Chapter 1
Britain in the 1980s

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How serious are the risks of continuing stagnation of the British economy through the 1980s? Is the regeneration of British industry possible, and if so by what means? The answers to these two questions will determine the severity of unemployment and attendant social problems during the remainder of this decade and set the context in which Britain has to cope with the decline of its offshore oil and gas fields in the 1990s.

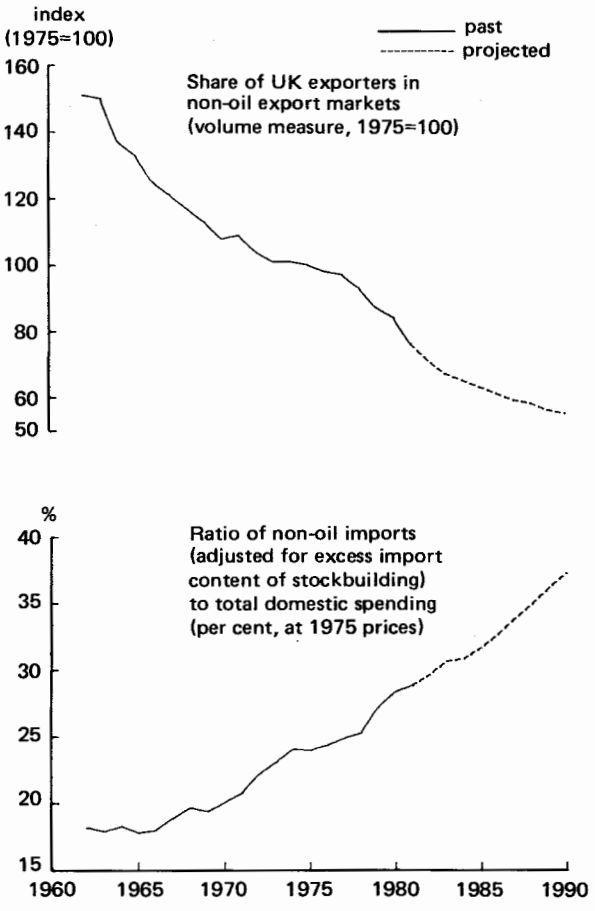
The first part of this chapter sets out the reasons why stagnation of non-oil production is all too likely and points to the danger of worsening social inequality if the burden is borne by the unemployed while the real income of those still in employment continues to rise. The second section examines policies to mitigate unemployment and ameliorate conditions in depressed areas, suggesting that the costs of such policies could not easily be accommodated with near-zero economic growth. Later sections review policies for economic recovery, starting with the government's hopes for a self-sustaining resurgence of business enterprise. We show that, whether business confidence improves or not, recovery of the economy as a whole is unlikely. The broad group of policies encompassing reflation, depreciation of sterling, and various types of incomes policy and job-creation schemes advocated by politicians in various parties is then examined in more detail. The last part of the chapter attempts to assess what might happen if a recovery programme of the kind now embraced by the Labour Party were put into effect by a future government.

1.1 The risks of prolonged stagnation

Chronic stagnation of non-oil production in Britain during the 1980s is virtually certain if past trends in export growth and import penetration continue. Since these trends have been persistently adverse under a wide range of government policies and external economic conditions, there is little reason to expect them to change suddenly in the future.

Chart 1.1 shows two crucial indicators – the share of UK producers in world markets for non-oil exports and the growth of non-oil imports (adjusted for stockbuilding) relative to domestic spending. The non-oil export share has fallen steadily by an average of 3½% a year (the best performance was between 1970 and 1977 when it fell only 1½% a year as exports were encouraged by rapid devaluation of sterling). Non-oil import penetration has risen somewhat more erratically since the mid 1960s, by an average of 3% a year (though to keep this trend in check, as we note below, required increasing restraint of domestic expenditure in the 1970s).

Chart 1.1 Trends of UK performance in non-oil trade



Consider what these two trends would imply if Britain's non-oil trade had to be kept continuously in balance and if GDP and domestic spending were to grow by 3% a year, which is roughly consistent with stable employment and which used to be considered normal. At this rate of growth the demand for non-oil imports would tend to increase by 6% a year in volume terms and, in the absence of terms of trade changes (the price of exports rising faster than the price of imports or *vice versa*), exports would need to grow at the same rate to keep trade in balance. Given a 3½% a year loss of market share, UK export markets would have to expand by nearly 10% a year for this rate of export growth to be achieved. This is broadly what happened in the late 1960s and early 1970s, when world trade growth was unusually high.

The trends in the chart imply that when world trade growth is less than 9-10% a year, export growth will fall short of the rise in imports and the non-oil trade balance will deteriorate. What the chart does not bring out, however, is the point at which such a deterioration becomes important and acts as a potential constraint on the growth of domestic output and expenditure. Moreover the overall trends for non-oil trade conceal very divergent trends for manufactured goods as opposed to other trade flows. In Britain, as in most other countries, the demand for imports of manufactured goods has risen very much faster than the demand for non-oil imports as a whole and has proved far more responsive to growth in domestic expenditure. This did not matter very much when the gap between the level of exports and imports of manufactures was substantial and when the latter comprised only a small part of the UK's total import bill. By the early 1970s, however, the gap had narrowed sufficiently, and manufactures had become important enough in total imports for rapid expansion of domestic expenditure to lead to a sharp deterioration in the overall external account. Since then, given the growth of exports actually achieved, avoidance of balance of payments problems has entailed restricting the growth of domestic spending and output below that required to prevent increasing unemployment in order to keep imports in check.

Given the past trends of Britain's trade performance, 6½% growth of world trade would imply *zero* growth of spending and output in Britain, while the 5½% average growth of UK export markets which has actually materialised since 1973 implies that, in the absence of oil or terms of trade gains, domestic spending and GDP should have *fallen* by 1% a year to prevent a widening trade deficit.

Of course, Britain does not have to balance its trade – still less its non-oil trade – from year to year. Moreover there are occasional terms of trade gains or losses as well as variations in the rate of loss of export market share and in the rate at which import penetration increases. The calculation can be refined to make allowance for these factors insofar as they are predictable and, more especially, to incorporate gains from Britain's oil. But in any medium-term or long-term projection the average growth rate of GDP and domestic spending is still dominated by assumptions about future trends in non-oil trade since the other factors are in comparison relatively small.

