<table>
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<th>Title</th>
<th>Stagflation, Fiscal Deficits and balance of Payments - Great Britain and Germany</th>
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<tr>
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The topic chosen for this section of the conference strongly suggests that the focus should be on the United States—a country large enough to be able to translate her fiscal deficits into balance of payments deficits which, in turn, can be covered by loans from abroad which enlarge the monetary base and thus maintain inflationary conditions in the rest of the world. I take it as a challenge to look at other developed economies under this heading, at countries which, while by no means insignificant, are not large enough to be able to unload their disequilibrium on the rest of the world, but which, on the contrary, have to take the rest of the world largely as given. My considerations will apply essentially to Great Britain, with some brief comparative glances at West Germany, and they will cover both economic experience and economic doctrine.

In size and structure these two countries appear at first sight to be roughly similar—both fit into the world economy by exchanging their manufactures and some services against the food, raw materials, and other manufactures which they need to import. Actually, even in these respects there has been a subtle divergence of roles in recent years, Great Britain mixing with her manufactured exports an ever larger share of services and North Sea oil, while taking ever larger quantities of manufactured imports from abroad. However, even where their roles appear to overlap, this often hides some fundamental differences in the relationships holding between different sectors and factors in those two economies.

Provoked by the international setting of this Conference it will be a second object of this paper to stress, what is not always stressed sufficiently, that some of these differing real relationships frequently enter into the assumptions of theory. In other words, even the most abstract theory frequently works with functional relationships which apply to one country, but not to another, and this is not the least reason why theoreticians disagree and why, sometimes, a theory has more chance to be acceptable to economists of one nationality than to those of another.

As illustrations of typically time-bound and country-tied building bricks of pure theory I might quote some elements of the original Keynesian doctrine. Take, for example, the notion that under less than full employment, additional purchasing power will increase employment, but that, as soon as full employment is reached, and not until then, additional purchasing power is translated into inflation. While no one presumably ever took this to be a representation of reality that was 100% correct, the extent to which it was true enough to be a workable hypothesis with some predictive power would clearly differ in time and
place, with Great Britain in the Great Depression of the 1930’s but not necessarily since, nor indeed other countries at any time offering a rather good fit. Or take, as another example, the related notion that wages are sticky downwards.\(^1\) This, if it was ever true, applied to the immediate British inter-war experience. Before 1914 it was plainly untrue even in Britain; indeed its very opposite was one of the basic assumptions of the Phillips curve,\(^2\) which has since become one of the tap-roots of Monetarism.

For the purposes of this paper, I shall be concerned mainly with those differences of actual national experience which lie behind the assumptions in which Keynesians and Monetarists differ, as well as with those in which Germany and Great Britain have followed divergent paths. The framework is, of course, the topic designated in the title.

II

The outstanding characteristic of the British economy since the end of the Second World War has been its failure to grow at the rate achieved by other comparable countries, including even those close to the technological frontier, like the United States (Table 1).

Behind this failure, in turn, lay the failure of manufacturing industry to keep pace with the output growth of comparable and competing countries (Table 2).

It will be seen that despite the slow preceding rise, the fall in manufactured output in the present world depression was more severe than in the other countries. Lastly, the relative British decline is reflected most disastrously in the falling share of the world’s manufactured exports held by the United Kingdom (Table 3).

This poor British showing was only to a very small extent due to the country’s earlier concentration on export commodity types or export markets with small growth potential: the fact was that British exports lost ground in all markets and in all types of manufactures.

**Table 1. Annual Growth Rates, GNP/GDP, Major Industrial Countries, 1951–1984**

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<tr>
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<tbody>
<tr>
<td>Japan</td>
<td>9.4</td>
<td>3.7</td>
<td>4.2</td>
<td>4.0</td>
<td>3.2</td>
<td>3.0</td>
<td>(4.5)</td>
</tr>
<tr>
<td>West Germany</td>
<td>5.7</td>
<td>1.9</td>
<td>1.8</td>
<td>-0.3</td>
<td>-1.2</td>
<td>1.3</td>
<td>(3.0)</td>
</tr>
<tr>
<td>Italy</td>
<td>5.1</td>
<td>2.1</td>
<td>4.8</td>
<td>0.2</td>
<td>-0.2</td>
<td>-1.4</td>
<td>(2.0)</td>
</tr>
<tr>
<td>France</td>
<td>5.0</td>
<td>2.9</td>
<td>1.2</td>
<td>0.2</td>
<td>2.0</td>
<td>1.0</td>
<td>(1.0)</td>
</tr>
<tr>
<td>U.S.A.</td>
<td>3.7</td>
<td>2.4</td>
<td>-0.2</td>
<td>1.0</td>
<td>-1.9</td>
<td>3.4</td>
<td>(5.0)</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>2.7</td>
<td>0.9</td>
<td>-1.9</td>
<td>-1.0</td>
<td>2.8</td>
<td>2.9</td>
<td>(2.5)</td>
</tr>
</tbody>
</table>

\(^{1}\) For the subtle way, in which behaviour observed at one time and in one place is woven into a general theory, see J. M. Keynes, *The General Theory of Employment, Interest and Money* (London, 1947 ed.), pp. 301 ff.


