

KEYNES LECTURE IN ECONOMICS

FIFTY YEARS ON: SOME PERSONAL
REFLECTIONS

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WHEN David Worswick, speaking as Chairman of Section 9 of the Academy, told me that they wanted me in this Lecture to reflect on my long and varied career, I explained that I would shortly be publishing my memoirs,² and would not wish to plagiarize myself. But he was unmoved and said that if I declined to give the Lecture in 1988, I would be asked to do it in 1989. So I gave in.

Now it is not unusual in these Lectures to start with some personal recollections of Keynes. May I mention two.

The first goes back to 1936 when, as a graduate student, I was encouraged by Roy Harrod, my supervisor, to submit a paper to Keynes, then Editor of the *Economic Journal*. It was on the definition of prime and supplementary costs. He accepted it for the *Journal*, but asked if I could shorten it, and in a long letter made extremely helpful suggestions. I was flattered by the trouble he had taken, which, I am convinced, had little to do with the fact that I had made a minor criticism of his own definition of prime cost in *The General Theory*. I was also impressed by the modest way in which he wrote. His last sentence read: 'If you would be so kind as to attempt another version, it would be easier for both of us to come to a conclusion whether or not it is an improvement'. I wonder how many editors of learned journals today would deal with a whippersnapper of twenty-three in such a courteous manner.³

¹ The original written text has been amended to take account of official statistics becoming available between 8 December 1988 and the end of March 1989.

² *Don and Mandarin: Memoirs of an Economist*. (John Murray, 1987).

³ The article was published in the September 1936 issue of the *Economic Journal*.

Then, seven years later, in 1943, Lord Cherwell (better known as 'The Prof') and I, after attending the Second Quebec Conference between Churchill and Roosevelt, went on to Washington to continue discussions, initiated in Quebec, on Lend-Lease Aid to Britain between the German surrender and the end of the war with Japan. A fortnight later Keynes arrived to represent the Chancellor and I saw a lot of him during the following month. I was enormously impressed, not least by his willingness to listen to a youngster like myself, still only thirty; and not simply, I believe, because I was often representing the Prof, who was out of Washington for much of the time. I also witnessed examples of his well-known readiness to change his mind. On the morning after he arrived in Washington, after Prof had outlined his plan for negotiating with the Americans, Keynes completely disagreed; but in the afternoon, following discussions with U.S. officials, told us he was converted to Prof's approach more or less in its entirety. And once, when Prof was away, he rejected at a morning meeting a proposal I made; but after lunch, when we resumed, said that the best approach was precisely what I had suggested in the morning. He had totally forgotten this, and did not even seem to realize that he had completely changed his mind. I remained silent; but was pleased.

Now to the Lecture proper. I know it does not have to relate to Keynes's work, but I have been concerned during the past fifty years or so with many matters in which he was deeply interested. I had hoped to talk about three or four of these, but found I had time for only two: unemployment and exchange rates; although in discussing these I shall inevitably have things to say about related matters such as inflation, growth, productivity and the balance of payments.

Unemployment

I am one of the lucky ones who has never been unemployed. Although I have had nearly a dozen jobs, not counting numerous short-term and part-time assignments, I have never been obliged to have periods of 'job search' in between. But, having been born and brought up in Glasgow, I was well aware of the miseries of unemployment, seeing large numbers of men hanging around street corners, ill-clad and ill-fed—as early as the 1920s, and much more in the Great Depression of the 1930s, when I also began to appreciate the economic waste involved. (While unemployment in the 1980s may involve, in most cases, less hardship in

absolute terms, I doubt whether it involves less deprivation relative to most of those in employment, or less psychological distress, or less economic waste.)

When I went to Oxford in 1931, unemployment was much less visible there. The employment rate was a fraction of Glasgow's, hardly surprising considering that motor vehicle production fell by only 5 per cent during the Depression, before resuming its steep upward trend, whereas shipbuilding, for example, fell by 85 per cent, and iron and steel output by over 40 per cent. But I was sharply reminded of the unemployment problem, both in Glasgow during vacations and when, one summer, I had close contact with some of the victims at a camp for unemployed in County Durham run by University students (and, believe it or not, I was the Medical Officer for the first ten days until a medical student turned up).

So, when I started to read economics, I was keen to find out what could be done. Now I had an outstanding economist, Maurice Allen, to teach me most of my economics, but a historian tutored me for a paper called 'Economic Organisation'—trained economists were scarce in those days—and one week he set me an essay on how to reduce unemployment. I think this was just before Keynes's famous articles on 'The Means to Prosperity', in which he advocated public works financed by borrowing. In any case I suggested just this. My tutor said it would not work. The only reason he could give was that 'they' had worked out that it would do nothing on balance to help. 'They', I discovered later, were using arguments popular in some circles, but not accepted by me, in the 1980s.

By the time Keynes's *General Theory* was published, in January 1936, I was a graduate student. Cambridge students seemed to know all about it well before then, and I remember the embarrassment of the handful of economics research students in Oxford when we went, in the autumn of 1935, to a seminar in Cambridge at which our counterparts there were talking an almost unintelligible language and tossing around concepts with which we were entirely unfamiliar. But when the book appeared, although it took a big effort to comprehend what seemed to be revolutionary ideas, I eventually began to think that I was getting to the roots of the matter.

Then in Leeds, where I was an Assistant Lecturer in 1936–9, I learned more about the subject. I lectured on industrial fluctuations. I wrote a series of articles for the *Accountant* on official statistics, and one was on statistics of employment and unem-

ployment. This included a quantification of the effects of administrative and definitional changes on the official unemployment figures. Up to 1930, these swelled the figures substantially, but between 1931 and 1939 reduced them by about 275,000.⁴ Such changes have recently been more frequent, and in the past eight years have probably reduced the official figure by around 2–2½ times as much (excluding in general the effects of special employment and training measures).⁵ An example of *déjà vu*—only more so.

Then I did some work for the (Barlow) Royal Commission on the Geographical Distribution of the Industrial Population.⁶ This showed that the slow economic growth, between the wars, of the depressed areas could be largely explained (with the notable exception of mid-Scotland) by their heavy dependence on older industries destined to decline, and not by slower growth in them of more rapidly expanding industries, which in general grew as fast in the depressed areas as elsewhere. This suggested that there might be nothing inherently disadvantageous in their location—one, but not the only, reason why I have always tended to support regional policies, such as the Neddy proposals in 1963 and the Regional Employment Premium in 1967. The classic work of Professor A. J. Brown on regional economics, published in 1972,⁷ showed that my explanation of different regional growth rates between the wars had remained true after the war; and this seems to have continued since he wrote, according to findings of Mr Worswick in last year's Keynes Lecture.

