
Three views of macroeconomics

In this speech,⁽¹⁾ Sir Alan Budd, a member of the Bank's Monetary Policy Committee, reviews the changing approaches to macroeconomic policy shown by three Budgets that occurred at similar stages in the economic cycle. He concludes that this analysis provides an illustration based on experience of the need for robust policy rules.

Last November, I celebrated my retirement from the Treasury. It therefore seems appropriate for me to devote this talk to reminiscence. I want to talk about three Budgets and use them to illustrate changing approaches to macroeconomic policy. They are the Budgets of 1972, 1981 and 1992. I was directly involved, as a Treasury official, in two of them and took a particular interest in the other one. I should say now that I am not intending to reveal confidential information about the operation of the Treasury. (It is well-known that such efforts are immediately punished by a bolt of lightning, and I would not wish to cause any injury to innocent bystanders.)

In relation to each of these Budgets, I shall ask what they reveal about the views current at the time about the behaviour of the economy, in particular in relation to the determination of output and inflation. At the end, I shall attempt to draw some conclusions from these experiences. I have learned that when talking to sixth forms it is a mistake to assume that they all remember the early days of the Thatcher government. I suspect that it is a similar mistake when talking to this conference, so I shall take little for granted.

My final point by way of introduction is that this is not an exercise in mockery. It is true that I no longer hold some of the views implied in these Budgets, though in some cases I did at the time. A sense of modesty about it all is rather more appropriate than a sense of superiority.

My choice of Budgets is not completely random. Two of them, those of 1972 and 1981, were quite extraordinary, but all three occurred at approximately the same stage of the cycle. The troughs in the cycles, as recorded by the CSO (as it then was), occurred in February 1972, the first quarter of 1981 and the second quarter of 1992. Thus the Budgets were all very close to the trough.

We start with the Budget of 1972. The immediate background, as reported in the Budget 'Red Book', was that GDP had grown by 2½% between the first and second halves of 1971, although this had followed a rather prolonged period in which it had grown substantially below

the rate of growth of productive potential. Unemployment had risen sharply (by the standards of the day). It was 260,000 (or 1.2% of total employees) higher at the end of 1971 than it had been a year earlier. By the end of 1971, unemployment was more than 900,000 (about 4% of the labour force). Retail price inflation had reached an annual rate of 11% during the first six months of the year, but had subsequently fallen back to about 5½%. The twelve-month rate was 8%. Interest rates had been cut during the year by 2 percentage points. Broad money (M3) had risen by 13% during 1971. Public expenditure had been increased in a package of measures announced the previous July. Competition and Credit Control, which among other things involved the abolition of quantitative restrictions on bank lending and the conventional liquidity ratios observed by the clearing banks, had been introduced in September 1971.

Against this background, the then Chancellor of the Exchequer, Mr Barber, made generous tax cuts, in addition to the increases in public expenditure and cuts in interest rates of the previous year. The tax cuts were worth about 2% of GDP (from a non-indexed base); the main measures were increases in the married and single allowances, and cuts in purchase tax rates.

It was clear that the purpose of the Budget (as of the preceding policy changes) was to cut unemployment. In his Budget speech, Mr Barber said: 'There is universal agreement that the present high level of unemployment is on every ground—economic and social—one which no government could tolerate'. The Budget was expected to raise demand by about 2% of GDP.

So the aim of the Budget was clear. But what about the effects of demand expansion, and the resulting fall in unemployment, on inflation? Mr Barber made two interesting comments in his Budget speech.

The first was: 'While cost inflation is clearly one of the causes of high unemployment, I have never agreed with those who look to unemployment as the cure for inflation'.

The second was: 'I do not believe that a stimulus to demand of the order I propose will be inimical to the fight

(1) Given at the Royal Economic Society Conference held at Warwick University on 1 April 1998.

against inflation. On the contrary, the business community has repeatedly said that the increase in productivity and profitability resulting from a faster growth of output is one of the most effective means of restraining price increases’.

We can pause and ask what observations and what economic theories led to the conclusion that faster growth would actually help to reduce inflation. One clue was provided by a remark in Mr Barber’s 1971 speech. He said: ‘Two problems, above all, command attention at the present time, inflation and unemployment: a new and, in many ways, a baffling combination of evils’.

