were two main sources of pressure on the balance of payments. One was the size of Britain's net foreign investment flows; the other was the magnitude of British government activity abroad, and be-
tween them they have repeatedly imposed a burden on the British economy beyond its powers to bear (Pollard, 358). However, the economic arguments for foreign investment were fairly strong: on the one hand, they generated 'invisible' income in interest and dividends for Britain; on the other hand, they were mechanisms for getting through tariff barriers and defending market shares.

The behaviour of government itself was the prime -- and an increasing -- source of pressure on the British balance of payments in the 1950s and 1960s. As already indicated, the government sector consistently ran huge deficits in its current account balance of payments. These deficits probably amounted to about £200 million in 1950, they had increased to around £500 million in 1960 and had accelerated to almost £3,300 million by 1980 (Pollard, 359). Given the resulting slender levels of reserves, and given Britain's dominant commitment to defend the pound at a fixed exchange rate in the 1950s and early 1960s, the counterpart was a 'stop-go-stop' economy: Growth in output was stopped from time to time when sterling came under pressure, demand would then be expanded when unemployment rose to unacceptable levels, and growth would again be halted as sterling once more came under pressure. Thus, for the 1950s and 1960s, the real cost-benefit analysis of British foreign policy would have to count the costs of Government activities abroad not merely in hundreds of millions annually spent, but in the billions annually lost in output and income because of the restrictions [on economic growth] necessary to maintain it' (Pollard, 364).

Contractionary monetary and fiscal policies were the principal instruments through which a sterling devaluation was averted in the 1950s and early 1960s. Commitment to a fixed exchange rate also led to increasing resort to borrowing from the IMF and foreign central banks. For example, speculative pressure against sterling in 1960/61 was alleviated by (for the first time) borrowing from the IMF, and by further support from foreign central banks. Exchange controls aside, new defensive commercial policies were implemented for balance of payments purposes to a limited extent only. Thus, late in 1964 the Labour government attempted to improve the current account payments balance by an import surcharge of 15% and a system of export rebates, involving refund of certain indirect taxes, also became available in the same year. These measures, which were contrary to the spirit of the trade agreement, GATT, we
repealed in 1966 and 1968, respectively. However, they were followed by an import deposit scheme in November 1968. This scheme penalized importers by requiring them to deposit with the government for six months a sum equal to half the value of their imports. After being gradually relaxed, this scheme was abandoned in December 1970.

Sterling was under sustained pressure for much of the period 1964-68. The economy entered a phase of rapid expansion in 1963. As a result, the current account balance shifted from a large surplus in 1962 to a large deficit in 1964, while long-term capital outflows increased considerably. A standby credit of $1,000 million from the IMF was renewed in August 1964, and credit facilities were negotiated with a number of central banks a few weeks later. An election was due in Britain in 1964, and this inhibited the Conservative government from acting to stem the deteriorating balance of payments position. Government policy was largely immobilized until after the October 1964 election -- which brought the Labour government of Prime Minister Wilson into power. The new government had to decide whether or not to devalue, a decision which would have both economic and political aspects.

On the economic side, it was argued that an economy operating at full capacity could not release resources for an improvement in the current account to be brought about by devaluation. There was a question whether other countries would follow the pound if it were devalued. Finally, the era of Empire had left Britain with financial institutions heavily oriented toward overseas lending and other financial services. The importance of such services was greatly increased by a 1962 decision of the Bank to allow foreign securities denominated in foreign currencies to be issued in London. An effect was that London quickly became the world's dominant Eurodollar market (a market in US dollars outside the US), with new Eurobond issues in London rising from $134 million in 1963 to almost $3,400 million in 1968 (Strange, 205). These developments greatly increased the earnings of the City (a word used collectively to denote private financial institutions in London), but they also led to huge short-term capital flows into and out of London. Although such flows made it increasingly more difficult to defend the exchange rate, the commissions earned in connection with them made significant 'invisible' contributions to Britain's balance of payments. The City therefore became a powerful lobby against devaluation, which was widely
expected to weaken confidence in the international aspects of British financial markets. Hence, it favoured domestic deflation rather than devaluation in response to balance of payments crises.

The arguments on the political side of the devaluation debate were: First, the US was known to be sharply opposed to a sterling devaluation -- and the Prime Minister was anxious to strengthen his relationship with that country. Second, devaluation of the pound would have imposed real capital losses on overseas Sterling Area countries (as had occurred in both 1931 and 1949), and the continued existence of the Sterling Area -- as symbolic of Britain's role in the world -- was an important policy objective. In fact, the Bank of England itself had surprisingly suggested a floating exchange rate as far back as 1952, but this was vetoed by the then Conservative government, partly on the grounds that any weakening of sterling would mean abdication from Britain's responsibilities to overseas holders of that currency (Hall, 58; MacDougall, 52-3). Finally, Labour did not want to be identified as 'the devaluation party'.

On 17 October 1964 the decision was taken to defend the existing sterling parity, and from then on the subject of devaluation became known as 'the unmentionable' (Solomon, 88). The new government was slow in implementing a comprehensive fiscal programme to dampen the prevailing boom (and thereby improve the balance of payments). The ensuing speculation against sterling forced the authorities to raise Bank Rate from 5% to 7% and to draw on $1,000 million in credits from other central banks. It was in this period that the Minister of a new Department of Economic Affairs, picturing an international conspiracy of financiers against the Labour government, coined the phrase 'the gnomes of Zurich' to describe the speculators (Solomon, 88). A further international credit package -- of $3,000 million -- was announced in November 1964. This was in addition to a $1,000 million drawing from the IMF, also announced in November. (This IMF drawing was used to repay the earlier central bank credits which had been used before 26 November). For the following few months operators in the foreign exchange market were persuaded that the sterling exchange rate would be maintained.

Although Britain's trade statistics improved early in 1965 as the import surcharge of late 1964 took effect, the economy continued to experience excess demand and wages rose rapidly despite the impl
mentation of a voluntary wage-price policy in February 1965. A mildly restrictive budget was announced in April and in the same month the Bank tightened monetary policy and imposed ceilings on credit expansion by the banks. In May 1965 Britain drew $1,400 million from the IMF, which once again was used to repay credits to other central banks. However, after heavy reserve losses due to further speculation against sterling, the government in late July 1965 announced additional measures to curb demand, including a tightening of consumer credit controls, restrictions on some kinds of private building and a slowdown in government spending. But again, a favourable response in exchange markets was short-lived: in the first week of August the Bank had to use $225 million to support the exchange rate (Solomon, 90). Britain responded by announcing a new statutory wage-price policy, involving pre-notification of increases in wages and prices, and governmental powers to defer such increases. Very shortly afterwards, a number of European central banks and that of Japan began to buy sterling in the market, on the basis of agreements with the Bank in regard to guarantees on the value of the sterling they acquired. For a while, the market responded favourably to the combination of new incomes policy and concerted central bank action.

By February 1966 a reversal of speculative capital flows, plus an improved current account, enabled the Bank to repay much of its debt incurred in 1965 in defence of sterling. Although some senior advisers in Britain opposed the commitment to maintain the sterling parity (they would have preferred to let sterling float), officials in the US strongly supported the policy. The key considerations, in their view, were that if sterling were devalued, or depreciated under a float, 'probably followed by other currencies, enormous pressures would be imposed on the dollar as market participants came to expect a devaluation of the dollar or a suspension of its convertibility into gold... Among the concerns of American officials was a possibility that a breakdown of the monetary system, based as it was on the dollar as the major reserve currency, would lead to a reversion to restrictions on trade and payments as countries tried to protect themselves against a series of devaluations', as in the 1930's (Solomon, 91).

Wage rates rose rapidly in 1966 despite the wage-price package that had been introduced in the Autumn of 1965. Moreover, high interest rates in the US and Germany tended to draw funds out of ster-
ling. Although a restrictive budget was announced in May 1966, sterling again came under pressure in the exchange markets.

In mid-1966 further international assistance was negotiated -- the so-called 'Basle arrangements' under which a credit facility of $1,000 million was made available to Britain by the central banks of nine countries and the Bank for International Settlements. This assistance was specifically intended to provide resources to meet drains on Britain's reserves arising from any decumulation of sterling balances, but not those drains due to other components of the balance of payments (Midland Bank, February 1972, 123). (These Basle arrangements initially applied for a short period only, but they were renewed in March 1967 and March 1968.)

Late in July 1966, the Wilson government implemented a severe programme of restraint -- involving restriction of consumer credit, limitations on new building, increased taxes, reduced government spending at home and abroad, and a limit on tourist allowances -- aimed at stabilizing sterling once and for all. In addition, there was to be a six-month freeze on prices and incomes, to be followed by a further six-month period of severe restraint on prices and wages (Solomon, 92).

Helped by an ensuing sharp fall in the trade deficit in the fourth quarter of 1966 and by reductions in US and German interest rates late in 1966 and early 1967, sterling gradually strengthened. But once again, the respite was short-lived.

1.2. Devaluation, 1967

The level of British liabilities in the form of sterling balances varied from about £3,500 million to £4,000 million throughout the 1950s and early 1960s. Over the same years some countries used up most of their sterling holdings while others, such as the oil-rich countries of the Middle East, and some Far Eastern countries like Malaysia and Hong Kong, increased their holdings in London. The high and rising interest rates payable in London -- which actually reflected the underlying weakness of sterling -- encouraged
(mainly Commonwealth) countries to hold such substantial reserves there. Although the pound had come under pressure on several occasions in the 1950s and 1960s, successive British governments firmly resisted devaluation. Pressures from the US aside, a major reason for this was the existence of the sterling balances, some of which were owned by developing countries which would incur large capital losses in the event of sterling depreciation.

The Arab-Israeli war in June 1967 generated expectations that Arab funds would be switched out of sterling, and other holders of sterling acted on this expectation. In addition, the import surcharge that had been imposed in 1964 was lifted in November 1966, leading to a surge of imports early in 1967. The Bank, accordingly, again had to use reserves to support the exchange rate. For this reason, it used $800 million in the three months May-July, in part masking the problem by covering $660 million of this amount by drawing on credits from other central banks, thereby publishing a reserve decline of only $140 million. A dock strike that began in September 1967 added to Britain's problems. The Bank had to use about $350 million to support sterling in September, most of which was concealed from the public by official borrowing from central banks and by a one-day loan -- at the end of the month -- from the US. Between May and September, the Bank had borrowed $1,700 (Solomon, 93,4). The rate of reserve drain accelerated in October, but by then the government was hesitant to apply further deflationary pressure on the economy. On 14 November 1967 it was announced that in October Britain had incurred the largest trade deficit in its history. This was followed by an avalanche of sterling sales. It is estimated that in one day -- 17 November -- the Bank paid out more than $1,000 million of reserves in supporting a sterling parity that was to be abandoned the next day (Solomon, 95): Devaluation -- from £1 = $2.80 to $2.40 -- was forced on Britain on 18 November 1967. In the view of one writer, there was a prime example of how the historical burden of Empire and of former economic strength led to policies [of restricting growth] which were bound severely to curtail British prosperity. The enforced devaluation may be taken as a major step, albeit a belated one, in the slow recognition on the part of British Governments that their political ambitions based on past glories were beyond the capability of the economy to sustain and were inflicting an intolerable level of damage on it' (Pollard, 363).
The devaluation was accompanied by a package of restrictive internal policies -- tighter credit generally and an increase in Bank Rate from 6.5% to 8%, more discriminatory terms on consumer credit, continuation of the wage-price policy, and projected tax increases and reduction in government expenditure in the forthcoming Spring budget. The March 1968 budget included increases in indirect taxes designed to reduce the growth of consumer spending, and a ceiling on income increases was announced. Prime Minister Wilson described this as 'the most punishing Budget in Britain's peacetime history' (Solomon, 98). Nevertheless, unlike the case in 1949, the 1967 devaluation was followed by a short-run deterioration rather than improvement in the monthly trade balance, the eventual improvement in which occurred only after a delay of more than a year (Tew, 66) -- a phenomenon widely referred to as the short-run 'curve' effect. The current account balance of payments eventually moved from deficit into a large surplus in 1969. But the 1967 devaluation did not end the pressure on sterling, and further IMF loans were necessary. These loans were the transmission mechanisms for the IMF's emphasis on monetary targets in British economic policy, in the form of Domestic Credit Expansion (DCE). A loose undertaking on the money supply had been given by Britain to the IMF in November 1967; DCE followed in 1969. These events clearly demonstrated the capacity of lenders to enforce conditions on borrowers. However, the DCE targets ceased to have significance for a few years after April 1971, when the IMF loan conditions expired, by which time the Labour governments of 1964-70 had gone.

The 1967 devaluation was followed by withdrawals of funds from London as holders of sterling balances sought more security. Britain responded by negotiating the Basle arrangements which were announced in September 1968, under which twelve central banks, together with the Bank for International Settlements, extended Britain a loan facility of $2,000 million. This was to enable Britain to meet withdrawals from sterling and to guarantee the dollar value of a large part of the remaining official sterling balances. In the latter respect the measures of 1968 were fundamentally different from the Basle arrangements of 1966, subsequently renewed. Thus, parallel with the 1968 Basle credit arrangement, Britain negotiated a series of agreements (mostly for three years with provision for extension to five) with individual Sterling Area countries, whereby each undertook to hold a specified proportion of its reserves
sterling; in return, each of such countries obtained a dollar-value guarantee on its official holdings of sterling in excess of 10% of its total external reserves (Tew, 124). In the event, the sterling balances, both official and unofficial, increased in the following years, and the 1968 credit and guarantee arrangements (which had been renewed at intervals) ended in 1973-74, but not before Britain had to pay large sums in compensation arising from depreciation of sterling against the dollar in 1972-74.