Since there was full employment over most of the period until the mid-1970's, it is not difficult to show that it was the productivity on the ground which had not kept up with developments elsewhere, and this, in turn, was associated with the failure to invest in modern equipment and in new branches of production. It was precisely by its low investment rate, both in key industries and in the economy overall, that the British economy differed most dramatically from the rest.6

The failure to increase productivity at home led to lack of competitiveness abroad (as well as to growing penetration of the British home market by foreign manufactures). In theory, the failure to raise productivity and thus to reduce real costs at home in British factories might have been absorbed by corresponding falls in the exchange rate. This would not have averted the relative decline but would at least have made it gentler and free from crisis. In practice, however, Britain was tied by fixed exchange rates until 1971, so that the necessary devaluation had to occur in two large and costly lurches, in 1949 and 1967. Even under the freer conditions from 1972 on, the exchange rates did not always react quickly enough to declining real competitiveness: thus in 1977–82, there occurred a relative deterioration in British unit labour costs of 45% compared with the other major exporters, of which 5% was caused by the relative rise in the value of the pound, while the remaining 40% was caused by stagnating productivity and excessive pay rises in Britain.7

The actual method used to bring these incompatibles into line was the dreary sequence of "stop-go" policies. Starting from a position of balance in which a reasonable rate of growth could be permitted, production would quickly come up against a capacity ceiling because of the inadequate investment in the preceding phase; there followed a rush of im-

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4 O.E.C.D., Main Economic Indices.
ports and an inability to match them with exports, so that an inevitable balance of payments gap appeared. To this the Government reacted by a "stop", i.e. a bundle of deflationary measures, of which the major part was always a cut-back in investment. This would allow the foreign balance to be brought into line in due course, but at the cost of making the economy even less able to sustain a growth phase next time round.8

Outwardly, it was thus the balance of payments deficit which was the key variable in the British dilemma; in reality, it was the waning competitiveness, the failure to modernise and expand British industry on the ground, which caused not only the economy to lurch from crisis to crisis while the rest of the advanced world was enjoying an unprecedented boom, but, more importantly, which withheld from the British population the benefits of faster rising output and prosperity. Nevertheless, it was a British peculiarity, derived no doubt in part from a tradition of non-intervention, and in part from the surviving dominance by financial and trading interests, the "City", rather than by industrial interests over the official policy makers, that no corrective measures beyond a few marginal pressures were ever applied to the real causes in the real world. Instead, the authorities only manipulated monetary magnitudes, like interest rates, tax rates, and banking policies, in the vain hope that somehow these would ultimately make everything come right. In this they were disappointed: on the contrary, they continuously weakened the real base by inhibiting investments and full capacity utilisation, by preventing expansion and modernization and by encouraging trade unions to fear technical progress. No other major European country maintained exclusively macro-policies of that kind without direct regard to the concrete industrial base, and it is inconceivable that they should have done.

The Keynesians who dominated both economic thought and economic policy making in those years did not bring Government deficits into the debate on how to rectify the payments balance. Thus one influential study published in 1971 listed typically, among the possible methods of doing that: allowing unemployment to rise; imposing import surcharges, i.e. a tariff; reducing overseas military expenditure; reducing capital outflow; and devaluing the currency.9 Fiscal restraint was not on the agenda.

The change came in 1976, though there had been portents before.10 In December of that year, following four disastrous years in which British Governments had had to raise almost £6 billion abroad to cover mounting balance of payments deficit, (official indebtedness abroad rose from $266 million in 1972 to $14,160 million in 1976 and further to $18,042 million in 1977) the I.M.F. imposed humiliating terms on the Chancellor of the Exchequer, Denis Healey, including a "declaration of intent" which promised, among other things, to control the supply of money in future. In fact, Government spending was cut more savagely in the following two years than at any time before or since. The reign of Monetarism in British policy making had begun, though it was left to Mrs. Thatcher's administrations from 1979 onward to give it full-blooded support.