The 1960s had seen unemployment cycling around 2½% (on present definitions), but with a tendency to rise. Inflation had varied around 3%, but was also tending to rise. But in 1970, as Mr Barber remarked, both inflation and unemployment had risen. This observation gave rise to such comments as: ‘The Phillips curve is dead’ or, alternatively, ‘It has been stood on its head’. (Recall that I am talking about comments made in 1970 or thereabouts.) The rise in inflation under conditions of rising unemployment was variously explained as a response to rising trade union militancy, or as a sign of social breakdown. There were also the real wage push and catch-up theories, which could readily explain how faster economic growth would produce lower increases in nominal wages. Finally, there was the common observation that unit labour costs tended to fall in the early stages of an economic recovery, because of short-term increases in labour productivity.

If faster growth and falling unemployment would produce lower inflation, it is worth asking whether there was any limit to this process. That indeed is a question that could be asked of much of macroeconomic policy-making in the period up to 1972. It is possible that, mindful of the problem that had dominated post-war macroeconomic policy to the end of the 1960s, the limit was expected to be provided by the balance of payments. (Though even that limit was to be removed by the move to floating exchange rates in 1972.) Since the Red Book talked of productive potential, there was clearly some supply-side constraint, although it appeared to be rather weak. Also, the Red Book had specifically drawn attention to the exceptional rise in unemployment during 1971 at a time of economic growth, and concluded that there had been an upward shift in productive capacity. The official forecasts that accompanied the Budget showed GDP growing by 4¾% in 1972, and by 6% between the first half of 1972 and the first half of 1973.

There were certainly criticisms of the 1972 Budget. A particularly important source was Cambridge University, where the New Cambridge School, under Wynne Godley, argued that the rapid increase in the Budget deficit associated with the fiscal expansion would result in an equivalent deterioration in the balance of payments. To oversimplify somewhat, the New Cambridge School, with its emphasis on financial flows, argued that the private sector’s financial surplus tended to remain constant (at an annual rate of about £1 billion). Thus any increase in the

public sector’s deficit would be matched by an equivalent increase in the overseas sector’s surplus (ie in the balance of payments deficit).

The other source of criticism was from the monetarists, who had an explanation for the conjunction of rising inflation and rising unemployment (Milton Friedman had given his Presidential Address to the American Economic Association in 1968), and drew attention to the rapid growth of the money supply. They warned that the result, sooner or later, would be a burst of inflation.

The following years (with a further relaxation of fiscal policy in the 1973 Budget) saw, first of all, GDP growth of more than 7% in real terms in 1973. Unemployment fell to below 500,000 by the end of 1973. Then New Cambridge had its triumph. The balance of payments recorded a deficit of £1 billion (1½% of GDP) in 1973 and more than £3 billion (4% of GDP) in 1974. Finally we had, apparently, the triumph of the monetarists. By 1975, despite a series of prices and incomes policies, inflation reached a peak of 27% and unemployment was back to one million and rising.

From 1972, I move the story on nine years. 1981 was the new Conservative government’s third Budget. The economy was in a deep recession. GDP had fallen by 2½% in 1980. Manufacturing output had fallen by 9%. Unemployment had risen during the year from 5½% to 9½%, an unprecedented rise of one million in a year. Retail price inflation had fallen from a peak of 22% in May 1978 to 13% in January 1981. The underlying six-month annualised rate was 10%–11%, broadly in line with the OECD average.

Against this rather grim background to the real economy, the 1981 Budget was designed to produce a fiscal tightening of 1¾% of GDP. That made it, up to that point, one of the toughest of the post-war Budgets. (The other tough Budgets had been those of 1951 and 1968, but the circumstances had been entirely different. The 1951 Budget had been a response to the Korean War and rearmament; the 1968 Budget had followed the devaluation of 1967.) Since GDP was forecast to fall by 2%, the reduction in the structural deficit was significantly larger than 1¾% of GDP. The structural deficit was cut by between 4% and 5% of GDP.

The main measures were a freezing of personal income tax allowances (at a time when inflation was 13%), increased taxes on oil revenues, a special tax on bank deposits, increased excise duties on fuel, tobacco and alcohol, and a rise in vehicle excise duty.

The Red Book introduced the Budget in the following terms: ‘The Budget represents a further step towards the achievement of the Government’s medium-term objective of bringing down inflation and creating the conditions for sustainable growth of output and employment’.

The next sentence was a key passage: ‘In order to permit its monetary objectives to be met at tolerable interest rates, the

Government's aim is to contain public sector borrowing to a real level well below that of 1980–81'.

This point was set out in greater detail in the presentation of the Medium Term Financial Strategy. The growth of broad money (measured then by sterling M3) was to be reduced from the 20% it had reached during 1980–81, to 6%–10% in 1981–82 and to 4%–8% by 1983–84.

