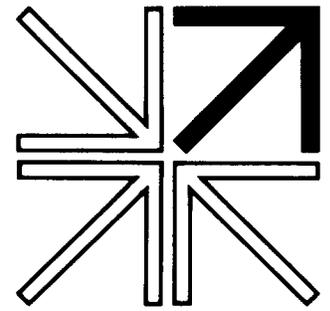


ECONOMIC COMMENT



NOVEMBER 14, 1980

CAN MRS. THATCHER DO IT?*

The British election in the spring of 1979 brought to power a Conservative government committed to a policy of reducing inflation and increasing the growth of real output and productivity. In the recent past, Britain even more than the United States experienced high inflation and slow growth of output and in common with the United States suffered from excessive regulation and scarce improvement in productivity. Between the sixties and seventies, inflation in Britain increased from an average of 4% to 13%, and the growth of output slowed from 3% to 2% or less.

Past Failures. The proximate causes of the British "disease" are well-known. The welfare state sustained a bloated bureaucracy with little incentive to serve the public. Attempts by government to fine-tune the economy from quarter to quarter have been followed by higher inflation, higher unemployment and slower growth of output. Reliance on formal and informal wage and price controls forced successive governments to confront the labor unions and produced a series of political skirmishes that made politics lively but left only heightened skepticism about the ability of any government to control inflation.

Nowhere was the belief more widely held, or more often repeated, that inflation could not be reduced as long as the labor unions refused to accept reductions in their real income. Those who held these beliefs had a ready explanation for every failure. Conservative governments were too hostile and harsh in dealing

with the unions. Labor governments were too friendly and unwilling to confront their party colleagues. No party seemed to find just the right approach according to the conventional view.

The Current Program. Prime Minister Thatcher's government replaced these counter-productive policies with a medium-term strategy to control inflation and increase growth of real output. There are five main elements in the new government's program.

1. The government's share of total income is to be reduced 1% a year to reach 40% by the 1983-84 fiscal year. (If the United States adopted a comparable program, government spending would be reduced approximately \$25 billion a year from currently projected levels.)
2. To increase incentives for private saving and reduce the size of the budget deficit while limiting the loss of tax revenues, the government decreased taxes on income and raised them on spending. The basic income tax rate was cut from 33% to 30%, and the maximum tax was lowered from 83% to 60%.
3. Subsidies to state enterprises and housing were pared, and publicly held shares in several state enterprises were sold to private investors.
4. A target growth rate of money (defined as currency and demand and time deposits) was set at 7% to 11% for the first year. This was the initial step in a policy of sustained, annual reductions in money growth.
5. Exchange controls were removed; for the first time in many years, Britons were permitted to invest in foreign securities without restrictions.

The first three items are major ones in a program of fiscal reform providing incentives to work, save and invest. The program recognizes three important principles. First, the main and lasting benefit of tax reduction comes from those that are concurrent with reductions in the size of government and not from those that leave the size of the government unchanged. Second, a main effect on incentives to work an additional hour or an additional day comes from reducing marginal tax rates, while incentives to work or remain on welfare are influenced by the minimum tax rate. Third, to increase growth, employment and real income, resources must shift from declining industries to growing industries. Subsidies to failing firms and to state enterprises prevent or delay the adjustment, so they reduce efficiency and the British standard of living.

*This article was prepared by Allan H. Meltzer, John M. Olin Professor of Political Economy and Public Policy, Carnegie-Mellon University. The views expressed in this article are not necessarily those of Mellon Bank, N.A.

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ECONOMIC AND FINANCIAL STATISTICS

	Most Recent Week 10-29-80	Change From	
		Week Ago 10-22-80	Year Ago 10-31-79
Banking Data—Large Commercial Banks			
(millions of dollars)			
United States			
Total Loans Adjusted.....	\$412,574	\$+2,497	\$+25,204
Commercial and Industrial Loans.....	166,208	+ 244	+12,709
U. S. Treasury Securities.....	37,679	- 293	+ 2,319
Tax-Exempt Securities.....	54,924	+ 8	+ 5,869
Demand Deposits Adjusted.....	108,086	+ 190	+ 2,817
Total Time Deposits Excluding Large CD's.....	151,344	- 456	+16,175
Negotiable Certificates of Deposit over \$100,000.....	138,026	+3,037	+11,691
	<u>10-29-80</u>	<u>10-22-80</u>	<u>10-31-79</u>
New York City			
Total Loans Adjusted.....	\$ 96,586	\$+1,957	\$+ 8,879
Commercial and Industrial Loans.....	48,565	+ 160	+ 3,182
U. S. Treasury Securities.....	8,105	+ 80	+ 1,791
Tax-Exempt Securities.....	10,835	- 43	+ 1,807
Demand Deposits Adjusted.....	23,904	- 582	- 801
Total Time Deposits Excluding Large CD's.....	18,841	- 86	+ 2,652
Negotiable Certificates of Deposit over \$100,000.....	32,296	+1,439	+ 5,582

