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Monetary Policy in the UK under Mrs. Thatcher

In 1979 Mrs. Thatcher inherited a monetary mess. Inflation was rising rapidly from an initial rate of over 10%. The policy of wage controls that had been used to hold it down in 1978 had crumbled in the 'winter of discontent' of that year when graves went undug and rubbish piled up in the streets. Large public sector pay increases had been promised by the Clegg commission under the previous government. The budget was in crisis; already the deficit was up to 5% of GDP and it would clearly rise sharply more with these pay awards on top of the usual spending pressures.

The advice from Professor MILTON FRIEDMAN was to reduce the money supply growth rate gradually and to cut taxes in order to stimulate output. The first part was accepted but the second was not because the deficit was seen to be important in conditioning financial confidence. Until the deficit could be reduced by other means taxes would have to stay up and perhaps even go up. This was the view not merely of the Treasury but also of the financial markets; in Liverpool we saw it as a rational expectations effect given the growing pressures for monetary financing of a long-lasting deficit.

This was the background to the policies pursued. As we shall see little importance was attached to the operating method used by the central bank, whether monetary base control or interest rate setting in pursuit of monetary targets. So that with this and the emphasis on fiscal policy support, the debate on monetary policy in Britain took a very different form from that in the US for example though it perhaps had a rather European character. I propose first to describe the intended policies and their rationale in more detail. Secondly, how they turned out in practice. Third, whether any alternatives might have had better results. Finally, I shall consider future policy and in particular the UK attitude to the EMS.

The Thatcher Government's Monetary Plan

The key problem was seen to be lacking of long-term credibility in counter-inflation policy. The previous government had instituted monetary targets, starting in 1976 in conjunction with the IMF support arrangement. It had also managed a substantial reduction in the budget deficit; the Public Sector Borrowing Requirement (PSBR), the usual measure of deficit in the UK including government net lending to the private sector, was reduced from 10% of GDP in 1975 to below 4% in 1977. Nevertheless, the policies lacked long-term durability. Incomes policy which had been emphasised as the key bulwark against inflation crumbled as widely predicted it must in a free economy. The money supply target for £M_3, a wide aggregate, was generally 'achieved' by using a tax on high-interest deposits, the 'corset'; excess money showed elsewhere, notably in rising M_0 growth. And budgetary discipline was based on cuts without any long-term strategy for reducing the size of the public sector; so they were seen as temporary pain to be reversed once the pressure (e.g. of the IMF) was off.

Thus the problem of a credibly durable monetary restraint on prices was one of fundamental political economy, not merely a technical matter of the central bank fixing appropriate targets. If the central bank had been constitutionally independent or even fiercely committed to price stability in practice with a high profile Governor respected for monetary probity,

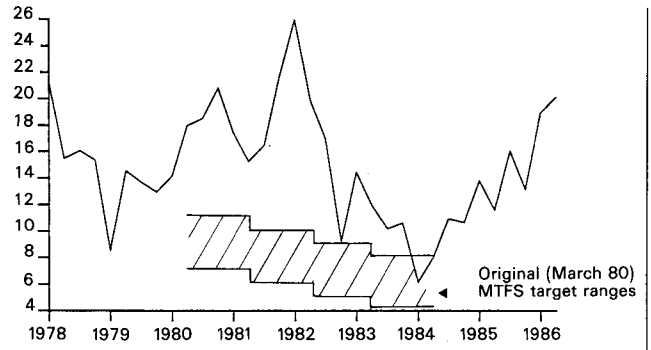

Figure 1: Annual percentage growth in Sterling M_3.

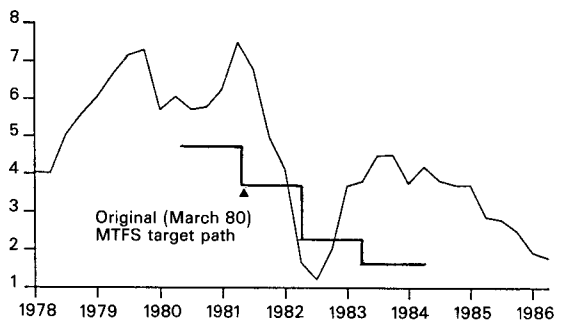

Figure 2: Four-quarter moving average of PSBR/GDP (%).

matters could have been different; analysis of Switzerland or the US or the Federal Republic of Germany would for example focus mainly on the central bank for this reason. But the Bank of England commanded no such position; formally an executive arm of the Treasury, it was staffed by Keynesians and had as Governor a lawyer whose main personal interest was regulation and who had no intuitive grasp of monetary theory.

