economic recovery: what Labour must do

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Economic Recovery: what Labour must do

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1. The Scale of the Crisis

The return to full employment must be the central objective and will be the main task of the next Labour Government. The Party's fitness for office in the run-up to the general election and its performance in government will rightly be judged by the seriousness of purpose with which we approach the task and the effectiveness of the policies we implement.

It is easy to be daunted by the sheer magnitude of the problem. We have endured a loss of employment without precedent. Two million jobs have been lost in the last three years; the loss in the period 1929-31 was, by comparison, only 840,000. A successful attack on unemployment would mean, in the lifetime of a single Parliament, creating over 3 million jobs.

There are those who believe that this task is impossible and that the cancer of unemployment will remain with us for the foreseeable future. We do not share this view. There are lessons to be drawn from the 1930s. In the four years to 1937, 2.6 million new jobs were created to raise the total in work to 18.5 million, 1.9 million higher than the 1929 figure. More than half of the new jobs were in manufacturing. In more recent times, Mr Heath created 864,000 jobs in the two years ending December, 1973 and reduced unemployment to 496,000 – a rate of 2.1%. We accept that the task now is much more formidable, but we believe that the damage which has been done in the past five years can be remedied within five years. If 600,000 new jobs could be created each year in the mid-1930s, we can do it again now. Our commitment to socialism demands no less.

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The first step in the fight for economic recovery is, however, to quantify the problem. The extent of the damage we have suffered is not always appreciated. It is tempting to assume, and we are encouraged to do so by the Tory Government, that we are simply on the downswing of one of those cyclical dips which characterise economic performance even at the best of times. The truth is different. It is not just that unemployment has soared with unprecedented rapidity; the unemployment total is just one reflection of a general industrial collapse which is also manifested in many other ways – for example, in the record number of insolvencies. British industry is not becoming leaner and fitter. It is becoming smaller and weaker. We are compounding, not correcting, past errors. Our problems threaten to become terminal.

The truth is told most starkly in the figures for industrial output. Manufacturing now accounts for only 29% of the Gross National Product – its lowest level for centuries – and manufacturing output is now 17% lower than it was in 1979. A fall of this magnitude and steepness has no parallel in the history of advanced industrial countries; even in 1929-31, manufacturing held up much better than it has done over the last three years. Two out of every three jobs lost under this Government have been in manufacturing. Employment in manufacturing has fallen by 3.2 million (nearly 36%) since its 1969 peak, and nearly half of the fall has occurred since May, 1979.

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suffering the rigours of recession, largely under the influence of the monetarist policies being pursued in the United States, the British experience, in terms of unemployment and output, has been considerably worse than any other. This is reflected in the grim statistics of our current trade account. Our share of world trade in manufactures continues to fall remorselessly. Whereas our exports of finished manufactures this year were only 5% higher by volume than in 1975, imports were up by 97% over the same period. The result has been that, for the first time in recorded history, we are now net importers of manufactured goods.

The one factor which has enabled the Government to conceal the true seriousness of our plight is North Sea oil. It would have been impossible to sustain the present destructive policies had it not been for the £12 billion advantage to our current account provided by North Sea oil by 1981. It is one of the gravest indictments of the present Government that this enormous benefit, in an energy-starved world, has not only been squandered, but has actually been the instrument of a worse industrial performance than that of any other country.

But even the oil cannot save us forever. The trends are so alarming – with unemployment still rising steadily, industrial output (despite so many Ministerial welcomes for a succession of false dawns) continuing to fall, and our trade balance deteriorating fast – that even oil production and sales at their temporary peak will not be enough to save us from our folly. A decisive change of course is now urgently needed if we are not to continue our headlong plunge over the precipice.

The present Government has persuaded many people that record unemployment is the result of factors which could not be foreseen, and cannot be controlled or even properly understood. But it was eminently predictable (and was indeed predicted by the present authors) that a monetarist squeeze would inflict great damage on the industrial economy. Both as a matter of economic theory and commonsense, the causal connection between deflation and recession is well-established and undeniable. Whenever similar policies have been tried in the past, they have produced the same results. When in the 1920s, successive governments squeezed the economy insensible in the effort to stay on the Gold Standard, it led inexorably to the Great Depression. At the time, those in charge of economic policy were just as vehement as Mrs Thatcher is now in proclaiming that there was no alternative. We now know better – or at least, we have no excuse for not knowing better.

The Thatcher Government oscillates between the claim that unemployment is a necessary medicine and the denial that unemployment has anything to do with them. But the latter posture is no more credible than the former. The world recession itself, far from being an extraneous and uncontrollable factor which offers an excuse for the failure of domestic policies, as the Tories claim, is merely the result of similar deflationary policies being applied in several countries at once.

It follows that the current mood of fatalism which has been encouraged by the Tory Government is misplaced and is an unnecessary obstacle to corrective action. Unemployment has been created by well-understood mechanisms; all that is necessary to tackle unemployment is to reverse the mechanisms which have created it. It is the monetarist ratchet of tight money, high interest rates and an over-valued exchange rate which has done the damage; there is no magic or mystery about setting the ratchet in reverse. We need cheap and plentiful money to finance expansion, an increase in purchasing power, and a competitive exchange rate so that imports are discouraged, exports stimulated and competitiveness and profitability improved. This is not just a matter of theory; our own experience of emerging from the Great Depression in the 1930s and ushering in an era of unparalleled prosperity shows conclusively how effective this alternative to present policies can be.

Commonsense tells us that there must be something wrong with a policy which stops four million people from working and which restricts our national output to only 70% of what it could be. We have the labour force, the plant and the capital to produce much more than we currently do; we are stopped from doing so only because no one can be found to buy the additional goods at a price which would justify the costs of production. This arises for two main reasons. First, there is not enough purchasing power in an economy which has been savagely deflated. Secondly, when people do have money to spend, they find that they get better value for money, both here and abroad, by buying products made elsewhere.

Commonsense dictates that, in order to remedy the obvious foolishness of deliberately impoverishing ourselves, we must tackle these twin problems – of deficient purchasing power at home and lack of competitiveness in world markets, including our own.

One man's expenditure is another man's income.

