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Returning to growth in the UK: Policy lessons from history

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A return to growth is urgently needed in the UK. Recovery from severe recessions was achieved in the 1930s and the 1980s in the presence of fiscal consolidation. This column examines the lessons from those experiences for today's policymakers.

Returning to growth after the crisis is proving elusive for the UK economy. Compared with the aftermath of the similarly severe recessions of 1930–1932 and 1979–1981, in mid-2012 the UK was well below the levels reached at the equivalent points, 1934 Q2 and 1983 Q3 (Figure 1). Moreover, there is little sign that the UK is about to enjoy the strong growth which followed in both the 1930s and the 1980s and which started in each case during fiscal consolidation. So are there lessons from those decades that are relevant to kickstarting recovery today?

More generally, precipitated by severe economic problems, both the 1930s and the 1980s saw major and long-lasting changes to supply-side policies that affected medium-term growth performance. What do these experiences and, more generally, the evidence from applied growth economics suggest might be the structural reforms to avoid or to embrace with a view to underpinning growth performance over the longer term?

Broadly speaking, the policies potentially available to promote recovery are fiscal stimulus, monetary stimulus or supply-side reforms that 'crowd in' private-sector consumption or investment spending. Fiscal consolidation not only rules out fiscal stimulus but is generally contractionary (Guajardo et al. 2011) and so requires an offset from one or both of the other two ways to generate recovery if it is not to prolong recession.

In the 1930s, British policymakers initially reacted to the world downturn by overriding the automatic stabilisers to reduce the structural deficit by about 4% of GDP and balance the budget in 1933 (Middleton 2010). The total fall in real GDP from peak to trough was 7.2% but, after a double-dip recession in 1932, recovery got under way in 1933 and the next four years saw average annual growth at close to 4%. It is well known that this was galvanised by a monetary policy stimulus in the guise of the 'cheap money policy' (Howson 1975).

Interpreting this episode in terms of modern macroeconomics, control of monetary policy passed from the Bank of England to HM Treasury, which adopted a price level target. With nominal interest rates at the lower bound and intervention in the foreign exchange market to maintain a substantial devaluation, real interest rates were reduced by inflation. The approach is reminiscent of the 'foolproof' way to escape the liquidity trap proposed by Svensson (2003). The commitment to inflation was credible because it was clearly in the Treasury's interests as an alternative to Keynesian proposals for public works and formed part of a strategy of financial repression in the context of a public debt-to-GDP

ratio of around 170%. A major part of the monetary transmission mechanism worked through the stimulus that it gave to private-sector investment in house-building which peaked at annual rate of 293,000 in 1934–5 underpinned by a ready availability of mortgage finance and an absence of land use planning regulations.

Rearmament did boost recovery but only after 1935. The stimulus provided by this exogenous fiscal shock was considerable and probably amounted to around 7% of GDP by 1938. However, this was based largely on private sector anticipation of future military spending rather than a large fiscal multiplier—recent estimates suggest a government expenditure multiplier between 0.5 and 0.8 (Crafts and Mills 2012).

In the 1980s, the Thatcher government sought disinflation through the medium-term financial strategy (MTFS), which entailed money-supply targets together with a reduction in the structural budget deficit by about 4% of GDP between 1979 and 1983. Unlike the 1930s, monetary policy was intended to be tight and the period was notable after 1981 for high real interest rates (Nelson 2001). In so far as recovery was stimulated by policy, the impetus is best thought of as coming from supply-side reform, in this case from financial liberalisation which made hitting the money-supply targets very difficult but saw a big increase in bank lending and a transformation of the housing market. The long-term supply-side results were to increase the efficiency of capital markets with positive implications for economic growth (Cline 2010) but the short term demand implications were felt through big reductions in the household savings ratio and a sizeable stimulus to consumption (Aron et al. 2012).

Financial liberalisation was part of a major shift in supply-side policy in the 1980s which had many elements but, in particular, saw a serious strengthening of competition in product markets, a process which had started with entry to the EEC in 1973, a restructuring of taxation, and a retreat from unsuccessful selective industrial policies ('picking winners') in favour of concentrating on horizontal industrial policies which, however, were not always well designed. The long-term results of increasing competition were favourable for productivity performance and formed a useful antidote to the problems of weak management and debilitating industrial relations, which had bedevilled the early postwar decades (Crafts 2012). Here there was a strong contrast with the 1930s when Britain abandoned free trade and imposed capital controls while the government encouraged the formation of cartels. This so-called 'managed economy' strategy (Booth 1987) made sense as part of the short-term drive to raise the price level (cf. Eggertsson 2012) but proved hugely damaging in the longer-term because the retreat from competition was so hard to reverse.

The policy lessons from these episodes can be summarised as follows.

- First, although it is not possible to cut nominal interest rates when, as now, they are at the lower bound, it is possible to deliver monetary stimulus by reducing real interest rates if, as in the 1930s, the authorities are willing and able to commit to higher inflation. However, the inflation-targeting regime in place since the 1990s would have to be revised.
- Second, although there are reasons to think the fiscal multiplier may be relatively large when interest rates are at the lower bound, history says that this claim needs to be treated with caution especially when public debt-to-GDP ratios are large.

- Third, a key component of a policy to stimulate recovery during an episode of fiscal consolidation is an ability to 'crowd in' private sector spending—private housing investment aided recovery in the 1930s and consumer spending did so in the 1980s.
- Fourth, if politicians wish to devise more interventionist industrial policies then it is essential that they are designed with a view to minimising the adverse impacts on competition (cf. Aghion et al. 2011).

If radical changes to monetary policy are ruled out and fiscal consolidation continues, the implication is that reforms to supply-side policies have to play a significant part in any attempt to stimulate growth. The 'good news' is that there are plenty of evidence-based reforms that can strengthen the UK's growth performance by improving horizontal industrial policies which have left much to be desired in the last 30 years. These include repairing a serious infrastructure shortfall (Kamps, 2005), institutional reforms to deliver higher quality schooling and improve cognitive skills (Hanushek and Woossman 2009), reforming taxation to reduce corporate taxes and expand the VAT base (Mirrlees et al. 2011), and addressing the massive distortions created by the land-use planning system which undermine the potential productivity gains from successful agglomerations (Cheshire and Hilber 2008). The 'bad news' is that these policy choices are very much exposed to government failure, are subject to implementation lags, and have their effects in the medium—and long-term.

If there is one area that could deliver short-term stimulus and long-term efficiency gains, as in the 1930s, it is surely private house building. The evidence suggests that draconian planning restrictions mean that the stock of houses is three million below and real prices are 35% above the long-run free market equilibrium (Hilber and Vermeulen 2012). The welfare gains from some relaxation of these planning rules are huge and the employment implications of steadily addressing the housing shortfall could be considerable—building 200,000 extra houses per year might employ 800,000. This would require addressing issues of housing finance and incentivising local communities to want development because they can benefit from it and builders to believe that delaying construction would not be profitable (Besley and Leunig 2012). In principle, this could be achieved very quickly but, sadly, it is not politically acceptable so the Chancellor of the Exchequer may find himself in the role of Mr Micawber for a while longer.

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