The Red Book said: 'The Government intend that fiscal policy should be consistent with this declining path for monetary growth. The PSBR as a proportion of GDP will be brought down substantially over the medium term, so as to create conditions in which interest rates can fall'.

In his Budget speech, Geoffrey Howe said: 'It is the experience of Governments around the world that if they try to borrow too much, either interest rates or inflation, or both, begin to soar.

Britain's experience tells the same story. If we are to stay on course for lower inflation and lower interest rates, we must borrow less. Public borrowing, as a proportion of national income, must be brought down. This is why the medium-term financial strategy envisages a downward path for borrowing, as well as for the growth of the money supply. These remain the essential prerequisites for a lasting grip on inflation'.

To explain the 1981 Budget, we can look back over the years since the 1972 Budget. As I mentioned, the immediate effect had been a rapid growth of GDP and a fall in unemployment, but three years later, inflation and unemployment had been at record post-war levels. In 1976, there had been the IMF crisis, followed by the severe fiscal tightening of 1977.

Those events produced a sea-change in policy circles.

Above all they produced:

- doubts about the effectiveness of fiscal policy in altering aggregate demand;
- acceptance of the inflationary role of the money supply;
- recognition of the link between public sector borrowing and the growth of the money supply;
- recognition of the role of the exchange rate in the monetary transmission mechanism; and
- appreciation of the role of supply and demand factors in determining the level of unemployment.

Note that I am not, for the moment, saying whether those views were right or wrong; I am merely saying that they had permeated policy-making.

Mr Callaghan, the Labour Party Leader and Prime Minister, as he then was, had made his much-quoted speech in September 1976: 'We used to think that you could just spend your way out of a recession and increase employment by cutting taxes and boosting government spending. I tell you in all candour that that option no longer exists, and that insofar 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. Higher inflation, followed by higher unemployment. That is the history of the last twenty years'.

The idea that fiscal policy was ineffective was reinforced by the observation that the fiscal tightening of 1977 was followed by a healthy economic recovery in 1978.

The importance of the money supply was supported by the fact that the rapid monetary growth of the early 1970s had been followed (as the monetarists had predicted) by the inflationary outburst of the mid 1970s. The link between public borrowing and the broad money supply could be shown through the monetary identities. The role of the exchange rate in the transmission mechanism could be seen from experience. Once it was allowed to float, its fall had accompanied the rapid growth of the money supply and preceded the inflation of 1974–75.

All these ideas had been brilliantly incorporated in the London Business School model by Terry Burns. A fiscal expansion, unless accompanied by a rise in interest rates to encourage sales of public sector debt to the non-bank private sector, would result in a rise in the money supply. The rise in the money supply would generate a fall in the exchange rate. The open-economy model of inflation showed that prices of traded goods would move rapidly to equality with world prices, and the resulting inflation would spread (via wage increases) to the rest of the economy. Finally, experience had shown that the personal sector's savings ratio, as measured in the National Income Accounts, rose with inflation. Thus the effect of a fiscal expansion on demand would rapidly be reversed, and the result would simply be a rise in inflation.

It was these ideas that had provided the intellectual basis for the Medium Term Financial Strategy, which had been introduced with the 1980 Budget. But it had gone off course in 1980. The money supply had grown by 20% rather than the intended 6%–10%, and the PSBR had been £13 billion rather than the intended £9¼ billion. The Budget was designed to bring the Medium Term Financial Strategy back on course. Monetary growth had to be reduced. If this was to be done at the same time as interest rates fell, the PSBR had to be reduced. But would not the fiscal tightening slow down economic growth and raise unemployment?

The Budget Red Book provided some hint of official thinking: 'The past year has been difficult as the economy has had to adjust, against a background of world recession, to a higher exchange rate and lower inflation. The

immediate costs of this adjustment are falling output and sharply rising unemployment. However, part of the loss of output and employment could have been avoided had wage increases been lower; only since the Autumn has there been evidence of greater realism in pay settlements’.

In his Budget speech, Geoffrey Howe also commented on the role of excessive pay claims: ‘Many factories had already gone a long way towards pricing themselves out of the market by earlier pay settlements. Many of those who secured big pay increases may have improved their own standard of living, but only at the cost of pushing their fellow workers out of a job’.

But matters were beginning to improve: ‘Pay bargainers have begun to face up to the harsh truth that excessive pay is a major cause of unemployment’. He hoped that the government’s policies would produce lower inflation and, in due course, lower unemployment.