In the absence of a radical change in European and US government policies, which on the whole are aimed at containing both inflation and external deficits through fiscal and monetary restriction, there is no chance of world trade growth being nearly as high as in the late 1960s and early 1970s. And even if policies were to change, it would probably not be long before further increases in the price of oil once more reduced the rate of expansion. At best, world trade cannot be expected to grow very much faster in the 1980s than since 1973. Our base projection, to err somewhat on the side of optimism, assumes a 6½% a year average growth rate for UK export markets which, in the absence of increases in net exports of oil, would imply approximately zero growth of spending and output in Britain if the trade balance is not to deteriorate. Energy saving combined with growth of domestic energy supply (oil, gas and coal) could provide Britain with a rising surplus on oil trade, sufficient to feed a slow expansion of domestic spending and GDP. Table 1.1 sets out the pattern of growth projected under these assumptions.

Growth in net exports of oil could allow non-oil trade to move from the present substantial surplus position into significant deficits. Since much of the recent surplus is the result of the large rundown in stocks, it is likely to be reduced very quickly as destocking goes into reverse and pushes up imports. Moreover export growth is likely to remain exceptionally depressed as a result of the sharp loss of export competitiveness which has occurred in the past three years.

Any increase in non-oil imports over and above the rise of exports must necessarily mean that the growth of non-oil output falls short of any expansion in domestic spending. Thus even if total domestic spending (including stockbuilding) grows by some 2% in each of the next two years, non-oil output could fail to grow at all or even fall. The whole of the spending increase could well be absorbed by imports or be offset by a fall in non-oil exports. This forces us to be very pessimistic about the short-term prospects for any recovery of manufacturing output or employment.

Looking further ahead, growth of non-oil exports will hopefully resume while imports should rise less rapidly once stockbuilding is back to normal. The decline in manufacturing output may then at least level off and service sectors should achieve some growth (although under the assumptions of Table 1.1 even they would only expand by about 1½% a year).

How likely is it that continued stagnation will be avoided? Table 1.2 summarises a range of variant projections, any one of which might be at least as plausible as the base projection in Table 1.1. Most

Table 1.1 Trade, spending and GDP – a base projection

	Historical		Base projection				growth rate
	1980	1981[e]	1982	1983	1986	1990	1981-90
Expenditure and output	(£ billion, 1975 prices)						(% a year)
Consumers expenditure	71.5	71.6	70.8	72.9	75.6	81.3	1½
Public consumption	24.4	24.4	24.5	24.6	25.7	25.8	½
Fixed investment	20.7	19.1	18.8	17.9	17.1	16.9	–1
Stockbuilding	–3.1	–4.0	–1.0	0.4	0.7	0.6	—
Domestic spending	113.5	111.2	113.1	115.7	119.1	124.6	1½
plus Exports	33.3	32.5	32.0	31.8	35.5	41.4	2½
less Imports	–34.1	–33.3	–35.1	–37.2	–40.5	–47.8	4
GDP at market prices	112.7	110.4	110.0	110.4	114.0	118.1	1
of which:							
offshore oil and gas	3.1	3.5	3.9	4.0	4.2	4.3	2
manufacturing	25.6	24.1	23.9	23.5	23.4	23.4	–½
other sectors	84.0	82.7	82.3	82.9	86.4	90.5	1
Balance of payments	(£ billion, 1975 prices)						
Volume of non-oil exports	31.0	29.7	29.0	28.7	32.1	37.9	2½
less Volume of non-oil imports	–31.5	–31.2	–33.4	–35.6	–39.1	–46.7	4
plus Non-oil terms of trade gains	3.6	3.4	3.6	4.4	4.0	4.7	—
Non-oil trade balance	3.1	2.0	–0.8	–2.5	–3.0	–4.1	—
Net oil exports	–0.3	1.1	1.9	2.3	3.5	5.1	—
Net income from abroad	–1.2	–0.6	–0.4	–0.6	–0.5	–0.8	—
Balance on current account	1.6	2.5	0.7	–0.8	0.0	0.2	—
Energy balance	(million tons, oil equivalents)						
Domestic supply							
oil and gas	113	120	129	133	139	143	2
coal and primary electricity	86	85	86	87	91	95	1
total	198	205	215	220	230	238	1½
Domestic use	210	191	185	182	180	178	–1
Net exports	–12	14	30	38	50	60	—
Export competitiveness	(indices, 1975=100)						
Exchange rate	96	95	90	90	80	80	–2
Export cost competitiveness							
current	125	133	131	132	124	121	–1
lagged	108	115	120	123	123	122	½

of them add or subtract only around ½% a year to the long-run growth of domestic spending and GDP and up to 1½% a year to the growth of manufacturing output. For GDP growth over the remainder of the decade to be increased to 2½- 3% a year (which would, for example, just about prevent unemployment from rising further but would not be enough to bring it down) would require rapid growth of world trade to be combined with sustained depreciation and, at the same time, import penetration rising more slowly than in the past. Such a combination may be possible, but it is not likely.

If, as we expect, output grows slowly in the 1980s, there will then be a further gradual rise in unemployment throughout the decade. Table 1.3 sets out the implications of the base projection. The manufacturing sector has already shed some 2½ million jobs since the mid 1960s. Further increases in productivity are inevitable, in recession almost as much as with recovery, if only to avert continuing losses and bankruptcy. The only chance of maintaining employment in manufacturing would lie in a very rapid expansion of

Table 1.2 Variant projections, 1981-90

(growth rates, % a year)

	Domestic spending	GDP	Manufacturing output
Base projection	1½	1	–½
Variants:			
1½% a year faster growth of non-oil exports	2	1½	1
1% a year slower import penetration	2	1½	1
5% a year faster depreciation of the exchange rate	2	1½	1
No rise in the real world oil price	1	1	0
1% a year slower energy saving	1	½	–1
£2 billion (1975 prices) balance of payments deficits in the late 1980s	2	1	0
½% a year slower growth of output per person employed	1	½	–1
½% a year faster increase in real wage settlements	1	0	–1½

Note: The main assumptions of the base projection are:–
16% depreciation of the exchange rate by 1985
6½% a year growth of UK export markets
35% rise in the real price of oil between 1984 and 1990
zero balance of payments on current account in the late 1980s
4% fall in real wage settlements between 1981 and 1983

the sector's sales and output. Under conditions of stagnation a further 1½ million manufacturing jobs would disappear by the end of this decade.