The government sector's current account balance of payments deficit continued to grow in nominal terms after 1967. But, in line with reductions in military expenditure overseas, they fell in real terms. However, by the late 1960s and the early 1970s, the savings in the balance of payments thereby incurred were being offset by the need to pay interest and principal on monies borrowed by the Bank from the IMF and other central banks. Such foreign exchange losses reflected large loans raised by the Bank in order to cover Britain's periodic balance of payments deficits. Thus, 'Britain became a regular debtor in need of aid on the world's money markets, subject to control and inspection by her foreign creditors, even though her own non-Governmental economic transactions normally left her in healthy surplus, and her private citizens were still year by year investing heavily abroad. These official loans required interest payments which further burdened the external balance, and when restrictions [on output], devaluations and similar actions on the part of the Government had created temporary surpluses as in 1969-71, these could not be used fully to expand the economy, but had to be devoted to repaying the foreign loans' (Pollard, 364). However, by the late 1970s the coming on stream of North Sea oil and gas discoveries began to ease Britain's energy import bill and hence its balance of payments position. But the overall objectives of macroeconomic policy had fundamentally changed by then.

1.3. The Demise of the Sterling Area

The cohesion of the Sterling Area was in fact increased following the abortive attempt at convertibility in 1947. The members were so scared by the outflow of dollars that 'the consequence of this debacle was closer cooperation among members of the sterling area with respect to trade policies as well as in the uti-
lisation of sterling assets. More, rather than less, uniformity was introduced into members' exchange on questions of drawings on the central reserves; and capital movement policies became more concerted' (G. Paterson, quoted by Strange, 62). The Area was further reinforced by the sterling crisis which preceded the devaluation of 1949. Those Commonwealth countries which were members of the Sterling Area (i.e. all except Canada) then agreed that each would reduce its demand on the reserves during the next year by cutting dollar spending to 75% of 1948 levels (Strange, 62). The strengthening of the Sterling Area as a discriminatory bloc led by Britain caused a senior US official to note that Britain 'had agreed to work jointly with the United States towards a world of free convertibility and non-discrimination but now seemed to be moving in the opposite direction, discriminating against the dollar and against dollar purchases' (Cairncross and Eichengreen, 118). There was in fact a sharp fall in Sterling Area imports from the US, and over the twelve months July 1949 - July 1950 the fall was 25% as planned (Cairncross and Eichengreen, 120). Renewed pressure on the reserves following the outbreak of the Korean War (which started in June 1950) led to a commitment, in January 1952, under which governments in the rest of the Sterling Area agreed to tighten severely their restrictions on imports from outside the Area (MacDougall, 41). Hence, 'an important political effect of this period when the overseas sterling area operated as a dollar discriminatory club, was that British leadership of the Commonwealth was sensibly reinforced, and perhaps artificially prolonged .... There was not much in the field of foreign or defence policy even in the 1950s that the independent Commonwealth could find to agree about. The state of the gold and dollar reserves, however, provided a valid reason for periodic Commonwealth conferences of Finance Ministers if not of Prime Ministers. At this time the reserves were referred to as 'reserves of the sterling area' but what was meant by this term was that although the reserves of gold and dollars belonged to Britain, Britain (as banker) was holding them at the disposal of her reserve-currency customers in the sterling area .... [A] way in which these post-war monetary arrangements helped to arrest the process of imperial disintegration was by postponing the ultimately inevitable diversification of the members' reserves. So long as there was a collective agreement to limit dollar spending and to contribute dollar earnings to the dollar pool, there was little incentive to accumulate separate national reserves in gold or dollar assets .... But while the monetary arrangements between sterling area countries in this post-war period may have rein
forced, and thus helped to prolong British influence outside Europe, they also seemed to lull the British themselves into a false sense of immunity from the ultimately inescapable winds of change' (Strange, 67-69).

In the decades following the war, the practice by Sterling Area countries of holding separate national reserves -- rather than relying on the Reserve Pool in London -- generally became increasingly common. Also, at various dates after the war, South Africa left the British Commonwealth though remaining in the Sterling Area, Egypt and Iraq left the Area, and Burma left both. Most of the colonies attained independence. The latter countries set up their own central banks in place of the earlier currency boards over which Britain had some control. An outcome of all this was shrinkage of Sterling Area membership and considerable diversification of reserves of Area countries, mainly because additions to those reserves were in non-sterling, rather than in sterling as before. Also, partly through US balance of payments deficits, the US dollar replaced sterling as the world's dominant reserve currency. The relative switch out of sterling also reflected growing diversification of trade of Sterling Area countries, implying reduced dependence on Britain.

But probably the most important consideration in the trend toward reserve diversification in Sterling Area countries was the mounting evidence, especially from the mid-1950s onwards, that sterling was becoming progressively overvalued at its 1949 parity. The weakening in the links of the Sterling Area was demonstrated when sterling devalued in 1967. By contrast with 1949, several major Area countries, including Australia, South Africa and India, maintained a fixed parity against the US dollar, thereby effectively revaluing against sterling. Several others devalued, but not to the same extent as sterling.

Whereas in 1966 the main purpose of the Basle arrangements had been to offset pressure on the British reserves, the prime objective of the 1968 Basle arrangements was to prevent such strains by maintaining the level of official holdings of sterling by Sterling Area countries. On that occasion the Basle group of countries provided backing for dollar-value guarantees given to Sterling Area countries in respect of the bulk of their official holdings of sterling. Also, a further aspect of the 1968 arrangements was that
Sterling Area countries individually agreed with Britain to hold a minimum proportion of their reserves in sterling. Unlike the 1966 arrangements, the Basle arrangements of 1968 related to sterling balances held by Sterling Area countries only (Tew, 123).

Until 1990, Britain operated a floating exchange rate regime from 1972 onwards. The decision to allow sterling to find its own level on the foreign exchange market was accompanied by a measure which terminated the old Sterling Area. This was effected by redefining the Scheduled Territories -- as the Sterling Area was known for exchange control purposes. The Scheduled Territories were redefined as consisting of the United Kingdom, Channel Islands, Isle of Man, and the Republic of Ireland, thereby excluding the rest of the former Sterling Area. Exchange controls (relating to capital movements mainly) were then extended to transactions between the new Scheduled Territories and the rest of the world. As officially stated, the basic reason for this fundamental change was simply that many important countries no longer linked their currencies to sterling: For example, Australia decided formally to tie her currency to the US dollar in December 1971. With other currencies fixed in terms of the dollar and sterling floating, it was suggested that speculative outflows might take place if the supply of capital to overseas former Sterling Area countries remained free of control. Furthermore, following Britain's decision to float, many British Commonwealth countries severed the direct link between their currencies and sterling.

It can be concluded that what were considered to be symbols of British imperial glory -- the old Sterling Area and sterling as a key reserve currency -- gradually faded in the post-war era. But, as one economist wrote in 1971, while the decay 'was slowed down and disguised, the disintegration was deliberate, obscure and covered up. The British bureaucracy and British politicians showed all along a remarkable reluctance first to acknowledge that any disintegration was taking place, and then to deal coherently with it. The retreat from empire has been, in monetary as well as in military policy, a slow and grudging one, each step of the way has been fought with stubborn obstinacy' (Strange, 74-5). Thus, in the 1960's Britain fought to avoid the break-up of the Sterling Area, 'not only for monetary reasons but because with the political dissolution of the Empire and the erosion of the Commonwealth as a trading area, the sterling association now became one of the few things which held the Commonwealth together. As Mr Wilson
[then Prime Minister] remarked with feeling in November 1964, 'To turn our backs on the sterling area would mean a body-blow to the Commonwealth and all it stands for' (Strange, 89).

I. 4. A Floating Exchange Rate, 1972 Onwards

The postwar regime of fairly fixed exchange rates in the non-Communist world -- the so-called Bretton Woods system -- collapsed in 1971-73. Since then, major Western countries have operated managed floating exchange rate regimes, including (in the case of EC countries) floating currency blocs. Following severe pressure on the reserves (a loss of about $2.500 million in one week) Britain floated the pound in June 1972. This was initially done in order to allow economic growth to proceed unimpeded by the need to pursue 'stop-go-stop' policies under fixed exchange rates. Thus, in his March 1972 budget speech, the Chancellor of the Exchequer (i.e. Finance Minister) had stated that 'it is neither necessary nor desirable to distort domestic economies to an unacceptable extent in order to maintain unrealistic exchange rates' (Midland Bank, November 1972, 14). By October 1972 the pound had depreciated against the dollar by about 10%. However, floating later became intertwined with a new emphasis on control of inflation as the dominant objective of policy.

Exchange rate policy between 1973 and 1976 focused mainly on smoothing and slowing, but not fundamentally trying to reverse, the depreciation of sterling in line with higher than average rates of inflation in Britain. Thus, the prime objective in exchange rate policy seems to have been to maintain competitiveness in an orderly floating rate environment. But the trend of the exchange rate in those years seems to have reflected market forces rather than conscious attempts by the authorities to generate depreciation. However, rather than being produced 'in the market', depreciation early in 1976 was at first officially inspired: the Bank believed that sterling was overvalued in relation to Britain's competitive position, and consciously engineered depreciation (Tomlinson, 155). This, in turn, precipitated speculation against sterling which, as in the late 1960s under fixed exchange rates, ultimately led to a package of borrowings from the IMF and the usual types of conditions attached to such loans.
One of the conditions laid down by the IMF was the adoption of money supply targets, which then became a central feature of British economic policy. This meant that there was little scope for pursuing an independent exchange rate policy: the exchange rate would tend to move up or down depending on the variation in the money supply relative to that abroad. An abandonment of attempts to have independent exchange rate targets from 1977 seems initially to have rested largely on an irrepressible surge in purchases of sterling by foreigners at that time. However, the dropping of exchange rate targets -- in favour of money supply targets -- also reflected certain developments in economic theory in regard to the impact of monetary policy and exchange rate determination.

A simplified version of these theoretical developments runs roughly as follows (there are many variants of the argument): Under floating exchange rates, both the rate of inflation and the exchange rate are determined by the rate of growth of the money supply; given the foreign price level, expansion of the money supply at a rate in excess of the rate of growth in real output leads to an excess supply of money which spills over to the balance of payments in the form of current account deficits and capital outflows, thereby inducing exchange rate depreciation; the depreciation means higher domestic-currency prices of internationally traded goods and services; that in turn leads to higher wages, and hence we also get higher prices of nontraded goods and services; thus, the ultimate effects of expansionary monetary policies are exchange rate depreciation and inflation. These propositions pertain to the medium-run rather than short-term aberrations, and they are subject to qualifications in regard to the definition of money supply aggregates and to further qualifications in the face of institutional change and supply-side technical innovation in the financial field. For close to a decade from 1978 onwards, economic policy in Britain was based on arguments of the kind just outlined. Accepting the theoretical framework (though oversimplified as outlined) as broadly correct, it follows that under floating exchange rates, if a target is set for the rate of inflation, then the money supply must be adjusted to a level consistent with the inflation target and the exchange rate will tend to adjust to a level consistent with all of this. Because control of inflation became the dominant policy objective in Britain for several years from the late 1970s onwards, and in line with the reasoning just outlined, the notion of an exchange rate target was, in large measure, abandoned.
the early 1980s. But it would be wrong to infer that the Bank showed no interest in sterling’s exchange rate in those years. From time to time it intervened in the market, but such interventions were usually smoothing operations. Movement in the exchange rate was sometimes used as a barometer of domestic monetary conditions. As indicated by the Governor of the Bank in 1984, ‘let me repeat without qualification that we do not have an exchange rate target. But this is quite a different matter from saying that we are not concerned about the movement in the exchange rate. We are -- because there are times when the movement in the exchange rate is telling us something about domestic monetary conditions’ (Quoted by Fischer, 21). Thus, in April 1986 the Chancellor of the Exchequer noted that increasing attention was being paid to the exchange rate as an indicator of future inflationary pressure (Fischer, 22).

In the late 1980s emphasis again switched to exchange rate rather than money supply targeting in British economic management. Following major reductions in British inflation in the early and mid-1980s aided by tight monetary policies, this further switch in emphasis reflected problems in domestic economic management from the mid-1980s onwards, as well as the development of exchange rate arrangements between major EC countries. Elaboration could take us well beyond the terms of reference for this survey, and will therefore be brief.

First, the waning of interest in traditional money supply aggregates from the mid-1980s onwards was mainly due to the fact that reliance on such statistics led to serious underestimation of the strength of aggregate demand and to what, in retrospect, was an inappropriately loose monetary stance before corrective action was undertaken beginning in 1988. The monetary statistics had become less reliable as leading indicators of nominal expenditure because they had been affected by structural shifts related to supply-side innovation and credit deregulation throughout the 1980s (Directorate-General, Chap. 3).