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10 Possibly the most significant of these was the official statement Competition and Credit Control; see: Bank of England Quarterly Bulletin 11 (1971), pp. 189–193.
The Keynesians had fatally weakened their position by assuming blithely that any balance of payments gap arising from internal employment policies could always be rectified by devaluation, and opinions differed only as to when and how devaluation had best be carried out. Yet it was not difficult to show in theory that circumstances and elasticities were conceivable in which devaluation, far from rectifying a deficit, would make it worse, and that this was particularly likely where exports were constrained by capacity limitations. In the 1970's it was becoming clear that this was the position into which Britain was sliding. One leading Keynesian, A.P. Thirlwall, even came close to elevating that relationship into a theoretical inevitability, to the effect that the more Britain devalued, or the faster her output increased, the worse her balance of payments would become.11 Two aspects of this development deserve notice: one is, how quickly short-term experiences in one place may become rigidified into theoretical generalisations; and the other, that economists seemed to accept without question that Britain showed such perverse functions. To look for any cause in the real world of productivity and capacity was clearly outside their purview—though there were some exceptions.12 True to form, when the Keynesians had recovered sufficiently to re-integrate the experience of the 1970's, they sought salvation in renewed manipulation of their old stock-in-trade, falling back on the theoretical proof that devaluation policies needed the support of simultaneous fiscal and monetary policies in order to succeed.13 The Cambridge Group under Wynne Godley, on the other hand, drew the conclusion that no manipulation of that kind could help, and opted for protection, to allow the long-overdue modernisation of British industry to take place behind tariff walls.

III

The phenomenon of stagflation had emerged in Britain not later than the first OPEC oil price rise of the winter 1973-4. It hit most of the rest of the world at the time of the second oil price increase in 1979, by which time it had become chronic in Britain. Since stagflation was something which, according to the original Keynesian doctrine, could not occur, the Keynesians were temporarily in eclipse in Britain, and the Monetarists had their opportunity. The new Conservative Government under Mrs. Thatcher embraced their doctrine with remarkable singleness of mind, being no doubt at least as impressed by the convenient political implications of monetarism of the Friedman school as by its internal


12 Thus Morgan complains that results of this kind omit "from the analysis critical factors within Britain's own control—growth, adaptability," op. cit., p. 314.

logical consistency or its plausibility. By sheer chance, the inauguration of the new Government coincided not only with the onset of the world depression, but also with the flow of North Sea oil in sufficient quantities to end once and for all the perpetual balance of payments constraint on British policies, so that from that day onward, a deficit in the balance of payments ceased to be the obsession of British policy makers. Instead, we have a new, even more powerful and exclusive obsession: the rate of inflation. It has become the single overriding aim of the British Government to bring down, and keep down, the rate of inflation, and all else has had to be sacrificed to it.

On a purely theoretical level, Monetarists and Keynesians differ on the question as to which are the dependent and the independent variables, as well as on the question as to which are the important relationships, and whether markets are regulated by freely moving prices or not. But which is cause and which is effect, whether the quantity of money will affect at first only the rate of interest, as the Keynesians say, or only the level of prices, as is maintained by the Monetarists, which relationship is significant and how freely prices move, are all empirical questions, to be tested in practice by observation and not subject to theoretical proof or disproof; moreover, the relationships may not be identical in all countries. Thus in the U.S.A. wages appear to be much more flexible downwards, and much of the recent recovery has been accomplished with little rise in real wages, whereas in the U.K. even stagnation has been accompanied by an unremitting rise in real wage rates for those at work. Or, to cite another example, in the U.S.A. it has been possible to combine a tight monetary with an easy fiscal stance: a similar experiment in Britain, even if it could have been tried, is generally assumed to be likely to lead to very different results. In particular, foreign pressure on the dollar because of the huge American balance of payments deficits has had very different consequences from those which similar pressures would inflict on the pound sterling—let alone the Argentinian Peso or the Israeli Shekel.

With these preliminaries out of the way, let us return to the main theme, the relationship of fiscal deficits and balance of payments deficits in an age of stagflation. For a brief period, in the early 1970's, the view of the "New Cambridge School" gained some support, according to which the private sector's net acquisition of financial assets was stable or was subject to only "very small and predictable" changes, so that virtually the whole of the changes in the foreign balance of payments on current account were due to changes in the public sector financial deficit. However, this view very rapidly ran into strong criticism, nor could it be made compatible with the empirical evidence.15 In the Keynesian and the governing monetarist view, the relationship is not direct, but must be seen in two stages: the link money supply—balance of payments, and the link budget deficit—money supply.

Both Keynesians and Monetarists allow for a foreign and therefore international dimension. In the Keynesian scheme, as an early paper by Joan Robinson showed,16 any excess (shortfall) of planned investment over savings might be made good by a suitable foreign payments deficit (surplus) which allowed capital to flow in (out) just of the right

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14 There is an active literature. The best entry is the periodical Economic Policy Review published by the University of Cambridge, Department of Applied Economics.


amount to meet the gap. This, of course, implied that the rest of the world in its turn had made just such decisions as to produce, net, the exact amount of capital surplus or deficit needed. This basic notion has since then been extended and refined into a kind of "absorption" model. It can also accommodate the Government budget as a separate variable, the counterpart of a balance of payments deficit being an excess of government expenditure plus investment over savings plus taxes.