In addition, the large numbers of children born in the 1960s are still coming up to working age. Because of this and because of the growing tendency for married women to want to work, the labour force would have been expected, under normal circumstances, to rise by ¾ million in the next four years. If unemployment forces emigration and discourages the elderly or married women from seeking work, the recorded labour force may not expand so much. But in a true sense, well over 2 million jobs would have to be created by 1990 outside the manufacturing sector to stabilise unemployment at its present level. At least 1½ million jobs would probably be needed to prevent a further increase in the number officially registered as unemployed.

Given slow growth of GDP it is hard to see where so many jobs could come from. This is particularly so since cash limits on local and central government spending have ended growth of public service employment which contributed over 1 million new jobs between the mid 1960s and mid 1970s. Private services have generated few additional jobs in the past (less than 1 million in two decades) and are increasingly an area for labour-saving automation.

The next section will consider radical approaches to job creation which might mitigate the consequences of slow growth. But to complete the picture of what economic stagnation may entail, it remains to consider income distribution and inflation. Table 1.3 includes a summary of how the national income might divide up between wages and salaries and other forms of income. Rents and profits are likely to remain depressed under conditions of stagnation. Social benefit levels are sufficiently low relative to the average wage or salary to make the cost of supporting a rising number of unemployed comparatively cheap. The retired population is no longer growing fast and the total cost of social security may

Table 1.3 Consequences of continued recession

	Historical		Base projection				growth rates
	1980	1981[e]	1982	1983	1986	1990	1981-90
Employment			(millions)				(% a year)
Agriculture and mining	0.7	0.7	0.7	0.7	0.7	0.6	–1
Manufacturing	6.8	6.1	5.7	5.5	5.0	4.5	–3
Construction	1.3	1.1	1.1	1.0	0.9	0.8	–3½
Transport, communications and public utilities	1.8	1.8	1.8	1.7	1.7	1.6	–1
Services and armed forces	12.2	11.9	11.9	12.0	12.3	12.3	½
total	22.8	21.5	21.1	20.9	20.6	20.0	–1
Unemployment	1.7	2.5	3.1	3.4	3.9	4.5	6½
Labour force	24.5	24.1	24.2	24.3	24.5	24.4	0
Output per person employed			(indices, 1975=100)				
Manufacturing	104	111	117	120	130	143	3
Other sectors (excl. oil and gas)	106	108	107	108	112	118	1
Whole economy	106	110	111	113	118	126	1½
Real income after taxes and transfers			(£ billion, 1975 purchasing power)				
Wages and salaries	54.2	51.8	51.5	51.9	54.6	57.8	1
Social benefits	11.5	12.6	13.4	13.9	14.3	14.8	2
Other private income	24.8	24.2	23.5	22.9	22.8	23.6	–½
Public sector	24.6	25.1	25.5	26.2	27.3	28.7	1½
National income	115.1	113.6	113.8	115.0	119.1	124.8	1
			(1975=100)				
Average take-home pay	110	111	113	115	123	134	2
Inflation			(% increase over previous year)				average 1981-90
Real wage settlements	1½	–4	–2	–2	0	0	–½
Tax and price index	16	14	10	7	5	3½	6
Money wage settlements	17½	9½	8	5	5	3½	5½
Average money earnings	21	15	11	8½	8	6	8
Import and oil prices	12	9	7	5	5	4½	6½
Consumer prices	16	11	8½	6	5½	3½	6

therefore rise little as a share of national income. The implication is that aggregate wages and salaries could rise in real terms by about the same rate as national income – i.e. by an average of 1% a year. With falling employment this implies an average increase of 2% a year in real take-home pay per employee – a slightly faster improvement than has been achieved since 1973. Those who remain in employment might, therefore, suffer little as a consequence of continued stagnation, whereas the unemployed would bear most of the burden. With such a widening divergence in living standards between two sections of the community it is hard to see how increasing conflict and social unrest could be avoided.

What will happen to inflation under economic conditions so different from those of the past 40 years is highly uncertain. In the last two years, pay settlements have been depressed by the collapse in output and employment and by the squeeze on industrial profits resulting in large measure from the grossly overvalued exchange rate. At the same time, while there has been no formal incomes policy, the government has both set a low pay norm for public sector workers (enforced by cash limits) and made clear to private sector employers

what the going rate of wage increase should be. As conditions begin to stabilise – profits remaining depressed but not falling much further, unemployment remaining high but only rising gradually – wage bargaining behaviour may well revert, at least partly, to normal.* Pay settlements, though remaining depressed, are likely on average to be closer to the prevailing rate of inflation than over the past year. This would be consistent with inflation falling progressively to 4-6% a year.

Although any prediction of inflation at present is more difficult than in the past, there are constraining factors. If we assumed more ambitious wage bargaining without devaluation of sterling, the competitive position of industry would soon become impossible. On the other hand, if money wage settlements remained well below the rate of inflation (itself falling), export profits could recover rapidly, restoring the conditions under which industrial employees could press for larger increases without much risk of bankrupting the plant where they work. So long as Britain has a government which gives high priority to exchange rate stability, inflation will probably fall eventually to about the same rate as in other Western countries. If devaluation of sterling is accepted or encouraged inflation can, and probably will, be more rapid.†

1.2 Social policies in conditions of economic stagnation

Britain already has acute inner-city problems, areas of severe dereliction and concentrations of very high unemployment in particular communities. How far can action to tackle these problems be accommodated within the constraints implied by slow overall economic growth?

There are three main economic elements in any plausible attack on the social problems caused by recession. One is work-sharing. A second is an increase in resources for public services and infrastructure in inner cities and other derelict areas. The third is an improvement in social security benefit levels and entitlements to diminish the economic hardship of unemployed people and their families or dependants.

