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Are we on the verge of "the Clarke boomlet"?

Money growth is excessive and needs to be restrained

Four years of stability since late 1992

The four years since sterling's exit from the European exchange rate mechanism on 16th September 1992 have been a stable period for the British economy. Growth has been continuous, and for most of the time it has been at a trend or above-trend rate which has been sufficient to reduce unemployment. Indeed, unemployment is now the lowest in the large European economies. Meanwhile inflation - as measured by the twelve-month increase in retail prices - has been roughly 3% or less for four consecutive years, the best performance since the 1950s.

But this stability is now in jeopardy,

Mr. Kenneth Clarke, the Chancellor of the Exchequer, deserves credit for this achievement. However, Britain's new-found financial stability is in jeopardy. Between mid-1991 and the end of 1994 the money supply (on the broad measure, M4) grew at an annual rate of 5% or less. But since the start of 1995 it has been increasing at an annual rate of nearer 10%. The doubling of monetary growth has led to a strengthening in company balance sheets and excess liquidity in the financial system, and consequently to marked increases in asset prices. (For example, share prices, London house prices, hotel and restaurant valuations, and the price of farmland have been rising strongly.) Consumer spending is now growing briskly. In fact, "domestic final sales" (i.e., all items of domestic demand minus stockbuilding) were increasing in the first half of 1996 at an annualised rate of 4.0%. Domestic demand was more sluggish only because of an adverse movement in stocks. If the change in stockbuilding has a positive effect on the economy in early 1997 (as seems quite likely), domestic demand could well be expanding at 1% - 1 1/2% per quarter (i.e., an annualised rate of 4% to 6%). That sort of growth rate would qualify as a boom.

because of excessive monetary growth

Would it be unfair to hint at the emergence of "the Clarke boom", echoing its notorious predecessors, the Maudling, Barber and Lawson booms? In one sense, of course it would be. By the date of the next general election (presumably, April/May 1997) Clarke would have presided over only three quarters of rapid growth, a period too short to merit the term "boom". But the phrase "Clarke boomlet" would be reasonable. Most fundamentally, there is little sign in his official statements of concern about high monetary growth. The latest minutes of his monthly meeting with Mr. George demonstrate a clear contrast between Mr. George's foreboding about medium-term inflation prospects and his own complacency. Mr. Clarke's position is easily explained by two facts, that he is a politician and that a general election is a few months away. The meetings-and-minutes framework of monetary policy still leaves too much power over interest rates in political hands. It would be better if interest rate decisions were taken at the Bank of England, not in Whitehall, and so were more thoroughly de-politicised.

and - at a deeper level - because of the political control of interest rates

Professor Tim Congdon 9th October, 1996

Summary of paper on

Fiscal policy in the UK since the Second World War

Purpose of the paper

This is the second half of a paper which tries to assess the key theoretical influences on fiscal policy decisions since 1945. In particular, it asks, "did the UK ever have a 'Keynesian revolution'?". The first half of the paper appeared in the September 1996 *Monthly Economic Review.*

Main points

* **UK macroeconomic policy, including fiscal policy, was no longer Keynesian - in any shape or form - after the mid-1970s.**

* **The key turning-point, in terms of the abandonment of even a pretence of Keynesianism, was the sterling crisis of mid-1976, which stimulated drastic rethinking about macroeconomics in London-based policy-making and policy-influencing circles. (See pp. 3 - 4.)**

* **Initially, in the late 1970s and early 1980s, fiscal policy was intended to be consistent with targets for broad money growth (i.e., with "monetarism"). The interrelationship was reflected in the Medium-Term Financial Strategy, first presented with the Budget of 1980 and subsequently up-dated every year. (See pp. 5 - 6.)**

* **With the downgrading of money supply targets in the early 1980s, the rationale for PSBR targets was increasingly stated in terms of long-run fiscal solvency. This echoed older Treasury orthodoxies, but the PSBR is a very different concept from the "above-the-line" balance of Gladstonian finance. (See pp. 8 - 9.)**

* **A statistical test found no relationship between the change in the cyclically-adjusted public sector financial deficit and the level of the output gap in the post-war period, which refutes the notion that fiscal policy was "Keynesian". (See an appendix, obtainable from Lombard Street Research, fax no. 0171 337 2999.)**

This paper was written by Professor Tim Congdon. It is to appear in a book on the history of UK fiscal policy, to be published by Edward Elgar in 1997.

Fiscal policy in the UK since the Second World War

Part II: Trying to establish a new framework

Macroeconomic policy no longer Keynesian after mid-1970s

After some point in the mid-1970s it no longer makes any sense to describe British macroeconomic policy as "Keynesian". Textual and narrative analysis has to admit that there is scope for debate about whether fiscal policy was Keynesian between 1945 and 1974, but there is no doubt about the period from 1979. Policy-makers, official advisers to Treasury ministers and commentators are all agreed that - after the election of the Conservative Government under Mrs. (later Lady) Thatcher - fiscal policy was determined by non-Keynesian considerations.

I. Narrative from the mid-1970s

Was there a precise moment when policy changed?

