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The U.K.'s Rocky Road to Stability

At the end of 2004, the United Kingdom will have had positive economic growth for 50 consecutive quarters, a record unmatched in its half-century of quarterly GDP data. Over those 50 quarters, inflation has been steady, averaging around 2.5 percent. These achievements represent the culmination of major overhaul of the U.K. economic policy framework over the past 25 years.

By the mid-1970s, the U.K. had drifted away from allowing markets to allocate resources. The public sector, which had taken over several major industries in the 1940s, extended its ownership of companies in the 1970s. Government spending hovered near 50 percent of GDP. The growth of the public sector was accompanied by onerous regulations and taxes on private-sector activity. Although U.K. membership in the European Union (since 1973) exposed firms to greater competition, further benefits of membership for U.K. residents were stifled by foreign exchange controls that made travel and investment overseas prohibitive. On taxes, Joseph Pechman observed: "The 1978-79 top-bracket rate of 83 percent on earned income was close to the highest in the world; the top rate of 98 percent on investment income was surpassed only in Algeria..."¹

Price stability was a casualty of postwar U.K. policies. Inflation averaged 13.4 percent in the 1970s and peaked at over 25 percent in 1975. This failure reflected the attachment by policymakers to nonmonetary views of inflation and their consequent reliance on wage/price controls instead of monetary policy to handle inflation.²

The postwar pattern of U.K. policymaking came to be summarized as "stop-go"—a phrase that reflects the economic instability that occurred, but falsely implies major policy changes. In fact, policy differences between successive administrations were minor; instability occurred because the consensus policies themselves were destabilizing.

The Thatcher government, elected in 1979, quickly abolished foreign exchange controls and the highest marginal tax rates, and more gradually implemented reform of the labor market and privatization. These reforms seem to have helped reverse some of the decline in the U.K.'s

productivity growth after 1973. Another fundamental change was the rejection of price controls in favor of a strict monetary policy for fighting inflation, which brought inflation down to an average of 5.1 percent in the decade after 1982. On government expenditure, Thatcher's contribution was not lower spending but, instead, sustaining the reduction in the ratio of government outlays to GDP achieved by the prior (Callaghan) administration. In her second term, Thatcher lost interest in macroeconomic policy and permitted the Treasury to reinstate a policy of fixed exchange rates. The subsequent boom and monetary tightening meant that when Thatcher left office in 1990, inflation was near double digits while unemployment and the government spending/GDP ratio were climbing again.

The more durable period of growth alongside low inflation followed the resumption of floating exchange rates and the introduction of inflation targeting in 1992, which was reinforced by the independence conferred on the Bank of England in 1997. Monetary policy deliberations have been promptly disclosed to the public since 1994 and since mid-1997 have consisted of monthly minutes of the Bank of England's Monetary Policy Committee, the U.K. equivalent of the Federal Open Market Committee.

With control of inflation now institutionalized through inflation targeting, a principal economic concern for the U.K. is how fiscal and regulatory policies can stimulate productivity growth. After initial fiscal restraint, which in 1998 brought government spending and taxes simultaneously below 40 percent of GDP for the first time in decades, the Blair government launched major expenditure programs that have so far produced higher prices for government output but little apparent increase in output volumes. The government will need to ensure that its recently extended command over resources does not hamper private-sector productivity. The U.K. will also need to use its membership in the European Union to encourage a regulatory environment that is favorable for growth.

—Edward Nelson

¹ Pechman, Joseph A. "Taxation," in R.E. Caves and L.B. Krause, eds., *Britain's Economic Performance*. Washington, DC: Brookings, 1980, pp. 199-253.

² See Nelson, Edward. "The Great Inflation of the Seventies: What Really Happened?" Federal Reserve Bank of St. Louis Working Paper 2004-001; and Nelson, Edward, and Nikolov, Kalin. "Monetary Policy and Stagflation in the U.K." *Journal of Money, Credit, and Banking*, June 2004, pp. 293-318.