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Economic Policy Strategies in Major Industrial Countries

by Günter Großer, Günter Weinert, Hamburg*

The stubborn weakness of growth in the industrial countries since the mid-seventies is a manifestation of a serious crisis of stabilisation and adjustment whose roots go far beyond the oil price increases. Against this background there was a marked turn in the direction of economic policy as a result of changes of government in 1979 in the United Kingdom and in 1981 in the USA and France. The programmes to stimulate economic growth were based on the supply-side concept in the UK and the USA but on the demand concept in France. Our article assesses the measures actually taken and the policy accent in the three countries against the background of previous economic developments and the prevailing political and institutional circumstances.

The role of the state in relation to the private sector and the market system was a central aspect of the new strategies pursued in Britain, France and the USA. The terms neo-classical supply-side policy and Keynesian demand policy are generally used to characterise economic policy in the three countries, although they do not fully match these descriptions.

According to the supply-side policy concept, the persistent weakness of growth is essentially the consequence of adverse developments on the supply side, which chiefly stem from the increasing predominance of the state resulting from its excessive demands on and redistribution of resources, its all-embracing manipulation of economic activity and its interference with market mechanisms. Placing their trust in the stability of the private sector and its reaction to incentives, supply-side economists therefore expect that the restriction of state activities will represent a decisive step along the path towards sustained growth and hence, by creating viable jobs, towards a lasting solution of the problem of employment. The stabilisation of expectations by means of a monetary policy oriented towards stability and the economy's growth potential plays a key role.

By contrast, the demand management concept attributes slow growth to an acute shortfall of demand, which depresses the business climate and hence the propensity to invest. Private-sector demand cannot be expected to revive on its own, so that in the absence of external stimuli – as in a worldwide downturn – it is the duty of the state to improve sales prospects by boosting

demand. The improved propensity to invest induced in this way should set in motion a process of growth that should again reduce underemployment. With the reliance such a policy places on the volume effects, curbing inflation is considered to be a secondary aim.

The programmes to stimulate economic growth were based on the supply-side concept in the United Kingdom and the USA but on the demand concept in France. The measures actually taken and the policy accent in the three countries should be seen against the background of previous economic developments and the prevailing political and institutional circumstances.

United Kingdom: Priority for the Fight against Inflation

The first radical change of direction in economic policy occurred in the United Kingdom, where the problems were also the most serious. During the seventies the UK recorded the highest rate of inflation among the industrial countries (with consumer prices rising at an annual average of 12½ % between 1970 and 1979) and one of the lowest rates of growth (2 % in real gross national product).

The Conservative Government announced a re-orientation of economic policy that concentrated on the supply side; this was aimed at reducing the obstacles that the system of taxation and the unduly large role of the state placed in the way of initiative and the willingness to take risks. However, the fight against inflation was at the top of the list of objectives. The assessment of inflation as the most serious problem was clearly decisive in giving monetary considerations predominance in the overall concept. The function of

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fiscal policy was made subordinate to that of monetary policy, in that the public sector borrowing requirement became a monetary action parameter determining interest rates.

The supply-side strategy was given a medium-term time-horizon. According to a projection made in March 1980, the target range for the growth of the sterling M3 money supply was to be reduced steadily over a period of four years from 7-11 % in the 1980-81 fiscal year to 4-8 % in 1983-84. At the same time, real government expenditure was to be reduced by a total of 5 % and the public sector borrowing requirement was to be brought down from 3¾ % of gross domestic product to 1½ %. In view of the importance attached to reducing the borrowing requirement, there was initially no room for easing the burden of taxation in spite of the spending cuts. Finally, market forces were to be strengthened by abolishing the Price Commission, abstaining from the incomes policies that had previously been normal and privatising various nationalised industries.

USA: Scaling Down of Government

In the USA the record of the seventies was not quite as bad as in the United Kingdom with regard to either the long-term inflation rate (7 %) or the growth rate (3 %). However, the sharp recession and rising unemployment in the first half of 1980 at a time of a 14 % rate of increase in consumer prices fuelled the debate about the causes of the long-term adverse trend and the necessary therapy.

In the eyes of the Reagan Administration, the true cause of the weakness of growth and the stagnation in productivity lay in the fact that the state had exceeded the optimum point with regard to the burden of taxation on its citizens, the size of the public sector and the restriction of market mechanisms by means of regulation. Correction of these adverse trends would decisively improve supply conditions and very swiftly release the inherent dynamism that the Administration attributed to the private sector. The centre piece of the economic policy programme consisted in massive tax cuts in order to stimulate saving, investment and productivity and thereby move into a path of rapid, inflation-free growth. Monetary policy was expected to follow a steady course directed towards stabilisation. Nevertheless, monetary policy measures remained in the background by comparison with fiscal action, no doubt partly because of the constitutional independence of the Federal Reserve Board from the President.