But that leaves unspecified the precise moment between 1974 and 1979 when fiscal policy-makers consciously and deliberately abandoned Keynesian thinking. Of course, the notion of a "precise moment" is misleading. The attitudes of the key politicians, advisers and academics were in constant flux. They changed at different times to different degrees and in different ways from one person to another. Mr. Denis (later Lord) Healey, who was Chancellor of the Exchequer from 1974 to 1979 and took a closer interest in the niceties of economic theory than most Chancellors, made a fascinating appraisal in his autobiography, *The Time of My Life*. He found the PSBR so vulnerable to the economic cycle that it was "impossible to get [it] right", which - in his opinion - undermined the heavy emphasis on the PSBR in "the so-called 'budget judgement', which in turn determined the extent to which taxes or spending should be raised or lowered".(25) But he was also suspicious of dependence on the money supply, as "the monetary statistics are as unreliable as all the others". His response was to become "an eclectic pragmatist".(26) This may sound like a fudge, but it had an important consequence. After noting that when he arrived at the Treasury in 1974 it was still Keynes' intellectual "slave", Healey ventured the comment "I abandoned Keynesianism in 1975".(27)

Sterling crisis of mid-1976, and subsequent IMF visit, the key turning point

But the private and retrospective reflections of a Chancellor of the Exchequer are not the same as the public and transparent passage of events. For most observers 1976 was the crucial turning-point. Heavy selling pressure on the foreign exchanges hit the pound in the spring, obliging the Government to introduce a package of expenditure cuts and other policy changes. On 22nd July Healey announced a target for the growth of the money supply, on the M3 measure (including bank deposits), of 12 per cent during the 1976/77 financial year. It was the first time that a target for monetary growth had been included in an official statement on macroeconomic policy. As the pound remained under pressure in the next few months, the Government again sought help from the IMF in late September. The IMF gave a loan, but attached the condition that DCE should not exceed £9b. in 1976/77, £7.7b. in 1977/78 and £6b. in 1978/79. As in the late 1960s, this implied a constraint on the amount of bank credit extended to the public sector and so on the size of the budget deficit. Fiscal policy could not be focussed on the management of domestic demand and the maintenance of high employment, because it had to give priority to an externally-imposed target.

Keynesianism appeared to be replaced by "monetarism",

In the event the Government easily met the IMF's targets and the pound staged a spectacular recovery in 1977. However, the inflationary trauma and exchange-rate crises of the mid-1970s stimulated drastic re-thinking about both the theory and practice of macroeconomic policy-making. This re-thinking has been given the generic brand name of "monetarism". Arguably "monetarism" was - and remains - an even more disparate body of thought than Keynesianism, but the label cannot now be shaken off. In the mid-1970s two central tenets of monetarism were that high inflation was caused by high monetary growth and that targets to restrict monetary growth were therefore the key to controlling inflation. A large budget deficit undermines the task of monetary restraint, because there is a risk that the Government will have to finance its deficit from the banking system. In that case the banks add claims on the Government to their assets and incur deposit liabilities to the private sector on the other side of the balance sheet. These deposits are money. A target for monetary growth therefore implies some limit on the budget deficit. It needs to be emphasized that the limit is determined by the logic of monetary targetting. It applies whether or not the Government is borrowing from the IMF, and irrespective of the exchange rate regime it has adopted (i.e., irrespective of whether the exchange rate is fixed or floating).

with PSBR targets subordinated to money supply targets

The potential monetary consequences of excessive budget deficits demonstrate the interdependence of fiscal and monetary policy. If a decline in monetary growth is necessary in order to lower inflation, cuts in the PSBR are also an essential element in the programme. It follows that policy should be expressed in terms of both monetary growth and the fiscal position, and that these should be seen as two sides of the same coin of "financial policy". (In effect, financial policy absorbs both monetary and fiscal policy.) Moreover, the UK's inflationary plight in the mid-1970s was such that a rapid deceleration in monetary growth would cause a severe recession and soaring unemployment. So - for those persuaded by the broad thrust of the monetarist case - it was generally accepted that the reductions in monetary growth and the PSBR should be phased over a number of years. Official policy should look not just to the next Budget and the next year ("the short run"), but should be framed within a three- to five- year context of financial rehabilitation. Here lay the justification for medium-term macroeconomic planning, with the budget deficit geared to restoring medium- and long-run financial stability. Policy should not try to manipulate demand and employment from year to year in a Keynesian manner.(28)

Universities outside London irrelevant in intellectual shift, but key role for the London Business

Ideas of this kind were developed particularly among London-based policy-making and policy-advising circles in the crises of the mid- 1970s. These circles included the Treasury, the Bank of England, some stockbroking firms in the City and what might be termed "higher economic journalism".(29) The intellectual input from economists in universities outside London was minimal. In fact, most academic economists remained wedded to Keynesianism, a

School and the financial press

preference which led to sharp debates between the university-based profession and policy-makers in the 1980s. The London Business School played a vital role in promoting the new ideas. In 1977 T. (later Sir Terence) Burns and A. Budd proposed a medium-term financial plan in the London Business School's *Economic Outlook*. In 1979 the same two authors wrote an article in the same publication on 'The role of the PSBR in controlling the money supply'. In 1981 a book of *Essays in Fiscal and Monetary Policy* contained a paper by them on 'The relationship between fiscal and monetary policy in the London Business School model'. It made strong claims that "The relationship between fiscal and monetary policy is a very close one, and under a floating exchange rate the prime determinant of monetary variations is changes in fiscal policy" and - even more ambitiously - "Changes in the monetary aggregates are an 'efficient' estimate of overall policy stance".(30) The paper had originally been given at seminars organised by the Institute for Fiscal Studies in 1977 and 1978.

Introduction of the Medium-Term Financial Strategy embodying the new ideas

This emphasis on monetary variables as the best indicators of policy, combined with the linking of fiscal and monetary policy in a medium-term context, set the scene for the introduction of the Medium-Term Financial Strategy (MTFS). The Thatcher Government made clear soon after its election in June 1979 that it saw control of the money supply as necessary and sufficient to curb inflation. It was forthright in its rejection of Keynesian prescriptions. On 5th October 1979 a meeting to discuss medium-term financial planning was held at the Treasury between Sir Geoffrey (later Lord) Howe, his officials and a number of outside economists known to be monetarist in their doctrinal affiliations. Sir Frederick Atkinson, of Keynesian leanings, retired in late 1979 and was replaced as Head of the Government Economic Service by Burns on 1st January 1980. In the Budget of 26th March 1980 the first version of the MTFS was announced. It set out targets to reduce the ratio of the PSBR to GDP from 3 3/4 per cent in the 1980/1 financial year to 3 per cent in 1981/2, 2 1/4 per cent in 1982/3 and 1 1/2 per cent in 1983/4, and in parallel gradually to lower the rate of increase in the sterling M3 measure of money.

