Signs of the times

Robin Ramsay

"It's the economy, stupid."

'In economic and social policy, the Government accepts wholeheartedly the so-called "Washington consensus" —that deregulation, privatisation, hire-and-fire labour markets, balanced budgets and low taxes are not only the key to policy success but unopposable.'

Editorial, *The Observer* 5 September

Britain exports more of its Gross Domestic Product than any other country. We also import a great deal and pay for it with the exports, of which something like 70% are earned by the domestic manufacturing economy. Yet Labour has adopted economic policies, *which have nothing to do with the 'Washington consensus'*, which are damaging that domestic manufacturing economy. That a *Labour* government, whose supporters, roots and core constituencies are in the domestic manufacturing economy, has done this is very odd indeed and needs explanation.

The origins of the government's economic policies date back a decade to the period when the late John Smith was shadow Chancellor of the Exchequer. After the 1987 election defeat Labour leader Neil Kinnock and John Smith decided that putting forward alternative economic policies to those of the Conservative Party (on behalf of the City of London) was futile and/or mistaken (it isn't clear to me which). Smith and Marjorie 'Mo' Molam, who was then his deputy in the shadow economics team, set off on what became known as the 'prawn cocktail offensive' —touring the City of London's dining rooms telling the City's movers and shakers that Labour was going to toe the line —their line.

It wasn't the 'Washington consensus' Labour adopted: it was the City of London's consensus and that said, 'Leave everything to us; we know what we are doing. We are the success story of the British economy.'

In practice this meant Labour abandoning all its plans to regulate the City and to attempt to manage the economy.

'The British economy', it is not all of a piece. Different sectors of the economy serve the interests of different groups —and benefit from different policies. A 'strong' pound *damages* the makers and exporters of things but *benefits* the movers of money (and importers). Mrs Thatcher destroyed about 20% of the British manufacturing economy in the early 1980s with high interest rates, being 'tough' on inflation; but the City of London —the financial sector —boomed like never before.

Regulating the economy solely by using interest rates as the present government is trying to do, is what the bankers always wanted *because it makes them rich*. They tried to 'bounce' the Churchill government into accepting this in 1952 but were resisted, notably by Harold Macmillan, who—accurately—described the proposals as a bankers' ramp.

They tried again during Edward Heath's years, and succeeded in selling to the Heath government the idea that removing most of the regulations on banks would encourage 'competition' among the banks. Thus the Competition and Credit Control changes of 1971, which were implemented without political discussion as mere 'technical changes'. They got competition—but not competition between the banks to be more efficient or provide the best services. What they got was competition to see who could create and lend the most money. Inflation began to rise. At that point interest rates were supposed to rise to 'control inflation' —the system we have in place now. But Prime Minister Heath, who appears to have not understood any of this,[1] refused to put up interest rates. He was making the famous 'dash for growth' in the run-up to joining the Common Market in 1973, and wanted an expanding economy. The result was the boom of 1972/3. Inflation began to increase. It was Heath's —and this country's —misfortune for his inflationary boom to be in progress when the price of oil quadrupled, cranking up inflation and disrupting the world's economy. Taking office in 1974 the Labour government of Harold Wilson inherited inflation approaching 20% a year and rising.

The Labour governments of Wilson and then Callaghan, who succeeded him in 1976, bore the brunt of the great inflation created by the Heath government, the banks and the OPEC oil price rise, and in 1979 another Tory government duly took office. Prime Minister Thatcher and her Chancellor of the Exchequer, Geoffrey Howe — lawyers with little understanding of economics — proceeded to remove the controls reimposed by the Labour governments of 1974-79 and gave the bankers one more thing they wanted: the abolition of exchange controls, allowing the unhindered flow of capital in and out of the UK. This was an extraordinary thing for a government led by Thatcher and Howe to do because its economic policy hinged on controlling the money supply; which the abolition of exchange controls made impossible. It took nearly two years for this to dawn on Thatcher and Howe, illustrating graphically their tenuous grasp of the most elementary economic ideas.

Having got everything they had asked for so far, the bankers began arguing in the late 1980s that what Britain needed was a financial system *completely* free of restrictions, with the Bank of England removed from government influence at its centre. This was granted by Gordon Brown, to acclamation from the bankers, in his first week in office.