All these policies would have some tendency to increase inflation by raising production costs, tax rates and social security contributions. Given the fragility of Britain's non-oil trade performance, a government attempting such policies would probably have to allow or encourage the exchange rate to fall at least enough to preserve the present low profitability of exports. The side-effects of redistributive policies would then be felt mainly in terms of tax rates, social security contributions, real wages and domestic inflation.

Work-sharing schemes might conceivably reduce the overall growth of output per person employed to almost zero in the present decade – higher output per person-hour being offset by reductions in hours per week and/or weeks per year worked by each employee. But with non-oil GDP growing by less than 1% a year this could at most generate around one million jobs, barely enough to hold unemployment constant in the true sense. It would imply slower growth of annual pay in real terms. This might be accepted by some employees as a fair return for better holidays and shorter weekly hours. Moreover the government would save on unemployment benefit and employers might not always pass additional costs into prices. It is therefore arguable, if not probable, that work-sharing would not add to inflation. The effect on costs and prices would almost certainly be minimised if employees were able to choose arrangements which gave them the greatest personal benefit and for which they consciously decided to pay. For example, additional holiday schemes, or even sabbatical years off, might be attractive to people in better-paid occupations. The problem remains that for employees in low-paid occupations work-sharing cannot be an attractive option if it involves income-sharing as well.

The costs of improving social benefits and increasing public spending in depressed areas are easier to quantify than those of work-sharing. At present the average level of social security benefits per adult recipient (the 'benefit level' in what follows) is about 37% of average take-home pay per employee.* For illustrative purposes, let us assume the comparatively modest aim of increasing the benefit level to 45% of average take-home pay by 1986.

Local authority current spending on services has remained roughly constant in real terms in the past few years while capital spending has fallen to about one quarter of its level in 1970. To reinstate this and provide a growing range of community services during this decade, let us assume as a target an 80% rise in local authority spending by 1990.

To finance higher local authority spending without a higher rate burden, the central government would have to increase its Rate Support Grant to local authorities by 80% in real terms over the decade – an average increase of £1½ billion each year at 1982 prices. To improve the level of social benefits at the same time would cost a further £2

*See Chapter 5 for a discussion of wage bargaining behaviour.

†These propositions should not be confused with the view, argued by the London Business School in 1978-9, that the exchange rate determines the domestic price *level*, from which they inferred that revaluation of sterling could bring inflation to an end at virtually no cost to exports and output. The proposition in the text above is that the exchange rate can ultimately constrain the *rate of change* of the price level, though at great cost to exports and output. This does however constitute a modification of our own formal model which implied (e.g. CEPR April 1979) that revaluation of the exchange rate could reduce inflation for a time, but that such a policy could not be sustained for more than a few years because it would induce a complete collapse of the real economy.

* This is on a national accounts basis. The take-home pay includes all employees and makes some allowance for income in kind. The benefit level, based on total payments relative to numbers potentially eligible, incorporates the effect of shortfalls in take-up or coverage.

Table 1.4 Redistribution without economic growth – an illustrative projection

	1981[e]	1986	1990	growth rates 1981-6	1986-90
Local authorities	(£ billion, 1982 prices)			(% per year)	
Cost of services and investment	25.6	36.6	47.0	7½	6½
Grants from central government	16.1	21.2	29.1	5½	8
Other income (net)	9.7	10.8	10.7	2	0
Financial deficit	–0.2	4.6	7.2	—	—
Social security					
Benefit level (£ per week, 1982 prices)	40.15	52.60	56.30	5½	1½
Number of dependents (millions)	14.1	14.4	14.1	½	–½
Cost to central government (£ billion, 1982 prices)	29.4	39.5	41.2	6	1
Employment	(millions)				
Manufacturing	6.1	5.0	4.4	–4	–3
Public services	5.1	5.7	6.2	2½	2½
Other sectors	10.4	10.9	11.3	1	1
Total	21.5	21.6	21.9	0	½
Unemployment	2.5	3.2	3.1	4½	–1½
Income tax and social contributions					
(% of gross pay)	26.8	29.9	32.8	2	2½
Inflation	(% increase over previous year)			(averages) 1981-6	1986-90
Real wage settlements	–4	1½	1½	0	1½
Tax and price index	14	13	19	10½	17½
Money wage settlements	9½	14½	20½	10½	19
Average money earnings	15	16	22	12	20
Exchange rate	–1	–5½	–12½	–5½	–10
Import and oil prices	9	10½	19	10½	16
Consumer prices	11	12	18½	9½	16½

Note: GDP growth same as in base projection (see Table 1.1).

billion each year up to 1986 (see Table 1.4). In other words the central government might have to find some £15 billion (at 1982 prices) over the next five years and a further £10 billion or so by 1990 to finance such a programme, which would ease the problem of social deprivation but certainly not eliminate it. Increases in North Sea revenue might provide £5 billion of the £25 billion needed. Some of the rest might come from savings on debt interest. The central government could not expand its own borrowing much if local authority capital spending were to have priority. By implication, most of the cost not covered by increased North Sea revenue would have to be financed by higher social security contributions and general taxation. Assuming constant rates of indirect tax, our estimate is that income tax and social security contributions would have to rise from 27% of gross pay in 1981 to 30% in 1986 and 33% in 1990. This implies a reduction of about 1% a year in the growth of real take-home pay.

If this happened, there is a strong possibility that inflation would accelerate, requiring continuing devaluation of sterling to preserve the profitability of exports. Employees generally might be in a better position than now to press pay claims because unemployment would be less of a sanction. Take-home pay would be depressed by taxation in a more severe and sustained manner than at any time in the past when tax-push is thought to have accelerated wage inflation. Without profound changes in the politics of income distribution it is to be feared that any significant attempt to alleviate the hardship caused by unemployment would, under conditions of continuing economic stagnation, push up the rate of inflation to the point at which sterling became as unstable a currency as in the mid 1970s.

1.3 A spontaneous recovery?

If redistribution is so difficult with slow growth it is all the more crucial that economic recovery should not be long delayed. The remaining sections of this chapter examine the possibilities and problems of recovery within the framework of policies recommended by, respectively, the present government, the broad group of its critics who favour reflation, and the Labour Party which advocates radical intervention and planning.