First MTFS in 1980 did *not* include balanced budget objective

Two points need to made about the original MTFS. First, it did not envisage a return to a balanced budget at any date and its supporters did not appeal to old-fashioned balanced-budget rhetoric to defend their position.(31) Secondly, the rationale for targetting the PSBR was to support monetary control, which had increasingly seen in the late 1970s as more fundamental to the macroeconomic outlook than fiscal policy.

MTFS justified tax increases in 1981 Budget, which outraged the Keynesians,

The existence of the fiscal targets in the MTFS is crucial in understanding the 1981 Budget, which was the final nail in the coffin of Keynesianism at the policy-making level. 1980 saw the deepest recession (until then) in the post-war period, with GDP dropping by almost 2 1/2 per cent. In early 1981 output was undoubtedly well beneath its trend level. Meanwhile the pound had been a strong currency for over 18 months and there was no external constraint on fiscal relaxation. But the Government decided to increase taxes by over £4b., equivalent to more than 1 1/2 per cent of GDP. The objective was expressly to bring the PSBR/GDP ratio back into line with the target set in the 1980 Budget.

notably the 364 economists who wrote to *The Times* in protest

The defiance of Keynesianism was absolute, as fiscal policy was tightened in conjunction with weak output and rising unemployment. Most economists in British universities were appalled. Two Cambridge dons organized 364 signatures for a letter to *The Times* warning that "Present policies will deepen the depression, erode the industrial base of our economy and threaten its social and political stability". Plainly, a huge gap had opened up between the theory of macroeconomic policy taught in British universities and the analytical framework applied in real-world policy-making. Academic thought and official practice had been divorced.

But sterling M3 was demoted in 1980s,

In the event, the economy began to recover in the middle of 1981, which gave encouragement to the beleaguered policy-makers in Whitehall that they were on the right lines. Despite setbacks in other branches of macroeconomic policy, the Government persevered with the fiscal component of the MTFS. By the mid-1980s the PSBR/GDP ratio was down to the levels envisaged in the original MTFS. However, the official rationale for PSBR targetting changed markedly. In 1980 sterling M3 grew well above the top of its target range, greatly embarrassing the Government which had placed such heavy emphasis on this measure of money as the keystone of macroeconomic policy. In response, the target was "quickly abandoned (although not formally) as the government came to recognize [sterling M3's] apparent misleading behaviour".(32)

and link between the PSBR and money growth was de-emphasized

With the money supply dethroned, there was no longer any sense in justifying PSBR targets by their contribution to monetary control. Instead the emphasis shifted to such considerations as the need to prevent debt rising too fast relative to GDP and, more specifically, to avoid an excessive burden of debt interest. The downfall of the monetary argument for fiscal restraint was also attributable in part to evidence from Professor Milton Friedman to the Treasury and Civil Service Committee of the House of Commons. Friedman, universally acknowledged as one of the intellectual founders of monetarism, told the Committee that the concern with the PSBR was "unwise", partly "because there is no necessary relation between the size of the PSBR and monetary growth".(33)

So PSBR targetting came increasingly to be based on long-run concerns about fiscal solvency,

The defence of PSBR targetting instead relied increasingly on the need to secure long-run fiscal solvency. An illustration of the new approach was the publication of a Green Paper on *The Next Ten Years: Public Expenditure and Taxation into the 1990s* in conjunction with the 1984 Budget. This was the first Budget presented by Mr. Nigel (later Lord) Lawson, who was to remain Chancellor until 1989. Paragraph 56 of the Green Paper projected the PSBR/GDP ratio into future years and noted that, "net of debt interest little or no change in the PSBR is assumed". It continued "on this basis the tax burden for the non-North Sea sector can be reduced to the extent that public expenditure falls more than North Sea tax revenues as a share of GDP".(34)

focussing on debt interest costs

This sounds complicated, but the essential message was that any success in controlling non-interest public expenditure would in future be translated into tax cuts. The PSBR/GDP ratio might decline, but only as a consequence of lowering the ratio of debt interest to GDP. There was no mention in the Green Paper of adjusting the PSBR to combat the business cycle (on Keynesian lines) or of lowering it in order to dampen monetary growth (as favoured by the monetarists). The Green Paper is interesting in three ways, first, as early evidence of Lawson's preference for tax cuts over budgetary discipline, secondly, for its dichotomy between the policy implications of interest and non-interest expenditure and, thirdly, because of its medium- and long-term planning perspective. The PSBR/GDP ratio was intended to drop to 1 per cent by 1993/4, helped by the projection of a sufficiently large decline in the ratio of debt interest to GDP. Separately, Lawson described a PSBR/GDP ratio of 1 per cent as "the modem equivalent of a balanced Budget".(35) A PSBR/GDP ratio of 1 per cent had earlier been judged compatible with long-run price stability in a paper published in the London Business School's *Economic Outlook* in 1983.(36)

In practice, the PSBR was lower than expected in the late 1980s because of the Lawson boom and balanced Budget objective was restored in 1988