Finally, while at Leeds, I wrote a survey of the trade cycle of 1929–37 for a British Association book entitled *Britain in Recovery*. I included it in two volumes of studies in political economy which I collected in 1973 and 1974 and published in 1975 but only after considerable hesitation, because I feared it might be regarded as 'old hat', since we had surely learned how to prevent depressions anything like so severe as that of the 1930s. How wrong I was. In

⁴ Including an important definitional change in January 1939, after my article was published in November 1938.

⁵ According to estimates by the Department of Employment and the Unemployment Unit of the effects on the unadjusted figures including school leavers.

⁶ Reprinted in my *Studies in Political Economy*, Vol. 1 (Macmillan, 1975).

⁷ *The Framework of Regional Economics in the United Kingdom* (Cambridge University Press; National Institute of Economic and Social Research, Economic and Social Studies, 27).

the early 1980s we had just such a depression. This is sometimes blamed on adverse world developments, an excuse not easy to sustain. The volume of world trade in manufactures—crucial for the UK—fell by 40 per cent in the depression of the 1930s but actually rose during the downswing in British activity in the 1980s. I shall return later to a comparison of the 1930s and 1980s.

Then, in the war, while working with the Prof, I became involved with the problem of how to prevent large-scale unemployment after the war. We did not start working on this until it was fairly clear that we would win the war and could reasonably devote more time to post-war issues. James Meade, then in the Economic Section of the War Cabinet Secretariat, had begun earlier and had considerable correspondence with Keynes on the subject, particularly on a scheme for varying social insurance contributions up and down as unemployment went down and up. This eventually appeared in the Coalition Government's White Paper on Employment Policy of May 1944. I worked with James on his scheme, and supported it, though rather half-heartedly, being somewhat allergic to any automatic schemes fixed in advance for changing policy, preferring a more pragmatic approach.

Prof and I worked hard on post-war employment policy during 1943, and he produced a Cabinet paper on it early in 1944. I was helped by the various things I had done while at Leeds, and now did new work on what had happened in the transition to peace after the First World War. I spent many hours discussing all this with the Prof. He needed a lot of convincing, particularly on some of the ideas arising out of *The General Theory*. But I convinced him; his Cabinet paper was well received; and much of it reappeared in the Government's White Paper. Though naturally biased, I think his paper was the more readable. But it is, of course, much easier to write a readable personal paper than one that has to take account of many conflicting views.

In the event the transition from a war-time to a peace-time economy was remarkably successful. The transfer of large numbers of people to peace-time jobs was achieved with little frictional unemployment; and we avoided a repetition both of the inflationary upsurge of 1919–20 and the subsequent slump and soaring unemployment of 1921. We then went on to have a quarter of a century of more or less continuous full employment up till 1973, with few signs of the demand deficiency that many had feared might occur after the post-war transition period. On

the contrary, the problem was more often a threat of excessive demand. Economic advisers to governments found themselves urging restraint more frequently than expansionary policies.

Many had expected that budget deficits would be required to maintain employment, some that deficits in years of slack would be offset by surpluses in good years, others that *on average* deficits would be necessary. In fact, after 1946/47, the budget was in surplus 'above the line'—as it was called—in every year until that not very satisfactory concept (which was, however, widely used in judging the 'soundness' of a budget) was abandoned in 1965/66; and the budget probably remained in surplus in this sense for another half a dozen years.

One of many other balances that seems relevant to me is the current account of the public sector. This was in surplus in every year after 1946,⁸ and covered two-thirds of the net capital expenditure of the public sector between 1952 and 1973.⁹ The national debt, it is true, increased substantially in absolute terms after the war, but fell from over two and a half times GDP in 1946 to not much over one-half in 1973. Debt interest also fell as a proportion of GDP, though by much less, because of the large rise in interest rates. I would describe all this as reasonably 'sound' finance.

During the war there was considerable discussion of the 'acceptable' and 'achievable' post-war levels of employment. Much of it was in terms of the percentage unemployed among those insured against unemployment, which before the war exaggerated the level of unemployment as a percentage of the total work-force, which is now used, because it excluded classes of employees not insured against unemployment, and also the self-employed. To avoid confusion I shall use only estimates of the percentage of the total work-force, and confine technicalities to footnotes in the written text.

Beveridge's target was equivalent to about 2¼ per cent of the work-force.¹⁰ Keynes thought 3½ per cent more realistic,¹¹ while

⁸ Before allowing for depreciation and stock appreciation. After such allowance, some years might not show a surplus.

⁹ I can find no comparable figures before 1952.

¹⁰ In *Full Employment in a Free Society*, published in November 1944, his target was 3 per cent of those categories (wider than pre-war) which he proposed in his Plan for Social Security should be insured against unemployment.

¹¹ While not disagreeing with Beveridge's figure as an objective, he wrote in a letter to him that he would be surprised if it were achieved (*The Collected Works of John Maynard Keynes*, Vol. 27, p. 381), and in earlier discussions in the

Hubert Henderson preferred a figure about twice as high.¹² Prof's paper had an implicit target of 2-4½ per cent. The Government's White Paper had no target, but in an Appendix assumed an average figure equivalent to about 5-5½ per cent of the labour force.¹³

So, leaving aside Henderson, there was a range of targets of 2-5½ per cent. In fact, all proved pessimistic for the average of the first quarter-century or so after the war (see Fig. 1). Up till 1973, unemployment averaged 1¾ per cent, although there was a slight upward trend. As there were cycles averaging about five years—but the Chart shows how minor were these manifestations of the notorious 'stop-go' policies—it seems appropriate to take five-year moving averages. These show unemployment rising from just under 1½ per cent in the first five years after the war to rather

