BANK OF ENGLAND

Speech

The Budget of 1981 Was Over the Top

Speech given by

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Introduction

After the 1981 Budget, 364 university economists in Britain wrote to complain about the tightness of macroeconomic policy, prompted by the plans in the Budget to cut public sector borrowing by some £3.3 billion, mainly by increasing taxes. It is now a commonplace view that the 364 were wrong to complain because, shortly after writing the letter, the growth rate of real domestic demand and GDP in the UK switched from negative to positive. As it happens this view is incorrect. As one of the 364, I would say that wouldn't I, so in what follows, I pursue this question by analysing the periods before and after the sending of the letter. I conclude that the 364 economists were perfectly correct to complain about the macroeconomic policy of the day back in 1981

Why Sign the Letter?

I signed the letter because, at the time, I had long thought that monetary policy was too tight and that tightening fiscal policy in early 1981 was a mistake. While it was true that the letter was not everything I might have wished for, it was the only show in town and I felt that I should stand up and be counted. In particular, I had always believed that the world was best understood in a NAIRU framework and indeed at the time I was busy trying to estimate the path of equilibrium unemployment in Britain (see Nickell, 1982). So it is no surprise that I did not find the implicit theoretical analysis underlying points a) and d) in the letter entirely to my taste. However, I approved wholeheartedly of the main points b) and c), and still do. So how might they be justified in the light of the fact, already noted, that output growth in Britain turned positive shortly after the letter appeared? Surely, it is typically argued, all this talk of deepening depression must be so much hot air in the light of this fact. Fortunately for me, this argument is just wrong. For the depression to deepen or the output gap to get more negative, output growth does not have to be negative, it merely has to be below trend. So the 364 cannot simply be dismissed out of hand by pointing at the time series of GDP growth. More analysis is required.

What Happened before the Budget of 1981?

When the Thatcher government took office in the Spring of 1979, annual inflation (GDP deflator) was close to 11% and had fallen steadily since peaking at over 25% in 1975 after the disaster of the first oil shock. This fall in inflation had been engineered essentially by trying to use an incomes policy to lower the equilibrium rate of unemployment with actual unemployment fairly stable. In the years leading up to 1979, unemployment had been around 6% on the OECD measure and somewhat lower on the Department of Employment (DE) measure (see Layard et al. (1991), Table A3.) During this period and for many years before, wages tended to respond rapidly to changes in RPI inflation unless obstructed by incomes policy, inflation expectations were not stable (as far as we know) and there was no belief in the labour market that Government macroeconomic policy would respond aggressively to inflationary shocks.

Aside from scrapping the incomes policy, the change of government had little impact on these features of the labour market. The rapid response of wages to changes in RPI inflation, now completely unconstrained by incomes policy, was perfectly exemplified by the year following the first Budget of the new administration in June 1979. The main feature of this Budget was the switch from income taxes to VAT. This plus the rise in oil prices raised RPI inflation by over 5 percentage points between the second and third quarters of 1979 so that after a wage-price spiral (see Figure 1), by the second quarter of 1980, RPI inflation was 21.5%, wage inflation was 21.3% and the GDP deflator was rising at 22.3%. Wage inflation continued to rise, reaching 22.4% in the third quarter by which time the rise in VAT had dropped out of the RPI and things started to subside. Monetary policy responded aggressively to this inflationary shock with the policy rate reaching 17% in November 1979, having been at 12% when Mrs Thatcher took office.

So now the basic problem was to get inflation back down again, preferably to some reasonable level, in a world where, as we have seen, governments had little anti-inflation credibility. There is no option in this situation but to use a tight macroeconomic policy to raise unemployment well above the equilibrium rate and then wait for inflation to subside, before gradually loosening policy. The whole process is tricky, all the more so because if some of the unemployed get detached from the labour market after being unemployed for a long time, they are no longer so useful at exerting downward pressure on pay rises.

This, in essence, was the policy which was pursued. Of course, the details of the macroeconomic policy regime were quite complicated with monetary targets, the medium term financial strategy and so on. But to get inflation down, unemployment had to go above the equilibrium rate. In due course, policies which might reduce the equilibrium rate could be introduced but, in the mean time, the equilibrium rate at the time was probably around 7 to 8 per cent and so macroeconomic policy had to push unemployment above this level. By the 1981 Budget, unemployment was rising rapidly thanks to the very tight monetary policy, having increased by some 4.2 percentage points on the DE measure over the previous year. It was also plain at the time that on unchanged policies, unemployment was going to rise a good bit further, UK relative unit labour costs having risen by 44% since 1978 thanks to North Sea Oil and high interest rates.

So at the time of the 1981 Budget, the current and prospective path of unemployment was easily going to be high enough to bring down inflation to normal levels in a reasonable time. Indeed, I would have argued that monetary policy could have been eased somewhat without endangering the steady downward path of inflation. So what happened in the 1981 Budget and beyond?

What Happened after the Budget of 1981?

