Research Department
Federal Reserve
Bank of
San Francisco

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FRBSF Weekly Letter

# Thatcherism

The current debate in the U.S. on the Reagan economic program has led many commentators to draw parallels with the U.K.'s economic performance under Margaret Thatcher. Throughout their political careers, both Prime Minister Thatcher and President Reagan have consistently favored a less intrusive role for government. This is best exemplified in their espousal of lower public spending, reduced government regulations, and a hands-off approach to wage and price setting. On the basis of these shared principles, we might expect some similarity in other facets of their economic programs—and might expect that Britain's performance under Thatcher would provide a preview of the success or failure of Reagan's economic program.

From this perspective, economic developments in the United Kingdom since Thatcher's assumption of power in May 1979 may prove alarming. British consumer prices rose 18 percent during 1980—more than 7 percentage points above the rate prevailing in the final months of James Callaghan's Labor government. Despite this acceleration in inflation, the unemployment rate has climbed precipitously, from 5.3 percent in May 1979 to 10.1 percent currently—and the actual number of unemployed has passed the 2.5-million mark for the first time since the 1930s.

Quoting this chain of statistics, one might conclude that it would be wise for the U.S. to abandon similar policy initiatives. But this view is too narrow. In many respects, the differences between the Thatcher and Reagan programs are greater than the similarities. A closer look at the British experience may therefore prove enlightening for U.S. policymakers in the current discussion.

**Shift towards conservatism**

The Tories' victory in the Spring 1979 election reflected a myriad of factors. However, industrial disruptions, coupled with wage settlements well exceeding the government's guidelines, contributed to severe economic problems in the winter of 1978-79. Pent-up frustrations with this situation led the voting public to demand a change.

The victorious Conservatives' economic-policy program called for cuts in public spending and personal-income tax reductions to be financed by hikes in sales (value-added) taxes. Overall, the program was designed to lower the public-sector borrowing requirement (PSBR) to £8.3 billion in fiscal 1979/80 (4.5% of GNP) from £9.3 billion in fiscal 1978/79. The government hoped to achieve this goal despite a predicted fall in real economic activity and an acceleration in inflation brought about by the hikes in value-added taxes. The budget was designed to restore private incentives by shifting the burden of taxation from income to consumption, and reduce the government's role in the economy through reduced public spending.

Concurrent with this May 1979 budget proposal, the government announced that "sterling M-3" would be kept within an annual target range of 7-11 percent, down from the previous year's actual growth of 11½-percent. (That money-supply measure includes, among other factors, the PSBR less sales of public-sector debt to the non-bank private sector.) The planned cut in the PSBR was consistent with meeting this monetary-policy objective without putting undue pressure on interest rates. Reduced public spending and borrowing would help achieve a gradual deceleration in monetary growth, and hence in the inflation rate.

**Economic strategy**

The Thatcher and the Callaghan prescriptions for curbing inflation differed considerably. The Labor government had viewed efforts to curb inflation through a deflationary monetary policy as too costly and inefficient, leading to large-scale unemployment. For the

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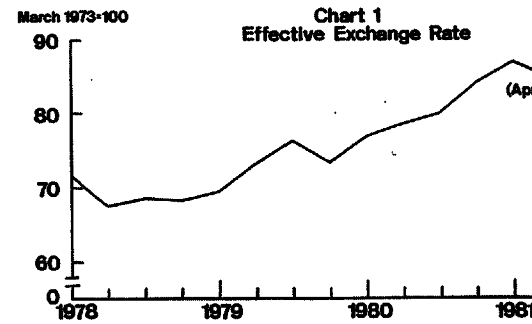



Laborites, cost-push factors—such as leap-frogging wage demands—provided a major impetus to inflation. Thus, the imposition of wage-price guideposts, in conjunction with a responsible monetary and fiscal policy, provided an appropriate response to inflation.

This position on economic policy got its support from two large-scale econometric models formulated by the National Institute of Economic and Social Research (NIESR) and the Cambridge Economic Policy Group (CEPG). By comparison, the Tories relied upon the empirical work of the London Business School (LBS) to support their policy prescription of reducing money-supply growth. According to the LBS, a tighter monetary policy would raise the exchange rate of the pound in terms of foreign currency, which in turn would help check domestic price and wage increases through increased international competition. While agreeing that a higher exchange rate would lead to lower import prices and hence to reduced pressure on domestic prices, both the NIESR and the CEPG argued that a high exchange rate would not act quickly to moderate wage behavior, and thus would lead to greatly diminished growth of output and employment.