A similar reasoning is also available to monetarists, except that in their case the foreign "balance of payments is essentially a monetary phenomenon." It can be seen as the link connecting demand and supply of home assets, including money, with those of the rest of the world. In the "International Monetarist Model," if for example, real income increases, imports will rise and exports remain constant, there will be a balance of payments deficit, possibly compensated by an inflow of capital if interest rates at home are raised simultaneously. Alternatively, if there is an excessive money supply at home, monetary reserves will flow out, the consequent balance of payments deficit will reduce the money supply at home and, if the Government takes no action, will result in unemployment. If the Government should stimulate demand, the cycle is completed and disequilibrium on the foreign exchanges returns. But if the Government runs a budget deficit while cutting money supply, it might restore both home employment and foreign balance—but in British conditions these two policies have proved extremely difficult to run in harness in the 1970's as an answer to a deficit. Should capital imports react very elastically to a higher interest rate, they might more than compensate the negative balance of payments and lead to a rise in the volume of money at home, unless the Government intervened to neutralise this. In any case, no permanent solution can be expected from piling up international debts.

Alternatively, the country might devalue or allow its currency to depreciate, with the doubtful consequences which Keynesians had already encountered. On the monetarist scheme, in a form of "absorption approach," devaluation would lead to a rise of prices at home, so that a demand overhang would emerge—i.e. insufficient money to clear the market. Portfolios will then be restructured to reduce the demand for paper assets as well as commodity purchases, so that even without changes in the interest rate, which might not be possible in a small country, fewer goods are bought, as well as fewer imports, while capital exports shrink and the balance of payments improves. However, this would be an unstable new balance, except in the improbable event of the Government pursuing a sterilization policy. The more likely outcome, according to Monetarist doctrine, would be that the money market equilibrium would be restored by an influx of money, wiping out the balance of payments surplus again.

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In Britain, perhaps not entirely surprisingly, the analysis was extended to perform a new task: to offer an alternative, international mechanism to explain the core of the Monetarist doctrine which holds that an increase in the money supply will lead to a rise in prices. According to this theorem, if the money supply were allowed to grow faster in the United Kingdom than elsewhere, money would flow out across the exchanges, the exchange rate would fall, the cost of imported goods would rise at home, this would lead to pressure for greater wage increases which would raise prices and thus offset, or more than offset, the gains in competitiveness achieved by the drop in the exchanges. The result would be faster inflation but no faster growth. The doctrine was clearly tailor-made to provide a prop for British restrictive policies, and was developed by Terry Burns, Alan Budd and others at the London Business School. However, it contained so many dubious links that it has found little support and has apparently been abandoned even by some of its authors.

We may now turn to the second link, that between the budget and the quantity of money. The new Government having taken the reduction of the inflation as its main target, and sharing the monetarist belief in the link between the quantity of money and prices, the limitation of the growth in the money supply became the prime instrument of its policy. Its implicit belief and a stable velocity of circulation, derived from Milton Friedman’s study of the American experience, was less securely founded for Britain, since Britain was the only country among the ten leading industrial nations in which the money supply M3 grew less fast than nominal GNP—despite the extraordinarily slow growth of GNP. Even according to the broadest measure of money supply, the British inflationary pressure was lower than that of most: yet her inflation was among the fastest.\textsuperscript{21} Between 1963 and 1980 the velocity (GNP at market prices divided by £M3) rose from 2.8 to almost 3.6; while in the worst of the Thatcher squeeze, to everyone’s surprise, the velocity actually fell.

Undeterred by this experience, monetary targets became the order of the day. At first the broad monetary target £M3 was chosen, but since it did not perform at all according to expectation, it was dropped in favour of others, such as M1 and PSL2. At one time thereafter it seemed that all monetary targets would be dropped, but in the winter of 1983–4 Mo seems to have crept back into favour. This desperate switch in the monetary targetry in the vain hope that at least one series might behave as the monetarists had predicted, played not a little part in discrediting the whole policy. However, it is possible that a monetary “target” helped to make the simultaneous savage fiscal squeeze more palatable.\textsuperscript{22}

That there was a fiscal link to the money supply and thus to inflation, the Government had no doubt. The more orthodox monetarists, at least, believed that neither high wages nor high private spending were the cause of inflation: only the Government could create more money. “Public spending is at the heart of Britain’s economic difficulties,” as the

\textsuperscript{21} N. Kaldor (1982), The Scourge of Monetarism, Oxford, pp. 80–1.

first sentence in a Government white paper of November 1979 asserted boldly. It was the Government’s deficit, conveniently summarised as the Public Sector Borrowing Requirement (PSBR) which had to be brought down to achieve the monetary target. The PSBR, very low or even negative before 1970, had indeed risen since then to a peak of £10.5 billion in 1975, and after having been reduced by a sharp cut in Government spending, to £6 billion in 1977, had expanded to a new peak of £12.6 billion in 1979. It seemed to be a suitable scapegoat.