The present recession, like every other recession, is by definition caused by a deficiency of spending power and it will be ended, as every other recession has ended, by an increase in spending. One man's expenditure is another man's income. We are constantly reminded of Jim Callaghan's statement to the 1976 Labour Conference that it was no longer possible to spend our way out of recession but its constant repetition does nothing to overcome its illogicality. The problem is not whether we can spend our way out of recession but when and how we do it.

A massive injection of purchasing power is one *sine qua non* of recovery. The other is to grapple with a lack of competitiveness which would, if not dealt with, make any expansion of demand extremely hazardous. The danger exists because the monetarist ratchet has pushed up the exchange rate in real terms by over 40% against our most dangerous rivals since the autumn of 1976. It is that enormous loss of price competitiveness which has destroyed the capacity of British industry to resist imports and compete in world markets. Before we can safely launch on a programme of expansion, that loss of competitiveness must be reversed.

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The role of the exchange rate is to enable us to balance our overseas accounts, in conditions of full employment of capital and labour, and at a high and sustainable level of growth. It is the current misalignment of the exchange rate – so severe that it cannot be remedied by any conceivable productivity improvement or fall in real wages – which prevents us from achieving this enviable state of affairs.

It is our contention that expanding the economy, improving competitiveness and countering inflation can all be achieved together – indeed, can only be achieved together – by applying a coherent and mutually consistent set of monetary, credit, exchange rate and industrial policies. We now set out in more detail the constituent elements of such a coherent programme.

Stimulating Demand

Although the present monetarist policies have been dressed up in an apparently new theoretical garb, their practical impact has been of the crudest deflationary kind. Both the disastrous consequences for the real economy and the isolated and belated success on inflation are exactly what would be expected from a contractionary policy pursued to an extreme degree.

There is no aspect of economic policy which has escaped the deflationary sledgehammer. A savagely restrictive monetary policy has been reinforced by a fiscal policy which, despite Tory electoral promises, has substantially increased the tax burden; a corporate sector whose profitability has been decimated and whose cash flow problems have multiplied has found that its public sector customers have fallen victim to a politically motivated attack on public expenditure; and it is this reinforcement of one contractionary pressure by another, and another, which has sent the British economy into such a dizzying nosedive.

We can pull out of this downward spiral only by reversing that shortage of demand and purchasing power which is the hall mark of recession. Money must be pumped back into the economy. For socialists, there is great attraction in doing this by means of a programme of capital expenditure, on projects like rail electrification and on restoring the Tory cuts in construction – housing, hospitals, schools and roads. It is clearly ludicrous that almost half a million construction workers should be without work at the same time as a housing crisis is building up. A programme of public spending on capital projects would provide three related benefits – the political benefit of re-stating the importance of the public sector, the social benefit of improving essential services and the economic benefit of boosting purchasing power.

We believe that some stimulus to the economy, perhaps totalling £1.5 billion a year, should be provided in this way; but, despite its political attractiveness, it should not be the only or even the principal instrument of reflation. Capital projects take a considerable time to plan and prepare, for contracts to be let and for work to start. Their main economic impact will therefore be somewhat delayed and they are therefore likely to be less useful in initiating a recovery than in sustaining one which has already got under way.

The main responsibility for stimulating the economy should rest on more quick-acting measures. Speed is essential, both economically – so that recovery is under way early enough in the lifetime of the Labour Government to bear fruit in good time – and psychologically, so that confidence in the expansionary programme is established quickly while the longer-term measures take effect.

The first thrust of a reflationary programme must therefore be a substantial increase in purchasing power. We must put money into people's pockets as quickly as possible, so that they are able to spend on the scale required to get back to full employment. The quickest way to get people back to work is to re-open the factories which have closed down and to make use of our existing skills.

Many advocates of reflation propose a reduction in the rate of Value Added Tax, but a reduction from 15% to 10% would cost at least £5 billion at current prices, a substantial part of the benefit would go to importers, and the better-off, who spend more, would gain very much more than the lower-paid, both in absolute terms and as a proportion of their total expenditure.

A more effective and acceptable measure for boosting purchasing power would be the reduction or abolition of National Insurance contributions. The abolition of the National Insurance surcharge paid by employers would help to reduce industrial costs, but would be of little direct benefit to consumers. It could, however, be combined with a reduction in, or the abolition of, the employees' National Insurance contributions, which would directly boost the consumer's purchasing power by increasing take-home pay. The complete abolition of the employee's contribution would be the equivalent of a 10-12% increase in the pay of the worker on average earnings. The low-paid would gain a disproportionately large benefit because National Insurance contributions are a regressive form of taxation, and their reduction, or abolition would therefore have a progressive effect.

We propose that the National Insurance surcharge should be abolished, that there should be a 50% cut in the employers' contribution and that the employees' contribution should also be abolished.

The implementation of this proposal would increase purchasing power without raising industrial costs. Indeed, the remission of employers' contributions would help to reduce costs. The proposal can be seen as the reversal of what is in effect a tax on jobs – the least desirable form of taxation at a time of high unemployment.

Ideally, we should like to take the principle of reversing the tax on jobs even further, by concentrating help on the manufacturing sector, where the greatest loss of employment has occurred and where the real prospects of growth lie. We have not, however, yet devised a satisfactory means of achieving this objective and further work is needed.

The National Insurance proposals would be of considerable help to wage-earners, but other measures would be needed to help the casualties of the recession and particularly the long-term unemployed. We therefore propose a spending bonus for the unemployed and those on supplementary benefit, with special help for those who have been unemployed for a year or more. The bonus would be a multiple of the weekly rate of benefit and the cost would be around £1.4 billion.

Direct Action on Prices and Real Incomes.