Whatever their differences, all three models concurred with the government's conclusion that the British economy was headed for a contraction in 1980.

**What results?**
The Thatcher government failed to achieve its twin objectives of cutting public spending and reducing money-supply growth during the 1979-80 period. The main monetary aggregate, sterling M-3, increased at a 16.4-percent annual rate between the first half of 1979 and the second half of 1980, considerably above the 7-11 percent target range. The reason may have been a massive £5-billion overshoot of the public-sector borrowing requirement, to £13.5 billion in fiscal 1980/81.

Many would argue that the linchpin of the Thatcher program—reducing money-supply growth—was never fully implemented, so no lessons could be drawn from the experience. But M-1 growth was reduced by more than half over this period.

Whatever the public may have thought of monetary policy, the foreign-exchange markets perceived it as quite tight. The pound sterling rose sharply in value reflecting the combined influence of a stringent monetary policy (more properly measured by high interest rates and M-1 growth than sterling M-3) and oil-price developments (see chart 1).

In the face of the pound's appreciation, U.K. manufacturers tried without success to maintain their price competitiveness through reduced profit margins. But the slackening of export markets came at a time of weakness in domestic markets as well. This led to a record overhang of inventories which had to be financed at the much higher interest rates created by inflation and government borrowings. The inability of firms to pass on these costs, including increased energy costs, into higher prices led to a sharp deterioration in manufacturers' financial position.

Under these circumstances, one would expect a strong deceleration in wage demands. On the contrary, wage demands actually accelerated (see chart 2), partly reflecting substantial wage settlements awarded to civil-service employees and hikes in sales taxes contained in the June 1980 budget. The 25-percent annual increases in civil-service pay set a standard for private-sector wage earners, whereas the sales-tax increases raised the retail-price index on which wage demands were partly based. As a result, average earnings increased 26.1 percent between September 1979 and September 1980.

The fall-off in domestic and foreign demand, coupled with cost increases, meanwhile led many firms to declare bankruptcy and to lay off workers. In the resultant recession, manufacturing output dropped about 17 percent (see chart 3). However, the run-up in unemployment has finally moderated wage in-

Chart 2
Prices and Costs, Manufacturing

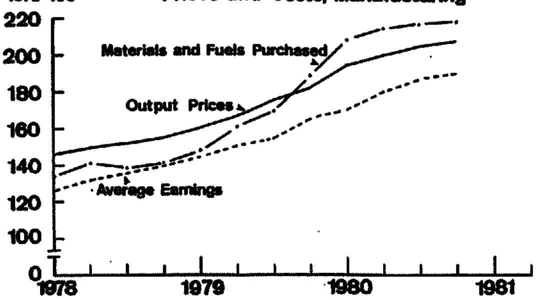
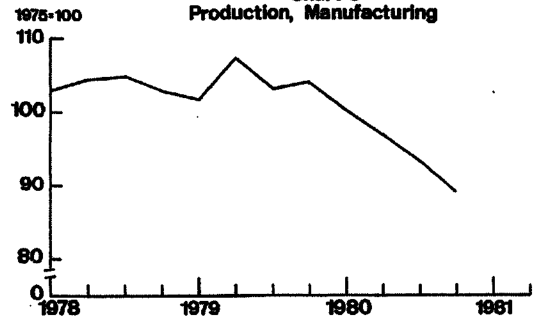



Chart 3
Production, Manufacturing




creases in the last six months, leading to some abatement of cost pressures.

Increased unemployment, and hence greater-than-expected outlays on unemployment compensation, helped push the projected PSBR to £14 billion—almost double the targeted amount—for the current fiscal year. The Thatcher government thus abandoned scheduled income-tax reductions and raised an assortment of other levies to reduce the deficit from £14.0 billion to £10.5 billion. The tax hikes will be imposed on an economy facing an expected 2.0-percent drop in real output this year after a 3.0-percent decline in 1980.