It should perhaps be added that the Thatcher government was in any case ideologically committed to reducing the scope of Government and transferring as much as possible to private enterprise. Others also, notably Bacon and Eltis out of Oxford, thought that Britain’s troubles arose from too large a Government sector. This may be considered an extreme example of the “crowding-out” argument.

Technically speaking, however, the PSBR was an odd target to take, as even Milton Friedman had to admit: “The key role assigned to targets for the PSBR seems to me unwise for several reasons,” he commented. “1. These numbers are highly misleading because of the failure to adjust for inflation. 2. There is no necessary relation between the size of the PSBR and monetary growth.” It was clear that not all of the PSBR was inflationary, only that part not taken up by the savings of the public. In Britain, its distinguishing mark is normally taken to be that portion that remained in the banking sector, since the banks, treating Government paper as assets, would expand their lending on it as base. Moreover, the PSBR was a small difference between two very large and partly ambiguous sums. The 1970’s had indeed amply proved that the PSBR bore no relation to the growth in the money supply (Table 4):

Nevertheless, the PSBR became the object of a five-year rolling target of diminution, the so-called Medium Term Financial Strategy (MTFS). It will occasion no surprise that the

<table>
<thead>
<tr>
<th>Year</th>
<th>PSBR (£ million)</th>
<th>PSBR Unfunded (£ million)</th>
<th>Sterling M3 Increase (£ million)</th>
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<tbody>
<tr>
<td>1974</td>
<td>6,370</td>
<td>3,202</td>
<td>3,255</td>
</tr>
<tr>
<td>1975</td>
<td>10,501</td>
<td>4,930</td>
<td>2,331</td>
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<tr>
<td>1976</td>
<td>9,198</td>
<td>3,428</td>
<td>3,565</td>
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<td>5,993</td>
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<tr>
<td>1978</td>
<td>8,357</td>
<td>2,336</td>
<td>6,772</td>
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<tr>
<td>1979</td>
<td>12,608</td>
<td>1,723</td>
<td>6,583</td>
</tr>
<tr>
<td>1980</td>
<td>12,189</td>
<td>2,754</td>
<td>10,914</td>
</tr>
<tr>
<td>1981</td>
<td>10,582</td>
<td>550</td>
<td>9,409</td>
</tr>
<tr>
<td>1982</td>
<td>5,823</td>
<td>-4,994</td>
<td>7,984</td>
</tr>
<tr>
<td>1983</td>
<td>12,404</td>
<td>2,271</td>
<td>9,577</td>
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</table>

26 Financial Statistics.
Table 5. PSBR, Forecast and Out-turn, 1979–84

<table>
<thead>
<tr>
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<th>Forecast, MTFS</th>
<th>Out-turn</th>
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<tr>
<td></td>
<td>Budget 1980</td>
<td>Budget 1982</td>
</tr>
<tr>
<td>1979–80</td>
<td>4.75</td>
<td>—</td>
</tr>
<tr>
<td>1980–81</td>
<td>3.75</td>
<td>—</td>
</tr>
<tr>
<td>1981–82</td>
<td>3</td>
<td>—</td>
</tr>
<tr>
<td>1982–83</td>
<td>2.25</td>
<td>3.5</td>
</tr>
<tr>
<td>1983–84</td>
<td>1.5</td>
<td>2.75</td>
</tr>
</tbody>
</table>

out-turn bore no relation to the targets, either (Table 5):

In view of the most savage deflationary policy which was maintained at the same time, this can hardly be claimed as a shining proof of the monetarist assumption that the “expectation” roused by the MTFS would itself reduce the inflationary pressure. Possibly, with a single strong trade union, it might have had some effect. In Great Britain, where large numbers of trade union leaders compete in militancy, such psychological pressures were hardly likely to work.

Sir Geoffrey Howe’s budget of June 1979, the first under the new dispensation, was broadly neutral, but since it set out to achieve a substantial shift of the burden from the rich to the poor—an aim which all subsequent Conservative budgets have continued to maintain with remarkable consistency—it increased the (indirect) VAT tax from 8% and 12% respectively to 15%, thus raising home prices by 4% and giving a further twist to the inflation spiral to increase the inflation rate from 8.3% in 1978 and 13.4% in 1979 to 18.6% in 1980. Subsequently, raising council house rents and the consumer prices of the nationalised industries were further examples of laying heavy burdens on the poor, carried through even at the cost of damaging what was allegedly the main aim, the curbing of the inflation. At the same time all restrictions on the export of capital were removed. Having thus started by boosting the inflation rate which it was the declared policy of the Government to reduce, it would clearly require exceptionally drastic deflationary packages to bring the economy back to anywhere near its “course” thereafter.