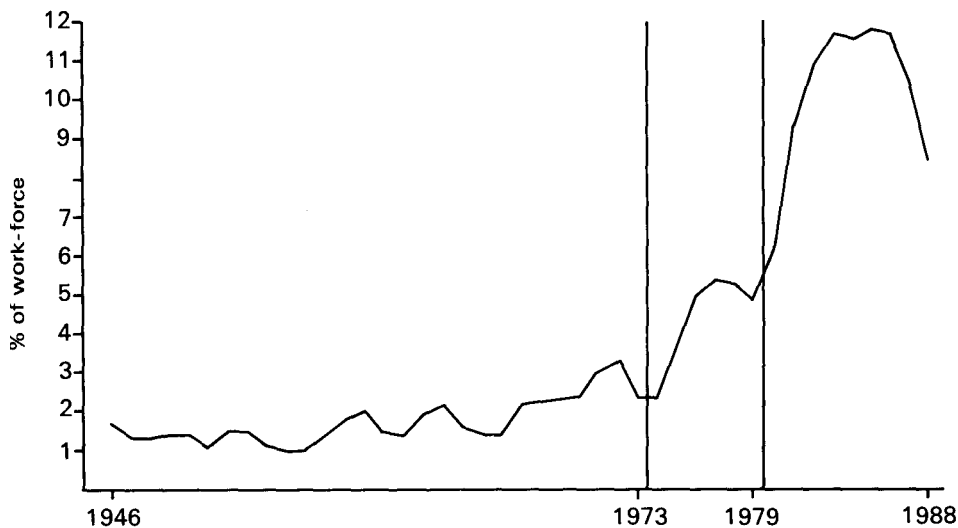


FIG. 1. Unemployment as a percentage of work-force. *Note:* Annual averages; including school-leavers. *Sources:* Derived from *Economic Statistics 1900-1983* by Thelma Liesner for *The Economist*; *Economic Trends Annual Supplement 1988 Edition*; *Employment Gazette*.

Treasury had talked about 5 per cent of the pre-war insured population (*Ibid.*, p. 305).

¹² *Ibid.*, p. 299.

¹³ 8 per cent of the insured population. The Appendix was on the possible use of variations in social insurance contributions.

more than 2½ per cent in the five years to 1973—a very small and slow rise compared with what was to happen later.

During this quarter-century or so we certainly had recurrent balance of payments crises, but an average growth rate of nearly 3 per cent a year and inflation just over 4½ per cent, which, when coupled with unemployment averaging under 2 per cent, was not a bad combination of these key variables—even though our growth was unimpressive by international standards, and our inflation high by previous British peace-time standards. So it is not surprising—though hard to believe now—that the argument about the appropriate level of unemployment was between daring economists like myself, who wanted to aim at 1½ per cent, and more cautious ones like Professors Paish and Phillips, who argued for 2½ per cent.

After 1973 there were two sharp step changes in unemployment. First, in the space of only two years, unemployment jumped from under 2½ per cent in 1974 to 5 per cent in 1976, and remained around this level till 1979. The second step jump was much steeper—from 5 per cent in 1979 to 9½ per cent two years later, and getting on for 12 per cent in 1985 before falling back sharply in 1987 and 1988, the result partly of rapid economic growth and partly of administrative changes affecting the figures.

So, when people say that there has been an upward trend in unemployment since the war—at least up to the mid-1980s—this can be misleading unless they add that it was very gentle for nearly three decades, and that the great bulk of the increase took place during roughly the following ten years—and most of it during the first half of the 1980s.

Now it may be that the slow upward trend to 1973 was largely due to such factors as a worsening of market imperfections, rapid technical change and the like. But I cannot believe that these speeded up sufficiently to explain more than a small part of the enormously faster rise in unemployment after that, and believe that the great bulk of this must be attributed to a rise in demand deficiency.¹⁴ I would call in aid, among other things, the CBI's *Trends Surveys*, which showed the proportion of manufacturing firms reporting orders or sales as a factor limiting output rising dramatically from 25 per cent in October 1973 to 96 per cent in January 1981.

¹⁴ This seems consistent with the analysis in last year's Keynes Lecture by Mr Worswick.

Why then was there this sharp increase in demand deficiency? I would say that the first step jump—to 1976—was the legacy of an over-rapid expansion of demand in 1972-3 and the miners' industrial action which gave them a huge wage increase, as a result of which we coped less successfully than most industrial countries with the oil price hike of 1973-4. By the spring of 1975 inflation was accelerating alarmingly and the balance of payments was weak; North Sea oil had not yet come to our aid. Despite forecasts of rapidly rising unemployment, and demands from the TUC for reflation, the Labour Chancellor—rightly in my opinion—maintained a moderately tight fiscal policy; and unemployment rose to 5 per cent. The Government also introduced a prices and incomes policy which continued for three years. (This included acceptance by the TUC of a limit on pay increases only half as great as the rise in prices over the previous year, something hitherto thought inconceivable and for which I think I can claim a little credit—I was then at the CBI and we had some crucial talks with the TUC.)¹⁵ This combination of policies was remarkably successful in getting inflation down, while keeping unemployment around 5 per cent.

The second, much larger, step jump in unemployment resulted from the attempt to control the inflation resulting from the collapse of the Labour Government's incomes policy during the 'winter of discontent' in 1978-9, coupled with the second oil price hike and the increase in VAT to 15 per cent in the new Government's first budget. They attempted to bring down inflation by policies, based on simplistic monetarist theories, that both raised the exchange rate to absurdly uncompetitive levels (aggravated by the advent of North Sea oil) and depressed domestic demand severely.

The resulting rise in unemployment was much larger than the advocates of monetary policies alone to control inflation ever expected. This is clear to me from conversations with members of the Conservative Shadow Cabinet before they came to office,¹⁶ and forecasts made not long after they did, by economists broadly sympathetic to these policies and assuming their implementation, which showed unemployment rising much less than it actually did.¹⁷

I mentioned earlier that we had a depression in the 1980s

¹⁵ See *Don and Mandarin*, pp. 218-22.

¹⁶ *Ibid.*, p. 211.

¹⁷ *Ibid.*, p. 252.

comparable to that in the 1930s; and the cycle of 1929–37 and the depression and subsequent recovery of 1979–87—exactly fifty year apart—are interesting to compare. Figure 2 shows estimates of unemployment as a percentage of the work-force in the two periods, but bear in mind that comparisons are somewhat hazardous.

It would seem that the cycle of the 1930s started from a higher rate of unemployment—in 1929—but, after rising steeply for two years, levelled off and then fell steadily back to about the 1929 rate in 1937. By contrast, unemployment in the 1980s, after rising relatively as much as in the 1930s, did not start falling until much later, and in 1987 was still double the 1979 rate. Why this difference?

It cannot be explained by movements in the work-force, which grew more slowly in the later period. The main explanation (in statistical terms—I am not commenting on causality) is that productivity rose much more rapidly.