The forecasts that were published with the Budget showed GDP falling by a further 2% in 1981, although a recovery was expected between the first and second halves of the year. GDP was expected to grow by 1% between the first half of 1981 and the first half of 1982. As was the custom, there was no forecast of unemployment. Retail price inflation was expected to be 10% by the end of 1981 and 8% by the middle of 1982.

In the event, the economy started to recover in the second quarter of the year. Growth between the first half of 1981 and the first half of 1982 was 2¼%. However, unemployment continued to rise until 1986. Inflation was 12% at the end of 1981, and was about 8% by the middle of 1982.

The 1981 Budget had considerably more critics than supporters. Notoriously, it produced the letter to the *Times* of 30 March, which included the following: ‘There is no basis in economic theory or supporting evidence for the Government’s belief that by deflating demand they will bring inflation permanently under control and thereby induce an automatic recovery in output and employment’.

Since this letter was signed by a large number of economists that I respect and admire, I have spent a great deal of time contemplating it. If ‘discuss’ was added at the end, it might make a good exam question. I would make the following comments. First, any economist worth his salt could invent six theories in a morning to match any posited set of observations. Second, there would be no need to invent such theories, since there would be perfectly good ones to hand. A standard eclectic model would produce the result that if demand were deflated (for example, by reducing the growth of the money supply), the ultimate result would be a fall in inflation and a return to the equilibrium level of output and employment. However, I recall this letter not as evidence of the state of economic thought at the time, but as

a sign of the bitterness of the debate and the extent of the breakdown in the consensus.

I shall deal with the 1992 Budget more briefly, since it is more clearly a descendant, though subject to further evolution, of the 1981 Budget.

The United Kingdom had joined the ERM in October 1990. At Budget time, retail price inflation was 4%, having been 9% a year earlier. Producer price inflation was 2¾%. GDP had fallen by 2½% in 1991 and was still falling at the end of the year. Unemployment had reached 9½%. Interest rates had been cut by 3½ percentage points during the year. The Autumn Statement, presented the previous November, had included increases in public expenditure.

The Budget provided a fiscal relaxation of about 0.2% of GDP in 1991–92 (from an indexed base), and about 0.3% of GDP in 1992–93. The main change was the introduction of the new 20% income tax rate on the first £2,000 of taxable income.

The Red Book stated: ‘Successful economic performance requires permanently low inflation and a healthy supply side’. In his Mais Lecture of 1984, Lord Lawson had emphasised that macroeconomic policy should be assigned to the control of inflation, and microeconomic policy should be assigned to the improvement of sustainable output and employment. The Red Book explained that, within macroeconomic policy, membership of the ERM provided the basis for monetary policy. At that time, monetary policy was directed at keeping sterling within 6% either side of the central ERM parities. The announced policy was that in due course sterling would move to the narrow 2¼% band round the central parity of 2.95 Deutsche Marks.

The government’s fiscal policy was to maintain a firm fiscal stance by balancing the Budget over the medium term. ‘This approach ensures that fiscal policy supports monetary policy in achieving low inflation’.

The Red Book continued: ‘ERM membership will remain the central discipline underpinning UK macroeconomic policy in the medium term. In principle, policy requirements are not fundamentally altered by ERM membership: they would be much the same even if the United Kingdom had chosen to pursue the objective of defeating inflation outside the ERM. But ERM membership now provides the medium-term nominal framework within which the UK economy must operate’.

Given the constraints of ERM membership, of the objective of balancing the Budget over the medium term, and of its commitment to meeting the Maastricht criteria (which included the avoidance of an excessive fiscal deficit, indicated by a deficit of more than 3% of GDP), the government had little room for manoeuvre.

Mr Lamont denied that he was engaging in fiscal activism. In his Budget speech he referred to the success in bringing

down inflation and said: ‘There are those who would put this [fall in the inflation] at risk by seeking to pump up demand, but I am not prepared to take steps which would call into question the Government’s determination to match or better the inflation performance of our Community partners.’

And even if it were thought desirable, it is not remotely feasible for Governments to try to target the level of demand month by month or quarter by quarter. Having made such progress in getting inflation down, it would be tragic now to throw it all away with an ill-judged or ill-timed attempt to kick-start demand’.

However, Mr Lamont believed that it was appropriate to allow some short-term relaxation of fiscal policy, since this was consistent, according to the projections made at the time, with bringing the PSBR back to $\frac{3}{4}\%$ of GDP over the following five years. The PSBR was projected to reach a peak of $4\frac{3}{4}\%$ in 1993–94 and then to fall steadily.