The reduction of National Insurance contributions will do much to stabilise prices; the counter-inflationary prospects can, however, be reinforced by a number of other reflationary measures which will act directly on prices and will boost real incomes. They could include:

- *a 10% increase in the income tax threshold, which should thereafter be maintained in line with inflation.*
- *the stabilisation overall of nationalised industry prices for a period of two years, making due allowance for the differing needs of the various industries.*
- *a reduction in interest rates to 6% (long-term rates) and 4% (short-term).*
- *the immediate introduction of food subsidies costing £3 billion, pending the abolition of the EEC levies on basic foodstuffs, and a negotiation of new long-term supply agreements with our traditional suppliers – a step which should be taken whether or not we remain formally members of the EEC.*
- *the provision of vocational and other training for sixteen-year olds who wish to remain in education, a small attendance allowance for each student and an increased family allowance.*
- *a reduction in charges for school meals, school transport, dental treatment, spectacles, fares etc.*
- *a review of social security payments to ensure that their real value does not fall; a restoration of the cuts in the real value of unemployment benefit; and a return to earnings-related benefits.*

A package on these lines would boost real incomes and reduce prices. It would change inflationary expectations and make it worthwhile for all sections of the community to co-operate in helping to achieve price stabilisation in conditions of rapid expansion. The initial cost of the total package – the suspension of National Insurance contributions, higher benefits and allowances, increased public spending on capital projects and on employment, and the measures to reduce prices – would be of the order of £20-£25 billion, but much of this would be self-financing and, to the extent that it was not, the increase in the money supply (resulting from a refusal to fund the whole of the increase in PSBR) should make a worthwhile contribution to reversing the ratchet of tight money, high interest rates and an over-valued exchange rate.

Industrial Policy

The outlook for industry would be transformed if home demand were raised and the exchange rate enabled industry to compete effectively at home and overseas. Profits would be substantially increased and the public would rightly expect the Government to secure their share by making the 52% rate of Corporation Tax fully effective. The Green Paper on Corporation Tax (Cmnd 8456) shows that in 1979 companies were able to set £18.6 billion of capital allowances and £9.6 billion of stock relief against profits at a cost to the Exchequer of £9.5 billion in 1980/81. The amount which could be claimed in this and earlier years frequently exceeded the amount of profit and by 1982 an estimated £30 billion of "tax losses" had been accumulated to offset future profits.

A system which might perhaps have been justified as a means of keeping industry in funds at a time of exceptionally low profitability could not possibly be defended, however, when the policies which brought about that situation are reversed. The reliefs – and the carry-over – should be abolished as soon as the new Government comes to office. An effective Corporation Tax would prevent the new-found profitability of the corporate sector from getting out of hand and would provide a major source of revenue.

The over-riding objective must be to maximise the number of jobs. Indiscriminate capital allowances provide a huge subsidy to replace men by machines. It is questionable whether this makes sense, even in conditions of full employment, but with 3 million registered unemployed and another 2 million in the shadows, the whole of the emphasis must be on job creation. This does not rule out selective assistance to firms in areas of exceptionally high unemployment, but even this needs to be closely monitored to ensure that the expenditure is justified in terms of the number of jobs provided. We believe that subsidies to jobs, as with our proposal for reduced National Insurance contributions, are much more appropriate in current circumstances.

There is nevertheless a case for providing loan finance to firms in manufacturing industry at a low rate of interest to avoid the uncertainties of the overdraft system in times of stress. This would have the added advantage of making productive industry independent of the City and impressing on the financial establishment the Government's determination to put the interests of the real economy before those of the money economy. We therefore propose the establishment of a National Investment Bank with unlimited capital – financed in effect, if not in name, by revenue from North Sea oil – to rediscount a specified proportion of every eligible loan to manufacturing industry by approved institutions for periods up to 15 years at a fixed rate of interest. The proportion initially would be 90% and the rate substantially below market rate. The lending institutions would provide the balance and charge an agreed market rate. The loans would be available to finance working capital as well as plant and machinery, especially in the recovery stage.

The loan scheme might need to be supplemented in the early stages by a crash programme designed to make the fullest possible use of our existing, if depleted, resources. Such a programme might include grants to employers to cover:-

- 75% of specified costs of re-opening any plant within 12 months of the election date or of an "appointed day", together with a *per capita* payment for each individual job provided.

- a *per capita* payment for each additional job provided in an existing plant for a period of one year.
- 25% of the cost of building a new plant or a new extension plus a *per capita* payment for each new job provided.

The total cost of employment subsidies and investment growth might be £2.5 billion each year.

Monetary and Credit Policy

There would be little point in or possibility of reflating the economy unless monetary policy were adjusted to accommodate expansion. That would require a complete break with past orthodoxy. Interest rates, monetary and credit policies – so long seen as instruments of deflation – must be consistent with an expansion of demand and an exchange rate target fixed in the interests of the real economy.

Monetarists have constructed a whole economic theory on the basis of the undeniable fact that inflation occurs when too much money chases too few goods. There is nothing in that simple proposition, however, which means that inflation is best cured by reducing the supply of money rather than by increasing the supply of goods. When the economy is less than fully employed, as is certainly the case at present, the emphasis should be on increasing the supply of goods, and monetary policy should aim at the cheap and plentiful supply of money which is needed to finance this expansion.

Monetary policy since 1973 has been far too tight, as is evidenced by high interest rates, a 50% increase in the velocity of circulation, and the savage deflation of demand. It must be relaxed until interest rates have fallen to the level required to finance expansion and to reduce the exchange rate to a more competitive level. The ratchet of tight money, high interest rates and a high exchange rate must be reversed and this can only be achieved by a policy of easy money, low interest rates and a low exchange rate.

A strategy based on expanding the money supply, or what is pejoratively described as "printing money", may sound revolutionary, but it is in fact the mechanism which, even under the Gold Standard, ensured recovery when the trade cycle turned down too far. When this happened, gold flowed in, interest rates fell and trade picked up. This is also what happened when we went off gold in 1931. The real money supply increased by 21% between 1929 and 1933 and this helped to push down the rate on Treasury Bills to only 0.71% in 1933. Cheap money, combined with protection from imports, was largely responsible for an increase in manufacturing output of 53% in the period 1931-1937 – the most successful performance of any industrial country at that time. Monetarists choose to ignore this because it confounds their prejudices, but it shows clearly, as the more recent experience of Japan and Germany also shows, that an accommodating monetary policy is a necessary pre-condition for growth.

The lesson which we must repeat over and over again is that growth reduces costs in real terms, and that an increase in the money supply cannot of itself be inflationary if labour and capital are under-utilised.

The lesson which we must repeat over and over again is that growth reduces costs in real terms, and that an increase in the money supply cannot of itself be inflationary if labour and capital are under-utilised. Our problems are entirely due to a combination of an overvalued exchange rate, combined with excessive saving, and they will only be solved by giving people the opportunity to spend more and, as a necessary corollary, allowing a more flexible monetary policy to bring down the exchange rate. We must not be afraid of increasing the quantity of money by whatever amount is required to achieve this objective. We must likewise ignore pressure from the City to fund the borrowing requirement, because funding takes out of circulation money which would be better spent on goods and services.