In addition, as Fig. 3 shows, the available figures (Feinstein¹⁸

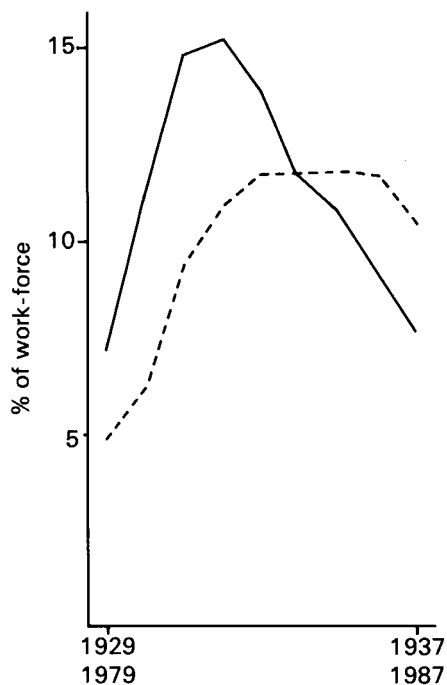


FIG. 2. Unemployment as a percentage of work-force. *Solid line:* 1929–37, *broken line:* 1979–87. *Sources:* as for Fig. 1.

¹⁸ C. H. Feinstein, *National Income, Expenditure and Output of the United Kingdom 1855–1965* (Cambridge University Press, 1972).

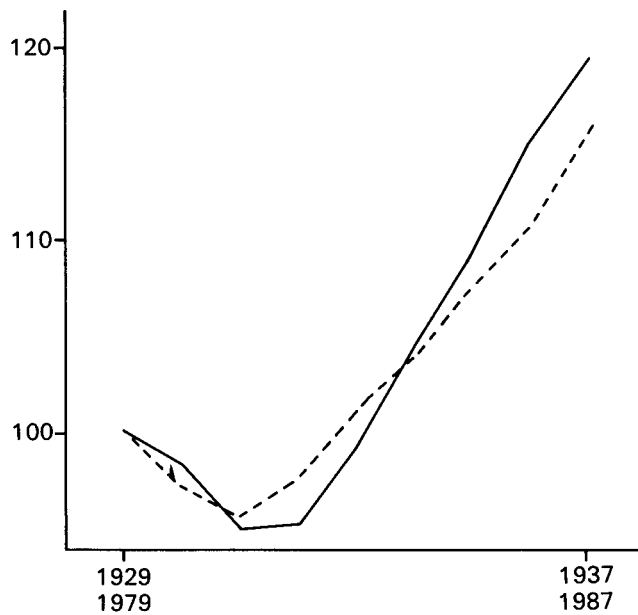


FIG. 3. GDP where 1929 and 1979 = 100. *Solid line: 1929-37, broken line: 1979-87.*
Note: GDP(O) for reasons explained in note 19, and including North Sea production.
 Excluding such production the 1979-81 fall is greater and the recovery to 1987 smaller.
Sources: C. H. Feinstein, *National Income, Expenditure and Output of the United Kingdom 1855-1965*; *Economic Trends*.

for the first period, the CSO for the second) show GDP,¹⁹ after falling by roughly as much between 1979 and 1981 as it did between 1929 and 1931, recovering more slowly between 1981 and 1987. However, some economists have argued that the CSO's figures underestimate recent growth for various reasons. Having studied their analyses and corresponded with them, my provisional judgement is that a true comparison might put growth between 1981 and 1987 roughly as fast as that between 1931 and 1937, but not significantly faster.²⁰ Hopefully, the

¹⁹ I have used the output, rather than the average, measure of GDP in this Chart (but not in the wholly post-war comparisons I make later) because Feinstein's estimates of the latter show GDP continuing to rise in 1938, which seems implausible—given other indicators—compared with his output measure which shows a fall, as mentioned later in my text.

²⁰ According to the Feinstein and CSO figures, GDP(O) rose two-thirds of a per cent per annum faster between 1931 and 1937 than it did between 1981

report of the official enquiry into national accounts statistics—not yet published—will help to clarify matters.

If we carry the comparison forward, beyond 1937 and 1987, it is true that output rose rapidly in 1988 but fell in 1938,²¹ while unemployment fell rapidly in 1988 but rose in 1938. However, it flattened out during the year and fell steeply during 1939. By the summer, just before the outbreak of war, it was well below the 1929 rate (and this was achieved without inflation; between August 1938 and August 1939, the Ministry of Labour's cost of living index actually fell slightly and their index of wage rates was virtually unchanged²²). The latest official unemployment percentage—for February 1989—is two-fifths higher than the average for 1979. It is hardly conceivable that by the summer of 1989 it will be well below the 1979 level, even given the lagged effects of recent rapid growth plus further administrative changes that seem to be in the offing—and I stress that I am expressing no opinion on the 'true' level of unemployment and only taking account of how such changes may effect *changes* in the level shown by the statistics.

and 1987. Professor Douglas McWilliams, in his Inaugural Lecture at Kingston Business School on 25 May 1988, entitled 'The Renaissance of British Management', 'guesstimated' that the CSO understated productivity growth in the service industries by an amount that underestimated GDP growth by 1 per cent per annum in the 1980s, and also growth of output in the IT industry by an amount equivalent to about a quarter per cent per annum of GDP; but that was when only 1980-based official figures were available, and he later told me that, compared with the 1985-based figures now available, and which I use in this Lecture, the understatement is much smaller, at 0.05 per cent per annum. On his present reckoning, therefore, GDP grew about 0.4 per cent per annum faster between 1981 and 1987 than it did between 1931 and 1937. However, the Liverpool Research Group in Macroeconomics, while arguing, in their *Quarterly Economic Bulletin* for June 1988, that official figures underestimate productivity growth in services by an amount similar to that suggested by McWilliams, tell me that their adjustments come from the employment side and not from the output side, and do not in themselves affect estimates of GDP growth. This makes one doubt whether McWilliams' estimate of 1 per cent is not too high, and I assume a smaller figure in this Lecture. An analysis by Bill Martin, in Phillips and Drew *Economic Briefing*, 9 June 1988, implies, on the basis of past upward revisions to CSO estimates, that the present figure of growth of GDP(O) between 1981 and 1987 could be revised upwards by about 0.3 per cent per annum; but to add this to McWilliams' suggested upward revision, even as scaled down by me, would seem to involve a large element of double counting.

²¹ At least according to Feinstein's output measure, though not his average ('compromise') measure.