Gordon Brown's camp are now saying Brown got the idea from America (from whence, as we know, everything good must now come); but the idea came from Germany. We are now supposed to forget that in the 1980s it wasn't America whose economy Labour politicians looked at with envy but Germany, which had higher growth, higher investment, higher productivity, higher living standards —and an independent central bank which controlled the interest rate, the central lever in a capitalist economy. A decade or more later all that remains of the German model in New Labour thinking is the one part of it which the City wanted —the independent central bank.[2]

Using 'regulate' in its loosest sense, the financial system regulates itself: the flow of credit is unchecked (how many credit cards have you been offered this year?) and every once in a while interest rates will be increased 'to control inflation' or 'dampen down' the economy. This actually means the following: bankers can lend as much as they can persuade us to borrow and when they —the lenders —decide there is too much money in the economy, they put up the interest rates on their loans. This is a racket which makes loan-sharking look refined.

However, Gordon Brown didn't go *quite* as far as the bankers wished. He didn't just tell the Bank of England to run interest rates: he appointed a Monetary Policy Committee, on which the Bank of England has a majority, to decide them. And he gave them an official job specification: *using only interest rates*, get inflation in the UK down to 2.5% and keep it there.

The theory says that if prices are rising too much (inflation), the solution is simple: raise interest rates. We spend less and as demand falls prices fall —or don't increase. But life isn't this simple. Raising interest rates also makes putting money in British banks attractive to the world's financial speculators if the interest rates in the UK are higher than elsewhere. The pound becomes a 'good buy' —demand for sterling increases and up goes the value of the pound vis-a-vis other currencies. This is a 'strong' pound. A 'strong' pound does two things to the domestic economy: it makes imports cheaper and it makes exports more expensive. As a result there is less demand for things made in Britain and, ultimately, businesses cut back or close. Unemployment rises. The unemployed have greatly reduced incomes and so demand in the economy falls and prices fall.

The Labour government's official economic policy consists of a promise to make people unemployed (and money-lenders richer) if prices rise above two and a half per cent a year, the official inflation target. And this *does* work. Creating unemployment *will* reduce inflation —Mrs Thatcher showed this to be true in 1980/81. But it works in a particular way: raising interest rates makes people unemployed in the *sector* of the economy which makes and exports things.

The Monetary Policy Committee appointed by Gordon Brown was initially dominated by inflation 'hawks' —that is, people who are 'tough' on inflation. Running British interest rates at approximately 2% more than the rest of Europe, the Committee has pushed the value of the pound up to levels not seen since just before the UK joined the Exchange Rate Mechanism at the beginning of the decade. Another swathe of UK manufacturing jobs has gone as a result and the losses will continue so long as the pound is at or near its current value.

In the last twenty years of economic policy, since the arrival of Thatcher-Howe, the one near-constant factor has been an over-valued ('strong') pound, creating prosperity for the City and difficulties for virtually everyone in the UK economy but the City.

The last twenty years has proved that if you give money-lenders control of economic policy they put interest rates up.

The covert aim of the theory of controlling inflation using interest rates is to keep British

interest rates higher than that of other countries, benefiting the City of London.

It's still the economy, stupid

'The new intellectual and political consensus is that manufacturing no longer matters. The future is the knowledge economy and the service sector. Manufacturing is yesterday's story: very Old Labour, very uncool Britannia...'

Will Hutton, *The Observer* May 1999

Hutton is correct that this is the current consensus in New Labour leadership circles *but it isn't new.* These attitudes first began to appear in the late 1970s when the scale of North Sea oil revenues began to become clear. In 1980 the economist Frank Blackaby quoted 'a senior Treasury official' saying, 'Perhaps we can either have North Sea oil or manufacturing but not both.'[3]

The Treasury official was referring to what was then seen as the potential *problem* created by Britain becoming self-sufficient in oil in the 1980s. Not needing to import oil, and assuming the British economy continued exporting as much as it had before oil, would produce a trade surplus. In the absence of measures to counteract this, such a surplus would, in theory, push up the value of the pound, which would make British exports more expensive abroad and imports cheaper. British exports and hence British manufacturing, which produced most of them, would decline as oil pushed up the value of the pound.

