Managing the UK economy

Fiscal and monetary policy since 1945

Week 7 – 1979-96: Thatcherism and turn toward markets

AY 2026-27

Department of Political Economy

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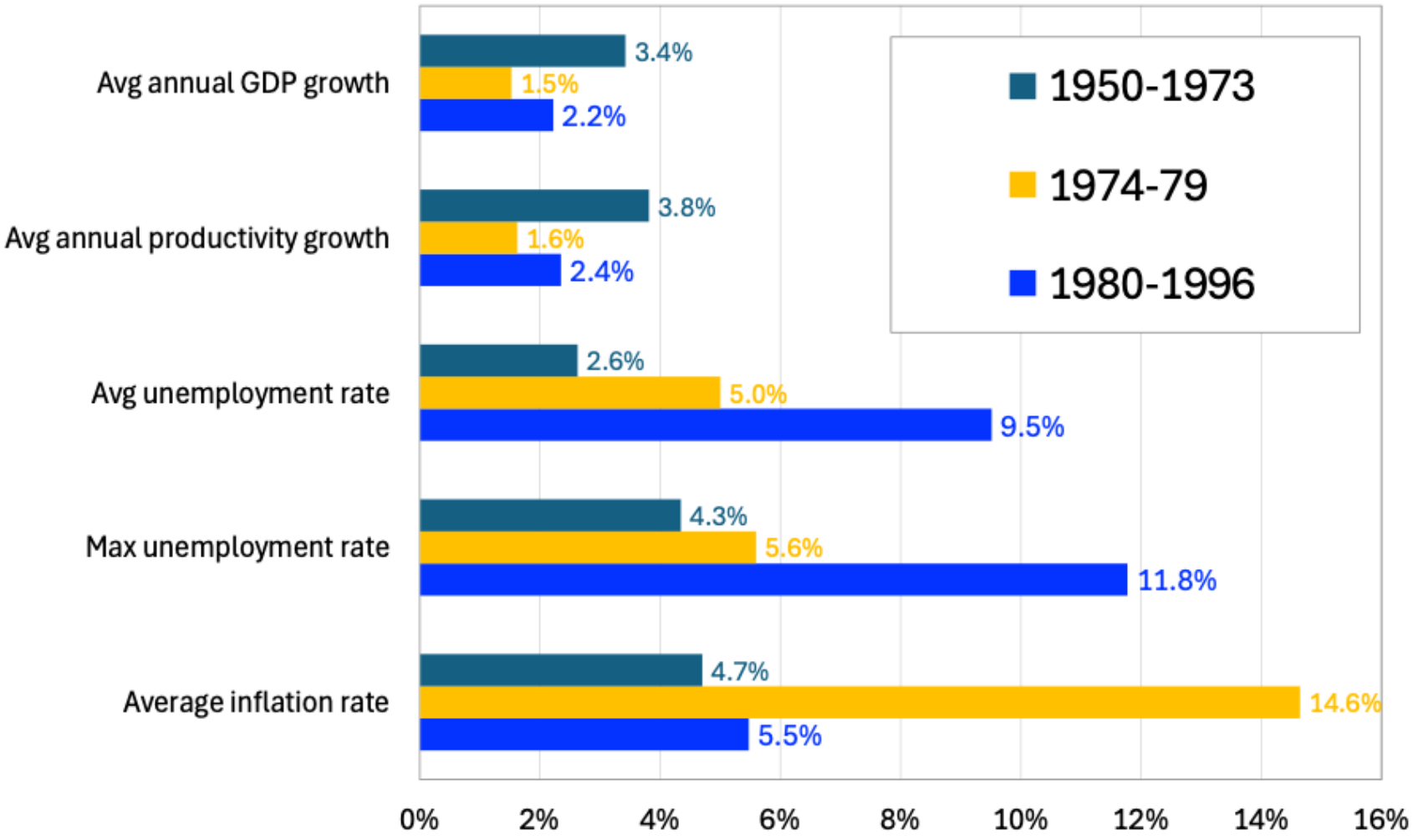
Plan for today: 1979-96