²² *British Labour Statistics, Historical Abstract, 1886-1968*, Department of Employment, Tables 13 and 89.

There has been much talk of the unprecedented, continuous growth of the economy in the seven years 1981 to 1988. But first, as regards continuity, this is far from a record. GDP rose in each of the ten years 1948 to 1957 and then, after a small fall in 1958, for fifteen years running from 1959 to 1973.

Secondly, there have been several seven-year periods since the war when GDP rose faster than during 1981–8, at least according to the latest official figures. One example is the seven years to 1965, following the minor recession of 1958, when GDP rose by 3.8 per cent a year against 3.2 per cent in 1981–8. An upward revision of recent official figures might show the recent recovery to have been roughly as fast but not, I believe, significantly faster, even though there was so much more slack to be taken up.

Thirdly, the growth after 1981 followed a large fall in output between 1979 and 1981. I recall American friends who advised the Democratic Administrations of the 1960s telling me that it was ‘duck soup’—American for dead easy—to combine continuous, rapid growth with low inflation—4½ per cent a year growth over eight years, with inflation averaging 2 per cent—when the outgoing Republican Administration had obligingly created so much slack in the economy. In the British experience since 1979, most of the slack was created during the early years of the same Administration as presided over the subsequent recovery.

If one starts with the last peak, 1979, rather than the trough of 1981, growth during the nine years 1979–88 averaged 2.1 per cent a year on the official figures. This has been exceeded in twenty-two nine-year periods since the war, one of the best being that beginning in the cyclical peak year 1964, when growth averaged 3.1 per cent, 1 per cent faster—an ample margin to cover any likely upward revision of recent figures. The official figures also show growth averaging 2.7 per cent a year during the thirty-one years 1948–79, over half a per cent faster than has been achieved since then.

Finally, turning to growth of productivity, I have seen few claims that this has been particularly impressive in the economy as a whole in the 1980s, but it seems to be widely accepted that in manufacturing it has improved out of all recognition.²⁵ How-

²⁵ Criticism of recent official estimates of productivity growth in the service industries as too low has not been matched by nearly such serious criticism in respect of manufacturing. Professor McWilliams’ argument, described in a previous footnote, that the official figures understate output growth in the IT industry (because the deflator applied by the CSO to the value figures is too

ever, the rise between 1979 and 1988 of 4.2 per cent a year is only slightly better than the 4 per cent achieved between 1961 and 1973.²⁴ This is illustrated in Fig. 4, which shows a renaissance—rebirth—after 1979, from the miserable performance in 1973–9, to a rather faster, though hardly dramatically faster, rate than was previously achieved.²⁵

I have no wish to belittle the remarkable improvements in efficiency recently made in many firms, nor the extent to which certain government action, for example in the field of industrial relations, has helped. I am merely trying to ensure, by a few historical comparisons, that their total effect on our economic performances is not exaggerated.

But for all the reasons I have given, I suggest that in purely statistical terms—I reserve judgement on the possible effects of changed attitudes—it is hard to substantiate the claim that there has been an ‘economic miracle’ during the past nine or ten years. This is quite apart from the difficulty I find in applying this term to a period when unemployment rose to 3¼ million and averaged 2¾ million—and, despite this, inflation²⁶ averaged 7 per cent a year; over 5 per cent even if one excludes the first two years of the period; and rose again to nearly 8 per cent in the year to February 1989. These figures compare with the average inflation

high) would imply an understatement of productivity growth in all manufacturing industry of about 0.2 per cent per annum between 1980 and 1985. This in itself is not large; and there may well have been similar understatements in earlier periods in other manufacturing industries, so that comparisons of recent with past performance may reasonably, I suggest, be based on the official statistics as a close approximation to the truth.

²⁴ 1961 did not contain a cyclical peak according to the CSO’s cyclical indicators, first published much later. But it was so regarded at the time when growth rate trends were commonly measured by comparing years of highest pressure of demand indicated by troughs in unemployment, of which 1961 was one. 1973 and 1979 were peaks in both senses.

²⁵ The *Autumn Statement 1988* showed an increase of 4½ per cent a year between 1979 and 1988. Since then, estimates of recent levels of manufacturing employment have been revised upwards, bringing the figure for productivity growth down to 4.2 per cent. Perhaps for this reason, the *Financial Statement and Budget Report 1989–90* showed a figure of 5¼ per cent per annum for 1980–8, but this is misleading as a measure of the trend growth rate because manufacturing productivity was at a trough in 1980, 4 per cent below the 1979 figure.

²⁶ As measured by the Retail Price Index.

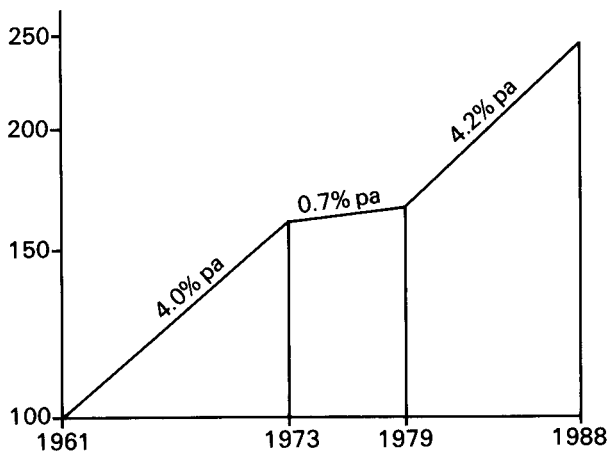


FIG. 4. Output per head in manufacturing where 1961 = 100. Sources: *Economic Trends Annual Supplement, 1989 Edition*; Department of Employment.

rate of just over $4\frac{1}{2}$ per cent in the quarter century or so after the war, when unemployment averaged under half a million.

In the first half of the 1980s it became fashionable to argue that unemployment was bound to remain at around three million more or less indefinitely. All sorts of reasons were adduced, and I spent some time while at the CBI casting doubt on these. Here are a few, with my ripostes.

One was the increase in the labour force. How could it possibly be absorbed into employment? I asked whether anyone told in 1860 that the labour force would double during the next hundred years (a considerably faster increase than we have had since the war) would not have been equally worried; but employment fully kept pace—it also doubled.

Then there was the fear of rapid structural change. But we have coped with this in the past. Agriculture accounted for one-quarter of the labour force in 1860 but is now down to 2 per cent; and during the inter-war years, big falls in employment in old staples like coal, cotton and shipbuilding were more than offset by large rises in industries associated with motor vehicles, aircraft, electricity, housebuilding and a wide range of personal and business services.