Economic Data

	10/80	9/80	Annual Rate of Change	
			3 Mos.	1 Year
Industrial Production¶†	NA	142.4	NA	NA
Unemployment Rate †	7.6%	7.5%		
Nonagricultural Payroll Employment (1,000)†	90,622	90,365	3.4%	0.2%
Consumer Price Index¶	NA	251.7	NA	NA
Excluding Food and Energy¶	NA	236.9	NA	NA
Housing¶	NA	267.7	NA	NA
Producer Prices, Finished Goods¶	252.2	248.9	9.4	12.5
Personal Income (\$ billions)†*	NA	2,159.5	NA	NA
Manufacturers New Orders for Durable Goods (\$ millions)†	NA	78,091	NA	NA
Retail Sales				
Nondurables (\$ millions)†	54,349	54,192	8.8	8.9
Durables ex Autos (\$ millions)†	11,169	11,135	11.3	- 0.5
Private Housing Starts (1,000)†*	NA	1,544		

¶1967=100

†Seasonally adjusted

*Annual rate

NA—not available

ECONOMIC AND FINANCIAL STATISTICS (cont'd)

Interest Rates	11-14-80	Week Ending 11-7-80	10-31-80	Latest Week Change From	
				1974 Highs	1976-77 Lows
				(Basis Points)*	
Short-Term					
Discount Rate	11.00%	11.00%	11.00%	+300	+ 575
Federal Funds	14.65	13.99	13.17	+110	+1,018
Prime Commercial Loans.....	15.50	15.50	14.50	+350	+ 925
Prime Bankers Acceptances, 90 Days†.....	14.60	14.75	13.80	+235	+1,005
Treasury Bill Auction Rates					
91 Days‡	13.51	13.34	12.33	+361	+ 924
182 Days‡	13.23	13.27	12.28	+330	+ 876
Negotiable Certificates of Deposit					
90 Days	14.84	14.88	13.97	+235	+1,028
180 Days	14.47	14.88	13.96	+230	+ 979
1 Year	13.79	14.34	13.75	+274	+ 879
Eurodollars					
30 Days	15.44	15.72	14.60	+162	+1,064
90 Days	15.85	16.40	14.91	+189	+1,084
Prime Commercial Paper					
30 Days‡	14.82	13.59	12.83	+257	+1,032
90 Days‡	14.80	13.81	12.92	+255	+1,017
Prime Tax-Exempt Notes, 1 Year.....	7.00	7.00	6.25	+130	+ 470
Long-Term					
Corporate Bonds, New Issue					
Aa Utility§	14.00%	14.50%	14.25%	+340	+ 620
Aa Industrial§	13.25	13.63	13.38	+340	+ 590
Municipal Bond Buyer Average.....	9.50	9.64	9.45	+235	+ 405
U. S. Governments					
12½% Notes Due 10/31/81.....	13.15	13.96	13.32	NA	NA
11¾% Bonds Due 2/15/10.....	12.13	12.69	12.34	NA	NA
FNMA Auction Rates					
FHA/VA	15.57	NA	15.30	+507	+ 712
Conventional	15.25	NA	14.92	+457	+ 641
Monetary Aggregates					
	4 Weeks Ending		Annualized Rates of Growth		
	10-29-80		3 Mos.	6 Mos.	1 Year
M1-B (Currency plus checkable deposits)†.....	\$411.0		18.3%	13.2%	7.0%
Bank Reserves (Vault cash plus deposits with Federal Reserve banks)†.....	41.6		15.7	7.8	5.3
Monetary Base (Currency plus member bank reserves)†.....	165.1		11.3	9.9	8.1
	Week Ending		Dollar Change Over		
	11-5-80		3 Mos.	6 Mos.	1 Year
Member Bank Borrowings (\$ millions).....	\$1,878		+1,051	+549	- 50
Net Free (+) or Borrowed (-) Reserves (\$ millions).....	-1,287		-1,070	-259	+165

* 100 basis points equal 1.00%

‡Discount basis

§As computed by Salomon Brothers

†Seasonally adjusted, billions of dollars

r—revised

NA—not available

CAN MRS. THATCHER DO IT?