At the beginning of 1981 the new Administration formulated its fiscal policy as a medium-term projection

from the very outset. The rise in both the receipts and expenditure of the Federal Government was to be greatly curtailed. The proposed reduction in income tax by 30 % over a period of three years and the raising of depreciation allowances were designed to produce a 16 % cut in projected revenue in the 1983-84 fiscal year. The Administration did not consider that this would jeopardise the aim of restoring the budget to balance by then, because apart from the planned cuts in expenditure it was banking on a strong acceleration in economic expansion. As part of the programme of deregulation the policy of wage-price guidelines was abandoned and price controls on crude oil were removed earlier than had originally been intended.

France: the State as the Engine of Growth

By comparison with the other industrial countries, France was still recording an above-average rate of economic growth in the seventies (4 %), although inflation was also relatively fast (9 %). Unlike the situation in the United Kingdom and the USA, unemployment had risen continuously, even during the cyclical recovery following the downturn of 1974-75.

The economic policy concept of the Socialist Government provided for the stimulation of overall demand by boosting private consumption, no doubt largely because it was an integral part of a strategy of redistribution in favour of lower incomes. Together with planned measures in the labour market and the announced nationalisations, this had a noticeable adverse effect on supply conditions. Nevertheless, it was assumed that the demand impulses would quickly stimulate investment and economic growth, an assumption similar to that made under the reverse economic policy sign in the USA.

In France monetary policy has traditionally had no independent role alongside fiscal policy; it is set by the central bank on the instructions of the Government.

In May 1981 the new Government announced many piecemeal measures, but no key fiscal policy data for either the short or medium term. Demand stimulus was to come primarily from the substantial increase in statutory minimum wages and social security benefits (family allowances, housing benefits and minimum pensions). On the other side of the coin special taxes were introduced for the most highly paid, and for banks and oil companies. At the same time additional subsidized credit was made available for corporate investment and financial resources were provided for residential construction. As even the anticipated acceleration in economic growth was not expected to

bring rapid relief to the labour market, this was to be achieved by creating a large number of new posts in the public service, subsidizing jobs in private industry and shortening the working week, increasing holiday entitlements and lowering the age of retirement. The substantial increase in government expenditure in 1981 and 1982 was accompanied by an only marginally smaller increase in revenue in order to keep a tight hold on the increase in the budgetary deficit.

Relationship between Monetary and Fiscal Policy

The economic policy concepts and programmes pursued in the three countries display marked differences, particularly in the order of importance of monetary and fiscal policies. Whereas in the United Kingdom fiscal policy is most definitely subordinate to the monetary objectives, in France the main function of monetary policy – external constraints permitting – is to support the fiscal and, especially, structural policies by channeling credit in the desired direction. In the USA, on the other hand, monetary and fiscal policies are independent instruments of economic policy for constitutional reasons.

The cross-grid of supply-side policy and demand-based policy merely provides labels for the fundamental approach of the programmes or indicates only the primarily intended effect, as in the case of ambivalent measures such as tax cuts. The actual shape of policy depends on many factors. In reality the United Kingdom and the USA have evolved very different fiscal strategies, in spite of having begun from essentially the same starting point in proclaiming their economic ills and the remedies required. Similarly, in France economic policy is so strongly influenced by the

interventionist tradition of the country that no very typical programme of demand management has emerged.

Considerable problems have arisen as a result of saddling policy programmes with objectives outside the true realm of the growth theory approach. One such objective is the rapid increase in defence spending in the USA, whereas in France the measures to stimulate demand were shaped by the aim to redistribute incomes.

In all three countries the actual monetary and fiscal policies developed from the economic policy projections diverged considerably from the original intentions.

Strong Restriction of Demand in the UK

The increase in sterling M3 was far in excess of the target rate in the 1980-81 fiscal year and gave the impression of monetary expansion running ahead of the economy's potential, particularly as the sharp increase in interest rates was consonant with the high rate of inflation. On the other hand, the behaviour of M1 attests to an extremely restrictive monetary policy; using the overall level of prices as a deflator, the money supply in this narrow definition contracted by about 15 % between the middle of 1979 and the end of 1980.

The public-sector borrowing requirement increased relatively little in the 1980-81 fiscal year despite the recession, but at 5.7 % of GDP it was around one-half higher than intended. Given the importance attached to this item in the economic strategy for money-supply management, this was seen as one of the causes of monetary "over-correction". The Government therefore made little change in its plans for reducing the borrowing requirement over the medium-term. The consolidation

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V E R L A G W E L T A R C H I V G M B H – H A M B U R G

effect, that is to say the discretionary change in the public-sector deficit, was estimated to total between 4½ and 5 % in 1981 and 1982 by the OECD and the EC.