To achieve durability – and it was hoped to convince people rapidly of that prospective durability – policy was cast in the form of a Medium Term Financial Stragety or MTFS. This consisted of a commitment to a 5-year rolling target for gradually decelerating £M_3 (the corset having been removed together with exchange controls and incomes policy) backed up by parallel reduction of the PSBR/GDP ratio – the original plans are shown in Figures 1 and 2, together with eventual outcomes. Announced in the 1980 budget, it carried the full authority of the Prime Minister and notionally of the Cabinet, so that future deviations should be seen as a seriously embarrassing breach of promise to the electorate. On the optimistic view that it would be totally credible, market expectations of both short- and long-term inflation should drop, interest rates should fall rapidly, and any recession should be short-lived, possibly non-existent, as the falling money growth was offset by falling inflation so keeping up real money balances and consumer purchasing power.

The basic analysis could not be faulted; it rested on the logic of (1) the government's 'intertemporal budget constraint', whereby deficits today must be paid for by taxes, money expansion or economies tomorrow; (2) the political pressure for money creation to relieve a rising debt/GDP ratio with its consequence in rising interest rates and future tax burdens. This analysis was later spread widely by Thomas Sargent and Neil Wallace in their well-known paper 'Some unpleasant monetarist arithmetic' (1985) which was applied even in the US context, assuming a constitutionally independent central bank and no rise in interest rates because of 'Ricardian equivalence' (whereby future taxes are perfectly anticipated and offset by higher current savings). The point is that if one assumes any reasonable termination of the rising debt/GDP ratio, whether because of a limit in distortionary taxes or on available savings (the S/W case), then money financing is eventually required in the absence of quite implausibly severe cuts in public expenditure.

Monetary Policy in Practice

Logic was not enough; the MTFS not only failed to command credibility, fully or even to a significant extent, it also failed to be carried out in its own literal terms. Yet policy turned out to be more fiercely contractionary than the gradualism intended; it was closer to shock tactics than gradualism. A paradox indeed! Tougher yet less credible; apparently the worst of both worlds.

Trouble came from two directions: technical design and politics. Technically, the choice of £M_3 was an error because after deregulating the banks (including offshore links with no exchange controls) high-interest deposits became the major weapon in the banks' battle for market share; as the banks' fortunes ebbed and flowed, so did £M_3. In 1980–81 it overshot its targets massively (Figure 1). Yet M_0 – the most

narrow monetary aggregate, consisting of currency in circulation and bank reserves – was unaffected by deregulation and told a quite different story, of sharply tightening monetary conditions (Figure 3); its growth rate halved in the 12 months to mid-1980 and halved again in the next 12. It is obvious from data on the economy (see below Figure 5) which story is the true one; the recession, the rapid fall in inflation, and the strong exchange rate all confirm M_0 as the accurate indicator.

Politically, the pain of recession, especially in the manufacturing sector, undermined the already insecure position of the 'monetarists' in the Conservative party, and Mrs. Thatcher faced substantial internal opposition. The days of the MTFS and perhaps even of Mrs. Thatcher herself seemed numbered.

So the MTFS was widely written off at this time as a failure because its targets had not been achieved and a temporary interlude before traditional politics returned. Meanwhile, the Chancellor, Sir Geoffrey Howe, doggedly persevered with the attempt to keep the MTFS 'on course'. Interest rates were kept up to reduce the money overshoot, and the PSBR was brought down on its track even though swollen by recession. Policies close to shock tactics were implemented by these means, perhaps mainly by accident but to some degree surely by intuitive survival instinct: that is, given that recession was connected in popular debate with the monetarist policies, it was vital to get results on inflation in short order as justification – to be hung for a sheep as a lamb, and better still to be applauded for the sheep of much lower inflation.