It has been argued that it is not within the Government's power to reduce interest rates and the exchange rate in opposition to market forces, but this would only be true if the Government relinquished its control over the monetary system. This is in fact what Mr Heath did in 1971 when he abolished the long-standing controls on the creation of credit, and what the present Chancellor did in 1979 when he added to the problems of monetary management by abolishing exchange controls.

Labour is committed to the reintroduction of exchange controls, not only because money has gone overseas which would otherwise have been invested in British industry, but because the free movement of capital over the foreign exchanges would make it impossible for us to reduce our interest rates independently of world interest rates. What we need are exchange controls which effectively limit the movement of capital in both directions, reinforced by the imposition of a withholding tax at the standard rate on gilt-edged securities held by foreign residents.

Selective controls on the expansion of domestic credit are also needed. The removal of selective controls in 1971 was responsible for the asset speculation which so disfigured the Heath era and sparked off the monetary explosion of 1972-3. The responsibility for this must lie with the Bank of England which had persuaded the Government to agree to a free-for-all, in which manufacturing industry soon dropped to the back of the queue. An attempt was made after the secondary banking collapse to introduce a monetary f[illegible] control over the banking system – popularly known as the "corset" – but this was based on aggregate deposits and left the banks free to lend in the most profitable markets, effectively diverting funds from productive and unproductive use. What is now required is a form of control designed to keep down interest rates by penalising speculative and less essential lending. This could be achieved by adjusting the Reserve Asset requirements for each Bank to take into account the quality as well as the quantity of its lending. The controls would have to be extended to all licensed deposit-takers under the new Banking Act and could of course be varied from time to time. No interest would be paid on reserve assets and a high reserve ratio for a particular category of lending could make the cost of lending in that category prohibitively expensive. There would be little or no need for restraint in the early stages, but when the need arose, control over credit would be much more effective than control over the money supply has been.

The initial reaction to the election of a Labour Government would be a flight of capital, a fall in the exchange rate and a rise in interest rates as capital values fell. There would be a sterling "crisis" and demands from every side for the Government to intervene. To do so would be to repeat the mistake of the present French administration which, by committing itself to monetary orthodoxy, has put at risk its whole programme for getting the French economy back on the rails. We must make it clear *before* we take office, that there is virtually no level at which a Labour Government would be prepared to support the pound in the short-term and that there is no prospect of our being held to ransom by a refusal on the part of the City to fund the Government's debt to the banking system at the target rate of interest. We must simply sit tight until they capitulate.

The Exchange Rate

In 1977, we wrote in an earlier Fabian tract

(*A Competitive Pound*, Tract 452) that if we were to achieve that combination of internal expansion and external equilibrium which is usually described as export-led growth, the exchange rate must (as a necessary though not sufficient pre-condition) enable us to sell in international markets (including our own) at a price which is both competitive and profitable; and that it was not enough that this conjuncture of competitiveness and profitability in export markets should be temporary – we needed an assurance that exporting would be set on a course of expansion and profitability so that long-term investment in new capacity would be encouraged.

Our experience since then has been the exact reverse of this prescription. A grossly over-valued currency has been the engine of deflation. The real exchange rate, measured in terms of relative export prices, rose nearly 50% between the fourth quarter of 1976 and the first quarter of 1981. It has since fallen by well over 10%, but this is due mainly to the increase in the value of the dollar, itself the result of American monetarist policies. The over-valuation of sterling against Germany and Japan – our main competitors – remains at nearly 50%. This unparallelled loss of competitiveness has slashed output, destroyed markets and sent unemployment and insolvencies soaring.

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The only way to reverse the destructive loss of competitiveness and the consequent attrition of our manufacturing base is through the exchange rate. No other measure is remotely as effective and quick-acting. The Bank of England in its Quarterly Bulletin of September, 1982, published the results of a study which showed that even a token depreciation of 5% was more immediately helpful to industry than either a 2% increase in productivity or a 5% fall in wage settlements; and while even these marginal improvements in productivity or falls in wages can only be achieved over time, with difficulty and at a considerable price, a much more substantial devaluation than that postulated by the Bank could be immediately put into effect.

In other words, no amount of deflation, of forcing down the level of real wages at enormous cost, or of spurious and unsustainable productivity improvements, can possibly restore the huge margin of competitiveness which has been lost. Unless the exchange rate is brought down quickly to a more realistic level, British industry will continue to lose markets and to be starved of the resources needed to invest, innovate and expand.

But there is another important reason for advocating a competitive exchange rate, or at least the abandonment of an uncompetitive one. Just as a high exchange rate has been the motor of the monetarist ratchet, so a willingness to allow the rate to fall is an essential element in escaping the monetarist straitjacket. A new Labour Government might well come to office with every intention of pursuing a policy of cheap money and substantial reflation of demand; but if it is tied to a particular parity for sterling, or any other monetary measure, it will find itself, as the French socialist government has done, compelled to make its monetary and fiscal policies conform to its exchange rate target. Only by refusing to tie itself to an over-valued rate can a Labour Government be free to pursue an autonomous credit and monetary policy and to finance the expansion of the economy.

The problem of exchange rate management is to identify a suitable target. Traditionally, the rate has been managed, or at least assessed, in terms of sterling's parity against gold, the dollar, or more recently, against a basket of currencies. It is essential however, that we should break with this practice. A target expressed in terms of the nominal parity against another currency or basket of currencies takes no account of differences in inflation rates and therefore fails to reveal what is actually happening to our international competitiveness. This makes it more difficult to be sure that the necessary improvement in competitiveness has been achieved. Our concern must therefore be with the real, that is inflation-adjusted, exchange rate.

Commonsense suggests that we should pay particular attention to the relative prices actually charged for internationally-traded manufactured goods. The difficulty with using an index of relative export prices for manufactures as an exchange rate target is that information about such prices is very slow in coming through. It is for this reason that we favour the terms of trade for finished manufactures as the principal indicator of competitiveness. Imports of manufactures now exceed exports and a measure based on the monthly statistics which reflects the prices of both seems to us more useful than any other.