There was the growing competition from the newly industrializing countries (NICs); but this problem has been with us for a century and more, with one set of NICs succeeding another.

There was the saturation of human wants argument; truly

absurd, when many people in Britain find it easy to spend many times more than their average fellow citizen—and many, many times more than the average citizen of the Third World.

Finally, when a prominent CBI member, worried by such arguments, proposed a research programme consisting largely of asking *existing* firms about their long-term employment projections, I argued that this would most probably underestimate the growth of employment since many of the jobs in, say, ten to fifteen years time were likely to be in firms not yet in existence, or in businesses too small to be covered by the enquiry, but destined to expand their work-force much faster than large firms, many of which would expect little if any increase (apart from that resulting from acquisitions).

Since the official unemployment figures started to fall after the summer of 1986, one has heard less and less of such fatalistic arguments. Indeed, unemployment would at present almost seem to have become yesterday's problem, judging by the relatively scant mention of it in public debate—as wrong-headed, in my view, as the earlier fatalistic arguments. The figure has now fallen to around 7 per cent. How much further can it fall? My answer is that I just do not know.

But of one thing I am certain. It is difficult to reduce it very quickly (apart from administrative and definitional changes affecting the figures). I remember being asked by the then Prime Minister towards the end of 1971, when the 'headline' figure of employment²⁷ looked like topping the politically sensitive million mark in the winter (which I had been warning for many months might happen, and did happen in January 1972), to prepare a plan to reduce it by 400,000 during the following twelve months. I argued that to aim at this would be dangerous and lead to inflationary bottle-necks. In fact it did, and it took about two years rather than one for unemployment to fall by the desired amount.

Now unemployment, according to the (unadjusted) official figures, fell $2\frac{1}{2}$ –3 times as fast as this during the couple of years up to October 1988, and substantially faster than in the earlier period even allowing for administrative changes. As a result, not surprisingly, the main indicators of inflationary pressure have been moving in an unfavourable direction. But the CBI *Trends Survey* for October 1988 still showed far fewer manufacturing

²⁷ Not seasonally adjusted, including temporarily stopped, school-leavers, adult students and Northern Ireland.

firms expecting to be held up by shortages of skilled labour or materials and components than the *Survey* of October 1973 (even before the Arabs and then the miners started to create shortages of oil²⁸ and coal, which led to many other shortages as well); and it shows fewer firms held up by shortages of capacity, albeit only marginally fewer, which is worrying, especially as the proportion working below capacity is considerably lower than in October 1973. The trend of wage and price inflation, though very worrying, is still rather less of a problem that it was then.

But, first, there is more slack to be taken up when one starts with over three million rather than one million unemployed. Secondly, most important, the dramatic worsening in the balance of payments current account during the past two years has been comparable, as a percentage of GDP, to that between 1971 and 1973, and the deficit is now a larger percentage of GDP than in 1973—unless more than seems likely of the notorious ‘balancing item’ reflects an overstatement of the current account deficit.

With this proviso, I do not think a deficit of the present size can be sustained for very long. In the past, developing countries with vast opportunities for profitable investment far in excess of potential domestic savings have run such deficits for long periods. But I doubt whether foreign exchange operators will continue indefinitely to regard the UK as such a country. Indeed, judging by the experience of the past ten years, they could be excused for regarding us a ‘natural’ net exporter of long-term capital. In every year from 1978 to 1988—at least according to the official estimates which may overstate net outflows—there has been net direct investment overseas,²⁹ averaging $1\frac{1}{2}$ per cent of GDP,³⁰ and in every year except 1987 (when portfolio investors repatriated large amounts following the October Crash) there has been net direct plus portfolio investment abroad, with the latter

²⁸ The *Survey* was carried out in the two weeks ending 17 October 1973, the very day on which the Arab oil ministers first announced cutbacks in production; but virtually all the respondents would have replied to the *Survey* before that. There may have been expectations of cuts, especially as the major oil companies had warned of such a possibility early in October; but if we go back to the July *Survey*, the proportion saying that their output was likely to be limited by shortage of materials or components was still far in excess of the figure for October 1988.

²⁹ i.e. an excess of direct investment overseas by UK residents over direct investment in the UK by overseas residents.

³⁰ At factor cost.

averaging over $1\frac{1}{2}$ per cent of GDP, even including 1987. A continuation of these types of investment, equivalent together to over 3 per cent of GDP, would require a current account *surplus* of over £10 billion to finance them, compared with the present large *deficit*, which the Chancellor expects to remain high for some time.

If these considerations led to a change of sentiment, there could be a very large outflow of funds. Much of the capital inflow which has financed the recent current account deficit can be regarded as 'hot money'.³¹ The use of our official reserves, though large, could stop the rot to only a limited extent and for a limited time; and the large overseas investments we have built up are privately owned and could hardly be requisitioned. Indeed, in these circumstances, investors could well invest even more abroad.

For balance of payments reasons alone, but for others as well, I agree with the generally held view that the recent rate of growth must be slowed down sharply; but I shall not discuss what government policies would be consistent with this. It will mean, after a time lag, a sharp reduction in the 'true' rate of fall in unemployment, and possibly a rise. Even if we can in time overcome our present difficulties, I fear it would take a good many years—although the projected deceleration in the growth of the work-force over the next five years may help—to get back to the sort of unemployment levels contemplated by Beveridge and others some forty-five years ago, let alone those actually achieved in the quarter-century after the war.

About whether we shall ever get there again—at least without drastic administrative or definitional changes affecting the figures—I am neither sanguine nor defeatist. I believe that something like that should be our ultimate objective, but the speed at which we should seek to advance towards it must be determined as we go along, and is likely to be uneven. Government has an important role to play, not only in regional, training and similar measures, but also in fiscal and monetary policies. It would, however, be only by coincidence if any rigid rule, relating to, for example, some measure of the money stock, money GDP, some public sector financial balance, or the exchange rate, brought about the desired objective. Nor do I believe that 'setting the people free' will, by itself, automatically secure something approaching 'full employment without inflation'.

³¹ See, for example, the paper by Tim Congdon in Shearson Lehman Hutton, *UK Economic Research Studies*, 11 August 1988.