The essential precondition for sustainable economic recovery in the 1980s is a significant improvement in the competitive performance of British industry in home and overseas markets. The present government hopes for a spontaneous resumption of economic growth without any substantial devaluation of sterling or large-scale state aid to industry. By implication, the historic trends of exports and import penetration must be reversed in some other way. An improvement might come through greater efforts on the part of management and labour or as a result of changes in industrial structure, such as the closure of inefficient and unprofitable plant, wrought by the present recession. It is conceivable also that the cost competitiveness of British industry will improve if wage settlements remain abnormally depressed. It is not possible to establish whether or not a spontaneous economic recovery will occur on the basis of abstract or anecdotal discussion of these matters. Nor is there any reliable statistical method for detecting changes in underlying trends until some time after they have occurred. What we can do is to make inferences about the magnitude of the changes necessary if the government's hopes are to be realised. This will at least provide benchmarks against which present and future developments can be judged.

As a starting point let us take government forecasts of 1½% GDP growth this year and 2½% growth next year.* Suppose that this was to be the beginning of a take-off into sustained long-run expansion with the growth rate climbing to, say, 4% a year from 1986 onwards.

Note first that a small rise in GDP this year would not itself be evidence of take-off. The main initial sources of expansion would inevitably be a turnround in stockbuilding which by its nature is a once for all stimulus to production and not sustainable in the long-run. Nor would a rise in consumer spending or even private investment demonstrate much. For growth of private spending is no more sustainable in the long-run than growth of public spending unless it is matched by an adequate external trade performance. If not, it can only be fed by rising borrowing and must therefore sooner or later come to a standstill.

Unfortunately the most crucial trends are the most difficult to judge in the short term – namely those of exports and import penetration. Recent trade figures are at present incomplete and delayed. The turnround in stockbuilding will temporarily boost imports, making the trade balance weaken suddenly. And export performance is still likely to be influenced, to an extent which cannot be precisely measured, by the large deterioration in cost competitiveness in 1979 and 1980, so a rapid short-term erosion of the trade balance will not necessarily indicate whether the recovery of GDP, if it occurs, is sustainable or not.

Table 1.5 provides a purely illustrative example of a take-off path eventually, if not initially, led by exports, which would bring the rate of growth of GDP up to 4% a year by 1986. The balance of payments on current account would deteriorate by some £4 billion at current prices this year and go into deficit next year. Non-oil imports would rise in volume by 10% this year, and by the same amount next year, while non-oil exports would grow by 1½% and then by 4½%. The latter figure would be the first sign of something unusual. It should be accompanied by a distinct upturn in manufacturing output, although there might still be continuing job losses for another year.

The real test of any recovery is what happens after 1983. Some combination of greatly improved export performance and reduced import penetration is essential. To keep GDP growing by 3% or more a year without dependence on ever-increasing borrowing, the growth of non-oil imports would have to slow from 10% to , say, 7% a year while non-oil exports would have to increase from 4½% to reach an 8-10% annual growth rate. Manufacturing output should then be rising by 4-5% a year. Then and only then would aggregate employment be likely to rise enough to bring unemployment gradually below 3 million.

A spontaneous export-led recovery, if it occurred, would permit rapid growth of profits and real earnings without much risk of accelerating inflation. Productivity and real national income would rise fast and the government could readily fulfil its aim of substantially reducing taxation. But the entire scenario rests on the crucial and totally implausible assumption that there will be a spontaneous improvement of the order of 6% a year, *every year,* in Britain's non-oil trade performance. If there is only a small improvement then there can only be a temporary recovery and unemployment is unlikely to fall. The present government would then have presided over an unprecedented contraction of industry and rise in unemployment with nothing to show in return except lower inflation.

1.4 The reflation alternative

Many politicians, including some in the Conservative party, are sufficiently alarmed by unemployment and evidence of persisting problems in industry to see the need for urgent government action to reflate the economy by public spending, tax cuts and lower interest rates. They are also

**Financial Statement and Budget Report,* March 1982.

Table 1.5 A possible spontaneous recovery?

	1981[e]	1982	1983	1986	growth rates 1981-2	1982-3	1983-6
Expenditure and output	(£ billion, 1975 prices)				(% a year)		
Consumers expenditure	71.6	71.3	74.1	81.2	–½	4	3
Public consumption	24.4	24.8	24.9	27.2	1½	½	3
Fixed investment	19.1	19.3	19.3	21.7	1	0	4
Stockbuilding	–4.0	–0.3	1.8	2.2	—	—	—
Domestic spending	111.2	115.1	120.2	132.2	3½	4½	3
plus Exports	32.5	33.2	34.7	44.4	2	4½	8½
less Imports	–33.1	–36.3	–40.1	–49.3	9½	10½	7
GDP at market prices	110.4	112.0	114.8	127.3	1½	2½	3½
of which:							
offshore oil and gas	3.5	3.9	4.0	4.2	10	2½	1½
manufacturing	24.1	24.7	25.5	29.3	2½	3	4½
other sectors	82.7	83.4	85.3	93.8	1	2½	3
Balance of payments	(£ billion, 1975 prices)						
Volume of non-oil exports	29.7	30.2	31.6	41.0	1½	4½	9
less volume of non-oil imports	–31.2	–34.3	–38.1	–46.6	10	11	7
plus non-oil terms of trade, net oil exports and net income from abroad	4.0	4.9	5.9	6.3	—	—	—
Balance on current account	2.5	0.8	–0.6	0.7	—	—	—
Employment	(millions)						
Manufacturing	6.1	5.8	5.6	5.6	–5	–3½	0
Other sectors	15.5	15.6	15.7	16.5	½	½	1½
total	2.5	2.9	3.1	2.7	15	7	–2
Inflation	(% increase over previous year)						
Money wage settlements	9½	7½	5	6	—	—	—
Average money earnings	15	10½	9	9½	—	—	—
Consumer prices	11	8	5½	5½	—	—	—
Real take-home pay	1½	2½	3	4½	—	—	—

generally sensitive to the danger that any alleviation of the present recession would encourage wage demands, threatening an acceleration of inflation and further damage to the profitability of exports. Various schemes for a future incomes policy have been floated to combat this threat. On past evidence it is reasonable to suppose that they could effectively hold down pay increases for a two or three year period, but not much longer.