The initial objective must be to get the real exchange rate, measured in terms of the index of the terms of trade in manufactures, down to the level of competitiveness which the Government undertook in its Letter of Intent to the IMF to maintain – an undertaking which, unnoticed by most commentators, was almost immediately broken. To return to this level is therefore not a particularly ambitious or unrealistic target. It would require an initial devaluation of about 30% – itself an indication of how far the real exchange rate has become over-valued. Further small devaluations might be necessary to take account of the effects of the first devaluation and to maintain the index of the terms of trade for manufactures at its target level.

The initial shock to "confidence" following the introduction of a reflationary package should be welcomed because it will help to ge the rate down. No attempt should be made to arrest the fall. Confidence would soon return as the prospects of industrial recovery lifted the price of ordinary shares on the stock market and the fall in interest rates raised prices in the gilt-edged market. The problem then would be to hold down the exchange rate to the target level. We would face the problem of neutralising the adverse effect which North Sea oil has had on the balance of trade in manufactures.

We should therefore think in terms of a two-tier exchange rate which would require importers and exporters of goods to purchase their foreign exchange from authorised banks at whatever rate of exchange was deemed to be consistent with the exchange rate target, leaving the rate for other transactions to be determined by market forces until it came into line with the target rate.

There should be no difficulty in administering such a scheme. The reintroduction of exchange controls will mean that traders again have to produce exchange control documents to HM Customs and Excise on importation and exportation. These documents would not be issued unless the deal had been financed at a specified rate.

In the longer term, the problem of holding down the exchange rate in real terms is likely to be less formidable. We shall be consuming more food and importing a higher proportion of what we consume. More will be spent on foreign holidays. We shall need to import more capital goods, materials and components to increase our productive capacity and to ensure that the non-renewable resource of North Sea oil is used to finance investment in productive industry. The exchange rate must be kept down to a level which allows us to make the maximum use of all our resources.

2. Inflation

Few now dispute that it is the massive loss of competitiveness which is British industry's chief burden; and most economists and a growing number of financial commentators now accept that the exchange rate is the only effective instrument for reversing it. Devaluation is however almost universally believed to be inflationary – especially when accompanied by a substantial reflation – and it is for this reason that what would otherwise be the most obvious and effective remedy for our problems is either resisted or accepted only half-heartedly.

Yet there is little evidence on which to base this prejudice. Our own experience of devaluation suggests, if anything, the opposite. In 1931, after we had left the Gold Standard and the exchange rate had fallen by 35%, prices actually fell. In 1949, at a time of full employment, we devalued by 30% and in the next 12 months prices rose by less than they had in the 12 months preceding the devaluation. (What subsequently pushed up the inflation rate was the trebling of raw material prices after the outbreak of the Korean War).

In 1967, when the rate of unemployment was only 2.5%, the exchange rate fell by 14.3%. In the next two calendar years, the prices of consumer goods and services rose by 4.5% and 5.2% respectively, just fractionally more than the increases of 4.7% and 4.0-% in 1965 and 1966. More significantly, the price of manufactured goods rose less than prices generally and the increase of 3.9% in 1969 was actually less than the figure of 4.0% in 1968 and the increase of 3.9% in 1965.

Few now dispute that it is the massive loss of competitiveness which is British industry's chief burden.

This was despite the fact that the employers' National Insurance contribution was more than doubled to 11.6% in 1966, with a further increase to 15.9% in 1969. Two-thirds of the advantage conferred by the devaluation to our competitiveness was thereby wiped out by the Government's own actions. Nobody seems to have noticed that this massive tax on jobs was even more inflationary than the increase in VAT from 8% to 15% in 1979. Could there be a better example of how little the issues are understood and how facile are the conclusions which even the supposed experts draw from the evidence? Most of these experts point to our experience of inflation in the mid-1970s when prices rose rapidly as sterling fell. This confuses cause and effect. Inflation peaked in 1975 and the pound fell sharply towards the end of 1976 – a consequence rather than a cause of the inflation. The pound's steady appreciation from 1977 onwards produced a new inflationary peak in 1980; the subsequent fall in the inflation rate in 1981-82 has been accompanied by a fall in the value of sterling, at least against the dollar – the rate which most directly affects import prices. There is little evidence here of the inflationary consequences of devaluation.

It is of course true that, in conditions of full employment, real wages must fall to enable a devaluation to succeed and that, in the absence of such a fall, prices must rise by the full amount of the devaluation. When the economy's resources are fully employed, the additional resources required for exports – to pay for the same quantity of imports as before – must come from some other sector of the economy. But this is a text-book proposition with no relevance to our present situation.

The real world is very different. We have a huge margin of surplus capacity and if the extra demand were there we could produce far more with our existing resources than would be required to pay for our increased import bill. Even in 1949, when unemployment was only 1.3%, we found that there was sufficient margin to increase exports substantially without cutting real wages. We have grown so used to restricting our potential for growth in the interests of defending a particular exchange rate that we do not realise how positively the economy would respond once the brakes were taken off.

This does not mean that a devaluation will not raise the price of imports. Indeed, import prices must rise relative to domestic prices if any strategy for growth is to succeed. We cannot have cheap imports and full employment. But an increase in import prices need not be inflationary overall where the scope for increasing economies of scale and therefore of reducing unit costs (in terms of both export sales and import substitution) is larger than the addition to costs resulting from a fall in the exchange rate.

The firms which are going down like ninepins are in industries which depend on high volume rather than high margins for profitability – steel, chemicals, textiles, motor cars, electrical appliances, cycles, toys and hundreds of other mass-produced goods. These are the industries which respond very rapidly to changes in price competitiveness and which are able, in conditions of high volume sales, to combine high wages with lower costs and prices, the perfect antidote to our present inflation. It is this counter-inflationary effect of expansion and increasing competitiveness which has so benefitted our successful rivals.

The example of Japan is particularly instructive. The rate of domestic inflation in Japan between 1952 and 1979 was almost as great as in the UK – 364% compared to 442% – but over the same period the unit value of Japanese exports rose only 33% compared to 380% in the UK. Even the Treasury conceded that this amazing success in holding down Japanese export prices was attributable to the economies of scale made possible by a near fortyfold increase in the volume of exports, mainly in electrical and other machinery.