The 1984 Green Paper was a theoretical document. The outturns in practice were very different. In the late 1980s the economy experienced a strong and unforeseen boom in activity, which gave the usual cyclical boost to the public finances. The PSBR declined to less than 2 per cent of GDP in the 1986/87 fiscal year and turned into small surplus in 1987/88. In 1988/89 the surplus widened to £14.7b. or 3 per cent of GDP. The attainment of a surplus in 1987/88 and the extent of the surplus in 1988/89 were not predicted by the Treasury. In the 1988 Budget Lawson took the usually benign fiscal performance as an opportunity to reinstate the doctrine of a balanced Budget. His Budget speech condemned the deficits recorded by previous Labour administrations, noting that "profligacy" had brought "economic disaster" and "national humiliation", as well as adding "massively to the burden of debt interest". Lawson saw the doctrine of a balanced Budget as "a valuable discipline for the medium term". Further, "...henceforth a zero PSBR will be the norm. This provides a clear and simple rule, with a good historical pedigree."(37)

and this has survived into the 1990s

The aim of balancing the Budget over the cycle has remained the focus of macroeconomic policy since the 1988 Budget. It was reiterated during the early 1990s, when in a deep recession the Government once again incurred heavy deficits. As in the similar circumstances of 1981, the two Budgets of 1993 raised taxes sharply in order to restore a satisfactory fiscal position over the medium term. But the official argument for a balanced Budget has been less strident and ideological, and far more pragmatic, than the case for medium-term PSBR reductions in the early 1980s. As in the Lawson period it has continued to rely on broad notions of stability and solvency. It has eschewed Keynesian demand-management considerations and been rather casual about the interdependence of fiscal and monetary restraint.

In Burns' words in 1995, now as Permanent Secretary to the Treasury delivering the South Bank Business School annual lecture, "Essentially we have two objectives, low inflation and stable public finances. We have two instruments, interest rates and fiscal policy. Both instruments can have an impact on inflation but only fiscal policy can ensure stable public finances on a sustained basis.

Intuitively, therefore, it seems clear that monetary policy will bear the main burden of delivering low inflation with fiscal policy taking the burden of delivering sound public finances." This formulation is rather vague and later in the lecture Burns conceded that "there are no hard and fast rules" for fiscal policy. But he made one exception, the need to contain "debt service costs and the level of total debt outstanding in a way that avoids being caught in a debt trap where it is only possible to finance debt interest charges by higher levels of borrowing".(38)

Worries about debt interest similar to those expressed in 1944 White Paper on *Employment Policy*

One interpretation of these remarks is that they represent a return to long-run solvency concerns of a kind emphasized by the Treasury knights in the 1930s and 1940s. The reference to runaway debt interest costs in Burns' 1995 lecture has more than a passing resemblance to the section in the 1944 *Employment Policy* White Paper which warned about "the charge on the Exchequer" from excessive public debt. Burns' views might therefore be regarded as the rejection of Keynesianism and the restoration of traditional sound finance doctrines. However, it is important to note major differences in definition and emphasis from earlier positions. No official statement on fiscal policy in the 1980s and 1990s has been expressed in terms of the old distinction between above-the-line and below-the-line items. In this respect modern sound finance departs significantly from the traditional version of the inter- war period and, indeed, from more distant Gladstonian precursors.

But the PSBR has no simple connection with the old "balance above-the-line" concept

Instead of the aim to achieve balance or surplus above the line, the PSBR has become the main benchmark of fiscal policy. The PSBR had initially been formulated to support the IMF's balance-of-payments and later it had been intended to buttress monetary restraint. Its position in discussions of long-run fiscal solvency is not, in fact, particularly comfortable. It does not differentiate, as did the above-the-line/below- the-line distinction, between non-recurrent capital items and other types of expenditure. As a result, it does not have any clear message for the Government's or the public sector's overall net assets (i.e., its gross stock of financial and tangible assets, minus its debt). Moreover, as the Government can both sell financial assets and borrow in order to on-lend to the private sector, there is no simple relationship between the PSBR and net debt.

Budget now in heavy deficit on old "above-the-line" definition

These points do not invalidate the PSBR's legitimacy as a target or control variable. The alternatives also have their weaknesses. However, it is interesting to note that - if the old above-the-line/below-the- line distinction had survived - the public finances would now appear to be in serious disarray. The PSBR has been held down over the last 15 years not by curbing current spending and recurrent capital expenditure relative to revenues, but by holding down capital expenditure and by taking in money from privatisation. While the modern Treasury and its political masters acknowledge a long-run solvency constraint on fiscal policy, they define it in a quite different manner from their predecessors before the supposed "Keynesian revolution".

At any rate, there is little doubt that certainly since 1979, and perhaps since 1975 or 1976, fiscal policy has not been regarded as "Keynesian" by policy-makers or their key advisers. It had a short phase in 1979 and 1980 when it could be characterised as "monetarist" more than anything else. Later it became subordinate to "sound finance", dressed up in modern terminology but still rather vague and ill-defined, and arguably it remained less restrictive of debt than the Treasury's old orthodoxies of the 1930s and 1940s. There are some similarities between today's formulations and those orthodoxies, but they are fortuitous, not consciously intended. Policy-makers sometimes admit that they remember what they were taught at university, namely that changes in the budget deficit can affect the level of demand in the economy.(39) But such considerations are secondary, or even tertiary, in actual policy decisions.

II. A statistical test of the historical reality of "the Keynesian revolution"

The record of official statements, positions and speeches is therefore very far from unanimous that fiscal policy was conducted on Keynesian lines even in the period from 1945 to the early 1970s, while it is clear-cut that a marked shift away from Keynesianism occurred in the mid-1970s. But the analysis so far as been literary and textual. Like all such analysis, it has required selection from a wider mass of statements, and it has involved judgements about different actors' tone of voice and their balance of priorities. Necessarily, the selection has been to a degree arbitrary, and the judgements could be criticised as imprecise and subjective. An alternative approach is to review policy actions in statistical terms, which should put the analysis and conclusions on a more objective plane.

Keynesian policy implies inverse relationship between budget position and unemployment,

The broad meaning of the phrase "Keynesian fiscal policy" is well-known. If fiscal policy is on Keynesian lines, the budget deficit is increased when unemployment is "high" and reduced when it is "low". The statistical test should therefore be designed to answer the question, "did policy-makers vary the deficit inversely with the level of unemployment?". But several statistical series could be deployed to handle this question. What are the right concepts of "the budget deficit" and "the level of unemployment"?

but how should the budget position and unemployment be defined?