**Lessons for the U.S.?**

The contentious debate among the various U.K. research institutes parallels a similar controversy in the U.S. But whereas the U.K. controversy is between monetarist and non-monetarist, the debate in this country adds an extra dimension in the form of "supply side" (tax incentive) economics.

Administration officials predict that their budget and tax-cut plans will bring about dramatically lower inflation and robust growth over the next five years. This can be achieved by across-the-board tax cuts which will promote labor productivity through increased work incentives. Moreover, the Administration figures that gradual reductions in money-supply growth will moderate inflationary expectations. This in turn will lead workers to reduce their wage demands, and thus lead firms to moderate their price behavior. Whereas the U.K. government relies more on international competition to keep wages in check, the U.S. government counts on the salutary effects of reduced price expectations to accomplish the same effects.

Regardless of the means of policy response, both the Thatcher and Reagan governments can be characterized as highly optimistic regarding the speed of worker and producer response to changed circumstances. Their sanguine scenarios thus justified a hands-off approach to wage and price setting, and allowed the dismantling of the incomes policies imposed by their predecessors.

The Thatcher government's miscalculation on wage behavior led to higher-than-projected unemployment, and thus led to higher-than-expected public borrowing. To curb the fiscal shortfall, the Tories then raised taxes in the midst of a cyclical downturn, partly in order to reduce money-supply growth while alleviating upward pressure on interest rates. By contrast, the centerpiece of the Reagan fiscal program are spending and tax cuts during a cyclical upswing. From the Administration's perspective, the tax cut will not stimulate consumer demand but rather will spur supply through increased savings and investment incentives. The higher deficit stemming from the tax cuts will be financed in the short run by greater private savings and in the long run by higher production and output. Consequently, the tax cut need not prompt greater monetary expansion and higher interest rates. On the contrary, a reduction in money-supply growth would help lower expected (and actual) inflation.

The lessons that can be drawn from U.K.'s experience, therefore, rest mainly in the results of its monetary-policy actions. In this regard, the failure of British market participants to respond rapidly to a restrictive monetary policy affected output more than prices. This could be a warning sign to U.S. officials as well. If wage behavior remains sticky, a tight monetary policy and high inflationary expectations could lead to higher-than-projected inflation, a squeeze on corporate financial positions, and to lower output growth, which in turn will enlarge the fiscal deficit. Thus, such portents as the United Mine Workers' rejection of a 36-percent wage increase (over three years) provide rather unsettling prospects for future stability.

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## BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

| Selected Assets and Liabilities Large Commercial Banks | Amount Outstanding 5/13/81 | Change from 5/6/81 | Change from year ago Dollar | Percent |
|---|---|---|---|---|
| Loans (gross, adjusted) and investments* | 148,888 | − 94 | 10,746 | 7.8 |
| Loans (gross, adjusted) — total# | 126,806 | − 73 | 10,371 | 8.9 |
| Commercial and industrial | 37,508 | − 301 | 3,397 | 10.0 |
| Real estate | 52,149 | 151 | 5,500 | 11.8 |
| Loans to individuals | 22,890 | 35 | − 1,287 | − 5.3 |
| Securities loans | 1,428 | − 234 | 520 | 57.3 |
| U.S. Treasury securities* | 6,466 | 1 | 99 | 1.6 |
| Other securities* | 15,616 | − 22 | 280 | 1.8 |
| Demand deposits — total# | 40,480 | − 832 | − 2,037 | − 4.8 |
| Demand deposits — adjusted | 28,606 | − 246 | − 2,103 | − 6.8 |
| Savings deposits — total | 30,226 | − 277 | 3,867 | 14.7 |
| Time deposits — total# | 79,343 | 1,118 | 14,502 | 22.4 |
| Individuals, part. & corp. | 70,018 | 901 | 14,125 | 25.3 |
| (Large negotiable CD's) | 31,784 | 725 | 8,758 | 38.0 |

| Weekly Averages of Daily Figures | Week ended 5/13/81 | Week ended 5/6/81 | Comparable year-ago period |
|---|---|---|---|
| **Member Bank Reserve Position** | | | |
| Excess Reserves (+)/Deficiency (−) | n.a. | n.a. | 126 |
| Borrowings | 275 | 162 | 4 |
| Net free reserves (+)/Net borrowed(−) | n.a. | n.a. | −123 |

* Excludes trading account securities.
# Includes items not shown separately.

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