The objections to devaluation on inflationary grounds are powerfully reinforced by the almost universal belief that we remain an economy which imports food and raw materials and pays for those imports by exporting manufactured goods.

The objections to devaluation on inflationary grounds are powerfully reinforced by the almost universal belief that we remain an economy which imports food and raw materials and pays for those imports by exporting manufactured goods. It is therefore argued that we cannot increase the competitiveness of our exports through devaluation without at the same time raising the cost of essential imports and therefore adding to industrial costs. The truth is that we are net importers of manufactured goods and over two-thirds of our import bill is accounted for by manufactures. Very little of what we import does not compete directly or indirectly with domestic production. Only 8% of our import bill is accounted for by raw materials and even some of these, such as aluminium, could be produced domestically if the exchange rate altered relative prices.

Even the increase in the price of crude oil which would result from a devaluation would encourage the use of coal; moreover, because we are substantial net exporters of oil, the increase in government revenue – which accounts for 85-90% of the price – would exceed the increase in cost to consumers and could therefore be used to neutralise the effect on the cost of living. We have in effect been bamboozled into allowing an over-valued exchange rate to depress output, damage competitiveness, swell unemployment, subsidise imports and penalise our own production, all for the sake of holding down the small fraction of our import bill accounted for by those few products we cannot produce ourselves.

The simple truth is that growth is itself a counter-inflationary force.

The simple truth is that growth is itself a counter-inflationary force. It not only encourages a reduction in unit costs, but the extra resources can be used, through the tax system, to act directly on prices and thus damp down any inflationary effects of the necessary increase in import prices.

This latter point has been grasped, though imperfectly, by the proponents of import controls. They argue that although import controls are the inflationary half of a devaluation, their effect will be less inflationary than devaluation because the proceeds of the tariff can be used to reduce prices. What they do not appear to understand is that a tariff is just another tax. What matters is the volume of extra resources rather than the precise form of the tax which raises revenue for price-cutting purposes. With devaluation, a fully effective corporation tax can be used to reduce prices in exactly the same way as a tariff would do. Indeed, because a devaluation stimulates exports even more than it helps to reduce imports, it will result in much higher levels of output and revenue for any given level of import price inflation, and therefore must be much less inflationary than import controls.

There seems therefore to be no good reason for eschewing the most obvious and directly effective measure to reverse the loss of competitiveness which has so damaged British industry. The solution to our problems clearly lies in a package of measures providing all the advantages to growth, profitability and competitiveness which can be expected from a devaluation and expansionary monetary policies, but which at the same time uses some of the additional resources thereby created for directly counter-inflationary purposes.

Many people fear that a devaluation-based expansion would lead, in the aftermath of a wages freeze enforced by high unemployment, to a wages explosion and that a formal incomes policy would be needed to control it. We do not agree.

Not only is there no evidence that a formal incomes policy is either obtainable or, in the longer term, effective, but we believe that it is not desirable either. To freeze the current pattern of wage levels would be to frustrate the ability of manufacturing industry to offer higher wages and increased rewards to the skilled labour which will be needed.

We do accept, however, that an understanding on the overall level of wage settlements would be helpful, and that the chances of sustaining an expansionary policy would be increased if wages were not to rise too fast. This does not mean that real wages should not rise – indeed, the whole point of an expansionary policy would be to ensure that they did.

What it does mean, however, is that a planned increase in real wages, on the basis of a voluntary understanding, would have a better chance of being sustained than if there were a free-for-all. We are optimistic about the chances of such an understanding in the unprecedented conditions which the expansionary programme would create.

Wage settlements would be made in a context which included a very substantial increase in take-home pay as a result of an increase in the tax threshold, combined with a reduction in the National Insurance concession; a much-improved social wage as a result of increased benefits and public spending; a lower inflation rate; rising output and productivity; a reduction in the cost of living as a result of lower food prices and lower interest rates and the stabilisation of public sector prices; and a wholehearted commitment to full employment. These objectives, and the real prospect of achieving them, would be explained fully by Ministers to trade union leaders and wage negotiators; the trade-off between the level of wage settlements and these other objectives would also be made clear. For the first time, an agreed policy on wages would be seen as an element in clear and itemised strategy for growth, rather than as a means of deflating the economy.

3. The Treasury Model

A package of this type, with a large devaluation and a massive reflation of demand, would cause apoplexy in the City. It would run counter to every tenet of monetarism and would provoke a huge loss of confidence: this need not worry us, provided that we are prepared for it and do not lose our nerve.

There will be many, however, well beyond the ranks of dyed-in-the-wool monetarists, who might applaud the expansionary ambitions of such a programme, but who would nevertheless expect it to spark off an inflationary bonfire. The basic belief that an increase in the money supply must be inflationary dies hard.

One way of testing such an expectation is to run the expansionary programme on a computer model of the economy. The most authoritative of such models is that constructed by the Treasury who use it to produce their economic forecasts (the base run) and to assess the likely outcomes of different economic strategies.

Members of Parliament have a limited access to the Treasury model and we were able, therefore, through Austin Mitchell, MP for Grimsby, to subject our programme to a test run.

We should say at the outset that we have some important reservations about the utility of such an exercise. As long ago as 1901, Alfred Marshall, the father of modern economics, pointed out that since not every economic fact can be expressed in numerical terms, the application of exact mathematical models to those which can is nearly always a complete waste of time.

Our suspicions of the Treasury model, in particular, are exacerbated by the fact that many of its assumptions are frankly monetarist and rely on past relationships which have little relevance to present circumstances, and by Sir Geoffrey Howe's recent admission that the model is unable to handle proposals which depart significantly from the course of present policy.

THE TREASURY MODEL

The Treasury Model is a computer programme consisting of a large number of mathematical relationships which simulate the performance of different parts of the British economy. Its main function is to provide predictions of the future based on the continuation of current policies – the "base run" – or on changes in policy to show what their effects might be. The complexity of the Treasury Model provides some check on the internal consistency of its projection. However the output of all such models is very dependant on both the mathematical assumptions and economic theory upon which they are based.