Second, the exchange rate mechanism (ERM) of the European Monetary System (EMS) had been established by EC countries late in the 1970s. The UK excepted, EC Member countries agreed to limit fluctuation of their currencies to within a band of plus or minus 2.25% of specified central rates against the European Currency Unit (the ECU, which is a weighted basket of national EC-country currencies). A
looser arrangement was made for Italy, permitting fluctuation of up to plus or minus 6% around the Lira central rate against the ECU. But (although sterling was included in the ECU) Britain stayed outside the ERM for over a decade. It seems that an important reason for that decision was the surrender of domestic control over monetary policy which such a return to (approximately) fixed exchange rates with other EC countries would have entailed, in an environment of largely unrestricted movement of both goods and financial assets within the EC. It was not until October 1990 -- shortly after the resignation of Prime Minister Thatcher -- that Britain was willing to become a full member of the EMS by joining the ERM. She did so by agreeing, as a transitional measure, to maintain sterling within a band of plus or minus 6% fluctuation against Britain's chosen central rate in terms of the ECU. This has meant that the exchange rate has again come to the fore as a target and as a constraint in British economic policy. Thus, time is replacing Britain's leadership of Empire by Britain's integration in the European Community, dominated by Germany.

II. ACTIVIST EMPLOYMENT POLICY AND ITS DEMISE

II.1. The Keynesian Experiment, 1951-73: Stop-Go-Stop

In October 1951 the Conservatives returned to power, a position they sustained until they were replaced by Labour in 1964. They restored to private ownership the iron and steel industry (though this decision was to be reversed under Labour in 1967) and road haulage, but otherwise they perpetuated most of the policies initiated by the out-going Labour government. However, whereas active monetary policy was in abeyance until 1951 -- Labour had extended the long-prevailing 'cheap money' policy throughout its year in office -- the new Conservative regime introduced more active monetary measures to supplement fiscal policy in the regulation of demand.

Keynesian demand management was a central feature of British policy until the 1970s. Demand was expanded at times when unemployment showed signs of rising. Controls on consumer credit, increases
tax rates and in Bank Rate, and spending cuts (often in the investment programmes of the nationalized industries) were put into force when growth threatened the balance of payments. Given the sensitivity of the low level of foreign exchange reserves to changes in output and employment, this symmetry in policy stance led to policy-created cycles of about 5 years duration from trough to trough, and hence to the 'stop-go-stop' economy. Thus, the kind of short-run management adopted differed from that implied by Keynes' *General Theory*. Because he had, for the most part, assumed a closed economy, Keynes had not concerned himself with the possible need temporarily to stop economic expansion due to a balance of payments constraint under fixed exchange rates. Fiscal rather than monetary measures were dominant in the stop-go-stop process of the 1950s and 1960s. Indeed, there was 'probably no country in the world that ... made a fuller use ... of budgetary policy as a means of stabilizing the economy' (Dow, 178). Furthermore (in contrast to what might have been expected from statements in the 1944 White Paper on Employment Policy), the emphasis in fiscal policy was on variation in tax rates rather than in real public expenditure (though the latter did occur). This made sense: Partly because it is politically difficult in the short run to cut back on current items such as civil service numbers or pay, and because public investment is typically 'lumpy', it is more efficient to raise tax rates rather than, say, temporarily abandon a school-building programme, if a boom has to be moderated due to a given commitment to fixed exchange rates.

Until the 1970s, Keynesian policies were implemented around a trend of a fairly high level of economic activity. Indeed, the trend levels of economic activity would probably have been high even in the absence of such policies. (See Tomlinson, who in effect regards investment demand as beyond the domain of budgetary policy, for an extreme case of this argument). The government's current budget was in fact consistently maintained in surplus throughout the 1950s and 1960s. Britain's unemployment rate, on average, was well below 2% in the 1950s; in the 1960s it was close to 2%; only in 1971 and 1972 did it rise to above 3% over the period 1951-73.

In an examination of the stop-go-stop cycle, it is appropriate to begin with the year 1951. In its analysis of the shortfall in savings over investment that would have to be rectified by government through a current budget surplus, Labour's budget early in 1951 was more obviously Keynesian than those of earlier
post-war years. Rearmament for the Korean War led to severe deterioration in Britain's terms of trade, speculative inventory accumulation and to pressures on domestic supply capacity, and hence to a sudden current account payments deficit in 1951. The extent of the deficit was not fully apparent at the time. Labour's spring budget. Taxes on consumption were raised slightly, but the major changes in the tax code implemented at that time had the effect of curtailing private fixed investment. As the massive current account balance of payments deficit became more obvious late in 1951, Bank Rate was raised almost immediately under the new Conservative government; this was followed by a further increase early in 1952, and by open market sales to make the higher interest rate policy effective, thereby changing the stance in monetary policy for the first time since the early 1930s. The 1952 budget saw further retirement aimed at freeing resources for rearmament, away from private consumption and investment. Aid by the measures taken, as well as by a fall in import prices, the current account balance of payments improved in the same year. The Conservatives then initiated a reflation (including restoration of incentives for private investment) in 1953-54. By the end of 1954 the ensuing boom was beginning to endanger the balance of payments. Monetary measures taken at the beginning of 1955 included increases in Bank Rate and restrictions on consumer credit. However, mindful of the forthcoming general election to be held in May 1955, the government added to the expansion in its spring budget through cuts in income tax, and by the summer of 1955 the economy was once more in crisis. The year as a whole showed a large current account payments deficit. An emergency budget in the autumn of 1955, in which taxes were sharply increased, became necessary to rectify the current account deficit and to curb speculation against sterling. Early in 1956, tax incentives for private investment were reduced, and further measures of monetary restraint were implemented. This crisis also saw severe cuts in the investment programmes of nationalized industries. Thus, the first stop-go-stop cycle of the 1950s was revealed by late 1956.

The budget of April 1957 was neutral, if not mildly expansionary. But at best, this was to prove a false start. Given a commitment to a fixed exchange rate against the dollar, a package of deflationary measures was forced on the authorities in September, following renewed speculation against sterling. Such speculation was not based on 'real' factors in the British economy in that year: Britain's curr
account payments position was actually in healthy surplus in 1957. Rather, the speculation was related to a number of external factors, including expectations of a possible revaluation of the West German currency unit. Thus, output and employment stagnated in 1956 and 1957. By 1958, when Britain (aided by substantial improvement in its terms of trade) had its largest current account payments surplus since the war, it was clear that the economy was deep in recession. The 1958 budget, which improved some investment incentives, laid the basis for a slow expansion. Monetary restraint was also eased in the same year. Nevertheless, an unemployment rate of 2.8% at the beginning of 1959 was the highest since the war. In response to such statistics, and with a view to restoring full employment, the April 1959 budget was probably the most expansionary in peacetime to date. A result was a grave deterioration in the current account balance of payments in 1960. The budget of early 1961 inaugurated another period of restriction. The large payments deficit of 1960 had been met, not by a run-down in reserves, but by short-term foreign loans. Speculation against sterling in the first half of 1961 was met by further borrowing, including a loan from the IMF, all of which weakened sterling in the long run. Measures implemented in mid-1961 included increases in tax rates and in Bank Rate, combined with promises of major cuts in government expenditure as insisted by the IMF. These policies turned moderate expansion in the first half of 1961 into a sharp contraction during the rest of the year, thereby completing the second cycle of stop-go-stop.

Another reflation, involving reduced taxes, increased investment incentives and eased monetary conditions, was instituted in 1962 and 1963. The crisis year was 1964, which marked the third cyclical peak after 1951. The Conservatives were hesitant to relax the boom early in 1964 because of a general election to be held later that year. In consequence, the 1964 current account payments deficit was the largest since the war. Almost immediately after coming to power in October 1964, the new Labour government applied several crisis measures of demand contraction, and further deflationary policies were implemented in 1965-67. Nevertheless, the current account payments remained weak, and speculation against sterling was persistent. Following the 1967 devaluation, the squeeze on demand was extended into 1968, and unemployment continued to climb from the low levels which prevailed in 1964-65. This was the period of the fourth -- and, to date, the longest 'stop' since the early 1950s.
Monetary and fiscal contraction were continued into 1969, but by then the devaluation of 1967 had begun to reveal its effects, and the balance of payments on current account had moved into surplus, which greatly increased in 1970 and 1971 (the latter being the biggest surplus to date). At first, the Conservative government which came to power in mid-1970 was cautious in setting the signals at 'go'. But in the face of rising unemployment, its budget early in 1971 was mildly expansionary. Further stimulation was applied later in the year, including programmes of public works, reductions in Bank Rate, the lifting of ceilings on consumer credit, and tax cuts. The 1972 budget, in seeking to deal actively with the unemployed, then at a temporary peak of about 3.5%, was even more expansionary. Although the external constraint on demand expansion for employment creation was relaxed when sterling was allowed to float in mid-1972, the budget of 1973 was roughly neutral.

The Conservatives did not get an opportunity to complete the cycle set at 'go' in 1971-72. They were replaced by a Labour government early in 1974. But by then, attempts to fine-tune the economy along Keynesian lines subject to an external constraint, in a neighbourhood of full employment, were soon to be abandoned.

II. 2. Employment Policy under Labour, 1974-79: The Decline of Keynesian Management and the Emergence of Monetarism

A Labour government was in office from February 1974 until May 1979. The OPEC oil price increase of 1973-4, combined with strong upward pressure on wage rates, meant that -- for the first time since the 1950s -- control of inflation became a key objective of policy. The implementation of counter-inflation measures, unprecedented in severity, led to high and rising unemployment under Labour. This was in contrast to 1970-4, which saw real income growing at an annual average rate of about 4%. Unemployment had averaged around 3% over the same years. By contrast, the stagnation of the later 1970s brought a rise in the unemployment rate from 2.5% in 1974 to over 5% in 1979. Thus, the short-run stop-go-styly cycle of earlier years was replaced by a more sustained 'stop', and some abandonment of full employment as a paramount policy objective.
Fiscal policy in 1974 was roughly neutral. But for the first time since the war, the 1975 budget explicitly abandoned the full employment objective. With inflation running at a high level, and with unemployment also high, and rising, the fear then was that expansionary policies would weaken the floating sterling exchange rate, accentuate inflation and increase the Public Sector Borrowing Requirement (PSBR) -- which in itself became an important intermediate objective by the mid-1970s.

In September 1976 the Labour Prime Minister went so far as to state that Britain's option of restoring employment by spending its way out of recession 'no longer exists', and 'in so far as it ever did exist, it worked by injecting inflation into the economy. And each time that happened the average level of unemployment has risen. That is the history of the last 20 years' (Quoted by Peden, 221). In making this statement, according to one observer, 'he was hoping to make an impression on ... the US ... that he was serious about offering British financial rectitude in return for a US-backed IMF loan .... The speech was more a tactical move than a full and serious reappraisal of policy .... But the speech undoubtedly represented a partial reappraisal of policy' (Keegan, 90). In the same year -- 1976 -- the pound was allowed to depreciate against the dollar by 15%, in order 'to help employment at the expense of making inflation worse, thus operating directly against all the rest of the current policy package, which attempted to curb inflation at the expense of unemployment' (Pollard, 417). With sterling under severe pressure, limitation of domestic credit expansion (DCE) was again one of the conditions for the large IMF credit to Britain at the end of 1976. (Recall that such controls had earlier been insisted upon by the IMF in the late 1960s). A renewed emphasis on DCE represented a switch toward monetarist thinking, which had already begun to emerge in government circles with the announcement of money supply targets at the time of the budget early in 1976. Budgets now became linked to medium-term DCE along with cuts in real government expenditure and in the PSBR.

Britain had entered a phase of crisis in its public finances by the mid-1970s. This was reflected in rapid increases in both public expenditure and in the proportion of that expenditure financed by borrowing. The carry-forward interest burden effects of borrowing in earlier years aside, the sudden rise in the PSBR -- by about 250% in the two year period 1975-6 -- was not a consequence of contemporary Keyne-
sian policies aimed at reducing unemployment. Rather, it largely reflected increased relative prices of public sector inputs (labour, land and buildings), failure to adjust indirect taxes in line with inflation, and increases in the number of unemployed in receipt of unemployment relief. The rapid rise in the PSBR in 1975-6 meant that the government enormously increased the amount of debt it was trying to sell in a short period. Initially the emphasis was on sales of long-term securities in order to avoid the inflationary impact of more liquid short-term liabilities. But the response of potential private purchasers, who seemed to feel that the public finances had got out of control by 1976, 'was to stop buying long-term debt for a substantial period ... -- a 'gilt strike' which lasted for practically the whole of the May to September period in 1976, and forced the authorities to flood the market with short-term debt .... A consequence of the squeeze on government policy was of course a series of public expenditure cuts (February, July, November 1976) which were largely aimed at placating the markets' (Tomlinson, 132). But in 1976 it was not only private-sector institutions which imposed pressure on government for retrenchment: there was also the insistence of the IMF.

Although the PSBR crisis of 1975-6 brought about reversals in fiscal policy along with new emphasis on monetary control, rejection of Keynesian management was not yet final. Thus, in his 1978 budget the Labour Chancellor of the Exchequer argued that 'it is the first purpose of this budget to encourage the level of economic activity to get unemployment moving significantly down', and 'our main objective in the coming years ... must be to reduce the intolerable level of unemployment by stimulating demand in ways which create jobs at home without refueling inflation' (Quoted by Tomlinson, 136). Although the Chancellor also argued that 'inflation is the main enemy of full employment', he nevertheless felt that the prevailing context of a current account balance of payments surplus, falling inflation and the money supply apparently under control, at last justified the signals being set at 'go' in 1978. But after a neutral Labour budget in April 1979, the new Conservative government set out to implement major changes in policy in its budget of June 1979.
II. 3. Employment under the Conservative Experiment, 1979 and into the Eighties

The Conservatives returned to office, under Prime Minister Margaret Thatcher, in May 1979. The new government combined a political/economic critique of growing state intervention in the economy with a new emphasis on monetarist, rather than Keynesian, conceptions of economic activity. With control of inflation now the overwhelming policy objective, the goal of full employment, as something to be pursued in the short-run or medium-run, was almost totally abandoned for the following decade.