Emphasis on the merits and risks of devaluation varies. Most of the government's critics would welcome some fall in the exchange rate. A few would like to see the fall go a long way, although perhaps not too rapidly. Some must be concerned about the stability of the exchange rate in the absence of exchange controls. We shall assume that a government determined on reflation would be ready, if necessary, to regulate depreciation of the exchange rate by reintroducing restrictions on capital outflows and bringing sterling into the EMS at a suitably devalued parity.

The most crucial questions for this general policy are how much the government could afford to give away in reflationary budgets, and how much economic growth would result. The answers can at best only be suggestive because we do not know at what point the confidence of financial markets – in particular the foreign exchange market – would break, nor how effectively the government could control capital outflows, nor what support or pressures would come from other Western governments and central banks. These uncertainties express themselves chiefly, for our purpose, as doubts about the size of the balance of payments deficits on current account and budget deficits (or PSBR) for which the government could

reasonably plan.

Let us assume that any government undertaking reflation within the next few years starts with a PSBR of roughly the present order of magnitude, i.e. around £10 billion (at 1982 prices). We guess that the starting position for the balance of payments would be a surplus or rough balance on current account, although if reflation is postponed until 1984 there might by then already be a current account deficit. It would probably be safe to aim at something like a £5 billion increase in the PSBR, implying an eventual deterioration of a similar order of magnitude in the balance of payments. This would mean accepting the possibility of balance of payments deficits rising to £9 or £10 billion (at 1982 prices) when reflation triggered off large-scale restocking. We must emphasise that such planning assumptions could only be justified if the government was reasonably sure of being able to prevent or neutralise capital outflows and could secure a steady flow of medium-term and long-term external funding.

A £5 billion increase in the PSBR is small in relation to national income (about 2%) but over a period of two or three years it would permit large increases in public spending and/or cuts in tax rates since much of the cost of these measures would be recouped by the government as spending and income rose, generating additional tax receipts and nationalised industry profits.

Table 1.6 indicates the magnitude of reflationary gestures which might be possible over a three year period in the context of a relaxation of the government's financial deficit accompanied by cuts in interest rates. The financial resources available to the government could include not only a planned £5 billion rise in the budget deficit but also a saving of some £2 billion on debt interest payments as interest rates fell, a £3 billion rise in North Sea tax revenue, a £4½ billion improvement in nationalised industry profits, a £5½ billion rise in direct tax receipts, a £7½ billion prospective rise in indirect tax receipts and £1 billion other savings – a grand total approaching £30 billion (at 1982 prices) to be spent or given away by the government over the three year period. The distribution suggested in Table 1.6 is purely illustrative. It includes an 8% increase in the volume of public services and investment (costing some £11½ billion including an allowance for relative price increases), a £7 per week improvement in social benefits (costing some £5 billion) and a 40% reduction in net taxes on consumer spending (costing around £13 billion).

After several years of severe public spending restraints and rising taxes and charges, the notion of government budgets giving away anything like £10 billion a year for two or three years running strains credulity. But these are not huge amounts when compared with what happened in the old

Table 1.6 Reflationary budgets for 1984-86

	1983	1984	1985	1986	changes 1983-6
Discretionary changes					
Volume of public services and investment (1982=100)	100	101	106	108	+8
Social benefit level (£ per week, 1982 prices)	41.90	45.00	48.50	48.75	+6.85
Average rate of tax on consumer spending (%)	20.0	16.9	15.2	12.0	−8.0
Public accounts	(£ billion, 1982 prices)				
Cost of public services and investment	75.9	78.4	82.9	87.5	+11.6
Social benefits and other current grants	40.0	42.4	44.1	43.5	+3.5
Debt interest	12.3	10.4	10.1	10.1	−2.2
Total expenditure	128.3	131.3	137.1	141.1	+12.8
Offshore tax revenue	6.9	8.5	9.6	10.1	+3.2
Direct taxes and social contributions	53.4	54.2	56.0	59.1	+5.7
Indirect taxes less subsidies	40.2	37.8	37.5	34.7	−5.5
Other income	18.0	19.3	21.0	22.4	+4.4
Total income	118.4	119.8	124.2	126.2	+7.8
Financial deficit	9.8	11.5	12.9	14.9	+5.1

days when it was not unusual for public spending to rise by 3 or 4% in a year, i.e. by the equivalent of some £4 billion at today's prices, on occasion accompanied by tax cuts of a similar size. The PSBR of £15 billion (at 1982 prices) which we estimate could be reached after three years of such budgets would be almost exactly the same as that incurred by the present government in 1980 and smaller than that in 1979.

How much would reflation on the scale discussed here do to raise output, create jobs and improve the trend of economic growth? The best chance of reaping sustainable benefits would come if reflation were accompanied by devaluation of the exchange rate to provide a stimulus for exports. We have included a major cut in taxes on consumption in the illustrative budgets in Table 1.6 because this would help to neutralise the effects of devaluation on the cost of living. Coupled with the introduction of some form of incomes policy such tax cuts could probably bring down the rate of inflation, at least for a year or two, at the same time that the exchange rate depreciated. This conjunction would permit a considerable improvement in exporters' profits. We cannot readily predict just how much devaluation would be desired or accepted by a future British government undertaking reflation. Though economists in Britain might be in favour of a large devaluation, the interests of investors in sterling would have to be taken into account as would the protests of governments in competitor countries, especially in the EEC, who might well threaten retaliation in some form. Let us assume a 20% devaluation between 1983 and 1985, recognizing that this, like the scale of reflation postulated earlier, probably represents the limit to what a determined government might plausibly seek to achieve.