I argued in an article published nearly thirty years ago,³² that a reasonable combination of inflation and unemployment could only be achieved if there were some kind of understanding between government and representatives of unions and employers; and I have lived through almost every conceivable type of prices and incomes policy since the war. Most have succeeded temporarily—some spectacularly so—but none permanently. Given the present very different industrial relations scene, such a policy may now in any case be impracticable. Recent measures to make more equal the bargaining power of employers and employees should help. But we still have a serious problem to which I doubt whether anyone has yet got a workable answer. If so, it will be more difficult to get unemployment down, but it would be foolish to suppose that there is any particular ‘natural’ level, much higher than we achieved for so many years after the war, below which it cannot fall, since the relationship between unemployment and inflation is so uncertain and variable—as is the relative importance attached to each by the electorate.

Exchange Rates

May I now turn to my second main topic—exchange rates, with which I have been concerned for a long time, both in my academic work and in public service, on the questions both of the best kind of exchange rate regime for Britain and the world, and of how exchange rates should move, if at all, at various times.

On the first question, there have been several cycles of opinion in my lifetime. Before 1914 the rigidity of the gold standard was widely accepted. Then the wild fluctuations in exchange rates after the First World War were followed by a general return to fixed rates in the 1920s. These became unpopular, in Britain at least, as a result of our return to the gold standard at the pre-war parity, which meant an over-valued pound. The experience of competitive devaluations and depreciations in the 1930s had in turn much to do with the Bretton Woods philosophy of greater rigidity which emerged in the 1940s. Then in the 1950s, there began a hankering among quite a few economists after greater flexibility as a way of freeing ourselves from balance of payments constraints. But following the huge and damaging fluctuations after the major currencies floated in the early 1970s, the fashion

³² ‘Inflation in the United Kingdom’, *Economic Record*, December 1959, reprinted in my *Studies in Political Economy*, Vol. 2, 1975.

has changed again to a desire for greater stability, even among some who were the most ardent advocates of flexible rates in the 1950s and 1960s.

I personally was a consistent supporter of the IMF 'adjustable peg' ever since the wartime discussions leading up to Bretton Woods. Under this system countries did their best to preserve their parities but were permitted to change them if in 'fundamental disequilibrium'—a less rigid system than the gold standard. I took the view that, while the need to devalue under this system should be regarded as a defeat, it should not be delayed for reasons of national pride, or for any other reason, once the need had become clear.

I supported the IMF approach during the war, when working for the Prof and Churchill, against critics like Lord Beaverbrook, who tried to scare Churchill by saying it was 'the gold standard all over again', a matter on which Churchill was sensitive, having been Chancellor in 1925 when we returned to gold at too high a parity. I supported it in my academic work in Oxford after the war. It was necessary, first, to refute those who thought that devaluation would not improve the balance of payments. I showed in 1947, in an article on 'Britain's Foreign Trade Problem',³³ that, before the war, our export performance compared with that of each of our main competitors had been quite closely related to our relative export prices of manufactures; also that, in the 1930s, our share of world exports of manufactures was closely correlated with an 'effective' exchange rate, which I calculated, against the currencies of twenty-six competing countries—possibly the first time such a rate had been computed.

A few years later I tried in further articles³⁴ to show, using a novel method, that the price elasticity of substitution between British and American exports was about ten times as high as that calculated by Mr Tse Chun Chang,³⁵ whose results influenced those who argued that devaluation could not improve the balance of payments because foreign trade elasticities were too low to satisfy Joan Robinson's famous condition for this to happen. Such 'elasticity pessimists' were quite numerous at the

³³ *Economic Journal*, March 1947, pp. 173–8.

³⁴ 'British and American Exports: A Study Suggested by the Theory of Comparative Costs', *Economic Journal*. December 1951 and September 1952.

³⁵ 'A Statistical Note on World Demand for Exports', *Review of Economics and Statistics*, May 1948.

time.³⁶ I did, however, make clear that the elasticities, although moderately high in the longer run, were likely to be considerably lower in the short term; and argued that for this reason a depreciation of sterling would be likely to worsen the external balance of the Sterling Area in the short run, before it began to improve it—probably one of the earlier uses of the ‘J-curve’ argument.³⁷ Then in 1957, in *The World Dollar Problem*, I tried to demonstrate the same point in much more detail when arguing that an effective upward revaluation of the dollar was unlikely to worsen the US balance of payments significantly, in the first year at least, but likely to do so in the longer run, though it could be a good many years before its full effects were apparent.

I also argued against those who claimed that the favourable effects of devaluation on a country’s competitiveness would inevitably be quickly eroded by more rapid inflation. I showed that, after the 30 per cent devaluation of sterling against the dollar in September 1949, the UK retained virtually all the competitive advantage gained, as measured by hourly earnings in manufacturing, for four to five years, and the bulk of this advantage for considerably longer.³⁸

In the 1950s and 1960s I argued strongly against those who advocated floating rates, both in my public appointments and in my academic work. I helped to defeat the ‘Robot’ Plan in 1952,³⁹ one of several objectionable proposals in which was to float the pound—which would certainly have sunk! I was very disappointed that the new Wilson Government in October 1964—when conditions had completely changed since 1952—turned down my plea for an early devaluation and delayed it till 1967; but this did not change my support for the IMF system.

I was therefore sad when the major currencies floated in the early 1970s, but regarded this as regrettably inevitable, in view of the enormous growth of funds ready, and free, to slosh around from one currency into another. And the floating started even before it was made still more inevitable by the oil price hikes in

³⁶ A notable exception was Professor A. J. Brown, whose results were similar to mine. See ‘The Fundamental Elasticities in International Trade’, in T. Wilson & P. W. S. Andrews (eds), *Oxford Studies in the Price Mechanism*, Clarendon Press (Oxford 1951).

³⁷ ‘A Flexible Rate for the Pound?’, *Financial Times*, 13 May 1954; and ‘Flexible Exchange Rates’ in *Westminster Bank Review*, August 1954.

³⁸ *The World Dollar Problem*, p. 82, Diagram V.

³⁹ *Don and Mandarin*, Chap. 5.

the 1970s, leading to much faster inflation world-wide, and, more important in this context, a much wider dispersion of inflation rates in the main industrial countries.

The dispersion has been smaller in recent years but still wider than it was on average in the 1960s and early 1970s. I would also say that the mass of internationally mobile money is larger than it was fifteen years ago, and more mobile. I therefore doubt whether we shall be able, in the foreseeable future, to get back to anything like the stability of the Bretton Woods era when, for example, the pound-dollar rate was unchanged for eighteen years between 1949 and 1967 (admittedly three years too long in my opinion).