One method was to raise interest rates, already exceptionally high, still further. This brought in foreign short term capital which, together with the North Sea oil, boosted the international value of the pound and made British exports even less competitive abroad, leading to massive losses of export markets.

Basically, however, monetary policy took a back seat. It was fiscal policy which became dominant: it was the reduction in the fiscal deficit which was to save the British economy. To have this as an overriding objective at the cost of enormous sacrifices was all the more surprising since unlike the position of most other countries, the burden of the National Debt measured against annual G.N.P. had fallen greatly in Britain owing to the inflation, from a ratio of about 1:1 in the 1950’s to only about 50% in the early 1980’s. Bearing the inflation in mind, British budgets were actually in surplus, except for the election

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“Financial Statistics; National Income and Expenditure. P.S.F.D. = Public Sector Financial Deficit, including other items such as sales of financial assets.

The “atomic cloud” of footloose international speculative capital funds seeking temporarily high rates and wresting the control over exchange rates from the monetary authorities has continued to grow. See report of lecture by Denis Healey (1983), Financial Times, (5 June).
year 1983, and there was a particularly heavy surplus in 1981. This was unprecedented in the depths of a severe depression. A budgetary stance calculated on the basis of full employment would no doubt have shown even more deflationary effects. Actually, several other countries were in the same position (Table 6), but in their case the effect on the foreign balance of payment was far less damaging.

The reasons for the more destructive effects of deflationary budgets, i.e. of fiscal surpluses, in Britain than elsewhere lie in a sphere normally left out of account completely in the reasoning of British economists: the real world of production, especially manufacturing production. For each of the main events, and main Government actions taken, served further to weaken the productive base, and in particular, cut still further the precariously low investment rate which was ultimately responsible for the slow post-war growth. Thus the oil bonanza was not used to build up industry at home, to stand ready when the oil ceased to flow, probably in the 1990’s: instead it was used to finance long-term capital investment abroad, to boost the productive capacity of Britain’s competitors (Table 7).

The high interest rates, in addition to the oil, had raised export prices at least to 1983, and as noted above, damaged exports; meanwhile at home, firms reacted to the depression in the usual way by cutting back on investment and on stocks, further aggravating the fall in employment. Thus industrial investment fell 40% in 1977–81 and was even in 1984.

<table>
<thead>
<tr>
<th>Change in Actual Balance</th>
<th>Change in Inflation-Adjusted Structural Budget Balance</th>
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<tbody>
<tr>
<td>United States</td>
<td>-1.8</td>
</tr>
<tr>
<td>Japan</td>
<td>+0.3</td>
</tr>
<tr>
<td>Germany</td>
<td>-0.4</td>
</tr>
<tr>
<td>France</td>
<td>+0.9</td>
</tr>
<tr>
<td>U.K.</td>
<td>-0.6</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Net Current Balance of Payments</th>
<th>Net Capital Exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>1977</td>
<td>+54</td>
</tr>
<tr>
<td>1978</td>
<td>+1,158</td>
</tr>
<tr>
<td>1979</td>
<td>-653</td>
</tr>
<tr>
<td>1980</td>
<td>+5,235</td>
</tr>
<tr>
<td>1981</td>
<td>+6,547</td>
</tr>
<tr>
<td>1982</td>
<td>+5,551</td>
</tr>
<tr>
<td>1983</td>
<td>+2,049</td>
</tr>
</tbody>
</table>

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well below the level of the 1970's, while Britain's net foreign assets grew from £12.5 billion (=6.5% of GNP) in 1979, to £70 billion (=22% of GNP) in 1984: this is almost exactly equivalent to the £56 billion contribution of North Sea oil to the economy in the same period. In addition, the Government itself achieved the "improvement" in its budget stance which allowed it to cut the PSBR, largely by cutting public capital formation. This fell from 2.7% of GNP in 1978 to under 1.8% in 1981–4. As a result, roads, public housing and schools, among others, are in the opinion of experts rapidly reaching a point of no return in deterioration.

The consequence was a drastic fall in production and in the competitive power of British industry. The output of manufacturing industry fell by 15% in the first two years of the Thatcher Government and has even today (1985) not recovered its pre-Thatcher level. The loss of foreign markets and the penetration of British markets by foreign producers has reached the point where for the first time in perhaps three hundred years, British manufactured imports exceed manufactured exports, while industrial regions lie derelict, their skilled populations unlikely ever to find productive employment again.