The Conservatives also placed a new emphasis on the supply, rather than the demand, side of the economy, and the scale of government economic activity was to be reduced in order to allow for reductions in taxation, thereby restoring incentives for work and entrepreneurship, and many traditional economic activities of the state were to be transferred to the private sector. That entailed selling off -- 'privatizing' -- many of the nationalized industries, sub-contracting services formerly provided by public sector employees, and reducing the stock of public housing by selling much of it into private ownership.

Inspired by monetarist economists, and in reflection of a growing consensus on the right of the Conservative Party when in opposition in the late 1970s, Thatcher argued that rising levels of inflation were caused mainly by monetary expansion which followed from public sector deficits. Furthermore, so the argument ran, Keynesian pump-priming merely raised the public deficits, the money supply and the inflation rate; therefore, growth in output and employment without inflation would best be pursued if government adhered to rigid targets for growth in the money supply and low PSBRs, regardless of the state of output and employment in the short-run. Insofar as Thatcher adopted specific employment policies at all, they were to be mainly microeconomic rather than macroeconomic in character.

Adopting the standpoint of rational expectations theory, several economists argued that the announcement of credible monetary targets would automatically lead workers to reduce their wage demands, in the knowledge that to act otherwise would price themselves out of a job -- into unemployment that would then be voluntary. As one of Thatcher's economic advisers put it in 1980, 'on the assumption that policies are properly understood when they are announced and implemented, the distur-
bance to output and employment from reduction in the money supply and in the PSBR will be minimum.

(Quoted by Hall, 101).

Immediately after it came into office, the new government found that public expenditure was running
at levels well above what had been forecast or revealed. This was partly because Labour, in its run-up
the general election, had relaxed its policy of cash limits on departmental expenditures (originally deve-
oped in 1976 under Labour, but subsequently extended by Thatcher) and had made various decisions
to subsidise nationalized industries. Furthermore, the incoming Conservative government quickly dis-
ered that the statistics for the wide money supply (sterling M3) and the PSBR were much higher than they
had thought. In consequence, the maximum spending cuts feasible in the Conservatives' June 1979 bud-
et could not permit substantial simultaneous cuts in both taxation and the PSBR. Reductions in income
taxes (especially in the high marginal rates) offset by large increases in indirect taxes, and allowing the
nationalized industries to increase their prices substantially, were the main direct supply-side aspects
of the budget. On the demand side, the overall stance of fiscal policy was tightened: the PSBR fell signi-
cantly between fiscal 1978-9 and 1979-80. On the monetary front, the Minimum Lending Rate (MLR)
a transform of the old Bank Rate, and now the key interest rate in the system -- was raised from 12%
the beginning of May to a record high of 17% in November 1979.

A major theme of the three years from June 1979 was the political and economic price which the
Conservatives risked in order to bring inflation under control. The economic price was manifested in
fall in output not experienced since the 1920s or early 1930s, and a massive rise in unemployment. Some
of this would have occurred in any case, as a result of world recession induced by the 1979-80 energy
price increases, the application of contractionary macro policies internationally, and the impact on tradi-
tional industry of appreciation of the pound sterling influenced by British North Sea oil revenues which
began flowing, and rising, around that time (although this was probably of minor importance relative
to contractionary monetary policies in Britain). Britain suffered much more than most: by January 1983 the
unemployment rate, which had averaged 5.5% in 1979, was 13.3%, compared with an average for deve-
oped Western economies (at 5.1% in 1979) of 8.9% in January 1983 (Keegan, 131).
Monetary and fiscal policies were generally contractionary in 1980-82. Given its objectives in regard to growth of monetary aggregates and reduction of the PSBR, the government sought cuts in its expenditure early in its term of office 'so that tax reductions could follow just before the next election' (Hall, 103). Sharp appreciation of sterling on foreign exchange markets accentuated the falls in output and employment in 1979-81. Although the effects of Britain's North Sea oil production and perhaps also international confidence in Thatcher's government played some roles, it seems that high interest rates in Britain were the main causes of that appreciation and the ensuing loss of competitiveness. In consequence, monetary policy -- though still tight -- was relaxed slightly in 1981, when it was decided that depreciation of sterling should be encouraged. Around the same time -- in the summer of 1981 -- Thatcher's insistence on a contractionary fiscal stance in the face of a continuing recession and rising unemployment induced a revolt in the Cabinet. But Thatcher 'took revenge by dismissing several moderates ... and promoting Ministers known to be loyal monetarists' (Hall, 106).

Aided by modest tax cuts in the March 1983 budget in anticipation of a general election to follow shortly afterwards, output began to recover in 1983-4. But unemployment continued to rise, averaging 13.2% in 1984. The Chancellor of the Exchequer was concerned about this problem. However, in contrast to the Keynesian view, the Chancellor told the nation late in 1984 that 'rising unemployment resulted from real wages that were too high and rigidities in the labour market .... It would fall only when workers accepted lower real wages and when microeconomic measures were taken to eliminate the labour market rigidities (such as union power) that fostered high wages' (Hall, 106-7).

The budgets of 1984 and 1985 remained tight. Macroeconomic policy was still concerned about inflation. Those two budgets did, however, contain some measures to combat unemployment: To encourage firms to hire more labour, the government's manpower training schemes (which had already been on a large scale under Labour in the late 1970s) were expanded, profits taxes and employers' national insurance charges (the latter being taxes on hiring labour) were reduced, and tax allowances which favoured capital investment rather than labour recruitment were repealed. Employment policy was therefore very definitely microeconomic rather than Keynesian.
Before proceeding, it is worthwhile passing further comment on the manpower training programmes to which reference has just been made. These were various in form. Under one scheme the government paid minimal wages to school-leavers employed in industry-based training, and under another it offered firms subsidies to employ young people at wages below a certain ceiling (thereby supplementing downward flexibility in open labour market wage bargaining). A scheme was devised to enable local authorities to utilise unemployed persons on a variety of public works projects. Early retirement was subsidised in order to make jobs available to the young unemployed. These programmes were costing the British Exchequer substantial sums by the mid-1980s. The government's objective was not just (for social or political reasons) to reduce the number of persons officially recorded as unemployed. There was also the hope of creating work experience, of up-grading the skills of young persons who would otherwise be unemployed, and of reducing wage costs at the lower end of the labour market (thereby lowering the wages spectrum generally). Manpower policy under Thatcher reflected the view that the high levels of unemployment resulted from imbalances between the demand for skills and the endowment of skills (mismatch in the labour market) and excessive wage rates, rather than from general deficiency of demand.

The second half of the 1980s saw substantial recovery in output. But unemployment, averaging over 10% in 1987, responded in a downward direction only very slowly. Following Thatcher's victory in the general election of June 1987, major measures proposed in the Conservatives' election manifesto were implemented. These included a major cut in the basic rate of income tax (to 25%), and extension of the privatization programme. Thus, emphasis on supply-side measures was maintained. By 1990 -- Thatcher's last year as Prime Minister -- unemployment had fallen to around 6%. However, following counter-inflationary measures implemented around that time, and following the UK's October 1990 accession to the ERM of the EMS at what some observers regarded as an overvalued central exchange rate given prevailing rates of increase in wages, it seems that Britain's rates of unemployment in the early 1990's will exceed those of the late 1980's.
III. ECONOMIC GROWTH AS A POLICY OBJECTIVE

III. 1. Indicative Planning for Growth?

Following the fall of the Labour governments of the early postwar years, the thinking of the Conservatives on economic matters when they returned to power in October 1951 can be summarized in two phrases: preserve the welfare state while encouraging the market mechanism rather than state intervention. In response to persistent balance of payments pressures (and as indicated in Section II above), the 1950s saw the emergence of the stop-go-stop economy. Partly in consequence of this, British economic growth began to lag behind that of continental countries. Between 1950 and 1960 the average annual growth in British gross national product was 2.2%; Germany achieved 6.5%, Italy 5.3% and France 3.5%. Also, the relatively low proportion of gross national product going into capital formation in Britain suggested that new policies would be needed if relative decline was not to continue. It was not until around 1956 that the decline set in, and recognition of the problem did not become apparent until around 1960.

The 1960s saw a return to favour of economic planning in Britain. Rather than being based on political philosophy, this reflected a desire to stimulate steady and rapid growth. Planning no longer had the same meaning as under the 1945-51 Labour government; rather, it came to mean indicative planning, in some respects along French lines.

Much of the initiative in the movement toward planning came from the private sector. 'The next five years' was the theme under discussion at the November 1960 conference of the Federation of British Industry, attended mainly by private sector industrialists, but also by the Conservative Chancellor of the Exchequer. Stop-go-stop was severely condemned, and it was suggested that the government and industry might meet to consider 'whether it would be possible to agree to an assessment of expectations and intentions which should be before the country for the next five years' (Leruez, 86). The Conservative government's reaction to this view was favourable. This represented a convergence of views between the Conservatives and Labour: two years earlier, in a 1958 document, the Labour Party had referred to a plan-
ning system in which 'day-to-day decisions can be left to industry and the customer ...'. The objective of planning will be to provide a broad framework within which new wealth can go smoothly and rapidly ahead whilst the detailed decisions of industry do not come into conflict with national objectives' (Quoted by Tomlinson, 89).

Renewed speculation against sterling necessitated a special crisis budget in July 1961. In that budget speech the Chancellor of the Exchequer, having announced a long series of short-term 'stop' measures, indicated his intention to devise a framework for medium-term planning and growth. The result was the establishment, early in 1962, of the National Economic Development Council (NEDC). NEDC, a tripartite forum for consultation between government, labour and employers, was to last for the next twenty years. Its terms of reference (Leruez, 100) were: (i) To examine economic performance and plans for the future. (ii) To identify obstacles to growth and measures to improve efficiency. (iii) To seek agreement on measures to increase the rate of economic growth.

From 1964 onwards NEDC strengthened its links with individual industries by setting up tripartite economic development committees (EDCs) in 21 sectors of the economy. However, 'more often than not [these] became institutions which industry used to lobby government for special subsidies or protection rather than instigators of fundamental microeconomic change' (Hall, 87).

NEDC recommendations were to be the outcome of bargains struck between the three parties involved. Unlike the French Planning Commission, it was not well integrated into the policy-making process, where the Treasury remained dominant. Thus, it did not have the 'teeth' needed to implement policy recommendations.

The preparation of medium-term growth targets for 1961-66 was NEDC's first main task. These were accepted by the government early in 1963 (Leruez, 106-7). Not surprisingly, given the absence of adequate policy instruments, they were not attained. The 22% growth target for 1961-66 contrasted with an out-turn of 16%. The economy did expand very rapidly in the year in which the NEDC targets were published (1963). But 'this was an expansion of capacity utilisation not capacity, fuelled not by planned but by an 'old-fashioned' pre-election fiscal expansion' (Tomlinson, 93).
The general election of October 1964 brought to power a Labour government under Wilson committed
to growth. A dominant theme in Labour’s pre-election campaign was the need to break out of the
stop-go-stop cycle, above all with more interventionist policies. These were to include incomes policy
and an array of interventions in industry. Thus, in Labour’s pre-election rhetoric, priorities were to be
medium-run and long-term, implying an escape from the short-run obsessions of the past.

The first act of the 1964 Labour government was to set up a Department of Economic Affairs. The
new Ministry’s brief was: to take general responsibility for economic policy coordination; to prepare a
five year plan; and to develop an industrial policy, a regional policy and a prices and incomes policy. In
principle, the division of labour was that the Department of Economic Affairs dealt with the long-term
aspects of policy, while the Treasury remained responsible for short-term management with emphasis on
the financial aspects. A new Ministry of Technology was also created in 1964, to administer research and
development funds and supervise certain high-technology industries. In 1966, an Industrial Reconstruc-
tion Corporation was set up to assist in the rationalization of British industry.

The role of NEDC was reduced under the 1964-70 Labour government. Having lost its main func-
tion of preparing a plan, it was reduced largely to a consultative body on general economic questions and
to developing and coordinating the work of the sectoral EDCs. Within weeks of coming to power, the
new government indicated that it would replace the NEDC targets for growth to end-1966 by its own
National Plan, which was hastily prepared and published in September 1965. With 1964 as base year, it
sought an economic growth rate of 25% over the six year period to end-1970. However, this was little
more of a plan than NEDC’s earlier projections. The Department of Economic Affairs and the National
Plan were dismal failures, partly because they did not have the tools to implement their proposals, but
also because, given its opposition to devaluation, unremitting pressure on sterling forced the government
into a series of deflationary measures, which led to the effective abandonment of the plan by mid-1966.
The stop-go pattern of earlier years was then replaced by a more prolonged stop. Had the government
devalued and deﬂated immediately after it came to power, it might have relaxed the balance of payments
pressures which continued to frustrate its plans for growth. However, the Department of Economic
Affairs would still have lacked the means to implement its plan. Thus, 'the publication of the report achieved nothing and could achieve nothing .... In a sense, it was a largely academic exercise' (Youngson, 203).