1. Overview
2. Macroeconomic policy 1979-96
3. Important themes
   - Tax reform
   - Privatization
   - Deregulation

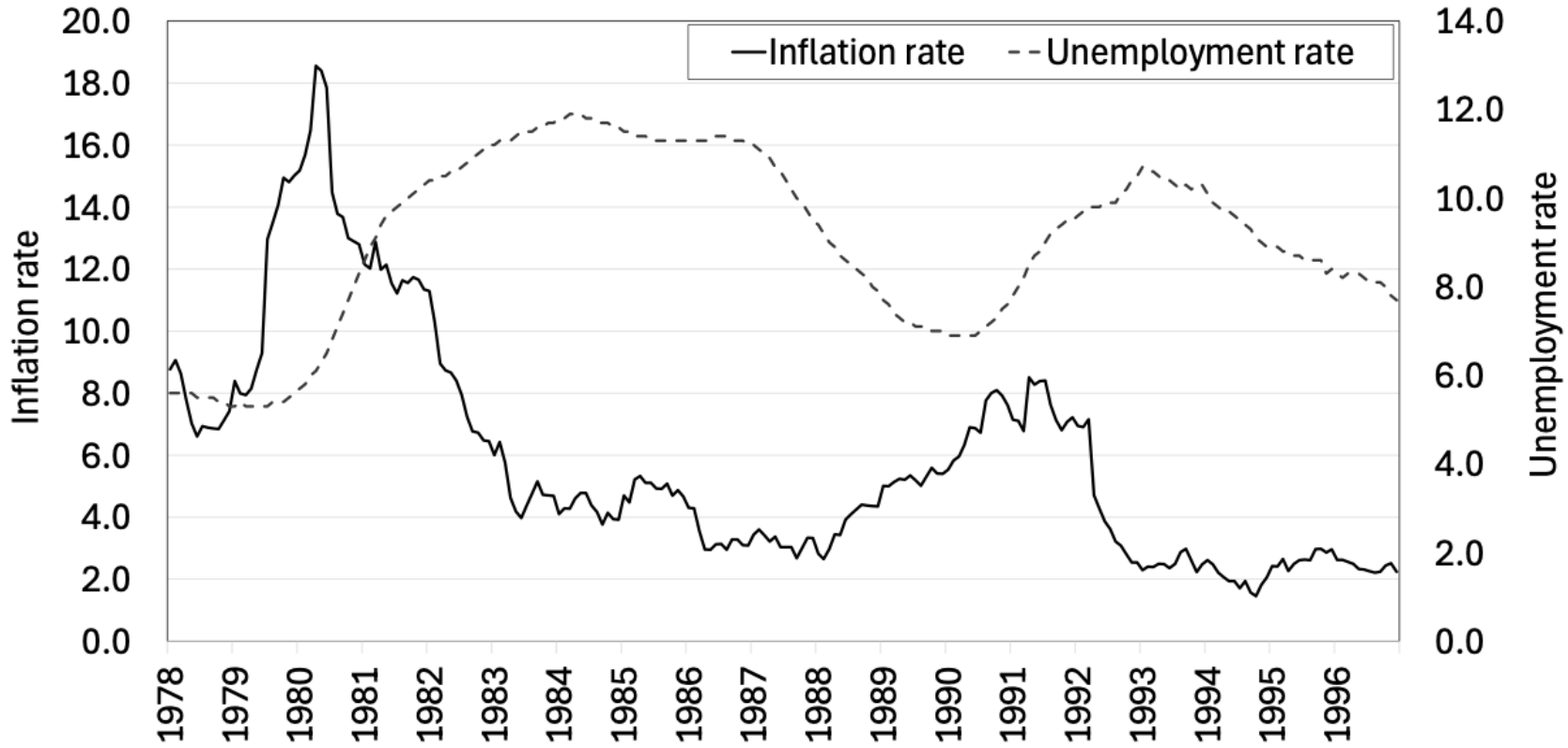
1979-1996: Overview



- Growth improves over the crisis period 1974-79, but does not go back to the 1950-73 pace.
- Inflation falls.
- Unemployment skyrockets.