There are those, inside the Government and out, who predict that ultimately, when the monetarist measures begin to work, Britain's strength will turn out to be the invisible exports, the services which, indeed, have held up much better than secondary industry in the depression. Yet it is hard to believe that a country the size of Britain can survive within the international division of labour by selling banking and insurance only, while her productive base falls further and further behind. Meanwhile, as Table 7 shows, even the favourable balance of payments created temporarily by the oil has been eroded year by year since 1981, to leave a yawning gap, when the oil receipts decline, and possibly even before: the reason, of course, is the inability of British manufactures to hold their place in the world's markets. Thus, while the oil revenue has been squandered to allow the Government to maintain a destructive policy of high unemployment and low investment, a new persistent balance of payments deficit is already appearing on the horizon, and it has been caused precisely by the package of restrictive financial and above all fiscal measures which theory alleged, could be counted on to rectify a balance of payments gap. The mechanism for ensuring a result exctly opposite to that expected by economic theory is that element usually neglected by economists, at any rate in Britain: the real world of factories, steelworks and roads—what T.W. Swan has called the "relative cost situation." It may be some consolation to the economics profession, though none to the British population, that this perverse result has been caused by the particular tradition, and the particular concatenation of circumstances affecting the British economy, though apparently few others.

32 See the comments by Lord Weinstock, managing director of Britain's G.E.C. to a Select Committee of the House of Lords, as reported in The Times, 25 April 1985. On the same occasion, Mr. John Harvey-Jones, chairman of I.C.I., said: "I don't believe Japanese governments would do some of the slightly thoughtless things that seem to happen in this country and which have a significant effect on our ability to compete internationally." Also see Economic Policy Review, 3 (March 1977); T. Sherif (1979), A De-industrialized Britain (Fabian Research Series 341, London.)

IV

We may now turn briefly to the German economy by way of contrast and comparison. Superficially, there were many similarities. Both the British and the German economies rested on a long industrial tradition, they were exporters of manufactures and of capital, and both the Sterling and the Deutschmark played the role of minor reserve currencies. Yet the contrasts were equally striking. Above all, Germany enjoyed an enormous balance of payments surplus in normal years, in spite of a negative invisible item. This meant not only an export-led incentive for German industry to work to full capacity and plan for expansionary investments, but also a constant upward pressure on the international value of the Deutschmark. In consequence, similar actions of the monetary authorities frequently led to results very different from those in a country like the United Kingdom, where devaluation was an ever-present threat. In spite of defensive actions by the German authorities against the infl- x, their currency reserves were constantly on the increase.34

The export successes were achieved in part by industrial efficiency, and in part by a very low internal tendency for prices to rise: what little inflation there was, was largely "imported." Conversely, export-led growth also led to a growing dependence on exports (Tables 1–3).35

The measures that were taken against the threat of importing inflation included the repeated revaluation of the Deutschmark, even after it had joined in the European Monetary System (E.M.S.); taxes on exports and tax reductions on imports in 1968; official intervention in the foreign exchange market; and obstacles to the inflow of foreign fugitive capital.36 Meanwhile longer-term capital exports, for a time among the most rapidly growing in the world, relieved some of the pressure.37 By contrast, fiscal policy seemed not to consider the foreign balance of payments at all. Inasmuch as it had a wider object, it was in the first place to ensure growth, and secondly, at a later stage, to secure price stability.38

In the recession of 1966–7, the large balance of payments surplus permitted the Government to run a large fiscal deficit in safety (just as in the two preceding years, the opposite effect could be counted on): in both phases, therefore, the foreign balance had a stabilizing effect.39 Again, in the crisis provoked by the oil price rise of 1973–4, the German authorities, using for the first time their new-found freedom of action after the floating of the dollar, managed to overcome their economic difficulties with much greater ease than the rest of Europe. There was spare capacity to produce exports, especially to O.P.E.C. countries, and since the

39 Schöllhorn, p. 411.
Deutschmark had just been revalued, the German central bank, the Bundesbank, was able to buy dollars and sterilize them. A deflationary fiscal policy and high interest rates kept liquidity down, and helped to contain the inflationary pressures from abroad, while absorbing an oil price rise that increased the cost of oil from 1 1/4% of G.N.P. in 1972 to 3 1/4 % in 1974. These successes were aided as much by the low internally generated pressure towards inflation, as by the inflationary reaction of other countries to the O.P.E.C. price rise.40

In December 1974 the money supply become for the first time a stated objective of the German monetary authorities. The measure chosen, however, was not any of the series M0 to M3 favoured in the Anglo-Saxon countries, but the so-called “Central Bank Money Supply,” i.e. the cash circulation plus the legal minimum reserves of the banks for their inland liabilities, since these were more clearly the direct responsibility of the Bundesbank.41

The oil crisis and the incipient world depression of 1979-80 were not so easily surmounted as the earlier crises. Since the German growth rate was then considerably faster than that of most other advanced countries, exports had little room for expansion while imports stayed high. The result was, for the first time, a major deficit in the balance of payments, absorbed to some extent by the influx and/or repatriation of capital (Table 8).