The Department of Economic Affairs was abolished in October 1969, and the Treasury took over medium and long term forecasting division. The Industrial Reconstruction Corporation was more successful. It ultimately supported or financed 50 mergers involving 150 British companies. While some of the resulting hybrids performed poorly, others became viable firms in growth sectors. However, the scope of the Corporation's operations was small, affecting only 50 of the 3,400 mergers which took place in Britain while it was in operation (Hall, 88).

In Britain, growth had little role in the policy debates of the late 1960s. The devaluation of 1967 was followed by a severe 'stop', which eventually brought substantial improvement in the balance of payments. But this was attained at the cost of abandoning attempts to make the economy expand.

The fall of the Labour government in 1970 marked the end of attempts to develop comprehensive macroeconomic plans for medium-term growth. The absence of an adequate balance of payments strategy had virtually doomed such attempts to failure. The Conservatives came to power early in 1970 intent on reducing public expenditure and restoring discipline in the labour market. The 1970 budget was roughly neutral. But faced with rising unemployment, the government soon reversed its policies. Fiscal measures were expansionary from mid-1971. The control of credit was also greatly relaxed from 1971 and private borrowing was stimulated by a concession in the March 1972 budget which made almost all interest payments deductible from income for tax purposes. That budget aimed at a 5% growth rate, an objective which was roughly achieved in the year to mid-1973, but only at a cost of a rapid increase in the PSBR. Sterling was allowed to float in June 1972. The government's belief that it could make a 'dash for growth' -- such was the phrase widely used -- seems to have been related to that relaxation of the external payments constraint. But sterling rapidly depreciated, and a 32% rise in import prices between the third quarter of 1972 and the third quarter of 1973 was added to internal inflationary pressures (Peden, 174).
consequence, Britain had a severe inflationary problem even before the oil price crisis of October 1973. Thereafter, control of inflation rather than full employment or growth became the dominant policy objective.

The year 1973 marked the end of a 'golden age' of (by subsequent experience) high employment and moderate inflation. The 1973 level of output was not exceeded until 1977. There was a further fall in output between 1979 and 1981, and the 1979 level was not attained until 1983. In consequence of the new emphasis on control of inflation, economic growth as an objective to be pursued by short-run or medium-term macroeconomic management faded into the background after 1973, and had disappeared entirely by the 1980s. Insofar as policies in those years bore much relation to growth, they were to become much more microeconomic in character. The demise of growth as an objective to be attained by active economy-wide planning was symbolized by the return to power, in 1979, of the Conservatives, who abolished NEDC. As compared to the 1960s, growth was now to be left to the market mechanism, albeit guided by the microeconomic policies of the state.

III. 2. Regional Policy and Industrial Policy

There are two complementary strands in the argument for having a regional development policy, one the social aim of reducing unemployment and poverty in lagging areas, the other the avoidance of waste of production potential that arises when manpower or infrastructure are unemployed or underemployed.

Active pursuit of any regional policy was weak in the 1950s. Until the 1960s British governments viewed regional policy almost exclusively in social terms. The recognition of the economic waste involved emerged clearly only with the new thinking of the 1960s, with its emphasis on economic growth. Thus, in February 1963, when the national unemployment rate had risen to 3.9%, it had soared to 7.1% in the North-East of England. It was not until 1963 that attempts were made, by NEDC, to relate regional policy to the goal of growth. NEDC's calculations suggested that if the difference between national and regional unemployment rates could be cut by half, this would produce an increase of 1.3% in
the overall growth rate. A further economic argument was that the disparities between regions made it difficult to apply general monetary and fiscal policies against inflation because deflationary measures that might be needed to check excess demand in one region might have disastrous effects on more backward areas; conversely, general stimulation of demand to help areas of high unemployment would tend to add to inflation in regions where unemployment was low (Leruez, 154).

In 1963 NEDC recommended the formulation of a coherent regional strategy linked with the general conduct of national economic policy. In consequence, late in 1964 the Labour government announced that the entire country would be divided into regions and that regional institutions would be established. Labour set up two bodies in each of the regions of Britain -- a regional economic planning board and a regional economic planning council. Thus, 'the Labour government of 1964-70 was the first to treat regional development as an extension of central planning, forming a coherent whole with it and meeting the same criteria' (Leruez, 133).

The main task of the regional economic planning boards was coordination of the work of the various government departments in their region and cooperation with local authorities in the preparation of a medium-term economic plan within the context of the 1965 National Plan. The regional economic planning councils had the function of evaluating their region's productive potential and of working out a long-term strategy for its development. With this in view, each council undertook a study of its region. The resulting series of about eleven studies was completed in 1968. On the basis of these studies the councils suggested growth targets for each region, and made projections of the distribution of population, industry and employment, taking into account the targets of the National Plan (Leruez, 160). But, as seen in the immediately preceding subsection, that plan had effectively been abandoned by then.

Reduction of regional unemployment relied mainly on the level of industrial investment incentive and from 1963 these included grants of up to 10% and 25% of the cost of new machinery and building respectively. A regional employment premium was added in 1967 to subsidise wages in manufacturing industries, whether new or already established, by about 6%. Such employment subsidies ceased in 197...
Until the Conservative governments under Thatcher from 1979 onwards, very substantial proportions of all state aid for industry was devoted to regional development programmes, the object of which was not to promote specific firms or sectors but to transfer resources to the more depressed areas of the country; in that sense it was not selective. It has been estimated that about 300,000 manufacturing jobs were created directly by regional policy in the main development areas over the period 1960-76 (Peden, 186-7). But even then, the principal effect was probably more to change the location of investment than to stimulate new investment or rationalization.

Regional objectives and non-selective investment incentives continued to dominate policy under the Conservatives in 1970-74 and under Labour in 1974-79. In abolishing the Industrial Reconstruction Corporation and the Ministry of Technology, and in replacing investment subsidies by tax incentives, the Conservatives initially tried to withdraw the state from industrial intervention. But in the face of rising unemployment, in 1972 they passed a new Industry Act which provided for large industrial subsidies. However, 'almost three-quarters of the funds spent under this Act went to non-selective aid for the development areas' (Hall, 89). By contrast, around that time in France the bulk of industrial aid was selective, and only a negligible sum was allocated under regional policy (Leruez, 188).

British governments did begin to spend larger sums on selective aid to industry in the 1970s. But 'the great bulk of these funds went to failing firms in declining sectors of the economy' (Hall, 89). Most of the funds which the Labour government made available to the National Enterprise Board, set up in 1975 and modelled on the earlier Industrial Reconstruction Corporation to rejuvenate British industry, were channelled to a few large unprofitable firms.

Late in 1975 the Labour government announced a 'new industrial strategy', which was tripartite and voluntarist like that under Labour in 1964-70. Under the guidance of the NEDC, sectoral working parties (SWPs) were set up in 39 industrial sectors. Like the sectoral EDCs established by NEDC in the late 1960s, they sought to stimulate greater productivity through industrial reorganization. However, the outcome was very similar. In some cases the SWPs effectively lobbied the government for additional indus-
trial aid; but in the few instances where their efforts resulted in new industrial plans, most of the firms involved indicated they would have undertaken the investment regardless of SWP assistance' (Hall, 90).

The industrial policy of the Conservatives under Thatcher from 1979 onwards had two main features. On the one hand, the government reduced intervention by selling off nationalized industries and reducing the funds available as grants to the private sector. On the other hand, where the state continued to intervene, its actions were much more selective than its predecessors. Having rejected macroeconomic manipulation, the emphasis switched to microeconomic means to rejuvenate the economy.

By the end of 1985, over 50% of the shares in at least a dozen nationalized companies had been sold to the private sector under the privatization programme (Hall, 110), and this trend was maintained in the later 1980s. Many of these firms seem to be performing well under private ownership -- though it should be noted that these were mainly firms which had been profitable when owned by the state. Proceeds from the sale of public assets increased from £377 million in fiscal 1979 to £2.6 billion in 1985 (Kay and Thompson, 191). Although the sales helped reduce the government's PSBR in the 1980s, the profits foregone will reduce public sector revenues in the 1990s.

The Conservatives also implemented major rationalization programmes in many of those industries which remained in public ownership. They placed progressive businessmen in charge of some of them and directed them to make those industries profitable. In consequence, reorganization programmes involving job losses to the extent of 250,000 between 1979 and 1985, proceeded in the automobile, coal, national airline, railway, shipbuilding and steel industries, and 'all of those industries were more efficient, if much smaller, as a result' (Hall, 111).

More selective intervention in the private sector under the Conservatives in the 1980s was aimed mainly at high-technology industries. On the premise that, if much of investment in development areas was efficient it would occur there in any case, public resources going into regional development were severely curtailed. In fact, central government spending under regional policy was reduced by about 50% over the decade of the 1980s, in real terms (Wren, 62). Some of the resources thereby saved were directed into research and development.
Four important themes can be identified in a summary of important changes in UK regional policy in the 1980s (Wren, 52-62): First, the geographic coverage of assisted areas was narrowed. Second, there was a shift in policy emphasis away from subsidization of relocation projects, which consciously diverted activity away from elsewhere in the UK, and which had formed much of the basis of earlier regional efforts, towards indigenous regional development. In the 1960s job diversion -- 'taking the jobs to the workers' -- had been the major aim of policy. However, the flow of mobile projects began to dry up in the 1970s, and increasingly assistance was taken up by firms which were either indigenous to the assisted regions or which had relocated through previous regional assistance. Conscious diversion of employment to the assisted regions was no longer promoted after policy changes in 1983. Third, there was a shift away from the direct subsidization of employment towards a regional aid programme based on employment creation through a strengthening of existing firms and improved competitiveness. Fourth, assistance made to firms in the special regions was linked more directly to jobs actually created. By contrast, regional policy in the 1970s concentrated heavily on assistance to a few large, highly capital-intensive, firms or sectors.

The microeconomic emphasis of the Conservatives in the 1980s sought to create the conditions for long-term growth through the market mechanism. Although huge regional disparities remained, the British economy was booming in the late 1980s. Thus, the policies of the Conservatives in the 1980s do appear to have attained qualified success, though that success (being apparent mainly towards the end of the decade) took a long time in coming. However, full evaluation of the supply-side policies of Mrs Thatcher in the 1980s must also take into account a rise in Britain's inflation rate toward the end of the decade.
IV. COUNTERINFLATION POLICY

IV.1. Postwar Inflation and Monetary Policy

Economic policy in the years immediately following the war was dominated by a high level of repression against inflation. The excess demand was prevented from revealing itself in open inflation only by price controls, rationing and other physical restrictions. The war-time use of Keynesian budgeting had not been a complete success, 'for even with the immense aid of free lend-lease supplies, it had been unable to prevent the accumulation of potentially inflationary funds, ready to burst forth as soon as the control barriers were removed. Personal 'forced savings', in the absence of any goods to spend incomes on, and firms' accumulated balances, were waiting to be spent after years of austerity, and the banks had been forced into a state of over-liquidity which was potentially more dangerous' (Pollard, 364-5). For these reasons, the war-time controls were dismantled only over a period of several years. Furthermore, the continuation of the policy of cheap money -- in a period of full employment and inflation -- probably slowed down the dismantlement process. Indeed, interest rate policy could not be used to counter inflation until cheaper money was firmly ended in 1951 -- by which time most of the controls had been abolished. Nevertheless, control of inflation was a striking achievement of the first postwar Labour government, 1945-51: important prices increased by 125% over that period, yet retail prices rose by only 38% (Peden, 150).

There were several reasons why the policy of cheap money was actively pursued in 1945-47. First, the war had been financed at low rates of interest and it was thought both possible and desirable to extend the policy into peacetime in order to minimize the tax burden. Second, it was fear of depression rather than boom which worried policymakers in the early postwar years. Bank rate was kept at 2% where (except for a very brief period at the start of the war) it had been since 1932, and open-market purchases were undertaken to force other interest rates down to artificially low levels. However, the latter policy came under increasing pressure as private investors found the coupon on government bonds increasingly less attractive, and it was abandoned toward the end of 1947. From then until 1951 monetary policy was
dormant; indeed, 'for a year or two in the middle of the period there is scarcely a sentence in any official statement which mentions credit or interest rates' (Dow, 227).

The Conservative government, which had just returned to power, raised Bank Rate to 2.5% in November 1951. In fact, successive Conservative governments changed Bank Rate 24 times over the period November 1951 to October 1964 (Kareken, 71). These caused other short-term interest rates to move in the same directions, and thereby induced movements in the capital account of the balance of payments. November 1951 also saw a change in the way in which the authorities sought to control the commercial banks. Until then, the method of control focused on a minimum ratio of cash to deposits, at 8%. But after the war the banks found themselves holding large quantities of Treasury bills which they could readily sell to replenish any reduction in their cash holdings brought about by policy. Greater reliance was therefore placed on another method of control -- namely, that the banks should not reduce their liquid assets (mainly cash, Treasury bills and money at call) below 30% of their deposits. Around the same time there was a 'forced funding' of a huge volume of Treasury bills in exchange for new government stock. The point of this manoeuvre was that the new stock would not count as a liquid asset in the banks' balance sheets. In consequence, the banks' liquid assets ratio fell from 39% in March 1951 to 32% a year later. For several years after this, the aim of debt management policy was to finance government deficits by borrowing long rather than short -- so as to keep the banks' actual liquidity ratio close to 30%. It was hoped that this would facilitate control over bank lending. Thus, the effective base of bank credit became liquid assets, based on the availability of Treasury bills, instead of the supply of cash.