Subject matter continued from front page

The full benefit of the new program will not come until the recession ends. There is no reason to expect a high rate of investment during the current recession. Saving rates appear to have responded, however. The share of after-tax income saved rose, following the shift of taxes from income to spending. Although the new tax law became effective in the latter part of the year, the reported saving rate was one to two percentage points higher in 1979 than in any recent year.

Lower Inflation. The higher rate of saving means that consumers spend a smaller fraction of their incomes on domestic goods and on imports. The volume of imports has fallen, and the value of the pound has increased. The effects of tax reform and recession both work to raise the market value of the pound, so the precise effect of tax reform cannot be inferred.

The rising market value of the pound has two effects. The cost of British exports to foreigners rises, deepening the recession. But the cost of raw materials imported into Britain and the prices of substitutes for British production fall, reducing the rate of price change. Currently, the consumer price index is rising at an annual rate of 11 to 12% compared to a maximum rate of about 22% earlier in the year.

The rising value of the pound, the slower growth of money and the deepening belief that the government intends to persist in the policy of reducing inflation have also lowered expected future rates of price increase. A dramatic sign of this change in beliefs is found in the labor market. Recent gains in hourly wages in the unionized private sector have fallen from above 16% for the past year, to below 10% in recent weeks. The government's policy of reducing the rate of wage increase—without intervening in contract negotiations

and without developing guidelines, guideposts or contracts—appears to be working.

Sustained evidence of success in bringing down the rates of wage and price advances is necessary before anyone can be certain that inflation has been reduced permanently. A sudden reversal of government policy, now, would damage credibility and convince the many skeptics that this government—like previous governments—will not see the policy through.

A sustained, anti-inflation policy is required also to extend the lower rate of increase in wages and prices to other parts of the private sector and to the public sector. Private sector wages are a major element in costs of production. A slower rate of wage increase means that the unions are willing to anticipate slower inflation and to base their contracts on that belief. The slower rate of increase in private sector wages provides leverage for reducing public sector wage increases. This slows the growth of public expenditures and the prospective budget deficit and opens the possibility of additional tax reduction in a year or two.

Can Mrs. Thatcher Do It? It is too soon to call the British experiment with a medium-term, market-oriented approach successful. Responsible proponents of medium-term policies recognize that it takes about two years to convince the public that the government is willing to impose the initial costs so as to achieve the longer-term benefits. Yet, as we move into the second year, Mrs. Thatcher's government shows no sign of yielding to the pressures of the public sector unions concerned about demands for efficiency in the delivery of government services or private sector businessmen worried about short-term losses and the high failure rate of British firms.

Currently, the major threat to success does not come from private sector unions who have been portrayed as villains in often repeated stories about the intractability of inflation in modern economies. The determination of the government and the growing belief that it will persist in its policies stiffens the back of private sector employers and lessens the demands of private sector unions. For many firms the alternative to hard bargaining is bankruptcy; for many union members the alternative to a lower rate of wage increase is a long spell of unemployment.

The government's safety net under individual firms and unions has become smaller as its determination to reduce inflation has become clearer. But as the safety net shrinks, the message spreads to workers and managers and it becomes more useful to believe that the policy can succeed than to insist that it must fail.

Success is not foreordained. Public sector rates of wage increase far above those received by private sector employees. The Bank of England, like the Federal Reserve in the United States, remains unwilling to adopt procedures to control the growth of money. The most frequently used measure of money, known as sterling M3, exploded during the summer to an average annual rate of increase of 41% for the three months ending in August. The twelve-month rate of increase rose to 18%, far above the 7-11% target rate of growth and the rate required for success of the medium-term plan.

Part of the monetary explosion is the result of a change in regulations, so the reported rate of increase overstates the actual rate. Nevertheless, the practices of the Bank of England raise doubts about their willingness to control money growth and leave an uncertain answer to the question: Can Mrs. Thatcher Do It?