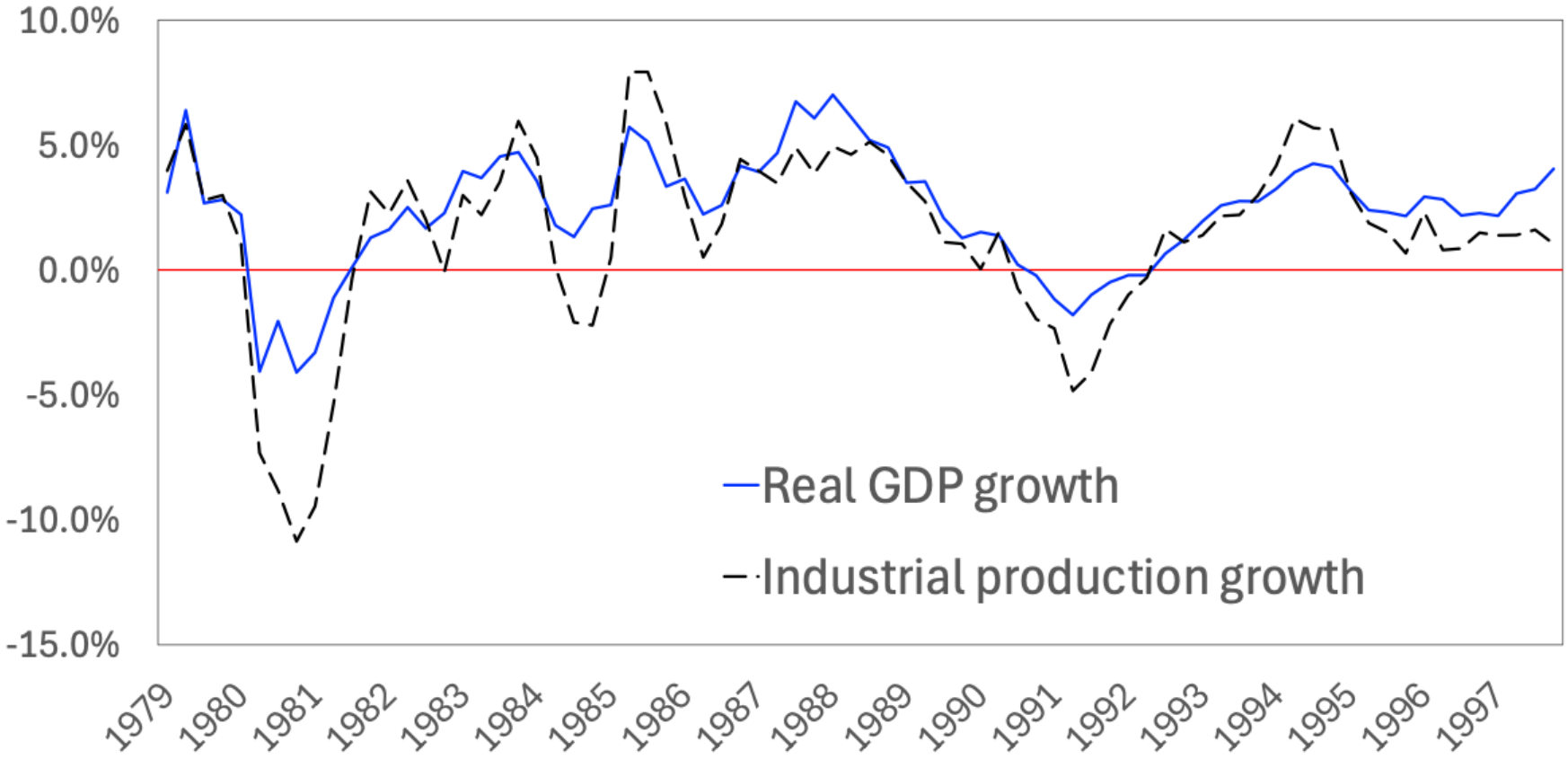
1979-1996: Overview

- The war on inflation is won, but employment is the casualty
- These trends more pronounced in the UK than other similar countries.

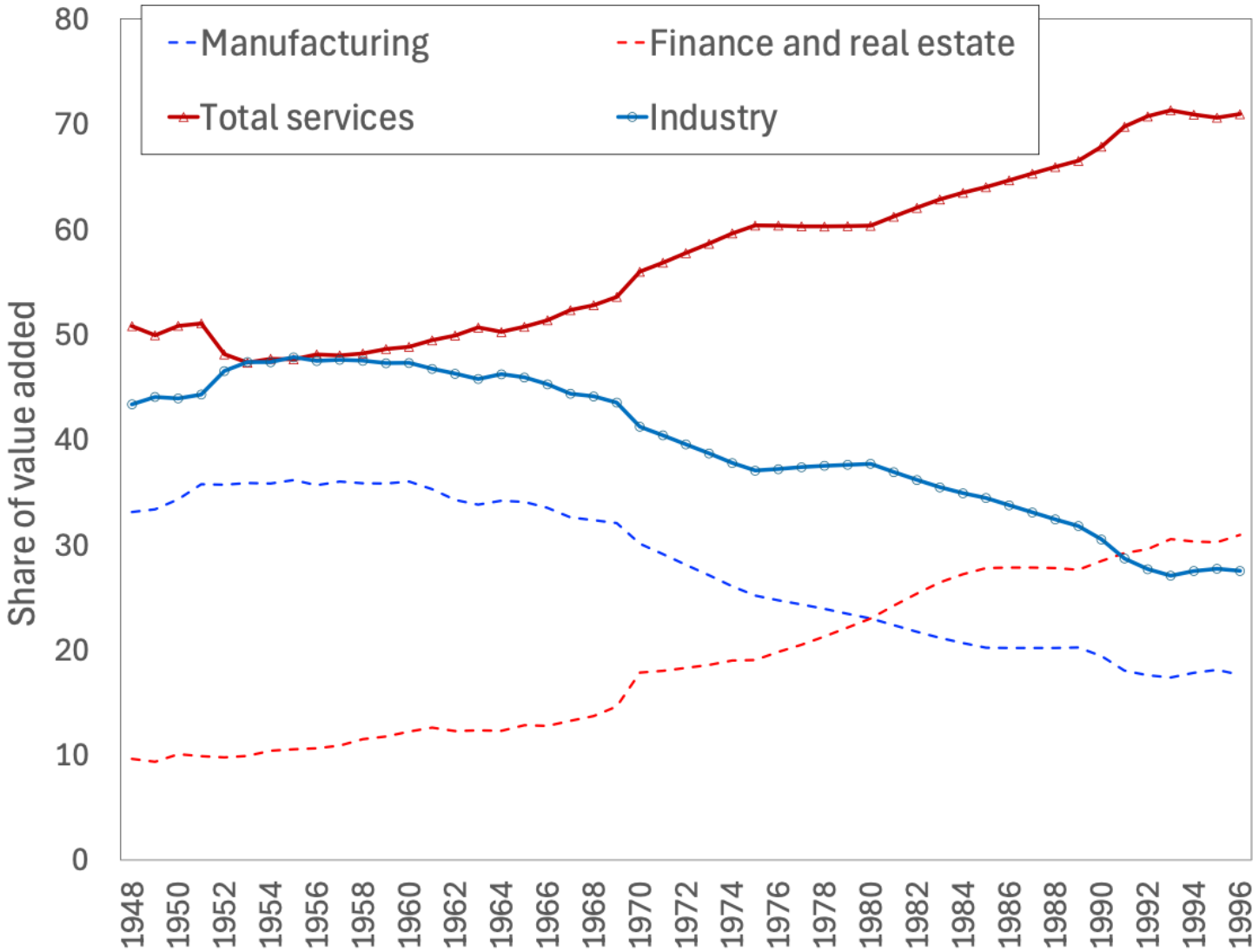


1979-1996: Overview

- Two deep and long recessions (1979-81 and 1990-92)
- A sustained output expansion between 1981 and 1989