Whatever the reasons, the rapid fall in inflation – down to 5% by end-82 – restored the fortunes of Mrs. Thatcher and her supporters. In early 1981, too, the technical problems were appreciated, with the arrival of Sir Alan Walters and his circulation of an influential paper by Professor JÜRG NIEHANS of Berne University (NIEHANS, 1981); the decision was taken to loosen monetary policy in order to weaken the exchange rate, to stabilise M_0 at a growth rate around 5%, and permit output to recover. To enhance credibility, the budget of 1981 increased taxes by 2% of GDP to cut the PSBR even though the recession still had not ended. This cut was crucial in finally creating market confidence in the policies' durability; long-term

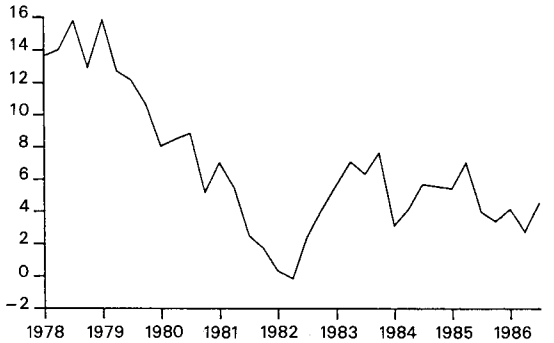

Figure 3: Annual percentage growth in M_0.

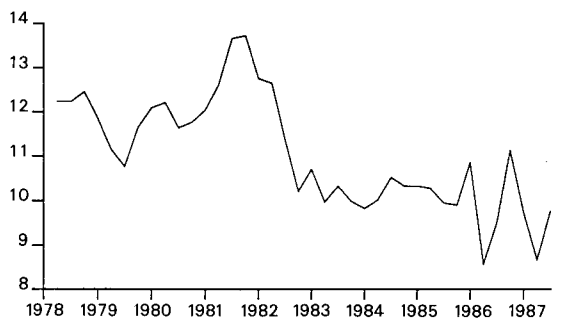

Figure 4: Long-run rate of interest, based on gross yield of 2.5% consols.

interest rates which had fluctuated around 14% for two years began to fall at last during 1981 (Figure 4). Output also started to recover in spring 1981.

This episode was the furnace in which the current monetary policy of the UK was forged. Those now running that policy have fashioned it with that experience in mind. The key elements are:

(1) The PSBR must be kept down to sustain market confidence.
(2) M_0 is a reliable indicator of monetary conditions.
(3) Rapid movements in the exchange rate may contain monetary signals and will in general not be permitted, unless M_0 confirms systematically after the event that they should.
(4) In controlling monetary conditions what matters is that interest rates be moved *symmetrically* as dictated by targets (without political intervention for example to hold interest rates down) and that market participants can understand the system's *signals* in forming their expectations. Monetary Base control – a method according to which M_0

should be kept rigorously to a fixed path – was rejected in favour of a system using M_0 as the key monetary indicator to guide interest rate changes; this was an extension of familiar methods.

Though much ink has been spilt on such monetary control methods per se, from the modern perspective of rational expectations these key features of symmetry and efficient signalling attach to a wide variety of short-term control methods, and there is no reason to prefer Base Control over the method currently used in principle. Difficulties arise under the current method only when ambiguities creep into the practice, as has occurred recently with uncertainty about EMS and the exact status of exchange rate targets; but these problems also arise in base control systems, as the Swiss experience shows.

Since 1982 these principles have been pursued with the objective of keeping inflation below 5%; no strong efforts have been made to drive it to zero, because of fears that these might destabilise a smooth recovery and falling unemployment. The emphasis in policy innovation switched to the supply side – deregulation, union laws, privatisation and tax cuts. Nevertheless, even the process of keeping inflation down has implied occasional deflation, so that over the whole period from 1979 to 1986 we have estimated (MATTHEWS and MINFORD, 1987) the cumulative effect of tight monetary and accompanying fiscal policy on unemployment was no less than 1 million, just over 4% of the labour force.

Was there an Alternative?

The counter-inflation policies were therefore clearly far from costless in conventional terms. With hindsight it is natural to ask whether an alternative strategy could have conquered inflation at less cost. Some argued for incomes policy; however past experience of this in the UK is hardly encouraging. As argued earlier in a free economy (and as shown by BEAN et al., 1987, Britain is low in corporatist features), such policy can only be a temporary expedient; apart from the costs it imposes in distorting markets while in force, it cannot therefore provide a durable mechanism either for controlling inflation or for reducing its unemployment cost. Hence policy credibility would not have been enhanced, and so long-term interest rates would not have come down. As for inflation, though it might have been held down in the short term, so limiting the contractionary effect of monetary tightening, as controls crumbled inflation could well be higher than otherwise. So the contractionary effect would merely be displaced in time.

A more interesting possibility is that advocated by HAYEK and new classical economists (SARGENT, 1985) of proper openly proclaimed shock tactics. In a recent paper (MINFORD and RASTOGI, 1988) I took the calculations of MATTHEWS and MINFORD (1987) for the effects of the policies actually pursued and recomputed them assuming shock tactics.