Several competing notions of the budget deficit are candidates. As already demonstrated, for much of the 1950s and 1960s the Treasury continued to frame budgetary decisions in accordance with principle that the budget should be balanced "above the line". The above-the-line central government position is, however, too narrow to serve as a valid indicator of the underlying thrust of fiscal policy. It excludes many capital items and the effect of public corporations' transactions, yet some Keynesians insist that capital spending, particularly capital spending by the nationalised industries, ought to be a prime instrument of counter-cyclical fiscal policy.(40) On the other hand, the public sector borrowing requirement, which came to dominate public discussion of fiscal policy from the mid-1970s onwards, is too broad. It is affected by "financial transactions", such as nationalisation, privatisation and government lending to industry and for house purchase. Such transactions do not constitute net injections into or withdrawal from aggregate demand.

According to most authorities, the best compromise between narrow and broad measures of the budgetary position is "the public sector's financial deficit".(41)

Best measure of budget position is cyclically-adjusted public sector financial deficit

This covers the entire public sector, but excludes the effect of purely financial transactions. It approximates to the difference between the flow of the public sector's receipts and expenditures, and this difference is usually taken to the addition or subtraction to the circular flow of income which lies at the heart of the Keynesian theory of income determination. A complication is that the public sector's financial deficit is both an influence on and is influenced by the cyclical course of the economy. (Social security spending rises and falls with unemployment, while tax receipts vary inversely with it.) So discretionary policy action is best understood as and measured by its effect on the cyclically-adjusted estimate of the deficit, not on the unadjusted deficit. In the statistical work in the appendix fiscal policy decisions are therefore measured by the change in the cyclically-adjusted public sector financial deficit. (Various methods of cyclical adjustment are possible. An appendix on the methods adopted in this paper can be obtained from Professor Tim Congdon at Lombard Street Research on fax no. 0171 337 2999. Two sets of assumptions are used to obtain two separate estimates of the cyclically-adjusted fiscal deficit. The estimation of two such series helps in checking whether the conclusions are special and depend on the assumptions, or are more general and robust.)

The identification of the appropriate unemployment variable is also difficult. In the 1950s "full employment" was widely thought to mean an unemployment rate, measured by the count of benefit claimants as a ratio of the workforce, of under 2 per cent.(42) But in the 1970s and 1980s economists stopped thinking about full employment as a single number, while various institutional changes to the structure of the labour market caused an increase in the level of unemployment consistent with a stable rate of price change (the so-called "natural rate of unemployment"). More recently the Conservative Government's attempts to increase labour market flexibility may have reduced the natural rate. These ambiguities suggest that no long-run series for unemployment is altogether reliable as a guide to state of the labour market.

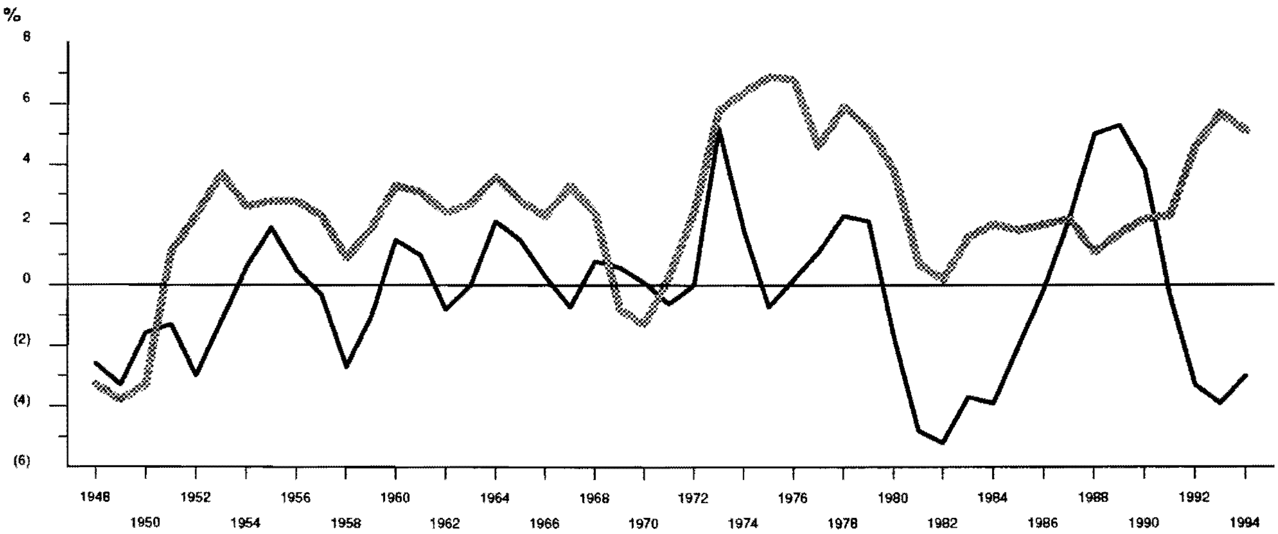
and the "output gap" is a less awkward mesure of the business cycle than unemployment

A more general measure of activity in the economy is provided by "the output gap", defined as the upwards or downwards deviation of output from its trend and usually expressed as a percentage of that trend.(43) Like assessments of the "fullness" of full employment, calculations of the output gap depend partly on the analyst's methods. But the temptation and opportunity to manipulate the numbers is less with politically-neutral GDP figures than with politically-charged unemployment statistics. Further, cross-checks can be made between several different techniques for calculating output gaps, which limits the scope for the analyst to impose his own hunches and prejudices. Comparison is also possible with calculations made by, for example, the Organisation of Economic Cooperation and Development. (The method of calculating the output gap in this paper is explained in the appendix.)