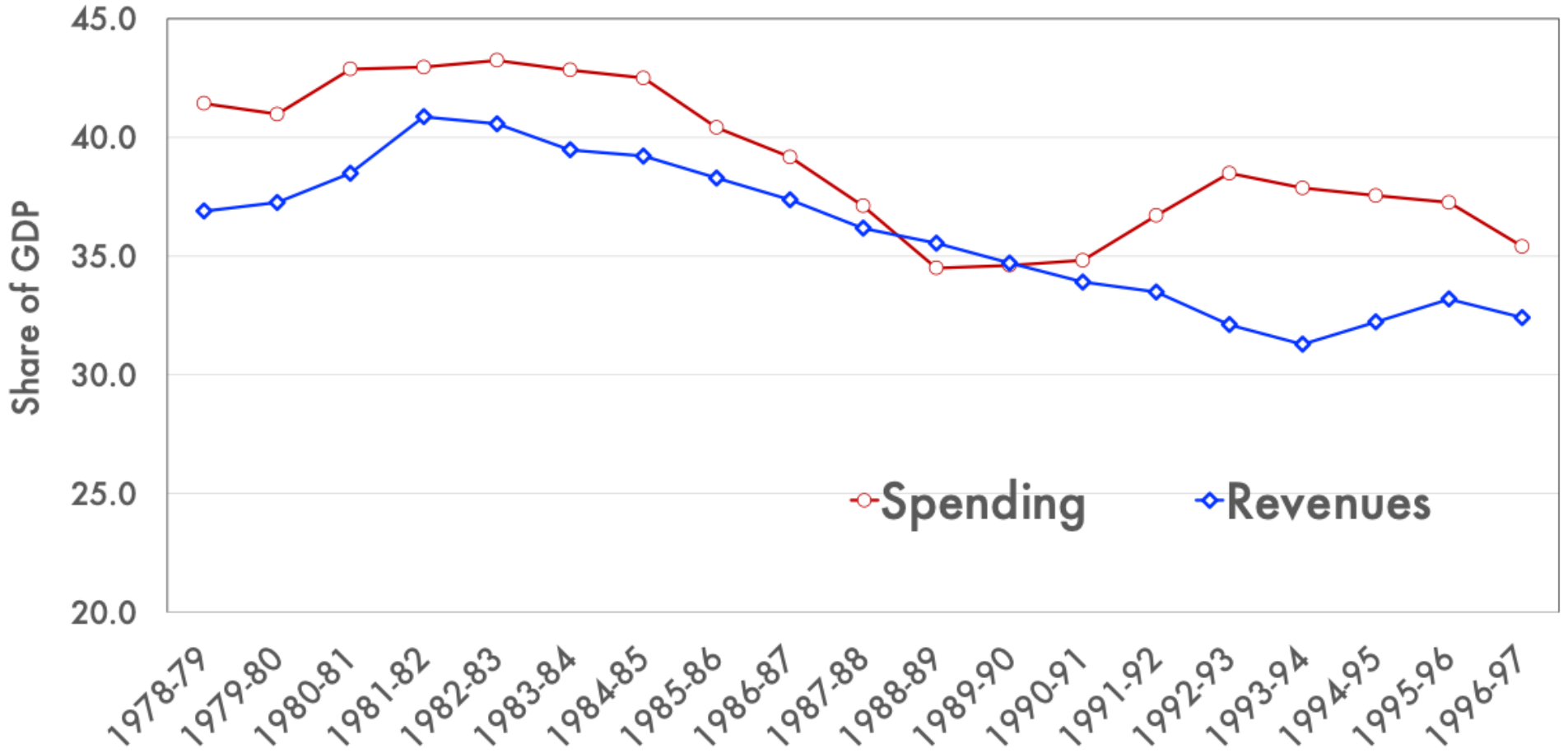
1979-1996: Overview



- De-industrialization accelerates in the early 1980s.
- By mid-1990s services account for 70% of VA (& 76% of employment).
- Financial and real estate rise to around 1/3 of VA.