This theory came into its own as the rise in the value of sterling between 1979 and 1981 destroyed a quarter of British manufacturing industry. Nothing to be done, said the financial experts employed by the City. It is merely the mechanism through which the balance of trade between this country and the rest of the world corrected itself. Importing no oil, we needed less manufacturing output.[4] Further, said the financial experts, the massive flight of capital *from* this country after the abolition of exchange controls in 1980 was a *good* thing. The outflows helped to balance the capital *inflows* from the North Sea, preventing an even bigger trade surplus, an even higher pound, and the destruction of even more British manufacturing! Senior Treasury official at the time, Leo Pliatzky, wrote later, intending no irony that I can detect, that:

'It is understandable that people are frustrated that more primitive (sic) countries which produce oil have used the revenues from it to finance industrial and social development while in Britain both have been cut back since the North Sea oil came on stream.'[5]

The theory followed the money

What happened is that economic policy and theory followed the money. This isn't supposed to happen. Economic policy is supposed to be a rational business carried out by experts. But that is what happened: the theory followed the money. Frank Blackaby noted in 1980 that:

'just at the time when oil output was building up, *there was a major swing in fashion in thinking about the exchange rate.* Up to 1977, the doctrine had been to use the exchange rate to preserve competitiveness [i.e. keep the pound relatively cheap] ...The doctrine was then changed to assert that (a) there should be no exchange-rate policy, and (b) that a high exchange rate was a good thing' (emphasis added).

Blackaby called this:

'one of those unfortunate *accidents* which have so bedevilled British economic policy since the war' [emphasis added].[6]

In the same year, the *Guardian*'s Victor Keegan asked:

'What happened to the oil revenues which, five years ago, led people to expect the dawning of a new age of prosperity? Most of it, in the *supreme irony of economic history*, has gone to pay out unemployment to those who would not have lost their jobs if we had not discovered it in the first place' [emphasis added].[7]

But wait a minute: we are supposed to believe that these changes in 'doctrine' on the exchange rate which led to the recession of 1981-3 and the loss of two millions jobs and the boom in the City of London, were the result of an 'ironic accident'? In fact these 'changes in doctrine' occurred in 1977, when, after some months of debate in the economic press and the pages of *The Times*, 'the core institutional nexus' —i.e. the City, the Treasury and the Bank of England —plumped for oil rather than manufacturing and tried to persuade the Labour government to do two things: allow the pound to rise and scrap exchange controls. Both were refused by the Callaghan government; both were introduced by Thatcher and Howe three years later. With exchange controls abolished, interest rates jacked up and almost all of the remaining financial controls scrapped, the pound soared and large chunks of manufacturing collapsed —as the core financial nexus knew it would.

In reply to the protests from the manufacturing sector at its collapse, the City, parts of the Treasury and Bank of England, and some politicians, replied that the loss of manufacturing capacity was unimportant because Britain was on some natural evolutionary path towards a post-manufacturing or post-industrial service economy.[8] Chancellor of the Exchequer Nigel Lawson contemptuously offered this line in 1985 to a House of Lords committee looking at Britain's shrinking manufacturing base.

Mrs Thatcher bought the line. In his memoir the former BBC political correspondent, John Cole, describes asking Mrs Thatcher for an example of how this 'service' or 'post-industrial economy' would work:

'She cited an entrepreneur she had met the previous week, who wished to take over Battersea power station and turn it into what we both then knew as a "Disneyland", but subsequently learned to call a theme park.'

The next day Cole recounted this to the Economic Attaché of the United States embassy:

'He looked at me in genuine astonishment, thoughtfully laid down his fork, and exclaimed: "But gee, John, you can't all make a living opening doors for each other."'[9]

Former Treasury mandarin, Leo Pliatzky:

'It was a strange period to look back on. There appeared to be a great gulf between attitudes in much of the City and in industry throughout the country. In some quarters there was a Khomenei-like fanaticism about, a reluctance to see the connection between high interest rates and a crippling exchange rate. North Sea oil had made sterling a petro-currency, it was alleged; *the days of manufacturing were over'* [emphasis added].[10]

The political journalist, Edward Pearce, recounts how a 'Treasury knight'—i.e. one of the very senior civil servants in the Treasury—said of John Major's period in office, 'that though very fond of Mr Major, he worried a little at his anxiety about manufacturers. "He wasn't very happy with the analogies we made about Switzerland, *so prosperous entirely from service industries*, so it was necessary to let him make friendly things (sic) to the manufacturing people" ' [emphasis added].[11]

Fifteen years after they first appeared in financial circles, these attitudes have now been adopted by the New Thatcherites running the Labour Party; only they talk of manufacturing being replaced not by the 'service economy' but by the 'knowledge economy' —a vague mishmash of the City, computers, film production, rock music and the Internet. The difference these days is that unlike John Major, New Labour hasn't even felt it necessary to 'make friendly things' to the 'manufacturing people' as they go down the pan.