This development is all the more remarkable, as government expenditure was still rising even after price adjustments, whereas a reduction had been planned. Moreover, attempts at consolidation on the expenditure side were mostly at the expense of public investment. The decisive factor, however, was the increase in government receipts. The consolidation of government finances that this produced did admittedly contribute to stabilisation, but it contrasted unmistakably with the supply-side aim of strengthening the private sector.

Steep Increase in the US Budget Deficit

In the USA the central bank accompanied the Administration's supply-side stance until the late summer of 1982 with a declared strict stabilisation policy, which also enjoyed the fundamental approval of the Administration. However, during this period monetary expansion fell short of the requirements for potential-oriented stabilisation.

The key fiscal policy projections were revised repeatedly from the very outset, expenditure being increased and revenue reduced. Whereas the original aim had been to balance the Federal budget in the 1983-84 fiscal year, now the Administration is aiming to prevent the deficit exceeding 5½ % of gross national product. Instead of falling by 4 percentage points as a proportion of GNP, Federal expenditure will rise slightly to 24 %. By contrast, the revenue share projected for 1983-84 is set to decline by 2 percentage points to the earlier target of 19 %.

The marked discrepancy between the projections of the original programme and the actual fiscal policy is attributable to various causes. The first of these is undoubtedly the fact that the Government could not obtain approval to cut non-military expenditure to the planned extent. The more important factor, however, was miscalculation of the impact of economic measures. The sharp rise in the budget deficit that was largely due to this aroused fears that private demand for capital would be crowded out and that monetary policy might accommodate the rise without regard for stabilisation. Real interest rates rose so much that the stimulatory impact of fiscal policy was completely nullified at first. The initial result was a shift into recession instead of the desired acceleration in growth; the macro-economic potential path was not raised but probably levelled off, with rapidly declining industrial investment. However, over the long term such a

development leads to a further structural increase in the state's share of the GNP and according to supply-side notions thus generates the need for further consolidation.

Only Temporary Demand Stimulation in France

Comparison of the economic policy actually pursued in France with the previously declared intentions is made difficult partly by the lack of quantitative targets and partly by the very incomplete key data available for the period since the change of policy. The transparency of fiscal policy is further impaired by the fact that numerous measures relating to a wide variety of subjects were taken in rapid succession, many of which were not fully consistent with demand stimulation. The general trend, however, was to move swiftly away from the original strategy of consumption-led expansion.

The dramatic increase in many social security benefits in mid-1981 was followed the same year by the decision to reduce the deficits of the social security fund by substantially increasing the contributions of both employers and employees. In 1982 steps were taken to promote investment by private and public enterprises, whereas the expansion in private consumption was progressively dampened by measures to consolidate government finances.

The credibility of the Government's stabilisation intentions was undermined from the start by the fact that the declared aims were not "safeguarded" by curbing monetary expansion. In these circumstances the exchange rate of the franc was under latent pressure, and this appreciably restricted the scope for the intended reduction in the level of interest rates in spite of tighter controls on international payments.

After the brief phase of stimulation the need to improve the conditions for growth through progress in stabilisation and adjustment therefore once again came to the fore. However, state intervention continued to play a predominant role in every respect.

Deviation from the Policy Concepts

At the time of the change in economic policy the Governments of all three countries clearly underestimated the strength of the forces of recession and overestimated at least the short-term impact of measures to strengthen the forces of growth. Those responsible for economic policy in all three countries reacted to the unexpectedly adverse trends in economic activity and hence in the government finances by making corrections that led away from the original programme to a greater or lesser extent and in some

cases even diverged from the concept. Nowhere was this clearer than in France, where households now bear the brunt of austerity measures designed to push ahead with internal and external stabilisation and to improve the underlying conditions for growth. Similarly, in the UK and the USA economic policy projections now accept a larger state share than was originally planned on both the expenditure and revenue sides. The raising of the target ranges for monetary expansion in the United Kingdom (1982) and in the USA (1983) reflect in part no more than a changed assessment of monetary processes, but another factor is clearly the endeavour to ease the restriction of demand that was initially accepted as the cost of breaking inflationary expectations.

Results of Economic Strategies to Date

The results of the economic policy strategies should obviously not be measured by seeing how far real GNP has fallen short of the level initially predicted by the Governments, for the official projections were overly optimistic, at least in the USA and France. Nevertheless, it is a fact that the forces of stagnation prevailed in all three countries throughout 1982.

The weakness of growth that had to be overcome being a deficiency that had developed over a fairly long

period, the supply-side strategies pursued in the United Kingdom and the USA were from the beginning based on a medium-term concept. By contrast, the demand stimulation attempted in France relied primarily on an assumed short-term reaction. Hence in this instance the absence of trigger effects was more likely to arouse or strengthen doubts about the underlying concept. This was probably an important reason why economic policy in France so quickly moved away again from the stimulation of private consumption.