Tables 1.7 and 1.8 give estimates of the response of the economy to the assumed reflationary budgets and 20% devaluation of sterling. In addition to a rise in stockbuilding and deterioration of the balance of payments already mentioned, the immediate consequences would be higher consumer spending, sharp upturns in GDP and manufacturing output and a small reduction in unemployment. With major cuts in indirect taxes inflation might be held down to 5-6% despite the

Table 1.7 Reflation and devaluation – consequences for trade, spending and output

	1983	1984	1985	1986	1990	growth rates 1983-85	1985-90
Expenditure and output		(£ billion, 1975 prices)				(% a year)	
Consumers expenditure	72.9	75.5	78.0	82.7	90.5	4½	2½
Public consumption	24.6	25.0	26.1	26.6	29.1	2½	2½
Fixed investment	17.9	17.8	18.9	19.1	20.2	2	½
Stockbuilding	0.4	1.3	2.6	2.4	0.2	—	—
Domestic spending	115.7	119.5	125.5	130.7	140.1	4	2
plus Exports	31.8	32.9	34.8	36.8	43.2	5	4
less Imports	–37.2	–38.6	–40.9	–43.7	52.4	5½	4½
GDP at market prices	110.4	113.8	119.5	123.8	130.9	4	2
of which:							
offshore oil and gas	4.0	4.2	4.2	4.2	4.3	1½	½
manufacturing	23.5	24.4	26.1	27.5	27.7	5½	0
other sectors	82.9	85.3	89.1	92.1	98.9	3½	2
Exchange rate and export competitiveness		(indices, 1975=100)					
Exchange rate	90.2	81.1	73.0	71.6	64.7	–7½	–2½
Export cost competitiveness							
current	132	121	112	114	118	–5	1
lagged	123	123	119	118	117	–1½	–½
Balance of payments		(£ billion, 1975 prices)					
Volume of non-oil exports	28.7	29.7	31.5	33.4	39.7	5	4½
less Volume of non-oil imports	–35.4	–37.0	–38.8	–41.3	–50.3	5	5
plus Non-oil terms of trade, net oil exports and net income abroad	5.9	5.3	3.8	3.9	6.6	—	—
Balance on current account	–0.8	–2.0	–3.5	–4.0	–4.0	—	—

Table 1.8 Reflation and devaluation – consequences for employment and inflation

	1983	1984	1985	1986	1990	growth rates 1983-86 (% per year)	1986-90 (% per year)
Employment	(millions)						
Manufacturing	5.5	5.4	5.4	5.4	5.0	–½	–2
Public services	5.0	5.1	5.4	5.5	6.1	3	2½
Other sectors	10.4	10.4	10.5	10.6	10.6	½	0
total	20.9	20.9	21.3	21.5	21.7	1	½
Unemployment	3.4	3.5	3.3	3.2	3.3	–2	½
Inflation	(% increase over previous year)						average 1987-90
Real wage settlements	–½	–2	3	5	½		1
Tax and price index	7	4½	5½	5½	10		9
Money wage settlements	5½	2	8½	11	10½		10
Average money earnings	8½	6	8	12½	12½		12
Import and oil prices	5	14½	16	8½	7½		7½
Consumer prices	6	4	6	5½	10		9
Real take-home pay	2	2	2	6½	2		3

devaluation. After several years of economic disaster, such benefits would no doubt seem miraculous.

Whether or, more realistically, how long the miracle could last is another matter. The long-run outcome would depend mainly on three factors – how far and how fast the exchange rate was allowed to depreciate, the net effects of this, along with incomes policy, tax changes and other political and economic circumstances on the rate of cost inflation, and the extent to which any gain in cost competitiveness improved trade performance.

Our estimate is that there would be something like a 15% improvement in the current cost competitiveness of British exports (although this would probably be at least partly eroded in the longer run if and when incomes policy broke down). Such an improvement is unlikely to be enough to promote a sustained export-led recovery. The average growth rate of non-oil exports from now to 1990 and the trend of non-oil import penetration might together be ameliorated by 1-1½% a year, permitting an improvement of the same order of magnitude in GDP growth and raising the average growth of manufacturing output to 1½-2% a year. This would not be enough to reduce unemployment over the remainder of the decade taken as a whole, although it would imply, by past standards, quite a reasonable growth of national income.

The reasons for being sceptical about long-run prospects under policies recommended by many of the government's critics are that devaluation is unlikely to be pursued vigorously for long and that incomes policy cannot be relied on as a means of holding down wage costs indefinitely. Sustained devaluation would encounter several objections: it would make sterling very unattractive as an investment currency, it would feed internal inflation, and it would be unpopular with other EEC governments (witness the sharp reaction to recent devaluations by Belgium and Denmark). It is necessary to be cautious about the efficacy of incomes policy in the aftermath of devaluation and a spurt of economic growth because wage settlements have recently been much depressed by the abnormal insecurity of jobs. Reflation would dramatically alter the context of wage bargaining at a time when many employees must feel they have undergone harsh treatment. A future incomes policy will not necessarily break down but the condition for its survival will probably be a high degree of flexibility which allows a considerable improvement in the average level of wage settlements.

Our conclusion is that large-scale reflation is possible in the next few years and that it could yield large immediate benefits. But once these had come through there would be little acceleration in the underlying trend of economic growth. The level of unemployment would not have been brought down significantly except, perhaps, if the government's reflationary measures were concentrated almost entirely on job creation and the funding of work-sharing schemes without any substantial cut in general taxation.

1.5 The Labour Party's alternative

The Labour Party's proposals that reflation should be backed by a range of interventionist measures to regulate the financial system and to plan trade and industry are rather different in kind from the proposals of the government's other main critics. Labour's proposed intervention measures conflict with EEC rules and with the prevailing assumptions of international business and finance. They would certainly invite the threat, and in some cases the implementation, of retaliatory sanctions.

Adverse reaction to Labour's plans in financial markets could probably be neutralised to a large extent by controls on capital flows and regulation of lending by banks and other main financial institutions. Provided that a government can limit the flow of funds abroad, it should be able to fund its own borrowing without too much difficulty.

Internal industrial sanctions, e.g. unwillingness to invest or expand production, are not very probable because if demand is rising it is always strongly in a company's own interest to try to meet it. In any case the government has strong potential bargaining power *vis-à-vis* individual domestic producers.