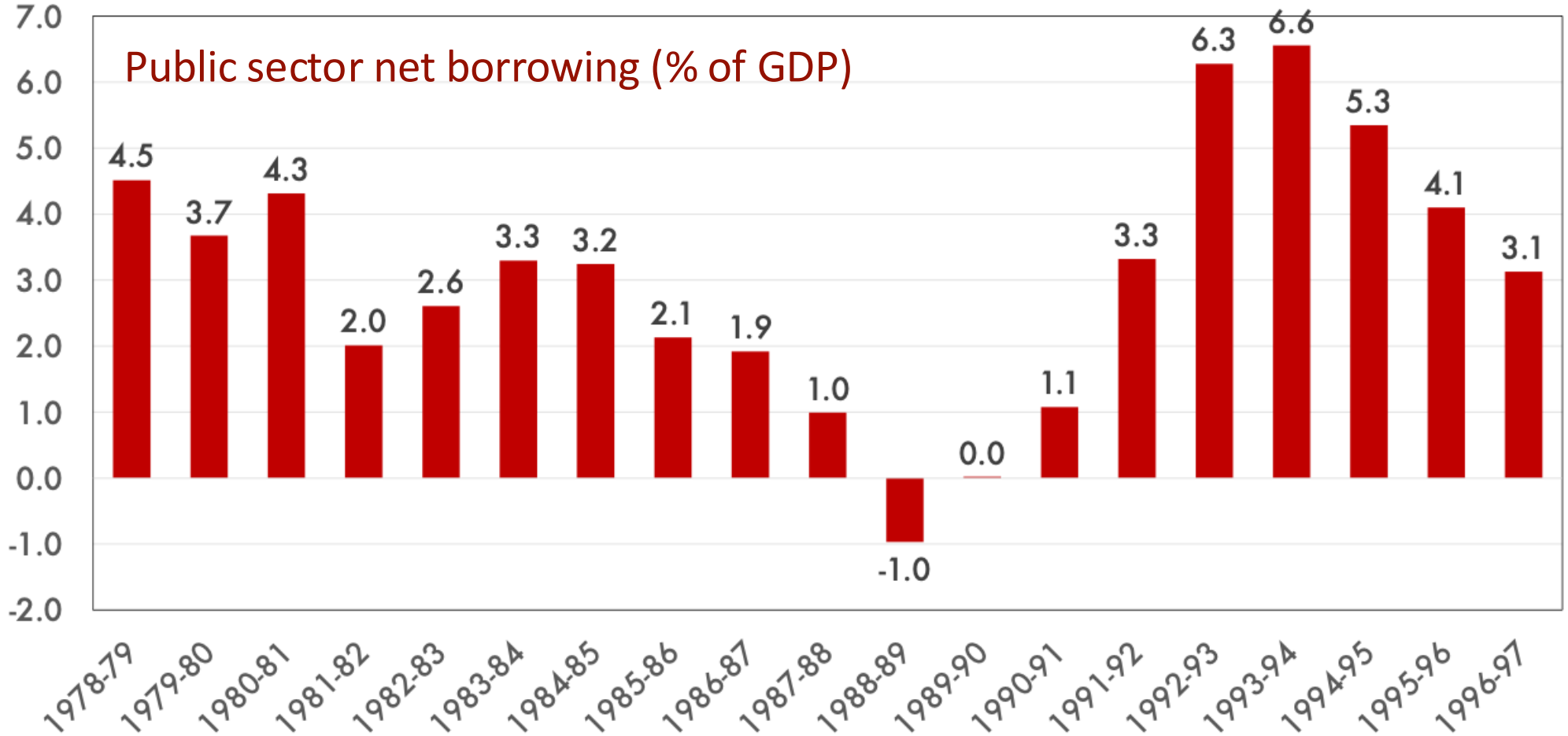
1979-1996: Overview

- Since 1983, decrease in public spending & revenues as a % of GDP.