In the 1950s and 1960s, control over the banks was aimed, not directly at their deposits and the money supply, but at their advances and the supply of credit. Monetary policy was characterized by a so-called 'package deal' over the stop-go-stop cycle: 'the typical cycle has been for a collection of measures, intended to have a deflationary impact, to be imposed amid some publicity, all together at one date; and then to be followed by piecemeal, gradual and unpublicized relaxation' (Dow, 252). Included in the package deals were: (i) Variations in Bank Rate. (ii) Variations in installment credit arrangements. (iii) Direct
quantitative controls over bank advances. (iv) From 1960 onwards, calls for Special Deposits to be made by the commercial banks at the Bank. Because such deposits were not reckoned as part of commercial bank liquid assets, they had the effect of reducing the banks' liquidity in the short-run, as they restructured their portfolios.

Because Britain operated under fixed exchange rates in the 1950s and early 1960s, the balance of payments rather than inflation was the main target of monetary policy. However, referring to inflation pressures which accompanied the sterling crisis of 1955, the Chancellor of the Exchequer stated that the government, in its 'efforts to check inflation ... relied very heavily on monetary policy' (Dow, 255). The government attributed the 1957 sterling crisis to domestic inflation, and implemented a very severe package of monetary restraint. As reported by Dow (256): 'So long as it is generally believed', ran the Chancellor's crisis statement, 'that the Government are prepared to see the necessary finance produced to maintain the upward spiral of costs, inflation will continue and prices will go up'. If then (his argument ran) the supply of money were limited, inflation would run up against an immovable obstacle. Rising prices would be prevented -- if necessary, at the cost of falling activity and falling employment.' In indicating that monetary expansion would not be used to validate cost-push wage pressure, this reasoning was remarkable for its time: it sounds much more like that of the Conservatives in the early 1980s.

IV. 2. Resort to Incomes Policy

In 1945 Keynes wrote that 'simply because one knows no solution, [one is] inclined to turn a blind eye to the wages problem in a full employment economy' (Quoted by Tomlinson, 73). Although the trade unions agreed to wage restraint for a short period after the devaluation of 1949, systematic policy wage bargaining did not accompany full employment during the first post-war decade. In part, this may have been because inflationary pressures were initially perceived as temporary, reflecting post-war reconstruction, the 1949 devaluation and the Korean War. But even after such shocks had passed, inflation showed a gradual upward trend, from 2% in 1956 to over 5% in 1969 and reaching a peak of almost 25%
in 1975. However, insofar as government action was concerned with inflation between the early 1950s and the mid-1970s, it focused mainly on incomes policies -- understood as voluntary or compulsory controls on the rate of growth of wages and, to a lesser extent, of prices -- rarely questioning the priority of full employment.

A growing awareness of inflation was marked by the establishment in 1957 of a council to prepare periodic reports on prices, incomes and productivity. Those reports tended to focus on the redistributive and balance of payments effects of inflation. In mid-1961 the Conservatives announced the first of a succession of incomes policies. Government employees were to experience a 'pay pause' for a year, and thereafter, money incomes were to rise by no more than 2.5% annually. In spite of trade union opposition, a National Incomes Commission was set up in July 1962 to supervise the operation of the 2.5% guideline and to arbitrate on wage claims. Like most of its successors, the incomes policy had two features: its main focus was on wage rather than product-price restraint, and the Commission had no powers of compulsion in regard to its judgements. It was over-optimistically hoped that by publicizing excessive wage claims, public opinion would be brought to bear against them. Not surprisingly, the new policy was largely a failure.

The Labour governments of October 1964 to June 1970 sought to implement a series of prices and incomes policies, beginning with the establishment early in 1965 of the National Board for Prices and Incomes, to advise on whether the behaviour of prices or of wages was in the national interest as defined by the government. By December 1964 the government had persuaded the employers and the unions to sign a joint statement of intent on productivity, prices and incomes. In return, the government pledged itself to create the conditions needed to achieve and sustain a rapid increase in output combined with full employment. The Trades Union Congress (TUC), of which most British trade unions are members, agreed to monitor all major wage settlements over the ensuing five years. However, the employers organization would not agree to adopt a similar system for prices.
The first phase of Labour's incomes policy was voluntary. It merely amounted to asking the trade unions not to use their bargaining powers to the full, and employers not to bid against one another for scarce labour .... But the Government was either incapable of understanding or deliberately shut its eyes to the limitations of such a policy (Youngson, 202). Not surprisingly, the results were disappointing: between April 1965 and July 1966 earnings rose twice as fast as prices, which had also risen steeply. One outcome of the 1966 sterling crisis was therefore statutory control of prices and incomes. In July 1966 the government announced a six months standstill during which there would be no increases in incomes or dividends and price increases would be severely limited. That freeze was followed by a further period of six months of 'severe restraint'. Legislation in August 1966 empowered the government to prohibit an increase in either prices or incomes during the period to July 1967, without any need to refer to the Prices and Incomes Board. The restraint which the government sought in that period was attained: the government had to use its statutory powers on only fifteen occasions -- fourteen times over wages and once in regard to prices (Leruez, 200). However, such restraint was not enough to prevent the November 1966 devaluation. In the period July 1967 to March 1968 the government retained the power to defer wage and price increases on condition that the matter was referred to the Prices and Incomes Board: in practice these meant delays of up to 7 months (Leruez, 200). However, incomes began to 'take off' even before the devaluation, as unions sought to make good the losses of the previous year. A further phase of statutory controls, introduced with the budget of March 1968 and designed to maximize the gains from the devaluation, was scheduled to expire at the end of 1969. However, it ended in frustration as various groups of workers, in both the public and the private sectors, obtained wage awards well in excess of the government's guidelines. In consequence, by the beginning of 1970 prices and incomes policies existed in name only.

The Conservative government of 1970-74 abolished the National Prices and Incomes Board and initially sought to rely on a tough approach to public sector pay settlements. When this failed to get the inflation rate below 11%, and was broken by the coalminers union early in 1972, the government resorted to statutory control, and implemented three phases of wage and price controls starting in November 1971.
A Pay Board, with nominal power to reject wage settlements and to fine offenders was established in 1973. However the government -- which was soon to be voted out of office -- next became involved in another bitter struggle with the coal miners over pay.

The Labour government of 1974-79 initially relied on a so-called social contract negotiated with the unions, according to which wage increases would not exceed increases in the cost of living. In return, the government agreed to take measures to strengthen union power and to improve the economic position of the more disadvantaged groups in society. However, with inflation rising above 20% early in 1975 following the oil price increases, the TUC negotiated with the government a more restrictive lump-sum pay increase across the board for the year from July 1975. A further agreement followed in July 1976. But TUC enthusiasm soon began to wane in the face of severe cuts in public expenditure, rising unemployment and rank-and-file dissent. Finally, in July 1978 the TUC rejected the Prime Minister's attempt to impose a 5% norm on wage increases, and this was followed by the so-called 'winter of discontent' when incomes policy ended in disarray with a series of strikes across the public sector.

It is difficult to assess the effectiveness of incomes policies in post-war Britain. There is little evidence that they lowered inflation on any sustainable basis. Furthermore, distortion of real wage differentials, which those policies often entailed, impeded the efficient operation of the labour market. Typically, in the initial stages of governments' attempts to implement policy, 'calls for voluntary restraint would go unheeded, as individual unions quite rationally attempted to protect their wage differentials in the face of accelerating inflation. A severe balance of payments crisis would then force the state into a sterner position, often marked by a brief pay freeze, followed by a hard-won agreement with the TUC on continuing restraint. That agreement would hold for a year or two, often with more success under Labour, until rank-and-file discontent over the distortion of differentials and declining real incomes forced the trade union leaders into repudiating further restraint. In the subsequent free-for-all, many unions would make up the losses their members suffered over the preceding years' (Hall, 83). Thus, when statutory powers were invoked for short periods at times of crisis, they probably did succeed in lowering wage inflation; however, when the crisis was abated, a wages explosion tended to follow.
The unwieldly structure of British trade unionism caused major problems in attempts to implement incomes policies. The TUC had just enough authority over its 100-plus member-unions to achieve restraint at times of serious crisis. But it did not have much control over the rank-and-file to prevent disruption. At the plant level, a powerful stratum of shop-stewards facilitated unofficial work stoppages, and the presence of well over 100 unions (not all of them members of the TUC) gave individual unions incentives to break or ignore agreements, thereby inducing other unions to react so as to restore real wage differentials. In contrast to the fragmented structure of the trade unions in Britain, the more centralized structure of their counterparts in countries such as Austria and Sweden made wage restraint in return for government concessions more feasible in such countries.

Before turning to inflation under the monetarist experiment of the 1980s, it is important to understand political reactions to the incomes policy experience of the 1970s. It has already been seen that, late in 1973, the Conservatives entered a bitter conflict with the coalminers over the question of pay. The miners demanded a 30% pay increase - well above the existing incomes policy guidelines. The government refused to yield to the ensuing strike in that crucial nationalized sector, with the consequence that a large part of Britain's workforce was put onto a three-day work week in the winter of 1973/4. The government responded by going to the nation, calling for a general election in February 1974. The Conservatives lost the election narrowly, and the incoming Labour government conceded most of the miners' demands. However, that experience helped turn the Conservatives in opposition, and a large part of the public, into critics of the political power of the unions.

It has earlier been observed that the Labour government which came into office in 1974 sought to appease the unions by means of its 'social contract' with them, and that this contract broke down in disillusionment in 1978, when, during 'the winter of discontent', industrial strife led to temporary closure of hospitals, cemeteries and garbage collection in Britain. By 1979, following almost two decades of conflict between unions and government over incomes policy, the issue arose as to whether it was the electorate, government or the unions which really governed Britain. By that time, about 80% of the electorate, a
over 50% of trade union members themselves, had come to the conclusion that the unions in Britain had too much power (Hall, 95). It was in this context that monetarism -- a reliance on simple monetary rules rather than discretionary demand management and haggling over wages -- was seen by many as a more feasible solution to Britain's inflation problems. The core of the monetarist argument was that inflation could be controlled at an acceptably steady and low rate if the money supply were expanded at a steady and low rate (to accommodate increased money demand reflecting the trend in real economic growth). Furthermore, under conditions of floating exchange rates (and after 1972 Britain operated a controlled float), it was argued that monetary expansion was directly linked to the size of the PSBR. It was also argued that the exchange rate -- which, in an open economy, feeds back into the inflation rate -- was directly linked to monetary expansion. It was therefore concluded that both the inflation rate and the exchange rate could be stabilized at acceptable levels if the PSBR -- and hence the rate of monetary expansion -- were kept under control. It was felt that, in the 1960s and 1970s, money wage-push pressure had been politically facilitated by government expenditure and monetary expansion pulling up the price level, thereby preventing real wages from increasing at given productivity levels, and hence preventing mass unemployment from ensuing. At given productivity levels, so long as wages and prices always moved in line, there was little or nothing that demand management could do to expand employment; it merely increased inflation. (For more on this issue see Appendix). Given the stance of trade unions, it was correctly seen that if demand expansion could not affect employment on a sustainable basis, then Britain's growing unemployment problem was not due to deficiency of aggregate demand; rather than being demand-constrained it was largely cost-constrained, reflecting excessively high real wages at given productivity levels. In a sense, then, a significant part of Britain's unemployment was voluntary on the part of the trade unions.

To the extent that these arguments were correct -- and, it would seem, they did become more descriptive of Britain over time as money illusion in wage bargaining declined and as accelerating price inflation was extrapolated into the future for purposes of wage bargaining -- it followed that there was little need for government to expand demand, thereby both facilitating and enhancing union bargaining power; given
the stance of unions, discretionary demand expansion had little or no sustainable effect on employment in any case. It seemed to follow that if, by contrast, the government operated by a few simple rules -- such as a constant (and reduced) rate of monetary expansion which would yield an approximately constant (and reduced) rate of product-price inflation -- inflationary expectations would be lowered and excessive real wage pressure would be weakened, in the knowledge that such pressure would merely lead to increased unemployment.

As propositions about the long-run, there is much of merit in the arguments of the two preceding paragraphs. (See Appendix). However, the experiences of the Conservative governments in the 1980s were to show that the time lags involved, and other qualifications applicable in an open economy, were not adequately appreciated.

From the economic and more general political standpoints of the Conservatives, the monetarist view was 'a godsend. It seemed to confirm and justify what many had always believed: optimal economic performance could be achieved with minimum intervention in the economy .... It seemed to suggest that inflation could be reduced without any need to bargain with the trade unions .... One school of monetarists, who attributed 'rational expectations' to economic actors, assumed that the unions would automatically limit their wage claims in the face of a monetary rule because they know that unemployment would otherwise be the result .... Others realized that wage claims would be reduced only after unemployment had risen but were perfectly willing to see such an outcome. Each seemed a more desirable alternative to tripartism [between government, unions and employers] and a method of breaking the power of the trade unions' (Hall, 97-8).