The major problem facing a protectionist Labour government would be the threat or reality of sanctions against UK exports. This could come not only from overseas governments and official institutions such as the EEC but also from multinational companies which at present account for the larger part of Britain's export trade. If a Labour government proceeded with significant measures of import restraint UK exports would in all probability suffer at least some degree of discriminatory retaliation which the government could in the short run do little to prevent.

There seem to be three priorities for a Labour government's trade policy. One is evidently that the restraint on imports should be effective, i.e. strong and systematic enough to give control over the overall import penetration ratio. A second must be to salvage as much as possible on the export side, e.g. by progressive devaluation to guarantee the long-run profitability of exports, and by stressing exports in industrial planning. The third should be a deliberate policy of incurring trade deficits, both to demonstrate a desire not to damage the trade balances of other countries and to ease short-run problems of import substitution.

For illustrative purposes let us make some assumptions about how a Labour government's trade policy might work out. Suppose that tariffs averaging 15% were imposed on imports of manufactures and services rising to 20% in the second year and 24% in the third year. Our estimate is that this would cut the ratio of non-oil imports (adjusted for stockbuilding) to domestic spending by nearly 10% after three years. If non-oil exports also fell by 10% domestic spending could not be allowed to rise much at all. If non-oil exports were unaffected there would be scope for rapid domestic expansion. Though non-oil exports would probably fall, with devaluation to improve export profits, the fall should be something much less than 10%. Moreover retaliation is likely to be a once-and-for-all matter. After two or three years the situation should settle down for better or worse, and there is little reason why exports should not then start to grow from whatever level they had fallen to.

Assuming the net benefits and losses of import restraints and export retaliation roughly cancel out in the first two or three years, the budgetary opportunities for a Labour reflation would be similar to those for a more conventional reflation discussed in the previous section. The main difference would be the availability of some £15 billion tariff revenue (at 1982 prices) plus, perhaps, another £5 billion or so from higher taxes on profits and other forms of private income which Labour regards as under-taxed at present. There would also be some additional spending needs. To counteract the feed-through from tariffs into the cost of living would require tax cuts or subsidies on consumer spending of £9-10 billion. A Labour government might readily spend another £5-10 billion to encourage investment, compensating for the tariff element in prices of investment goods and for increased profits tax.

Priorities as between spending on public services and infrastructure, social security benefits and tax relief for consumers or employees might differ from those of other parties. But in general terms the outcome in the first three years would not be very different. Inflation of consumer prices could be held down to 6-8%. GDP and manufacturing output should rise sharply and unemployment might be reduced by several hundred thousand.

After the initial reflation, however, the prospects are more promising. So long as the initial period of retaliation had passed without too much damage, the government ought to be in a position to regulate the degree of import restraint so as to sustain growth in the longer run. The projection in Table 1.9 shows that by 1990 the average tariff would need to rise to almost 50% to secure GDP growth of 3½% a year. This, however, is purely the result of extrapolating past trends in trade performance. It does not allow for any improvement in competitiveness which might result from an unprecedented period of sustained expansion and an active industrial policy. If, as is at least possible, export growth was better than in the past, steady growth of domestic spending and manufacturing output could be sustained without the degree of protection rising as high as in Table 1.9. This would generate new jobs in non-manufacturing sectors bringing a progressive fall in unemployment. But it is not hard to imagine things going wrong. If for example non-oil exports grew more slowly than in the past, at an average of 2% a year, while import substitution levelled off (e.g. because of pressure not to increase tariffs) the economy would be back in a situation of very slow

growth.

Supposing that a Labour reflation did succeed in sustaining economic growth and reducing unemployment, how much would inflation accelerate in the longer run? There is no technical answer to this question. Our long run projection yielding an inflation rate of around 20% is the consequence of extrapolating past trends into a situation with unemployment and export profit margins not very different, by 1990, from those that prevailed in the 1970s. In practice, the outcome would depend on the institutional conditions of wage bargaining then prevailing and the importance by then attached to devaluation as a means of stimulating exports – neither of which are really foreseeable this far in advance.

Table 1.9 Possible consequences of a Labour strategy

	1983	1984	1985	1986	1990	growth rates 1983-6	1986-90
Expenditure and output		(£ billion, 1975 prices)				(% per year)	
Consumers expenditure	72.9	74.8	77.9	81.2	90.6	3½	3
Public consumption	24.6	25.4	26.5	27.2	29.2	3½	2
Fixed investment	17.9	18.9	22.3	22.9	27.7	8½	5
Stockbuilding	0.4	1.3	2.9	2.5	1.9	—	—
Domestic spending	115.7	120.4	129.5	133.8	149.4	5	3
plus Exports	31.8	30.9	30.4	31.5	37.1	–½	4
less Imports	–37.2	–37.1	–39.4	–40.1	–42.1	2½	1
GDP at market prices	110.4	114.2	120.6	125.1	144.4	4	3½
of which:							
offshore oil and gas	4.0	4.2	4.2	4.2	4.3	1½	½
manufacturing	23.5	24.4	26.5	27.9	33.9	6	5
other sectors	82.9	85.6	89.9	93.1	106.2	4	3½
Trade indicators		(indices, 1975=100)					
Exchange rate	90.2	84.6	78.7	72.9	45.7	–7	–10
Export cost competitiveness							
current	132	129	125	123	114	–2½	–1½
lagged	120	123	123	123	117	+1	–1
UK share of non-oil export markets	67	60	55	53	49	–7½	–2½
Average tariff on imports of manufactures and services (%)	1.5	15.0	20.0	24.0	49.8	—	—
Adjusted ratio of non-oil imports to domestic spending	30.7	29.2	28.1	27.7	25.5	–3½	–2
Employment		(millions)					
Manufacturing	5.5	5.4	5.4	5.5	5.6	0	½
Other sectors	15.4	15.8	16.3	16.7	18.0	2½	2
total	20.9	21.2	21.8	22.2	23.6	2	1½
Unemployment	3.4	3.3	2.9	2.7	1.9	–7½	–8½
Inflation		(% increase over previous year)				(average 1986-90)	
Real wage settlements	–1½	½	2½	2½	2	2½	
Money wage settlements	5½	6½	9½	11	20	16	
Import and oil prices	5	20	16	16	26½	22	
Consumer prices	6	5½	7½	8½	18½	13½	