As we have seen, credibility was only established as the PSBR/GDP ratio actually fell; the rules the markets believed on the basis of available information to be governing the authorities' actions were that this ratio would be kept constant at its current level and that M_0 growth would be set to keep the debt/GDP ratio constant at its current level. Our model gave a good fit to this period assuming these rules, which is some evidence that the markets did indeed believe these rules to be in operation.

If so, then to change expectations once-for-all policies should cut the PSBR/GDP ratio immediately to its zero-inflation value and cut M_0 growth in line. While this would represent a big shock to expectations, it would be the last and the economy could recover uninterrupted from that point on.

The simulations that follow assume that from the beginning of 1980 public expenditure was cut and taxes raised sharply in order to bring the PSBR down at once to approximately 0.5% of GDP on a cyclically adjusted basis. (Since inflation is planned to fall to zero also in short order, inflation adjustment is irrelevant.) Money growth (M_0) is cut in parallel – implying a steady growth of around 1% p.a. for stable prices – with temporary exceptions designed to prevent excessively violent changes in monetary conditions in any one year.

From 1981 onwards fiscal and monetary policy is sustained in this mode; whereas in 1980 of course the policy is a shock, on a major scale, from 1981 it is fully anticipated for reasons discussed above.

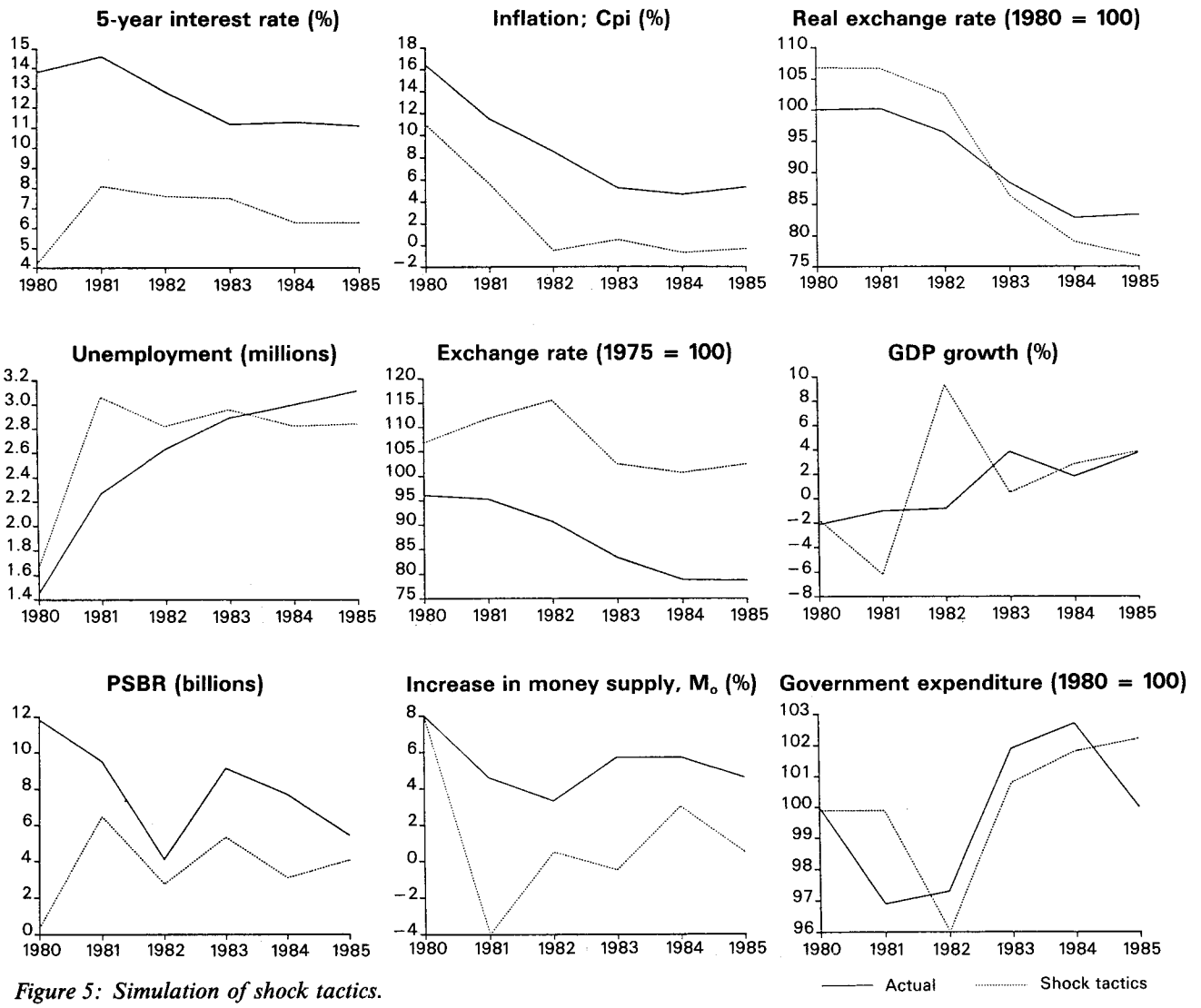

Figure 5: Simulation of shock tactics.