### Table 8. Balance of Payments of the German Federal Republic, 1977-1984 (Milliard Deutschmark)

<table>
<thead>
<tr>
<th>Year</th>
<th>Trade Balance</th>
<th>Invisibles (net)</th>
<th>Transfers (net)</th>
<th>Errors, Omissions</th>
<th>Total Current Balance</th>
<th>Capital Balance*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Private Official Total</td>
</tr>
<tr>
<td>1977</td>
<td>+38.4</td>
<td>-10.8</td>
<td>-18.2</td>
<td>+0.1</td>
<td>+9.5</td>
<td>-11.3 - 1.6 - 12.9</td>
</tr>
<tr>
<td>1978</td>
<td>+41.2</td>
<td>-7.4</td>
<td>-17.8</td>
<td>+2.1</td>
<td>+18.1</td>
<td>+0.5 - 3.3 - 2.8</td>
</tr>
<tr>
<td>1979</td>
<td>+22.4</td>
<td>-12.5</td>
<td>-21.1</td>
<td>+0.2</td>
<td>-11.1</td>
<td>+13.7 + 1.5 + 12.2</td>
</tr>
<tr>
<td>1980</td>
<td>+8.9</td>
<td>-13.0</td>
<td>-24.5</td>
<td>0</td>
<td>-28.6</td>
<td>-15.1 + 20.8 + 5.7</td>
</tr>
<tr>
<td>1981</td>
<td>+27.7</td>
<td>-14.6</td>
<td>-26.6</td>
<td>+1.1</td>
<td>-12.4</td>
<td>-9.7 + 18.0 + 8.3</td>
</tr>
<tr>
<td>1982</td>
<td>+51.3</td>
<td>-17.1</td>
<td>-28.1</td>
<td>+2.1</td>
<td>+8.2</td>
<td>-19.1 + 4.8 - 14.2</td>
</tr>
<tr>
<td>1983</td>
<td>+42.3</td>
<td>-10.2</td>
<td>-21.0</td>
<td>-0.4</td>
<td>+10.5</td>
<td>-12.5 + 5.1 - 7.4</td>
</tr>
<tr>
<td>1984</td>
<td>+54.0</td>
<td>-3.9</td>
<td>-31.5</td>
<td>-0.9</td>
<td>+17.7</td>
<td>-12.1 - 1.4 - 13.5</td>
</tr>
</tbody>
</table>

*A minus sign means capital exports.

Detailed figures reveal that the culprit, responsible for the sharp drop in the trading surplus in 1979-81, was not the Government deficit, but a large investment drive on the part of private business. The productive capacity created thereby made it easier to recover quickly, in contrast to those, like the United Kingdom, who attempted to redress their adverse foreign balance by cutting investment.43 The remarkably rapid German recovery thereafter was also aided by the fact that German prices had risen less fast than most, and the favourable effects continued even after the Deutschmark had been revalued.44

Yet, though Germany might escape the worst of the world’s inflation, she could not

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40 Deutsche Bundesbank (1980), Monatsberichte, 32/7, (July).
43 File and Heinemann, pp. 136, 143.
escape the world’s stagnation. Government deficits are accepted only reluctantly even in Germany, “sound finance” is the order of the day and, unlike countries where rapid inflation has helped to reduce the deadweight of the national debt and its interest burden, Germany’s sound currency has offered little relief to the budgetary authorities along that road. The balance of payments has returned to a sound surplus, but unemployment and stagnation continue (Tables 1–3).

V

The summary can be brief. This account of the British experience of recent years, set against the background of a cursory comparison with Germany, shows up very strongly to what extent generally valid relationships posited by theory, such as those between fiscal deficits, the balance of payments and the state of the economy, are affected by the overall pressures on the economy, by the experience of the recent past, and therefore by expectations. Ex post, of course, all foreign payments have to balance, but the pressures under which this balance was reached differed very greatly between the U.K. and the B.R.D. Britain, until the oil began to flow, had constantly to fight against a threatened deficit, while Germany had to guard against overlarge surpluses; the pressure on the £ sterling therefore was always down, and on the DM it was up; similar measures, especially those of an internal monetary or fiscal nature, might thus have widely varying results. In particular, it was the development of the real economy, suffering by repeated cuts in investment in Britain and therefore by continuing loss of efficiency and international competitiveness, while maintaining its modernity and competitive world position in Germany, which determined the outcome. The contrast was evident not only in terms of the real standard of living of the population, but precisely among those quantities and measures with which economic policy in both countries was mainly concerned.

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