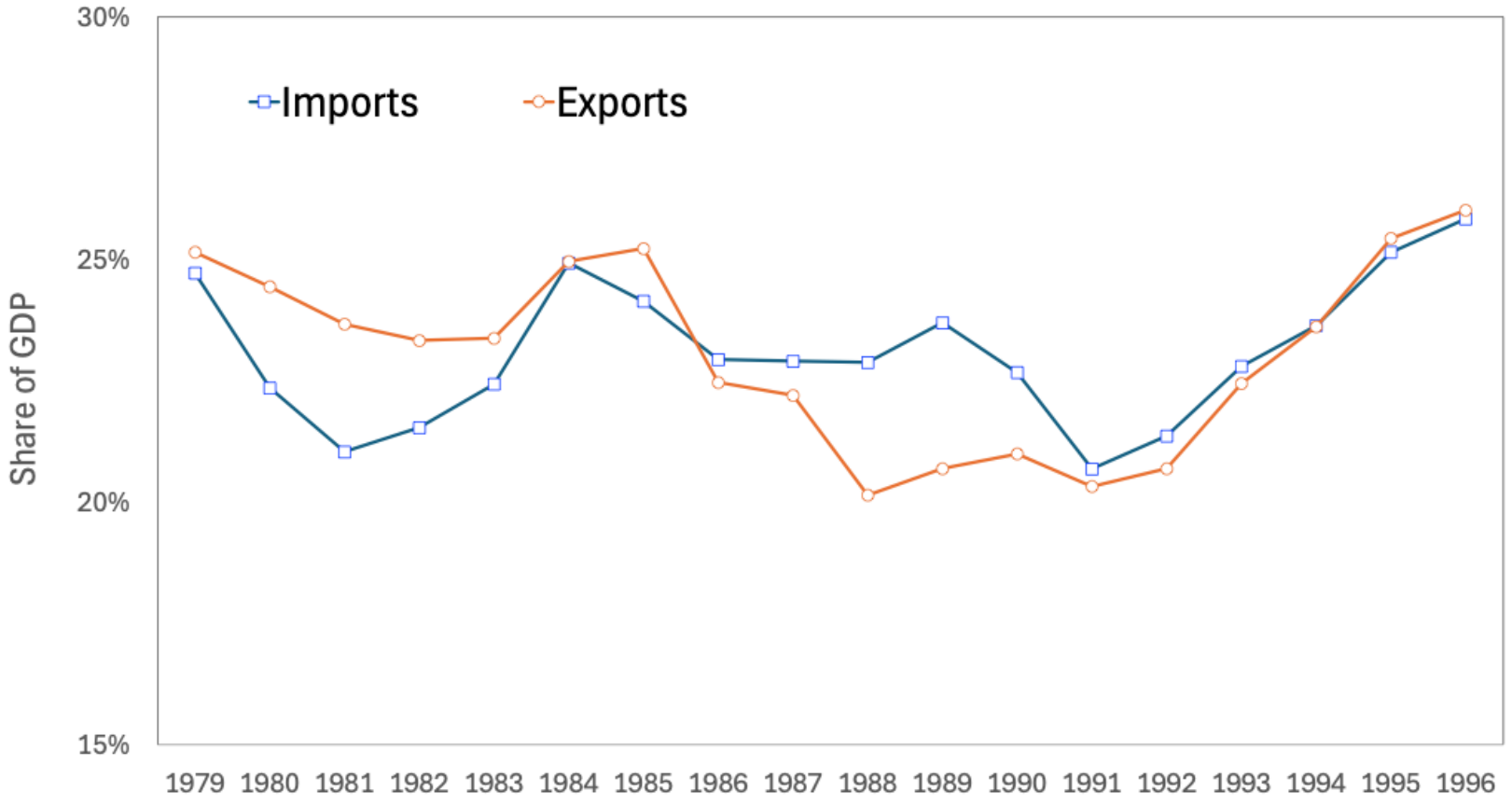
1979-1996: Overview

- Deficit decreases in 1980s, but rises again with 1990-92 recession.



1979-1996: Overview

- North Sea oil shields UK from 1979 oil shock, but deficits return during the 1986-88 credit boom.



1979-1996: Overview

- Inequality stops falling and starts increasing.

(Counter-)Revolution in macroeconomic policy

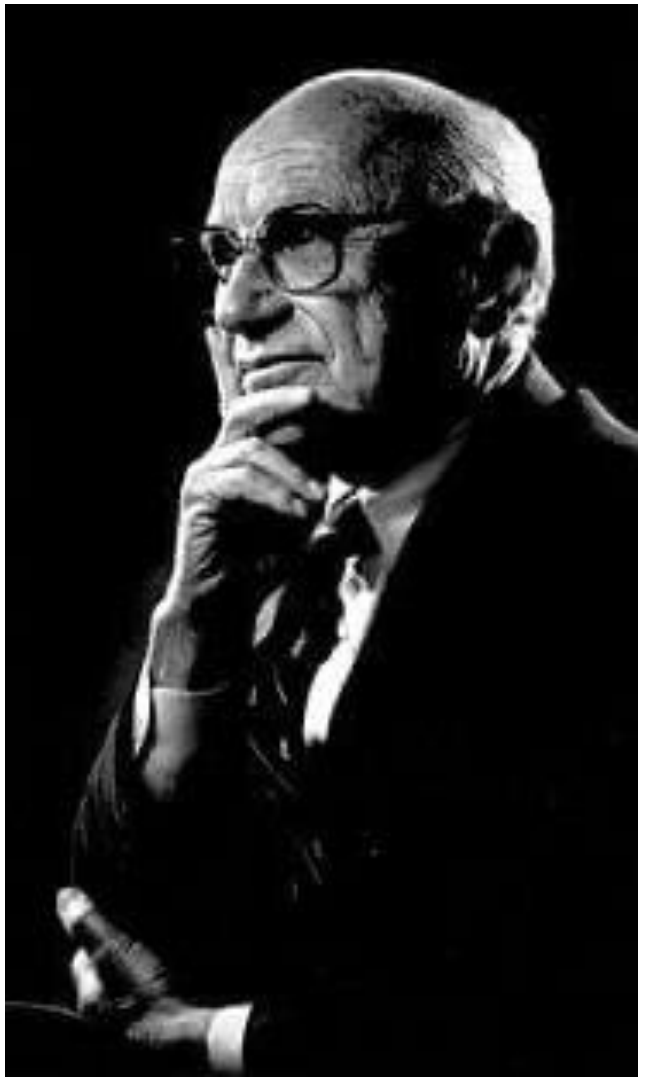
- A 1945 in reverse for economic policy.
  - Part revolution, part counter-revolution
- Reduced state intervention in the economy
  - Cut taxation & spending as a share of GDP, privatizations
  - Abolition of incomes policy
  - Deregulation (financial and in public services)
- Weakening of trade unions
- Primacy of monetary policy and inflation stabilization
  - Abandonment of Keynesian fiscal demand management.
  - Main goal: low and stable inflation (not full employment)
  - Initial attempt at monetarist money supply control, soon replaced by more pragmatic approach to inflation reduction using interest rates & tight budgets.

1979-1981: A bad start to the revolution

- Hard-core monetarist approach proves unworkable and leads to policy mistakes
  - 1979 budget inadvertently rises inflation through large increase in VAT & nationalized firms' prices.
  - Initial 'lassez-faire' approach to the exchange rate allows appreciation to undermine non-oil exports.
  - Failure to anticipate the employment cost of restrictive policies.
- 1981 budget: contractionary in a deep recession.
  - Turning point or policy mistake?
- Longer & worse recession than other countries, industry in tatters, unemployment at Great-Depression levels.
- Government near to a crisis, but Thatcher refuses to U-turn (also aided by weak and divided opposition).

1979-81: The monetarist experiment

- Three key monetarist propositions
  1. Inflation fully determined by money supply growth.
  2. Government can control the quantity of money.
  3. In medium-run unemployment returns to a 'natural' rate, unaffected by macroeconomic policy.
- 1) and 3) still contentious, 2) plainly wrong.
- Thatcher-Howe initially try monetarist precepts.
- System of monetary targets as main policy goal
  - Medium-term financial strategy (MTFS)
  - Let market determine everything else (including interest rates and exchange rate).