Success in Curbing Inflation

In the United Kingdom and the USA the conditions for a revival of growth have been greatly improved by the conspicuous success in curbing inflation. The marked slowdown in wage and price increases was clearly a consequence of monetary policy strictly geared towards stabilisation. Nevertheless, despite a decline in nominal terms, interest rates on long-term capital remain very high, particularly in the USA, in comparison with the now modest price rise. This can be taken as an indication of continuing high inflationary expectations over the longer run. In these circumstances a reduction presupposes confidence in a future consolidation of public finances. If that does not materialise in the USA and if real interest rates remain high, even a country such as the United

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Kingdom, which has probably "over-consolidated", will be seriously affected unless exchange rate relationships move in accordance with the medium-term prospects for stabilisation.

The extent to which supply-side conditions will be improved by the fact that fiscal policy is backing up a monetary policy geared towards stabilisation depends on the form consolidation takes. A reduction in the budget deficit by cutting state expenditure that does nothing to generate growth would undoubtedly be an optimum measure from this point of view. By contrast, to reduce it by increasing taxes would counteract the supply-side effects of stabilisation, in that it would endorse the increase in the state share of the economy by making adjustment on the revenue side. An analysis of fiscal policy over the past few years is made difficult by the fact that the strong cyclical influences cannot be clearly quantified, but it is evident that after initial setbacks the United Kingdom pushed ahead with the consolidation of government finances at the expense of a supply-side orientation in the fiscal policy. In the USA, on the other hand, the consolidation problems impeding stabilisation arose from the fact that fiscal policy was placing too much emphasis on government revenue in its attempt to achieve a supply-side orientation.

Fiscal Strategies Not Fully Implemented

Even disregarding the state's increased expenditure resulting from economic weakness, it is clear that neither the USA nor the United Kingdom has been able to reduce state spending as a proportion of national product in accordance with supply-side objectives. Hence bearing the underlying concept in mind, the question occasionally arose whether this has not actually prolonged the period of weak growth. By its very nature the answer depends on the theoretical assessment of the underlying circumstances, but the fact that the state sector in the USA is not only one of the smallest by international standards but has increased little over the long term and hardly at all in the seventies gives pause for thought, at least as far as concerns the short-term relevance of the size of the state sector in the countries in question.

Nevertheless, the argument that an increasingly large public sector, which is synonymous with an increasing redistribution of real incomes via the state, leads to a growth-impeding shift in the proportional remuneration of production factors should probably be taken seriously even in the case of the USA, and even more so in that of the economies of Western Europe, particularly since the energy price hikes have increased the need for

investment to bring about structural adjustment. On the other hand, in the light of developments in the past, the original intention to reduce the GNP share of state expenditure by four percentage points within three years by making changes in the US Federal budget constituted supply-side shock therapy. To a lesser extent this is also true of the projected two-point reduction in the GNP share of government expenditure within four years in the United Kingdom, given the near stagnation assumed to be prevailing there. It can therefore no longer seem surprising that the fiscal policy strategies were not fully implemented. At the same time, however, it is doubtful whether more rigorous curtailment of the rise in government expenditure in the USA and the United Kingdom in recent years would have brought a rapid improvement in growth prospects. Indeed, experience suggests that a supply-side fiscal policy should follow a gradualistic approach in the interest of credibility.

Uncertain Effects on Growth

All in all, the analysis of economic policy and developments so far in the United Kingdom, the USA and France does not lead to any universally valid conclusion as to the effectiveness of the supply-side and demand-management concepts in overcoming weak growth, even if the shortness of the period of observation is taken into account. In France demand stimulation proved to be little more than one episode in a strategy in which elements of a quite unique supply-side stance predominated, with the state playing an increased entrepreneurial role, particularly in the industrial sector. In the United Kingdom, on the other hand, the shock therapy to combat inflation by means of monetary and fiscal measures pushed the true supply-side policy aspects far into the background. Finally, in the USA the asymmetric stance of government revenue and expenditure policies endowed fiscal policy with Keynesian expansionary features, and this already at a time of monetary restriction.

All that has become clear so far is the differing effectiveness of the three countries' economic policies in curbing inflation in market economies. Still, it remains to be seen whether stabilisation in the United Kingdom and the USA has succeeded in a lasting improvement of conditions for growth. In the USA unbalanced fiscal policy in particular continues to be a cause of serious uncertainty that is probably the greatest obstacle to a significant decline in real interest rates and hence to a lasting revival in investment. This uncertainty permeates the entire world economy via the monetary and economic impulses emanating from the USA.

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