In line with their political philosophy, and in order to implement downward flexibility in real wage the Conservative government under Margaret Thatcher in the early 1980s resolutely resisted trade union pressure from strikes and associated wage claims and, under legislation of 1980, 1982 and 1984, greatly reduced the economic and political powers of the trade union movement (Hall, 109).
IV. 3. The Monetarist Experiment and Inflation

The late 1960s saw the first tentative step by the British authorities toward setting money supply targets. But this was attributable to the need to borrow from the IMF rather than any acceptance of monetarist principles by the then Labour government. In response to IMF pressure, Britain loosely agreed in November 1967 to reduce the rate of growth of the money supply. The authorities next agreed with the IMF to set a target for the rate of increase in domestic credit expansion in 1969-70. The IMF's primary concern was then with the balance of payments. Implications of such commitments were that in setting, in effect, target zones for the quantity of money, the price of money and the balance of payments would have to adjust; the authorities would therefore have to be prepared to allow for greater flexibility in interest rates, to be largely determined by market forces, than in earlier years. This was in fact provided for with the announcement of both institutional changes in, and changes in methods of control of, the banking system, beginning in 1971. These changes were introduced collectively under the heading of "Competition and Credit Control". However, the practice of announcing loose monetary targets temporarily elapsed in 1972.

As it accelerated, the mid-1970s in Britain saw important changes in policymakers' perceptions of inflation. In his budget speech of March 1974, the new Labour government's Chancellor of the Exchequer, indicating that the full employment objective would not be sacrificed to defeat inflation, stated that 'I totally reject the philosophy that would cure the high blood pressure in the economy by bleeding it to death'. But the same Chancellor had changed his mind in his budget about a year later (April 1975) in reporting that 'I have been urged ... to treat unemployment as the central problem and to stimulate a further growth in home consumption, public or private, so as to start getting the rate of unemployment down as fast as possible. I do not believe that it would be wise to follow this advice today', due to high indebtedness to foreigners and the prevailing inflation rate (Quoted by Tomlinson, 171-2). It seems that this was the first statement at an official level in Britain in which it was acknowledged that, in the short run, increased unemployment would have to be a price paid for reducing inflation. It has been seen that Labour continued to experiment with rather ineffective incomes policies for a few more years. But --
partly in response to IMF demands -- even that party had begun to attach a new importance to monetary measures by the second half of the 1970s.

It was not until 1976 that the first definite quantitative target was set for any measure of the money supply (Pierce and Tysome, 276). These, mainly for the broad money supply category sterling M3, covered fiscal 1976/7 to fiscal 1978/9. It is probable that the timing of the definite switch to monetary targets reflected a number of factors, apart from the influence of the IMF.

First, the adoption of floating exchange rates from 1972 onwards made independent pursuit of monetary targets more feasible. Indeed, in the long run, and so long as Britain really kept to fixed exchange rates, the rate of monetary growth in Britain had to mirror (loosely at least) that country's real economic growth rate plus its inflation rate; under the conditions specified, and in an economy which was becoming progressively more open over time, the British inflation rate was constrained by inflation rates abroad. The latter constraint was relaxed after sterling was allowed to float. Hence, the switch to a float gave scope for more independent monetary policies, aimed at controlling inflation, in Britain.

Second, it seems that by the late 1970s the British government was coming to the view that restraint on the money supply was a precondition in its fight against inflation. For example, in his April 1977 budget, the Labour Chancellor of the Exchequer stated that 'it remains my aim that the growth of the money supply should not be allowed to fuel inflation as it did under my [Conservative] predecessor' (Quote by Pierce and Tysome, 277).

A third possible reason -- though probably a weak one under the 1974-79 Labour government -- why the authorities adopted monetary targets was because of the discipline such targets impose and their possible effect on inflationary expectations. For example, those involved in wage bargaining might recognize that excessive wage increases would no longer be facilitated by passive monetary expansion; they might, therefore, settle for lower nominal wage increases. This view was expressed by the Governor of the Bank in 1977, as follows: 'One purpose of announcing monetary targets is to serve notice that excessive increases in domestic costs will come up against resistance. If people believe that the money supply w
be expanded to accomodate any rise in costs and prices, however fast, inflationary fears are likely to be increased. If, on the other hand, people are convinced that the rate of growth of the money supply will be held within well-defined limits, this should help to reduce inflationary expectations' (Quoted by Pierce and Tysome, 278).

Finally, money supply targets were adopted in the late 1970s partly because interest rates were less reliable as indicators for monetary policy in years of high and variable inflation. As the Bank's Governor stated in 1978: 'What swung the argument in favour of choosing a quantity rather than a price as the best indicator of the thrust of monetary policy was the acceleration of inflation.... We can ... think of the nominal interest rate as having an 'expected inflation' component and a 'real interest' element. But we can never observe expectations, which are in any case likely to differ from person to person, and to be volatile. The real rate of interest is an abstract construct. This has made it very difficult to frame the objectives of policy in terms of nominal interest rates' (Quoted by Artis and Lewis, 41).

On coming into power in 1979, the Conservatives under Thatcher argued that high and rising inflation was ultimately caused (or permitted) by excessive rates of monetary expansion due mainly to rising public sector deficits; therefore, inflation could best be lowered by adhering to rigid targets for monetary growth and low PSBRs, regardless of the state of economic activity. It was furthermore believed that by removing the uncertainty associated with the stop-go-stop era, this would foster economic growth in the long-run; also (from 1980 onwards), inflationary expansion of the money supply would no longer be used to validate wage-push pressures.

Although one of the objectives of Thatcher's administration was to weaken trade union bargaining, the government took few direct steps to counteract wage claims during its first year in office. In fact, in 1979 it honoured its electoral pledge by granting a large public sector pay increase. But it sternly resisted wage-push pressures in the public sector throughout the 1980s.

The central feature of the Conservatives' policy in the early 1980s was the Medium-Term Financial Strategy (MTFS), first published with the budget in March 1980, which proposed increases in taxation
and reductions in government spending, so that the PSBR could be reduced from almost 4% of Gross Domestic Product (GDP) in fiscal 1980 to 1.5% of GDP in fiscal 1983, almost regardless of the underlying state of the economy. The MTFS was designed to show the government's determination to adhere to a predetermined course, thereby influencing private sector expectations. The PSBR projections were mirrored in targets for the broad money supply, sterling M3. The MTFS has been described as a 'commitment to switch off the automatic fiscal stabilizers. When in 1981 the government responded to an unexpectedly severe recession (and consequent PSBR overshoot) by a severe fiscal contraction, the credibility had largely been established' (Begg, 58).

Although the PSBR did decline in 1980-83, it failed to meet the targets originally set; it actually fell from 5.4% of GDP in fiscal 1980 to 3.2% of GDP in fiscal 1983. There were several reasons for such overshooting. First, although she did chip at their edges, Thatcher in the early 1980s was unwilling to dismantle the major programmes associated with the welfare state. Secondly, economic recession in 1980-82 automatically increased outlays on unemployment relief. Third, in line with her political philosophy, Thatcher substantially increased real outlays on defence, law and order, and agriculture. Finally, although the number of civil servants fell by about 10% between 1979 and 1983, hopes of increasing the efficiency of public administration were not fully realised. As a percentage of GDP, the PSBR fell steadily throughout the 1980s, and actually moved into surplus -- equal to 0.3% of GDP in 1987.

Consistent with withdrawing the state from interventionist policies and improving supply side incentives, the Conservative governments of Thatcher sought to reduce the tax burden in the medium-to-longer runs, and were successful in this objective over the 1980s as a whole. In the short-run, however, their tax policies were largely determined by performance in reducing government expenditure and the PSBR. As the first Thatcher found that the tax burden could not be cut as much as anticipated. Partly in consequence of this, government revenue as a percentage of gross domestic product actually increased significantly between fiscal 1978 and fiscal 1983. Taxation aside, this partly reflected the fact that, more than any other British government, the Conservatives in the early 1980s benefited from North Sea oil revenues (which had just begun to flow on a substantial scale.)
with Britain becoming self sufficient in oil in 1980), and from the sale of public assets. Without these, the tax burden or the PSBR would have been higher in the early 1980s.

In the early 1980s the government also found it far more difficult than expected to control the rate of monetary growth, as represented by the targets set for sterling M3. Furthermore, the link between the PSBR and sterling M3, and the lags involved, turned out to be far less clear than anticipated. Sterling M3 grew at almost double the target rates in 1980 and 1981. But -- as was revealed by penal interest rates -- this did not reflect a loose monetary policy. Rather, firms were experiencing a severe liquidity squeeze and were forced into bank borrowing. Starting in 1981, it was therefore decided that depreciation of the exchange rate should be encouraged, and existing targets for sterling M3 were revised upwards. The large increase in sterling M3 in 1980-81 was also due to a once-and-for-all factor: Late in 1973 the government had introduced a scheme for discouraging increases in interest-bearing bank deposits (the so-called 'corset'), but this was abolished in June 1980. This abolition created a once-and-for-all upward shift in the money supply (as measured by sterling M3) as a result of a return of lost business to the banks. In 1982, the government began to employ a mixed set of monetary indicators, rather than the single aggregate, sterling M3, as target variables.

Throughout the 1980s, budgetary policy continued to be made within the framework of the MTFS, which had first been adopted in the March 1980 budget and was revised annually since then. Its central features have been the setting up of medium-term paths for key variables (typically, the current and three prospective financial years for monetary aggregates, the public finances and key output and inflation variables). Throughout the decade, important advantages sought in this approach were 'a medium-term monetarist approach to achieving disinflation by attempting to influence the expectational environment and the bringing together of revenue and expenditure planning, also over the medium-term" (Directorate-General, 47).

Although the lags involved were greater than anticipated, by the mid-1980s the government had substantial success in pursuit of its main objective -- lower inflation. But its tight monetary and fiscal poli-
cies contributed to a massive 220% rise in numbers unemployed between 1979 and 1984. And, as had been predicted, this weakened trade union bargaining power. It seems that rising unemployment, changes in the international environment, and especially tight monetary policies, all contributed to a lowering of Britain's inflation rate, from 13% in 1979 to 5% in 1985. However, although low by the standards of the 1970s, inflation did begin to creep upwards once more in an expanding British economy in the late 1980s. By then, traditional monetary aggregates were less reliable as leading indicators of nominal expenditure because they had been affected by structural shifts related to supply-side innovations and credit deregulation throughout the 1980s. Nevertheless, partly because of reliance on such indicators, a high and risky level of demand had been underestimated when interest rates were in fact lowered late in 1987 and again early in 1988. The ensuing rise in inflation 'damaged the credibility of the Medium Term Financial Strategy (MTFS) in maintaining downward pressure on inflation expectations' (Directorate-General, 3).

Thus, with inflation increasing toward 10%, when the authorities did take firm action from late in 1988 onwards, increased unemployment was an inevitable consequence.

V. OVERVIEW, SUMMARY, CONCLUSIONS

Assessment of the performance of the British economy since Thatcher came to power in 1979 raises the question of whether one should look at the period as a whole, giving an annual growth rate of about 2% in 1988, or whether one should focus on growth since the bottom of the cyclical slump in 1981, which gives a growth rate of 3.4%.

It can also be argued that a proper intertemporal comparison of average annual growth rates is one from cyclical peak to peak movements in GDP. By this criterion the British experience has been: 1960-64, 3.1%; 1965-68, 2.7%; 1969-73, 2.8%; 1974-79, 1.3%; 1980-88, 2.2%. On this basis, and taking 1979 as the previous cyclical peak, performance in the 1980s was very much better than over 1974-79, but not as good as in the 1960s.
Perhaps a fairer assessment should take into account the length of time over which output was growing since the cyclical trough of 1981, partly because, in contrast to the stop-go-stop management of earlier governments, Thatcher’s emphasis was on the sustainability of growth. Since 1945 only the years 1959-66 (3.6%) yield an average growth rate higher than 1982-88 (3.4%). The five years 1983-88 was the five year period with the fastest growth since the war, 3.8% as compared with 3.6% for 1960-64. A 3.3% British GDP annual growth rate between 1981 and 1987 compares with one of only 2.7% for developed Western industrial countries as a group. (Note: The statistics cited in this and in the two preceding paragraphs have been drawn from Ball, 1989).

However, the record in regard to unemployment is less impressive: the unemployment rate increased from 4.3% in 1979 to 11.3% in 1985 and 10.3% in 1987, but fell to 5.8% in 1990. It is probable that much of the unemployment in the later 1980s was structural, being in part associated with the modernization of British industry. This view is supported by the fact that despite the huge rise in unemployment, vacancies in 1986-7 were as high as they were in 1977-8 (Layard and Nickell, 132).

Apart from the statistical record just outlined, any assessment of economic policy in Britain in the 1980s should take note of the fact that the British economy in 1990 moved into recession, the extent of which was accentuated by measures implemented in response to late recognition of excess demand which had emerged in the last few years of the decade which had just ended.

Necessarily, the benefits from Thatcher’s supply-side policy (and the maintenance of that policy by her 1990 Conservative successor) have been, and will continue to be, slow in revealing themselves: ‘the time horizon over which one would expect such a policy to succeed is very long .... The Thatcher government has adopted a longer time horizon, and a lower discount rate on policy success, than previous governments. Per se, this should be regarded as a beneficial change in policy design’ (Begg, 58).