The monetarist experiment fails

- Implementation proved very hard
  - What measure of money supply to target?
  - Nobody knew how to control or even predict broad money
  - Narrow money predictable but unlikely to influence inflation
  - Money supply targets vastly and systematically overshot
  - Big rows with BoE ensued
- Ignoring other determinants of inflation was bad.
- Letting exchange rate appreciate too much was bad.
- Hard to even understand the stance of policy
  - Interest rates suggested tight stance, money growth suggested loose stance.
  - This confusion influenced the 1981 budget.

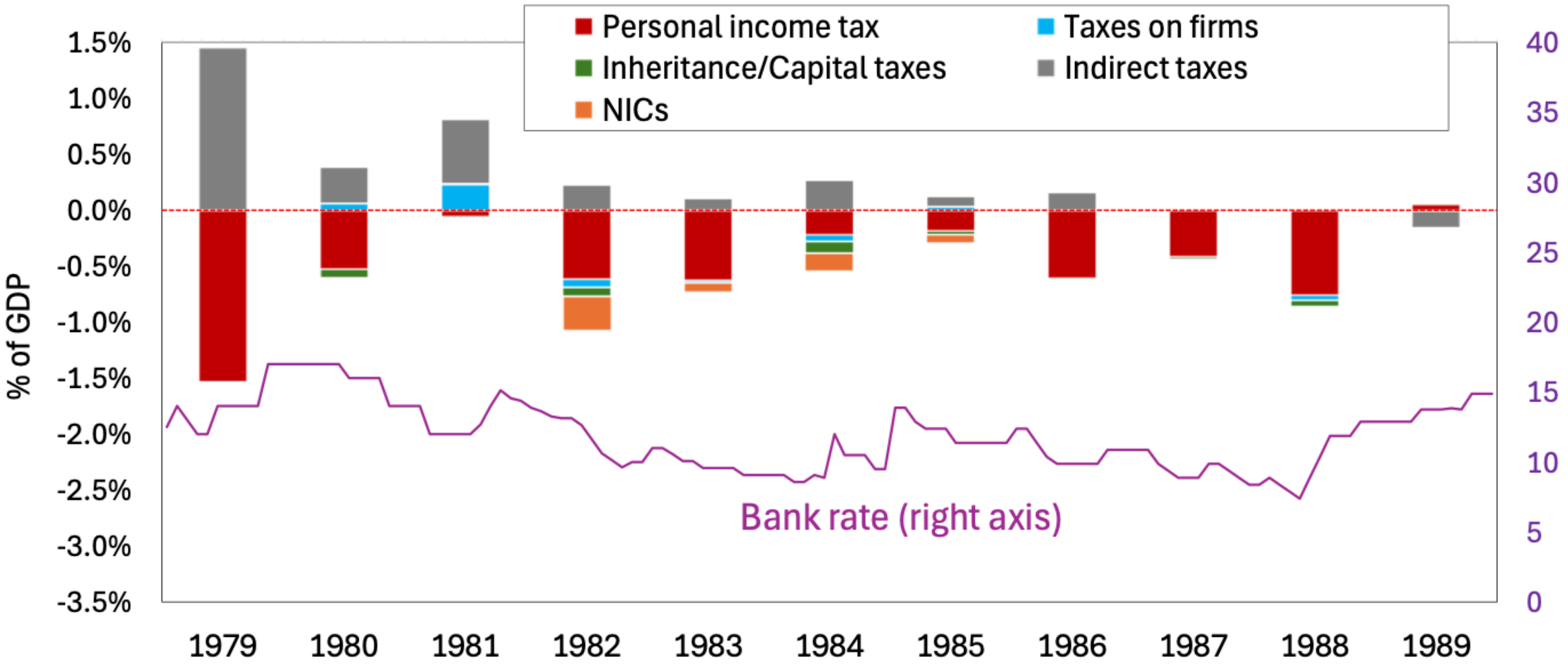
1982-1986: Recovery and pragmatism

- Shift to more pragmatic anti-inflation approach.
  - Monetary targets de-emphasized.
  - Interest rates adjusted more flexibly in reaction to a broader range of indicators (especially the exchange rate).
- Fiscal policy mildly relaxed in 1982-1984
- Economic recovery after 1979-81 deep recession
  - Strong output recovery since 1981
  - Unemployment peaks in 1984-86 then slowly declines
  - Inflation falls steeply between 1981 and 1983
- Unemployment undermines trade unions
  - Miners strike defeated in 1984-85
  - Government achieves lower industrial unrest and moderate wage demands without recourse to incomes policy

1986-1989: The Lawson boom & bust

- Lawson had become Chancellor in June 1983.
- Monetary policy increasingly targets exchange rate (especially with German Mark), even at the cost of neglecting domestic conditions.
- Fiscal and monetary policy turns more expansionary over 1986-1988.
- Recovery turns into inflationary consumption & credit boom but until late 1988 policy is not tightened in response.
- Return of inflation & BoP deficits eventually require steep rate hikes, triggering 1990-92 recession.