The discussion has pinned down the statistical test more exactly as an attempt to answer the question, "did the cyclically-adjusted public sector financial deficit vary inversely with the output gap?". If fiscal policy was Keynesian, the deficit ought to have increased when the level of output was beneath trend

Fiscal policy and the cycle - Exercise 1

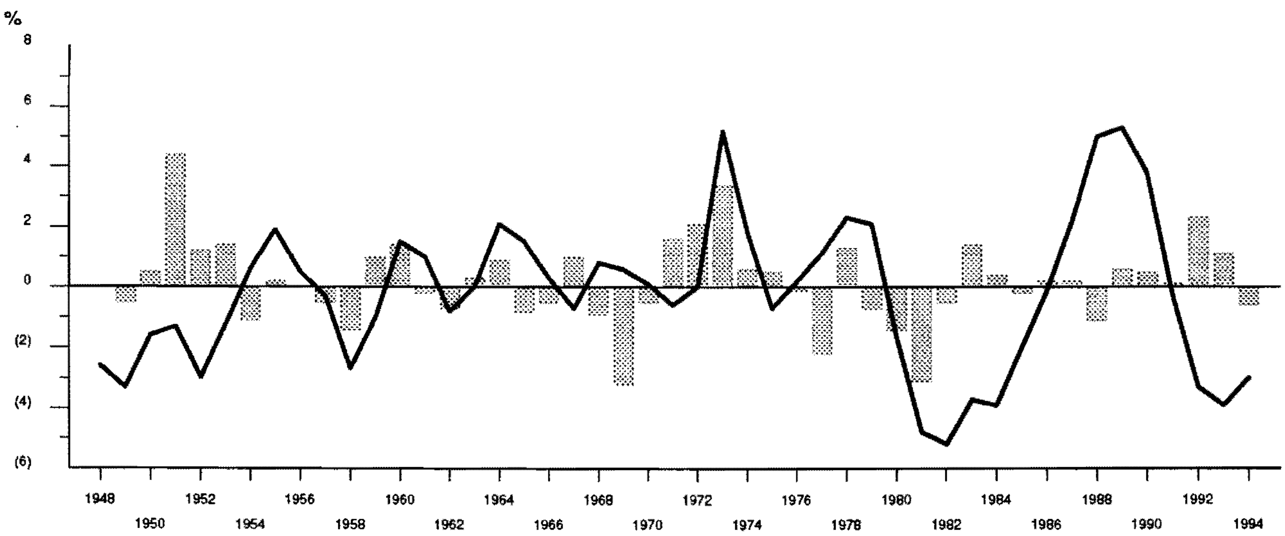
1. The *level* of the deficit and the output gap



Output gap (as % of potential GDP)

Cyclically-adjusted PSFD (as % of nominal GDP)

2. The *change* in the deficit and the output gap



Output gap (as % of potential GDP)

Change in PSFD (as % of nominal GDP)

In these charts cyclical adjustment to the PSFD depends on the output gap in the year in question.

and declined when it was above trend. Chart 1 shows the output gap and the cyclically-adjusted PSFD, estimated on one set of assumptions, and chart 2 the output gap and the corresponding change in the adjusted PSFD; chart 3 shows the output gap and the cyclically-adjusted PSFD, estimated on an alternative set of assumptions and chart 4 the change in the adjusted PSFD corresponding to those alternative assumptions. The same result emerges on both sets of assumptions, with the encouraging implication that the result is genuine and not an artefact of the chosen method of cyclical adjustment. In the 46 years between 1949 and 1994 there were 25 years when the fiscal stance changed in a Keynesian manner (i.e., inversely to the output gap), but 21 years when it did not. Keynesian fiscal policy was slightly more common in the period to 1974 than afterwards. Fiscal policy was contra-cyclical in 15 of the 26 years to 1974 (i.e., almost 60 per cent of the years), but in only 10 of the 20 years to 1994 (i.e., in 50 per cent of the years).

Policy in Keynesian direction in only half the years

and rigorous econometric tests invalidate notion that fiscal policy was "Keynesian"

More rigorous econometric tests have also been performed, with the change in the cyclically-adjusted PSFD regressed on the level of the output gap. It turns out that in virtually all of the equations - no matter which cyclical-adjustment assumptions or period are chosen - the coefficient on the output gap term is not significantly different from zero. In other words, fiscal policy was not "Keynesian", in the usually received sense, in the period from 1949 to 1994 as a whole or in the two sub-periods, 1949 to 1974 and 1975 to 1994. On the face of it, there was no such thing as "the Keynesian Revolution". (See the statistical appendix for a fuller statement of these results.)

III. Conclusion: "the Keynesian revolution" never happened

The great majority of British economists undoubtedly believe that something called "the Keynesian revolution" did happen. There is room for discussion about its precise meaning, for example, on the question of whether "fiscal policy" is best defined as the change or the level of the budget deficit. But the essence of the supposed "revolution" - that in and after the 1940s British fiscal policy (however defined) was used contra-cyclically in order to dampen fluctuations in output and employment, and maintain a high average level of employment - is well-known.