The knowledge economy

There was a supplement about 'the knowledge economy' in the *New Statesman* 27 September. Near the end of this a number of well known names are asked for a sound bite about the knowledge 'the world needs now'. James Dyson the inventor and manufacturer of the 'Cyclone' vacuum cleaner, dumped a bucket of cold water on 'the knowledge economy' idea.

'What I think we're losing is our intellectual property base, our know-how in both technology and manufacturing. We're losing the ability to make planes, cars, electrical appliances, in almost every traditional manufacturing area. That's a terrible thing. While you might think the world now depends on the software and service industries, in reality their output is a fraction of the traditional industries. I've had an argument with the governor of the Bank of England about this, *who thinks that software is replacing the need to make goods*' [emphasis added].

In the late 1970s and 1980s first the bankers thought it was oil which would replace manufacturing; then it was the growth of the City of London; now the Governor of the Bank of England thinks it is computer software.

In his comment Dyson concluded:

'If nothing is done about our dwindling technical know-how, we will end up as a very weak service economy. We'll have no manufacturing, few jobs and end up a very poor country. Tony Blair and Gordon Brown realise this....'

Do they? I wonder. There is little evidence of this. In his speech to Labour's conference at the end of September, Blair said nothing about this —though he did refer to 'the knowledge economy'.

In May 1999 the Monetary Policy Committee began to speak of the damage being done to manufacturing —by *their* decisions on interest rates over the previous two years.[12] Eddie George expressed himself as 'exasperated' by the pound's

strength —as if it was a badly behaved pet, rather than the result of policies for which he had voted on the Committee.[13] At the beginning of September we had a quarter per cent rise in interest rates, a compromise, after much discussion in the economic pages of the broadsheet papers, between the 'hawks', looking at the rising house prices in the South who wanted a bigger increase, and the others looking at the recession in much of the rest of the country, who wanted no increase at all.

But the Committee's job specification of 2.5% inflation remains and even with a majority now apparently worried about the effects of the high interest policy on manufacturing there is little it can do except chip the odd quarter per cent off rate rises called for by increases in inflation when they occur. Gordon Brown continually tells us that UK long term interest rates are at their lowest for forty years. Which is true but beside the point. UK interest rates are 2% higher than they are in the Euro zone. That is why the pound is overvalued and why Britain lost 150,000 manufacturing jobs last year. For the policy to change, the Committee's brief has to change and such a change will signal to the world that Brown made a mistake: and for Brown —like the rest of us — admitting he made a mistake will be last on the agenda.

New Thatcherites

Gordon Brown has the same problem that Thatcher and Howe had: reality doesn't match the neat model in his head. The model says that low inflation produces economic stability and that, in itself, will produce economic growth and that is basically all a Chancellor of the Exchequer really can or should do. Like Thatcher and Howe in 1979-81, Labour has no exchange rate policy. Indeed, Brown warns of the perils of having one. On 10 June this year Brown said that while he understood the concerns of exporters:

> 'Anyone who thinks that dropping the inflation target to replace it with an exchange rate target, or running inflation and exchange rate targets at the same time is the right way to achieve domestic stability is failing to learn the lessons of the 1980s.'[14]

Quite which 'lesson of the 1980s' he is thinking of is unclear to me. Certainly not the lessons of the early 1980s when Thatcher and Howe followed a policy identical to Brown's, with the same consequences —destruction of manufacturing jobs. Let me recap: Thatcher and Howe took office and put up interest rates. This pushed up the value of the pound, making British exports expensive and foreign imports cheap. Collapse of a large chunk of manufacturing. Brown got into office, handed over interest rate policy to the bankers, and up went interest rates, and the pound rose—but not as dramatically as it did in 1980/81. *New Labour's economic policy is simply Thatcherism mark 1*; but starting from lower inflation and thus not having —yet —to be as savage as Thatcher/Howe were in the early 1980s.[15]

As in the 1980s, the prosperous, City-driven greater London area can experience growth while large chunks of the rest of the country is in recession. In May this year the TUC reported that in the 106 constituencies where manufacturing employs more than 30% of the work force, half had recorded a rise in unemployment in the previous six months.[16] At present this has no political significance. Unemployment nationally is falling because the growth of the City/London/service sector has outpaced the lost jobs in manufacturing in the North, Midlands, Wales and Scotland.