Moreover, the Treasury model incorporates assumptions about the effect of exchange rate changes which are contradicted by our own practical experience in 1931, 1949 and 1967 and which produce a much more rapid erosion of competitiveness than is shown by the most recent work on the subject done by the Bank of

England. Like most models, too, the Treasury model is essentially linear and static in the way it projects developments; we believe, though the model does not, that a 30% devaluation will produce results quite different from those obtained by multiplying a 10% devaluation by three. Nor does the model make any real allowance for the dynamic effects of expansion on productivity and unit costs, though we believe that these effects have been crucial to the success of the Japanese and German economies.

Quite apart from these characteristics, which mean that the model is unsympathetic to the proposals which we advance, we also found that the model was simply not sophisticated enough to simulate some of our more detailed ideas. The computer, for example, does not allow us to test our proposals for discriminating in favour of industry.

The modellers themselves have some doubts about the model. We understand that the Treasury now think that the model overstates by 100% the monetary consequences of reflation and that these assumptions are to be changed. Even more surprisingly, when we tried an initial test run for our proposals, the results were regarded by the Treasury as so favourable that we were advised to delay a second run until the model could be checked and if necessary adjusted.

Despite these reservations, we did nevertheless decide to test our proposals on the Treasury model, mainly because a failure to do so would be taken by all those who attach great importance to modelling as a lack of confidence in the proposed programme. In order to accommodate the limitations of the model, we have had to modify and simplify some of our proposals. The main effect of this is that the stimulus we would prefer to provide to manufacturing industry in particular has had to be made more general and less selective and that the impact of some of our counter-inflationary proposals has been blunted. The main elements in the package which we ran on the Treasury model are as follows:-

- **The abolition of the National Insurance surcharge, a 50% reduction in the employers' contribution and the abolition of the employees' contribution.**
- **The indexation of income tax allowances, following a 10% increase to restore the ground lost under the present Government.**
- **Food subsidies totalling £3 billion pending withdrawal from the Common Agricultural Policy.**
- **Reductions in school meals, medical and dental charges, fares etc – total cost £500 million.**
- **Social security bonuses to cost £1.4 billion.**
- **Price stabilisation in the public sector, including the nationalised industries.**
- **Additional public investment to a total of £1.5 billion in the first year and £1 billion each year thereafter.**
- **Subsidies to employment and investment help costing £2.5 billion.**
- **A devaluation of 30% together with an increase of 5% in the tariff on manufactured imports.**
- **The imposition of exchange controls.**
- **Interest rates to be reduced to 6% (long-term) and 4% (short-term) with a commensurate monetary policy.**
- **The abolition of capital allowances and the imposition of a fully effective Corporation Tax.**
- **No formal incomes policy but an assumption that wages will rise in line with the base run forecast – a forecast which now looks rather high and allows an increase comfortably ahead of the likely inflation rate.**

In broad terms, therefore, the package comprises a £20-£25 billion reflation, backed by a very substantial devaluation, just the kind of package which the public have been led to believe would create huge problems on inflation and the balance of payments. The actual out-turn compared to the base-run is shown in the following table:

REFLATION: DIFFERENCES FROM BASE RUN

	1982/3	1983/4	1984/5	1985/6
GDP	+5.4%	+9.9%	+13.3%	+14.6%
Manufacturing output	+7.4%	+14.7%	+18.7%	+21.4%
Employment (000s)	+404	+1074	+1723	+2059
Wage costs	−2.7%	−1.8%	−1.1%	−1.1%
Retail prices	−3.1%	−1.6%	−1.1%	−0.6%
Real Disposable Incomes	+7.5%	+7.9%	+10.6%	+11.9%
Borrowing Requirement	+£12.3bn	−£0.6bn	−£13.3bn	−£19.5bn
£M3	+35%	+65%	+81%	+29%
Domestic Credit	+£50bn	+£16bn	+£6bn	−£29bn
Money velocity	−18%	−26%	−29%	−30%
Relative Export Prices	−20%	−11%	−12%	−12%
Balance of Payments (Current account)	−£2.5bn	+£3.7bn	+9.0bn	+£11.4bn
Index of Terms of Trade for manufactures	107	113	112	112
Oil taxes	+£4.4bn	+£8.1bn	+£9.6bn	+£10.2bn
Company taxes	0	+£12.3bn	+£23.1bn	£30.8bn
Companies – disposable income	+£11.4bn	+£13.3bn	+£9.7bn	+£10.6bn

The predicted benefits to GDP and employment are shown strongly, though we must emphasise our conviction that, for the reasons given above, the model has understated them. It is also clear that we have ourselves made mistakes which we would hope to correct in further runs with correspondingly better results. The figures for relative export prices and the terms of trade or manufactures show that we have failed to improve competitiveness to the target level; and Corporation Tax proves, in the last year or two of the period covered by the forecast, to be such an effective revenue raiser that the effect is far too contractionary. We could, in other words, afford a much greater degree of expansion in the later years. What the Treasury model does do, however, is give the lie to the nonsense that "there is no alternative" to present policies. It shows that a huge reflationary package with a large devaluation not only provides enormous benefits to the real economy; it also strengthens the balance of payments and, despite a massive increase in M3, lowers the inflation rate. There can hardly be a more dramatic demonstration, on a computer model which is sympathetic to monetarist assumptions, of our basic contentions – that reflation does not necessarily mean inflation, that the money supply has little effect on inflation, so long as there is room for output to rise, and that devaluation is the most effective stimulant to output and employment. Expansion is disinflationary. Boldness pays.

4.Conclusion

The results of the computer run do no more than offer a partial confirmation of what economic theory and commonsense would in any case lead us to expect. It is worth re-stating the fundamentals of the argument which underlies the construction of our package.

The reason for the collapse of output and employment is that markets which offer prices to cover the costs of production cannot be found for the goods which our idle factories could be producing. This is a consequence of the deflationary policies pursued by successive governments and of the huge loss of competitiveness suffered by British industry. A generalised lack of competitiveness is irrefutable evidence of an overvalued exchange rate and can only be reversed quickly and effectively through depreciation. The commonly held objection to devaluation, that it is inflationary, is not supported by our own practical experience and, as a text-book proposition, is falsified by the real-world situation of under-utilised capacity in which we actually find ourselves. There is little to risk and much to gain in this situation from an increase in spending and a substantial devaluation, since the potential for increased output will more than offset the inflationary consequences of expansion. Counter-inflationary forces can be strongly reinforced if a major part of the reflation of demand takes the form of measures which will directly reduce wage costs and prices.