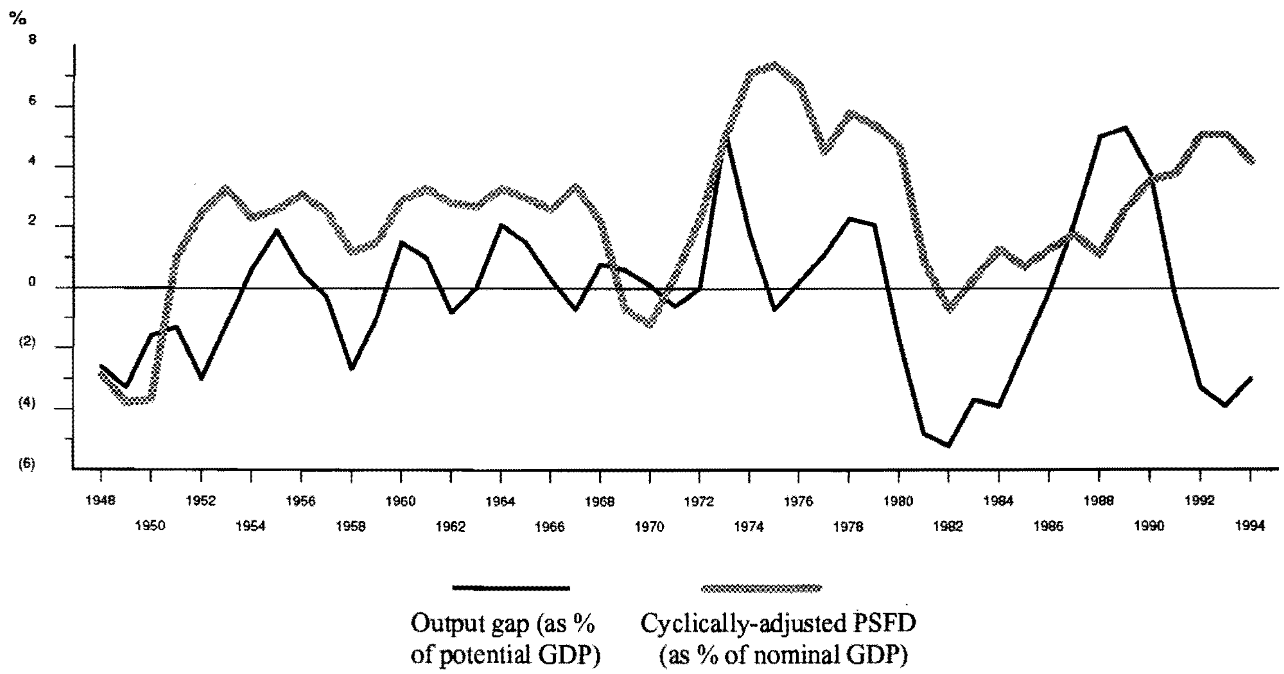
Fiscal policy was not Keynesian between 1941 and the mid-1970s, as is widely believed,

and policy thinking was certainly not Keynesian after the mid-1970s

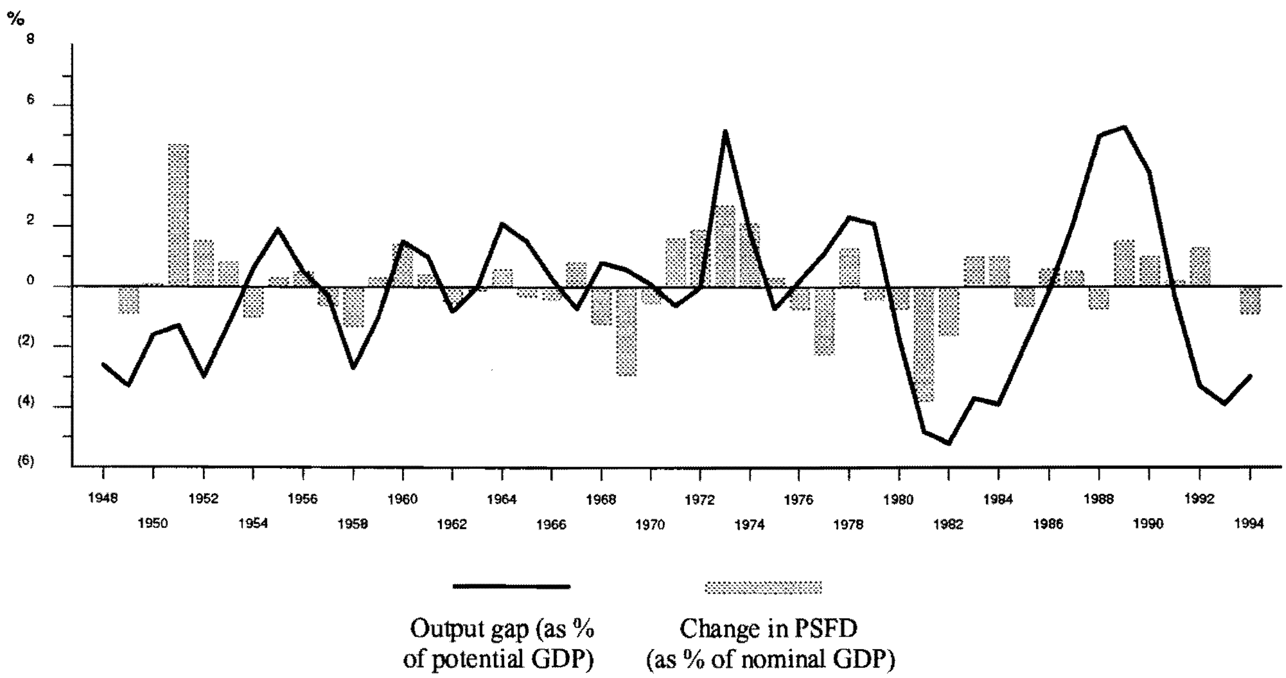
This paper has cast doubt on the historical accuracy of this widely-held view. First, it has denied that Britain ever had a Keynesian revolution in the usually understood sense. In the 30 years from 1941 fiscal policy was not in fact conducted in a Keynesian manner, whatever leading politicians and economists claimed at the time. Much policy thinking in this era certainly was Keynesian, but theory and practice were a long way apart. Secondly, the paper has tried to describe the shift in policy thinking away from Keynesianism in the mid-1970s. There is little controversy that a shift of some sort occurred, although again its exact nature can be discussed. As has been shown, the Government's rationale for action to restrict the PSBR varied over the years. Sometimes the official argument relied on a presumed relationship between the budget deficit and monetary growth, at others it reflected more traditional concerns about the accumulation of excessive debt which would be expensive to service. But

Fiscal policy and the cycle - Exercise 2

1. The *level* of the deficit and the output gap



2. The *change* in the deficit and the output gap



In these charts cyclical adjustment to the PSFD depends on the output gap in the year in question and in the preceding year.

official references to fiscal policy as an instrument for cyclical stabilisation were perfunctory or frankly dismissive.