Unemployment falling, inflation low —the garden is rosy. Or would be were it not for a huge structural problem which is not going to go away. The loss of manufacturing capacity since the 1980s has produced an ever increasing annual trade deficit on goods, actual *things*. This is now over £20 billion and heading rapidly towards £30 billion. At present this is counterbalanced by a combination of the surplus made by the service/financial sector and earnings from overseas investments; but it is entirely unclear how long this can be sustained. Pursuing 'the knowledge economy' Blair and co may now believe they are on the wave of the future, driven by technology and changing world markets; but the truth is they have simply swallowed whole the ideology of the City of London.

Alas for Gordon Brown, he (and Blair) have become enthusiasts for the free market, 'Washington consensus' with which I began this essay, just at the point when it is starting to be dismantled. The 'open source' intelligence group on the Internet, Stratfor, headlined its Global Intelligence Update of September 20, 1999, 'World Bank Reverses Position on Financial Controls and on Malaysia'. It quoted comments by Joseph Stiglitz, the World Bank's chief economist, who said on September 15,

> 'There has been a fundamental change in mindset on the issue of short-term capital flows and these kind of interventions —a change in the mind set that began two years ago...in the context of Malaysia and the quick recovery in Malaysia, the fact that the adverse effects that were predicted —some might say that some people wished upon Malaysia —did not occur is also an important lesson.'

Stratfor's analyst commented:

> 'These were not casual remarks. They were made during the presentation of a key World Bank annual document, the *World Development Review*, and were meant to be taken seriously. Indeed, Stiglitz's comments came a week after the International Monetary Fund (IMF) praised Malaysia for its skillful handling of capital controls.
>
> ....Stiglitz is following the new conventional wisdom: capital controls are chic.'

So Brown will have to start shifting his position again.

One final comment. The City of London has had complete control over British economic policy, and most British economic thinking, for over twenty years. So how important is the City of London to the British economy? According to the City-funded propaganda organisation British Invisibles, which may be presumed to be inclined to exaggerate, it constitutes only 6.4% of the UK's Gross Domestic Product.[17]

Notes

1. The competition and Credit Control changes are not referred to in his recent memoir.
2. In his memoir French banker called Emile Moreau, Chairman of the Bank of France, described Montague Norman, Bank of England chief in the 1920s and '30s, advocating an independent, autonomous, bank. This would, Norman argued, 'remove from the political arena... monetary security, credit allocation and price movements'. Cited in *Around the World on a Trillion Dollars a Day*, Gregory J. Millman, Bantam Press, London, 1995, p.52.
3. Frank Blackaby, 'Exchange Rate Policy and Economic Strategy' in *Three Banks Review*, June, 1980.
4. Hamish MacRae in the *Guardian*, October 13, 1981: 'As the energy sector grows, something has to shrink.' In this curious universe it is unclear how countries ever get richer, for as one sector grows, another, apparently, has to shrink. Did the Saudis grow fewer dates after they found in oil?
5. Leo Pliatzky, *Getting and Spending*, Oxford, Blackwell, 1982, p.194.
6. Blackaby op. cit.
7. Victor Keegan, *Guardian*, 16 May, 1983.
8. Lawson used to believe that as oil revenues declined, manufacturing, wrecked in the early 1980s, would spontaneously regenerate itself. See Nigel Lawson, *The View From No. 11*, pp.195&6. Not so far, Nigel!
9. John Cole, *As It Seemed To Me*, Weidenfeld and Nicolson, London, 1995, p.209.
10. Pliatzky op. cit. p.128.
11. *Guardian*, 8 January, 1992.
12. Discussed in William Keegan's column in *The Observer*, 23 May, 1999. The Bank of England likes to refer to manufacturing as 'the internationally exposed sectors of the economy'. Sounds so much better than manufacturing, doesn't it?
13. *Daily Telegraph*, 15 May, 1999.
14. *Guardian*, 11 June, 1999.
15. The oddity is that Brown appears to believe that something new is going on. Yet in the 1950s and '60s the policy of putting up interest rates as soon as a little inflation appeared was derided by Labour spokespeople as 'stop-go' economics.
16. Will Hutton, *The Observer*, 2 May, 1999. The Labour Party is now the two economies grafted together: Old Labour/ New Labour; centre/ periphery; industry/ City; national/ transnational.
17. *Guardian*, 6 January, 1999.