The forecasts published with the Budget had GDP rising by about 2% between the second half of 1991 and the second half of 1992, and by 3% between the first half of 1992 and the first half of 1993, helped by a projected improvement in competitiveness as UK costs and prices fell relative to those of its trading partners. Retail price inflation was forecast to fall to $3\frac{3}{4}\%$ by the end of 1992, and to $3\frac{1}{4}\%$ by mid 1993. Unemployment was expected to continue rising for a while, though at a slower rate than previously.

The events since the Budget of 1992 will be more familiar to most of you. The United Kingdom left the ERM on 16 September 1992. GDP fell by about $\frac{1}{2}\%$ in 1992, compared with a forecast rise of 1%. Unemployment continued to rise during 1992, but stopped just short of 3 million and has been falling ever since. Inflation was 2.6% at the end of 1992 and 1.2% in mid 1993.

That is the end of the story. What were the three views of macroeconomics? With some inevitable oversimplification, they can be characterised as follows.

In 1972:

- output and unemployment were determined by aggregate demand;
- aggregate demand could be freely manipulated by the authorities, particularly through changes in fiscal policy; and
- inflation was either unaffected by, or possibly reduced by, reductions in unemployment.

In 1981:

- output and employment were self-equilibrating (though not necessarily rapidly);
- attempts to change aggregate real demand through fiscal expansion would be ineffective; and

- inflation was determined in the medium to long term by the growth of the money supply.

In 1992:

- output and employment were self-equilibrating in the medium to long term, but determined by aggregate demand in the short term;
- aggregate demand could be affected in the short term by fiscal policy; and
- inflation was determined by the pressure of demand in the short term, and by the inflation of currency system partners in the medium to long term (recall that this was a period of quasi-fixed exchange rates, at least with the ERM currencies).

If that sounds as if 1992 was closer to 1981 than it was to 1972, that is deliberate. The changes between 1981 and 1992 largely concerned the speed with which markets are thought to adjust (though that is obviously not a trivial matter as far as policy-making is concerned).

If one were to bring the story up to date, one could perhaps say that as far as macroeconomics is concerned, we now have a flexible exchange rate version of the ideas behind the 1992 Budget, with the addition of those twin peaks of human evolution—the Monetary Policy Committee of the Bank of England at one end of town and the Code for Fiscal Responsibility at the other. It is also true, I think, that the basis of current policy is closer to the professional consensus than was the case in 1972 or 1981 (though that is not necessarily a source of comfort, and I am not saying who it is that has moved).

What do we learn from these experiences? In my own case, I find further evidence to support the one (rather tentative) conclusion that I draw from nearly 30 years’ experience, namely that it is all very difficult. I have described three very different Budgets, and I have suggested that they represent three different views of macroeconomics. It is hard to believe that all those views were right. I can offer two explanations for these swings in policy-making. They are not necessarily inconsistent with each other, though one is more benign than the other.

The benign explanation would run as follows. The early 1970s saw a number of shocks, including the change in policy regime following the breakdown of the Bretton Woods fixed exchange rate system and the oil price rises of 1973–74. It was not an easy matter to choose the right policies in these profoundly changed circumstances. It involved a process of trial and error. Policy-makers reasonably enough learned from experience, and also absorbed elements from developments in economic theory. The path of inflation from 1970 onwards looks consistent with the idea of erratic progress towards some degree of success in bringing it under control and stabilising it. (One might of course ask why other countries found the process rather less difficult.)

The less benign explanation (which is not obviously inconsistent with the previous one) would run as follows. Policies have been based on beliefs that have had flimsy foundations in terms of theory or evidence. When there are new events that seem to be inconsistent with the current approach, the framework is abandoned and replaced by something else that seems to fit the recent facts better. By analogy with econometrics, one could perhaps call this policy 'over-fitting'. As in econometrics, the new system rapidly breaks down in response to the next shock.

I think that the truth probably lies somewhere between the two explanations, and it would be inappropriate for me to say exactly where we should place it. If pressed, I would say that the 1972 Budget was an extreme version (in

response to short-term developments) of policies based on insecure analytical and empirical foundations. 1981 was a robust (and perhaps inevitably somewhat crude) attempt to place policy on a sound footing. It has been sensibly modified in the light of experience and further analysis. I believe that we now have an approach to policy that would have dealt better on average with the events of the past quarter of a century, even if it had not been entirely appropriate in all conditions. I believe that it offers a good chance of dealing successfully with future shocks, although it does not, of course, guarantee it.

Finally, you may feel that I have spent 50 minutes (if not 30 years) stumbling towards the familiar concept of robust policy rules. That is true; my purpose has been to show, from experience, how necessary they are.