As we have seen, planned fiscal policy was tightened significantly in the 1981 Budget and, at the same time, interest rates were cut from 14% to 12%. However, they were back up at 14% on 15 September and 15% on 12 October, so the monetary easing was temporary. In the complaint of the 364 economists, it was argued that the depression would deepen. So what happened? Despite positive output growth, unemployment continued to rise (See Figure 2). Unemployment peaked on the OECD measure at 12.5% in 1983 but did not fall below 11% until 1987. On the DE measure, unemployment continued to rise, year on year, until it peaked at 11.2% in 1986. Under the not unreasonable assumption that rising unemployment means that growth is below trend (there being no reason to believe equilibrium unemployment was rising much between 1982 and 1986), the depression deepened until somewhere between 1983 and 1986, exactly as the 364 said it would. Even though unemployment has to be above the equilibrium rate to get inflation down, this strikes me as overkill. By the 1981 Budget, monetary policy was already too tight. It could have been loosened and the fiscal stance need not have been tightened and still unemployment would have been far enough above the equilibrium rate to have brought inflation down. Maybe it would not have come down quite so fast, but with the fall in oil prices in 1986, it would almost certainly have been at reasonable levels by 1987. As it happened, of course, by 1987 macroeconomic policy became so gung-ho that by 1990, GDP inflation was back at its 1982 level (7.6%) and the whole business had to be repeated in an only slightly less dramatic fashion.

So is there any excuse for the policy overkill which the 364 economists complained about so bitterly? One possible excuse was that the exceptionally rapid rate of productivity growth from 1982 to 1986 was not expected. During this period, whole economy productivity growth was close to 3%. This was not just a cyclical recovery and was unusually high by recent historical standards (see Nickell et al., 1992 for some explanations). So over this period, trend growth rates would have been especially high, particularly relative to the 1970s. This would make it more likely that macroeconomic policy would be set in such a way as to generate output growth at a rate lower than would be desirable. And this is exactly what happened.

Conclusions

The main complaint of the 364 economists in their 1981 letter was that macroeconomic policy was unnecessarily tight and that it would deepen the depression. By ensuring that subsequent output growth was below trend for a number of years, it did indeed deepen the depression just as predicted. Furthermore, it was unnecessarily tight in the sense that a somewhat looser policy would still have raised unemployment far enough above its equilibrium level to bring inflation down over a reasonable period. So in their key comments on the facts of the case, the 364 economists turned out to be completely correct.

References

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Layard, R., Nickell, S. and Jackman, R. (1991), Unemployment, Macroeconomic Performance and the Labour Market (Oxford: Oxford University Press).

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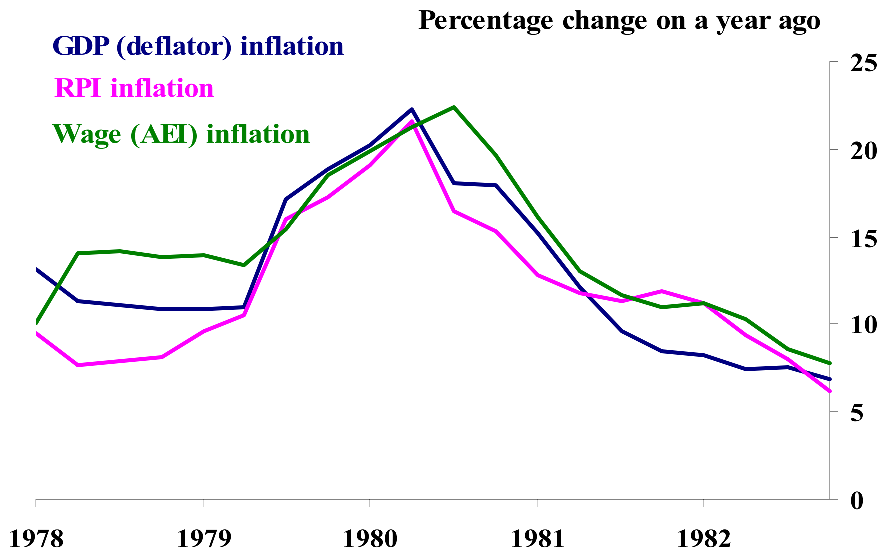
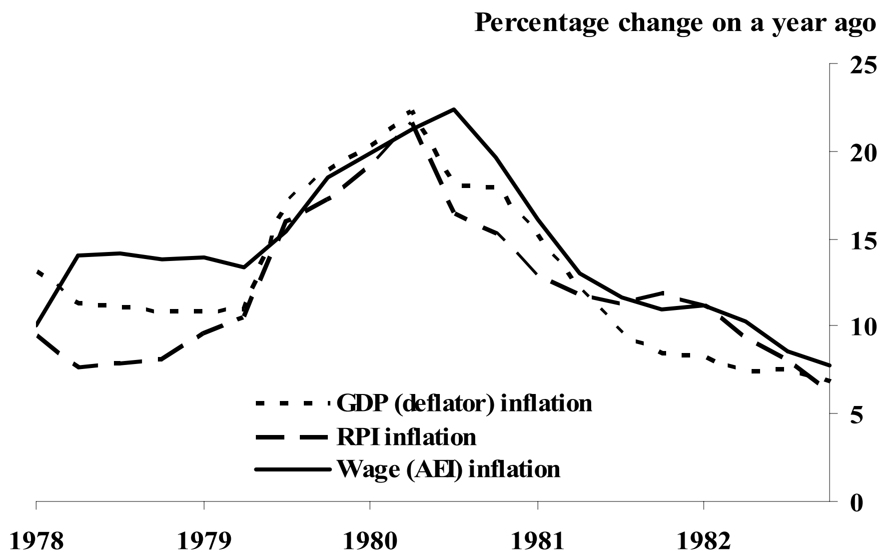
Inflation from 1978 to 1982

Figure 1





Unemployment and Inflation from 1976 to 1990

Figure 2