The story of this alternative strategy is clearly told in the charts of Figure 5, comparing the model's prediction of what would have happened under shock tactics with what actually happened.

The basic picture is clear. There would have been a deeper recession in 1980–81 and a quicker rise in unemployment, reaching 3 million by 1981. However because there are no further negative fiscal/monetary shocks after 1980, unemployment starts to fall sooner, and by 1984 it is falling decisively away from the 3 million mark.

The inflation rate falls more rapidly and settles at zero from 1982. It does not drop at once to zero in 1980 because the world recession and other negative shocks on the supply side reduce money demand in 1980–81 and cause 'defensive' price rises.

The real exchange rate similarly rises more sharply in 1980 but thereafter drops back more quickly as there are no more negative fiscal/monetary shocks.

We have found rather in line with new classical advice that the short sharp shock that cannot be reversed – and so bypasses issues of credibility – can be argued to give better results than gradualism. The question that remains is whether the treatment was too brutal to be a practical possibility even in the honeymoon period of the first 6–12 months.

The scale of the cuts needed would have been of the order of 10% of total government expenditure and 4% of GDP. By contrast, even with the 'Clegg awards' – public sector pay increases recommended by the Government Commission under Professor Clegg – actual government spending in 1980 remained roughly

constant in real terms (i.e. deflated by the GDP deflator). It is not that difficult to imagine a crisis package that could have been politically viable: withdrawal of Clegg awards, freezing of all benefits in money terms, general 10 % programme cuts, raising of the discount factor on capital projects, and bringing forward the tax rises of the 1981 budget (worth 4% of the GDP). The programme here in fact assumed that government expenditure followed roughly its actual path and that tax rates were raised by 4 % of GDP from 1980 and remain at this level throughout.

Judgement of political viability would require an extended discussion which would take us too far afield. But when the opposition has itself been practising or advocating cuts, experience shows it can be done; witness the recent policies of Haughey in Eire and Lange in New Zealand in just such circumstances.

In summary, the policies here would have caused substantial dislocation during 1980–81, with the real exchange rate appreciating about twice as much as it actually did and GDP falling 7 %, also about twice as much. But the recovery would have been faster with inflation eliminated; by 1985, GDP would have been nearly 5 % higher. Would such a cure have been so much more painful than what actually happened, that its speed and long-term gain would still not have seemed attractive?

Future Directions

We have argued that British monetary policy in its efforts to bring inflation under control has taken a form adapted to the institutions and political economy of Britain. It has emphasised the fiscal support needed, has put M_0 in the role of key indicator with the exchange rate in a supplementary role, and has used a traditional indicator intervention system. The policy was evolved out of the experience of the 1979–82 inflation battle.

We also argued that immediacy or cold turkey would have given better results especially for unemployment than the combination of announced gradualism and near-immediacy in practice.

What lies ahead? The case for Britain joining the EMS has been urged in many quarters recently; it has been resisted to date on the grounds that 'the time is not ripe'. This clearly does not rule out eventual joining; but no detailed circumstances for joining have been set out so the issue is vague.

The argument against is that the EMS is not a true fixed-rate system or monetary union; as a semi-fixed-rate system it is similar to the latest stages of Bretton Woods and liable to repeated currency crises. These to be controllable require monetary policy to veer sharply as crisis occurs and probably also need exchange controls in devaluing currencies; furthermore, the intervals between devaluation produce over-valuation for these currencies. All this may be worth enduring if domestic monetary policy is unable unaided to control inflation; but otherwise its cost is too high. A system of monetary union is attractive since it would reduce monetary transaction costs in the common market. But the time for the UK to join in EMS would be when it could make it a genuine monetary union with the DM at least; that of course requires convergence of monetary policy and inflation. It is in that sense that the time is not ripe. However, it may equally not be far off since it is no longer fanciful to speak of such convergence occurring.

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