The Exchange Rate Mechanism (ERM) of the EMS—a sort of mini-IMF, which I support in principle for this reason—was ten years old in March 1989. There have been eleven realignments, rather more than one a year (and 137 changes in bilateral central rates). More recently they have been less frequent—the last was in January 1987—and this improvement may continue, provided a lower spread of inflation rates persists (although this spread is by no means the only reason for exchange rate changes). But governments have only a limited power to influence exchange rates, especially if this means sacrificing other goals dearer to the hearts of the electorate than exchange rate stability. I therefore doubt whether such stability can be guaranteed over a period long enough to be relevant to many business investment decisions, where the time horizons can be many years; although the ERM can probably reduce medium-term uncertainty and can certainly help to iron out short-term movements.

If we joined the ERM we should benefit from this *vis-à-vis* member countries, but we still conduct about half our trade with other countries, and it would not help to stabilize the pound against the dollar or the yen.

Another argument for joining is, however, that tying the pound effectively to the Deutschemark, the currency of a country with a record of low inflation, would automatically keep our inflation rate low, by forcing pay bargainers to keep down unit labour costs so as to remain competitive and preserve jobs and profits. I cannot help being uneasy about this argument when I recall the devastating effects on British industry of the heights to which the pound was allowed to rise in the early 1980s, but which was approved by so-called 'international monetarists' using similar arguments (arguments which are once more becoming fashionable). In so far as it helped to bring inflation down, this

was bought at a heavy cost, and led to drastic cuts in capacity, investment, training and the like, and withdrawal from world markets. These contributed to the shortages, balance of payments problems and inflationary pressures we are currently experiencing; so that lower inflation then may be well offset by higher inflation now.

This rise in a floating pound was, admittedly, not the same as tying the pound to a currency like the Deutschemark (previously the dollar); and I used to argue myself, in the 1950s and 1960s, that a fixed rate provided more defence against inflation than a floating one because, under the latter regime, the unions—and employers—could argue that we need not worry too much about an extra few per cent on wages, since this could easily be offset by a small depreciation of sterling. This view seemed to be confirmed in the summers of 1965 and 1966 when George Brown twice persuaded the TUC—and the CBI—to accept a tougher prices and incomes policy because the pound's fixed parity was in danger.⁴⁰ But my faith in the argument was shaken—to my delight—when, in the summer of 1975, although the pound was floating, the TUC accepted an extremely tough pay policy which I have already described.

If we join the ERM, I sincerely hope that maintaining our rate against the Deutschemark—or the ECU—will not become a symbol of national virility, as it did—against the dollar—in 1964–7, with unfortunate results for the British economy.

Finally, I believe that an attempt to fix irrevocably exchange rates between EC countries—in effect to have a monetary union and so renounce the safety valve of exchange-rate changes—as some have recently suggested⁴¹ would be doomed to failure unless and until there was a much larger EC budget, which seems most unlikely in the foreseeable future. The reasons, in my opinion still valid, were given over ten years ago in the so-called 'MacDougall Report' on the role of public finance in European integration.⁴² They were based on a study of eight *existing* economic and monetary unions. The Study Group, of which I was Chairman, found that, on average, public finance reduced inequalities between regions by 40 per cent and also played an

⁴⁰ *Don and Mandarin*, pp. 161 and 167.

⁴¹ For example, articles by Samuel Brittan in *Financial Times*, 24 March and 11 August 1988; and see also my letter in *Financial Times*, 16 August 1988 commenting on the latter article.

⁴² *Report of the Study Group on the Role of Public Finance in European Integration*, Commission of the European Communities, Brussels, April 1977.

important role in cushioning fluctuations—by, for example, offsetting one-half to two-thirds of a loss of income in a region due to a fall in its external sales, through lower taxes and insurance contributions to the centre and higher receipts of unemployment and other benefits. Even with such powerful regional effects of public finance—and other equalizing and equilibrating mechanisms I have no time to mention—some of the countries we studied had only with difficulty avoided intolerable regional disparities in employment levels, living standards and rates of growth; and if these mechanisms were removed, serious separatist movements could well develop.

The EC budget required to sustain monetary union need not be nearly as high as the average of 45–50 per cent of GDP in EC member states, nor even the 20–25 per cent of federal (as distinct from state and local) expenditure in the federal states we studied. We reckoned that monetary union might be sustainable with EC expenditure of 5–7 per cent of Community gross product,⁴³ but only if the budget concentrated much more than in existing federations on geographical equalization of productivity and living standards and cushioning fluctuations. But I am unconvinced that, with an EC budget of about 1 per cent of EC gross product, as at present, irrevocably fixed exchange rates would be sustainable. On the contrary, I believe the attempt to achieve this goal would run the risk of setting back progress towards integration in Europe, which I keenly support.

Conclusion

I had hoped to conclude with sage generalizations from an economist elder statesman which would be guiding lights for younger members of the profession. But I have no time left. And this is fortunate, for I have no such generalizations to offer. So I end on a humble note.

The original rules of the Political Economy Club, adopted at its foundation in London in 1821, included the following: 'As the Press is the grand instrument for the diffusion of knowledge or of error all the members of this Society will regard it as incumbent upon them to watch carefully the proceedings of the Press and to ascertain if any doctrines hostile to sound views in Political Economy have been promulgated; to contribute whatever may be in their power to refute such erroneous doctrines and counter-

⁴³ 7½–10 per cent if defence were included.

act their influence; and to avail themselves of every favourable opportunity for the publication of seasonable truths within the province of this science'.

So economics was regarded as a science then; and there were 'sound views', 'erroneous doctrines' and 'seasonable truths' which were generally accepted (at least according to the rules of the Club, although we are told in its history that there was much disagreement on many issues among the original members who agreed these rules, who included such figures as Malthus, Ricardo and James Mill).⁴⁴

Since 1821 there has been a phenomenal increase in the study of political economy. This has been well worthwhile, and I defended it in my Presidential Address to the Royal Economic Society in 1974 which, despite some ribald comments, I entitled 'In Praise of Economics'.⁴⁵ But it is still, alas, far from being a science. There is no consensus of views. There are cycles of fashion on many issues. The behaviour of economic man changes inexplicably. We have learned a lot over the years, but I think the most important thing is how little we really know with any certainty.

⁴⁴ *Political Economy Club: Founded in London 1821: Centenary Volume* (Macmillan, 1921).

⁴⁵ Published in the *Economic Journal*, December 1974.