The majority of British academic economists were unsympathetic to the shift in thinking about fiscal policy, with their discontents registered most famously in the letter of 364 economists to *The Times* after the 1981 Budget. The frankness of policy-makers' rejection of Keynesian precepts by the early 1980s ought perhaps to have encouraged these economists to examine the substance of "the Keynesian revolution" with care and scepticism. Whether the official ending of the Keynesian period (if it deserves the title) is dated as happening in 1975, 1976 or 1979, the statistical evidence is that the actual management of the British economy was much the same before as afterwards.

Keynes was a great man, but "the Keynesian revolution" is and always has been an illusion

At any one period a great variety of personalities are involved in economy policy-making. As they often come with different perspectives, it would be naive to expect them to propound a single monolithic view of policy-making. Moreover, when the period of analysis is extended to a few decades, the cast of personalities changes, and no one canonical statement of theory and practice can bind them all. Keynes was a great man and a benign influence of British economic policy, and it is understandable that British economists should want to pay homage to his *General Theory*. But the substance of policy-makers' actions may have little connection with their advisers' descriptions of strategic intent. More bluntly, what people do may be quite different from what they believe they are doing. The United Kingdom is the homeland of Keynesian thought, but in the actual conduct of British fiscal policy "the Keynesian revolution" is and always has been an illusion.

Notes

(25) D. Healey (later Lord Healey) *The Time of My Life* (London: Michael Joseph, 1989), p. 380.

(26) Healey *Time of My Life*, p. 382.

(27) Healey *Time of My Life*, p. 383.

(28) See the papers 'Monetarism and the budget deficit', pp. 38 - 48, and 'The analytical foundations of the Medium-Term Financial Strategy', pp. 65 - 77, in T. G. Congdon *Reflections on Monetarism* (Aldershot: Edward Elgar for the Institute of Economic Affairs, 1992). A growing interest in a medium-term perspective can also be noticed in A. Budd 'Economic policy and the medium term', pp. 133 - 142, in G. D. N. Worswick and F. T. Blackaby (eds.) *The Medium Term: Models of the British Economy* (London: Heinemann, 1974).

(29) See ch. 6 'How Friedman came to Britain', pp. 172 - 202, in W. Parsons *The Power of the Financial Press* (Aldershot: Edward Elgar, 1989).

(30) See the paper 'The relationship between fiscal and monetary policy in the London Business School model', pp. 136 - 163, by A. P. Budd and T. Burns in M. J. Artis and M. H. Miller (eds.) *Essays in Fiscal and Monetary Policy* (Oxford: Oxford University Press, 1981). The quotations are from p. 136.

(31) See ch. 4 'Implementation and results of the strategy', pp. 58 - 92, in G. Maynard *The Economy under Mrs. Thatcher* (Oxford: Basil Blackwell, 1988). But the claim on p. 65, that the MTFS had as its "stated objective" a "progressive...return to budget balance", is not correct. The balanced budget goal surfaced in official statements much later, in 1988.

(32) Maynard *Economy under Mrs. Thatcher*, p. 66.

(33) The quotation is from p. 56 of M. Friedman 'Response to Questionnaire on Monetary Policy' in House of Commons Treasury and Civil Service Committee (Session 1979/80) *Memoranda on Monetary Policy* (London: HMSO, 1980), pp. 55 - 62.

(34) HM Treasury *The Next Ten Years: Public Expenditure and Taxation in the 1990s* Cmnd. 9189 (London: HMSO, 1984).

(35) N. (later Lord) Lawson *The View from No. 11* (London and elsewhere: Bantam Press, 1992), p. 812.

(36) A. Budd and G. Dicks 'A strategy for stable prices' *Economic Outlook* (Aldershot: Gower Publishing for the London Business School), July 1983, pp. 18 - 23.

(37) Lawson *View from No. 11*, p. 811.

(38) Sir Terence Burns *Managing the Nation's Economy - the conduct of monetary and fiscal policy*, given as South Bank Business School annual lecture (London: HM Treasury, 1996), p. 5.

(39) "...[T]here are very few practitioners who would argue that fiscal policy has no role to play at all in influencing demand...". Burns *Managing the Economy*, p. 5.

(40) See, for example, Susan Howson (ed.) *The Collected Papers of James Meade, vol. 1: Employment and Inflation* (London: Unwin Hyman, 1988), pp. 6 - 25, 'Public works in their international aspect', originally published in 1933.

(41) Andrew Britton *Macroeconomic Policy in Britain* (Cambridge: Cambridge University Press for the National Institute of Economic and Social Research, 1991), p. 215, but note Britton's warning on p. 217 that the cyclically-adjusted public sector financial deficits"do not identify policy acts, that is deliberate choices by government as distinct from the passive response of the system to events".

(42) Frank W. Paish *Studies in an Inflationary Economy* (London: Macmillan, 1962), p. 327.

(43) The recent development of this concept has been centred at the Organisation of Economic Cooperation and Development in Paris. See Claude Giorno et al 'Potential output, output gaps and structural budget balances', *Economic Studies*, no. 24 (Paris: OECD, 1995).

This publication, which first appeared as the ***Gerrard & National Monthly Economic Review*** in July 1989, is no longer to appear under the Gerrard & National name. The mailing list is to be reduced and it will instead be published as the ***Lombard Street Research Monthly Economic Review***.