The principal findings of the present study have been as follows:
1. Large-scale military expenditure overseas by Britain was an important reason why the country's level of foreign exchange reserves remained weak until the 1970s. Given Britain's commitment to a fixed exchange rate, policy responses to persistent balance of payments problems for close to three decades after the second world war had an almost continuous effect in stifling British economic growth. Britain was made a 'stop-go-stop' economy in the 1950s and 1960s: Growth would be stopped from time to time when sterling came under pressure, demand would then be expanded when unemployment rose to unacceptable levels, and growth would again be halted as sterling once more came under attack. With the popularity of the government in mind, the exact timing of the stop-go-stop cycles was often related to the timing of general elections. Commitment to a fixed exchange rate, at an overvalued level, also led to increasing resort to the IMF and foreign central banks in the 1960s. The conditionality and surveillance associated with such loans meant some surrender by Britain of domestic autonomy. Also, the need to pay interest and principal only further weakened sterling in the longer-run. Application of stop-go-stop policies failed to avert the 1967 sterling devaluation.

2. Although it was increasingly apparent that sterling was becoming overvalued at its 1949 parity, there were various political reasons why British governments refused to devalue until forced to do so in 1967. One reason was that the US was sharply opposed to a sterling devaluation, as it feared that pressure would then shift to speculation against the dollar. Another reason was that devaluation of the pound would threaten the continued existence of the Sterling Area -- by the mid-1960s, one of the few remaining symbols of past imperial glory, which Britain sought to perpetuate.

3. The cohesion of the Sterling Area as a bloc discriminating against the dollar in fact increased following the abortive attempt at convertibility in 1947 (which reflected pressure from the US). But in the 1950s and 1960s, the practice by Sterling Area countries of holding separate national reserves -- rather than relying on the common Reserve Pool in London -- became increasingly common. Most of the colonies attained independence, set up their own central banks, and diversified their reserves. Although the 1967 devaluation weakened the Sterling Area, Britain negotiated various measures to perpetuate its existence, until 1972, when it was decided to float the pound. This meant the effective termination of the Area and indicated belated recognition that the era of empire was over.
4. The 1972 decision to float was made in order to allow economic growth to proceed unimpeded by the need to apply stop-go-stop policies under fixed exchange rates. Around the same time, emphasis began to switch to control of inflation as a dominant policy objective. Because of this, and in reflection of IMF conditionality on loans to Britain, money supply targets became a central feature of British economic policy in the late 1970s. This meant that there was little scope for pursuing an independent exchange rate policy: the exchange rate would tend to move up or down depending on variation in the money supply relative to that abroad. Attempts to have independent exchange rate targets were abandoned around 1977.

5. In an effort to control inflation in the second half of the 1970s, the short-run stop-go-stop cycle of earlier years was replaced by a more sustained stop, and some abandonment of full employment as a paramount policy objective. For the first time since the war, the 1975 budget explicitly abandoned the full employment objective. Even under the Labour government of the late 1970s, there was a growing realization that policies of demand expansion were having major impacts on the rate of inflation rather than on the employment level.

6. With control of inflation becoming the overwhelming policy objective by the end of the 1970s, the goal of full employment, as something to be pursued in the short-run or medium-run, has almost totally been abandoned under the Conservatives since 1979. In consequence, unemployment attained unprecedented post-war levels in the mid-1980s.

7. The Conservatives since 1979 have virtually abandoned demand-management policy in favour of supply-side measures. One facet of their argument has been along the following lines: To the extent that it was effective at all, demand expansion in the past reduced unemployment by raising the price level, thereby getting real wages down and encouraging employers to hire more labour. But if, at given productivity levels, workers sought and obtained full money wage compensation for a higher price level (thereby preventing real wages from falling), then demand expansion could have no sustainable effect on unemployment; under such circumstances, only supply-side policies, which affect work incentives and productivity, could increase employment in the long-run. This probably did approximate the situation in Britain by the late 1970s. See also Appendix.
8. The Conservatives argued that the very high unemployment in Britain in the mid-1980s resulted from real wages that were too high and rigidities in the labour market, and that it would fall only when workers accepted lower real wages and when microeconomic measures were taken to eliminate labour market rigidities, among them trade union power. Such power was weakened in the 1980s, and employment recovered in the second half of the decade. Nevertheless, unemployment remained high by the standards of the previous postwar decades.

9. Excess demand during and for some years after the war was prevented from revealing itself in open inflation only by price control, rationing and other physical restrictions. In the 1950s monetary policy was restored to some prominence in order to counter moderate inflation. The 1960s and 1970s saw resumption of incomes policies -- which may, in the short-term, have led to misallocation of labour -- but they appeared to have had no sustainable effect on the inflation rate, which showed an accelerating trend.

10. By the late 1970s many people began to question whether it was the elected government or the trade unions which really governed Britain. Coming into office in 1979, the Conservatives sought to break trade union power. They made control of inflation their overwhelming objective, and sought to operate it by monetary rules rather than discretion, on the premise that if trade unions pushed up wages, the money supply would not be increased to accommodate their demands, and unemployment rather than inflation would result. Part of the increased unemployment in the mid-1980s was, therefore, in a sense voluntary on the part of the trade unions. The Conservatives were successful in reducing rather than eliminating inflation in the 1980s. But failure to prevent a rise in inflation toward the end of the decade is in part attributable to excessive confidence attached to certain monetary variables as leading indicators of the level of aggregate demand in the overheated economy of 1987-88.

11. The early 1960s saw a return to favour of economic planning in Britain. This reflected a desire to break the stop-go-stop cycle and to attain steady and rapid growth. But the two medium-term plans published during the decade had little meaning: they did not have the 'teeth' needed to attain their objectives and were increasingly frustrated by balance of payments pressures under fixed exchange rates.
12. The fall of a Labour government in 1970 meant the end of attempts to develop comprehensive macroeconomic plans for medium-term growth. In consequence of the new emphasis on control of inflation, growth as an objective to be pursued by macroeconomic management faded into the background after 1973, and had disappeared entirely by the 1980s, when growth was left to the market mechanism, albeit guided by the microeconomic policies of the state.

13. Until the 1960s British governments viewed regional policy almost exclusively in social terms. The recognition of the economic waste implied by regional disparities of unemployment emerged clearly only in the 1960s, given a new emphasis on economic growth. The Labour government of 1964-70 was the first to treat regional development as an extension of medium-term macroeconomic planning, forming a coherent whole.

14. In the 1960s and 1970s, a substantial proportion of all state aid for industry was devoted to regional development, the object of which was not to promote specific sectors, but to transfer resources to the more depressed areas of Britain. Thus, it was not selective. In consequence, a large proportion of such funds went to failing firms in declining industrial sectors of the economy.

15. The Conservative governments of the 1980s reduced intervention by selling off nationalized industries and reducing funds available as grants to the private sector. But where the Conservatives continued to intervene, their actions were much more selective than their predecessors. Having rejected direct macroeconomic manipulation, the emphasis switched to microeconomic -- or supply-side -- measures to rejuvenate the economy.

16. Although huge regional disparities remained, the British economy was booming in the late 1980s. Thus, the supply-side policies of the Conservatives in the past decade do appear to have attained qualified success, though it took a long time in coming. By their nature, the benefits of Thatcher's supply-side policies have been, and will probably continue to be, slow in revealing themselves. In part, that is because Thatcher's emphasis was on the sustainability of growth. However, in 1991 the British economy is in recession, the extent of which has been accentuated by the fact that the authorities failed to recognise at
an early stage that the economy was overheated in the late 1980s, and were therefore forced into deflationary monetary measures.

17. Britain's accession (1990) to the Exchange Rate Mechanism of the European Monetary System seems to be a final acknowledgment that the years of Empire, and of monetary autonomy, are gone. As is now indicated by change in the structure of her trade (in 1989 just over 50% of the UK's merchandise imports and exports was with European Community partners), the UK's economic future over the coming decades must be heavily in the context of the wider European economy.

REFERENCES


**APPENDIX**

*Keynesian versus Supply-Side Policies: A Simple Diagramatic Exposition*

Unemployment in a modern economy can be classified as frictional, structural, demand-deficient or cost-constrained. Frictional unemployment simply reflects that fact that at any point in time some people are in the process of moving from one job to another. Government can help to reduce it by improving information in regard to job availability. Structural unemployment reflects 'mis-matches' between the endowment of skills and the demand for skills, and/or immobility of labour across regions. It can be reduced by
manpower training programmes and policies in regard to industrial location. The primary interest here is on demand-deficient and cost-constrained unemployment. So, in what follows, we will forget about the first two kinds of unemployment.

To highlight the central issues involved, we assume homogeneous labour, a closed economy, and absent specialisation, unless indicated to the contrary, given factor endowments. Potential output is then a function of the level of employment.

Suppose that all markets -- including the labour market -- are perfectly competitive; thus, there are no institutional forces such as trade unions, minimum wage laws or unemployment relief payments from the state, preventing real wages from being determined by free market forces. It is easily seen that the only possible equilibrium for the system is then at full employment -- where everyone who is willing to work at the market-clearing real wage actually finds work.

The supply and demand for labour are depicted in Figure 1. Firms hire labour up to the point which the marginal physical product of labour (MPP_L) equals the real wage (w/p). Full employment prevails in labour market equilibrium, at L_F. From the aggregate production function in Figure 2, the full employment level of output is Y_F. Under the conditions specified, this is entirely independent of the price level -- for perfect competition implies that at any price level p, the money wage w will adjust to generate L_F in Figure 1. Hence, the aggregate supply curve, AS, is vertical -- at Y_F -- as in Figure 3. Assume that relevant equilibria are dynamically stable. Thus, with perfect competition in all markets -- in the labour market in particular -- the economy will automatically tend to full employment, and aggregate demand, AD, has no effect other than on the price level.

Suppose that we start with perfect competition, with p = p_0 and w = w_0 at the full employment equilibrium, but that next, trade unions (or the availability of high unemployment relief payments) force the money wage to w_1. From Figures 1A and 2A we see that with p = p_0, employment would fall to L'_F while output would fall to Y'. Thus, point Z in Figure 3A is a point on the new aggregate supply curve. Figure 1A also indicates that given w = w_1, if p were to increase (to, say, p_1), the real wage would fall.
employment would rise and firms would expand supply. Thus, given \( w = w_1 \), the aggregate supply curve will now have a strictly positive slope, depicted by AS' in Figure 3A; however, it overlaps AS in the diagram for sufficiently high \( p \).

Figures 1A to 3A show that given \( w = w_1 \), the system approaches a new equilibrium at \( Z' \), with output at \( Y'' \), below the initial full employment level. Employment has fallen to \( L'' \) at the new equilibrium.

Is the unemployment at \( Z' \) in Figure 3A cost-constrained or demand-constrained? The answer is that in a sense it is either. Figure 3B indicates that output, and hence employment, can be increased by a policy of expanding aggregate demand -- but only at a cost of a higher price level. However, if the money wage were reduced, so that the positively sloped part of the aggregate supply curve would shift to the right to AS' in Figure 3C, output and employment would again increase.

Next, instead of supposing that the trade union movement bargains for a higher money wage, assume that (starting from an initial situation of perfect competition) it demands and gets a higher real wage, given productivity. Furthermore, suppose that the government pursues policies of demand expansion in the hope that the ensuing higher price level will get the real wage down, but that trade unions are consistently successful in their bargaining by indexing the money wage to any increase in the price level. It is easy to see that under such circumstances demand management can do nothing to restore employment. Rather, the only hope is to resort to supply-side policies which increase the productivity of labour, thereby causing the aggregate production function to swivel upwards.

The initial position is at point E in Figures 1D to 3D. Given \( p_0 \), trade unions force the wage rate up to \( w_1 > w_0 \). The aggregate supply curve swivels around from AS to AS', output falls to \( Y' \) and the price level rises to \( p_1 \). If the government expands demand the price level will rise further and (given \( w = w_1 \)) employment will rise. But if the trade unions respond by forcing wages upwards again so as to compensate for the higher \( p \), the positively-sloped part of the aggregate supply curve will shift to the left, causing employment to fall again. Suppose that, in response to successive doses of demand expansion, the trade unions manage to index the real wage at the ratio \( w_1/p_1 \). Successive equilibria are represented by points

- 61 -
such as u, u’, u", etc in Figure 3D. In effect, the aggregate supply curve has been shifted to a vertical locus like AS", to the left of the full employment locus. Under such indexation, successive doses of demand expansion bring no recovery in employment, but only inflation.

Finally, suppose that we start with perfect competition and ensuing full employment, but that next trade unions push up the real wage to a level inconsistent with full employment, given productivity. The initial equilibrium is at point E in Figures 1F to 3F. After the trade unions push up and index the real wage at w₁/p₁, the system goes to point J in the three diagrams. Assuming that the indexation at w₁/p₁ is maintained, demand management policies, raising p, will be fruitless, but supply-side measures can both restore full employment and improve living standards.

Supply-side policies operate by increasing the marginal productivity of labour. Thus, the aggregate production function (the slope of which is labour’s marginal physical product) swivels upwards, from f(L) to h(L) in Figure 2F. Reflecting the same phenomenon, the demand curve for labour shifts to the right in Figure 1F.

As drawn in the diagrams, the productivity increase exactly validates the higher (permanently indexed) real wage. The new equilibrium is at point K in the three diagrams. The new aggregate supply curve is AS", implying that output and employment have increased, and the price level has fallen, despite the higher real wage.
Figure 1

Figure 2

Figure 3