We are confident that a package of this type will work. The Treasury model understates its merits but points us in the right direction, as does the practical experience of Britain and of other more successful countries. The main threat to its success lies in the risk that the next Labour Government will lose its nerve when it comes under pressure, as it will, from the domestic and international financial establishment. That is why it is essential that the hard preparatory work is done now, so that the Labour Government will have the intellectual self-confidence and political will to carry the programme through.

The success of the programme depends, in other words, on our readiness to think more radically about our problems than we have done in the past and to free ourselves from those orthodoxies which have dominated policy-making for so long. This is more difficult than it might seem. We have been conditioned for over a century to believe that financial rectitude is all that matters. The chief distinguishing characteristic of British economic policy throughout that period has been the excessive attention paid to the interests of the financial establishment. Whereas other more successful countries have tailored their economic policies to suit those who make and sell manufactured goods, we have habitually deferred to the interests of those who hold assets and deal in money.

The result has been policies of extreme financial orthodoxy which have done great damage to the real economy. Today's monetarism is only the most recent and virulent expression of a recurrent theme. The tragedy is that Labour governments have been just as ready as the Tories to subordinate their real economic objectives to the monetary talismans – the Gold Standard, the parity of sterling, the money supply – which the financial establishment has been so adept at inventing.

This susceptibility on the part of Labour governments to the special pleading of financial interests has been particularly destructive of any truly socialist attempt to resolve our problems. It is not on the floor of the House of Commons or in the legislative programme, but in the relationship between a Labour Chancellor and his Treasury and Bank of England advisers, that the real failures of Labour governments have arisen and the betrayal of working class interests has occurred. Yet we are still so far from learning this vital lesson that even those who are supposedly on the radical Left of the Party not only ignore the traps which the bankers set for them, but on occasions actually urge the Party to walk into them – it is only a few years ago that Tribune was urging an appreciation of sterling on a Labour government.

It is still the case that those who advocate the Alternative Economic Strategy seem totally unaware of the fact that a willingness to defend any rate for sterling, or to bring the money supply within any target limit, or to accept any other monetary measure, will simply hand over the general direction of economic policy to the financial establishment, and will render nugatory any of the other socialist measures which might be introduced.

This is all the more surprising since there is no shortage of lessons to be learned. The 1964 Wilson Government wasted its early years of promise in a futile effort to defend sterling; and ruined its 1970 electoral chances, after a devaluation which was typically too little and too late, by a severe deflation. The 1974 government exhausted the reserves in defending sterling and had to turn to the IMF for help; and then paradoxically turned its back on the IMF's prescriptions, at the behest of the Bank of England, by attaching over-riding importance to the money supply, irrespective of what happened to interest rates and the exchange rate.

That government offers a little-known, but all too common example of how destructive an attachment to a monetary measure can be. In April, 1978, Denis Healey ventured a modestly reflationary budget. The money markets took against it; in particular, they calculated that the reflation could be financed only by allowing the money supply to grow, that the Chancellor would therefore be bound to try to sell more gilt-edged securities, and that this could be done only by raising interest rates. Because the Chancellor had conceded what then seemed to be the supreme importance of the monthly £M3 figure (something which has now been quietly ignored), he was the prisoner of the money markets' logic. Their prophecy was self-fulfilling; they refused to buy gilts until interest rates were raised, and the modest attempt at reflation was brought to an early end. It is in such small, unremarked and losing battles that the failures of Labour governments consist.

The Mitterand government in France is now learning the same lesson. Once it conceded that a particular parity for the Franc must be defended, everything else – public spending, interest rates, monetary and fiscal policy – must all fall into line and even the most radical of policies is brought to a juddering halt. The bankers can always frustrate the reforming aspirations of radical governments by persuading them to accept the over-riding importance of whatever monetary measure is currently fashionable.

If the next Labour Government is to make a successfuul attack on unemployment, make full use of our resources and truly serve the interests of the working people of this country, it is essential that we should throw off the dead hand of financial orthodoxy. Nothing that is achieved by way of public ownership, industrial reorganisation, or the planning of trade will be of more than marginal value unless we get a grip of our exchange rate, monetary and credit policies and consciously make them a coherent instrument for securing our objectives.

POSTSCRIPT

Readers who have seen Labour's Programme for Recovery *published 23 November 1982 may well ask why the results of our computer runs are so much more favourable. The short answer is that in our case:*

* *devaluation is immediate and not spread over two years*
* *the compensatory measures to reduce inflationary pressures are much larger, much more broadly based and much more immediate in their effect.*

In other words, boldness pays. The results obtained from a further run on the Treasury Model of the economy confirm this and readers who would like to see these should send a large stamped addressed envelope to:

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72 Albert Street
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Economic Recovery: what Labour must do

The authors argue that reducing unemployment must be the major priority of the next Labour government. They believe that the quickest and easiest way to achieve very substantial reductions in unemployment is by lowering the pound's value through devaluation. They argue that the pound has been grossly overvalued for most of this century with resultant damaging effects on industrial production and capacity and to employment. A weakened industrial sector and over-powerful financial sector are the consequences of a high exchange rate policy.

Starting from this analysis the authors put together an economic package for industrial and employment growth for a future Labour government. There are many such "packages" but few based on so coherent an analysis and even fewer tested on the Treasury's own computer model of the economy.

This pamphlet offers hope to industry and to the unemployed and provides a counterpoint to the emphasis on import controls of Labour's economic strategy.

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The Fabian Society exists to further socialist education and research. It is affiliated to the Labour Party, both nationally and locally, and embraces all shades of Labour opinion within its ranks – left, right and centre. Since 1884 the Fabian Society has enrolled thoughtful socialists who are prepared to discuss the essential questions of democratic socialism and relate them to practical plans for building socialism in a changing world. Beyond this the Society has no collective policy. It puts forward no resolutions of a political character. The Society's members are active in their Labour parties, trade unions and co-operatives. They are representative of the labour movement, practical people concerned to study and discuss problems that matter.

The Society is organised nationally and locally. The national Society directed by an elected Executive Committee, publishes pamphlets and holds schools and conferences of many kinds. Local Societies – there are one hundred of them – are self governing and are lively centres of discussion and also undertake research.

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