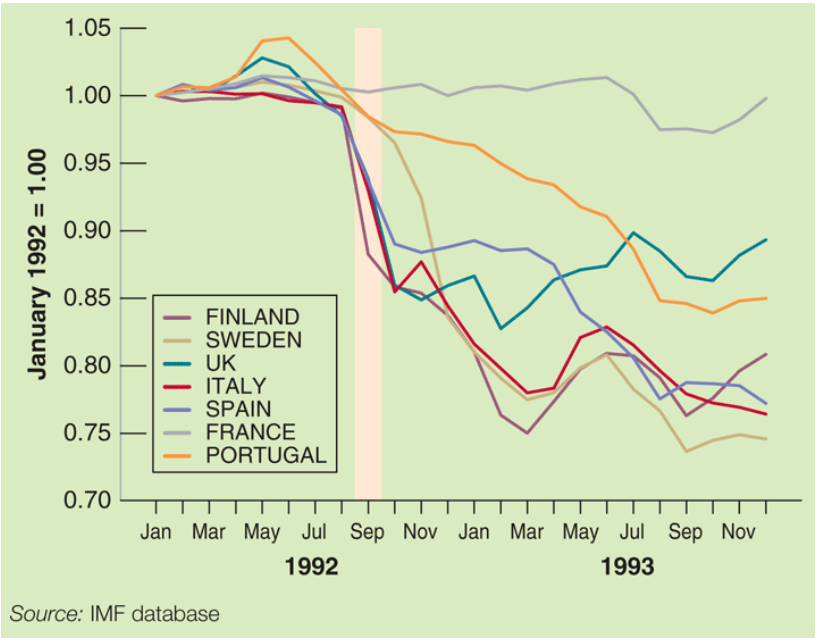
Fiscal & monetary policy in 1979-1989 in a graph



1990-1996: Recovery, ERM & currency crisis

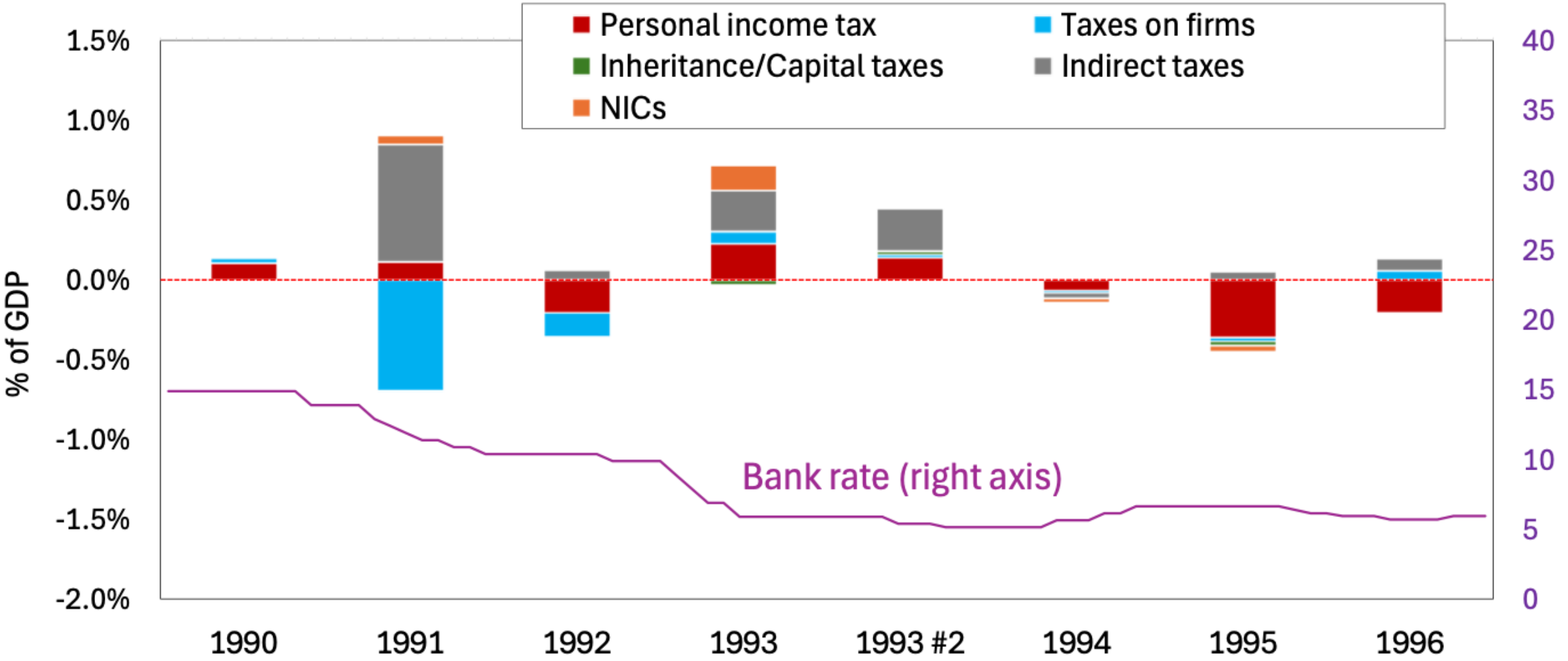
- Oct 1990: UK joins the European ERM
  - 2.95 DM per £ with ±3 percent band.
  - Natural continuation of Lawson's ER-targeting policy
- Nov 1990: John Major replaces Thatcher as PM.
  - Chancellor Norman Lamont [Nov 90 – May 93]
  - Chancellor Kenneth Clarke [May 93 – May 97]
- ERM prolonged 1990-92 recession & slowed down recovery by forcing too high interest rates.
- Aug-Sep 92: Currency crisis forces exit from ERM
- Oct 1992: inflation targeting introduced
  - Initially: 1 to 4% range. Since 1995: 2.5% target
  - Replaced money supply & ER targets that had proved inadequate.
  - Monthly BoE-Treasury meetings (aka 'The Ken & Eddie show')
  - Successful: inflation targets always met in 1992-1996.

Selected EU currencies relative to Deutsche Mark

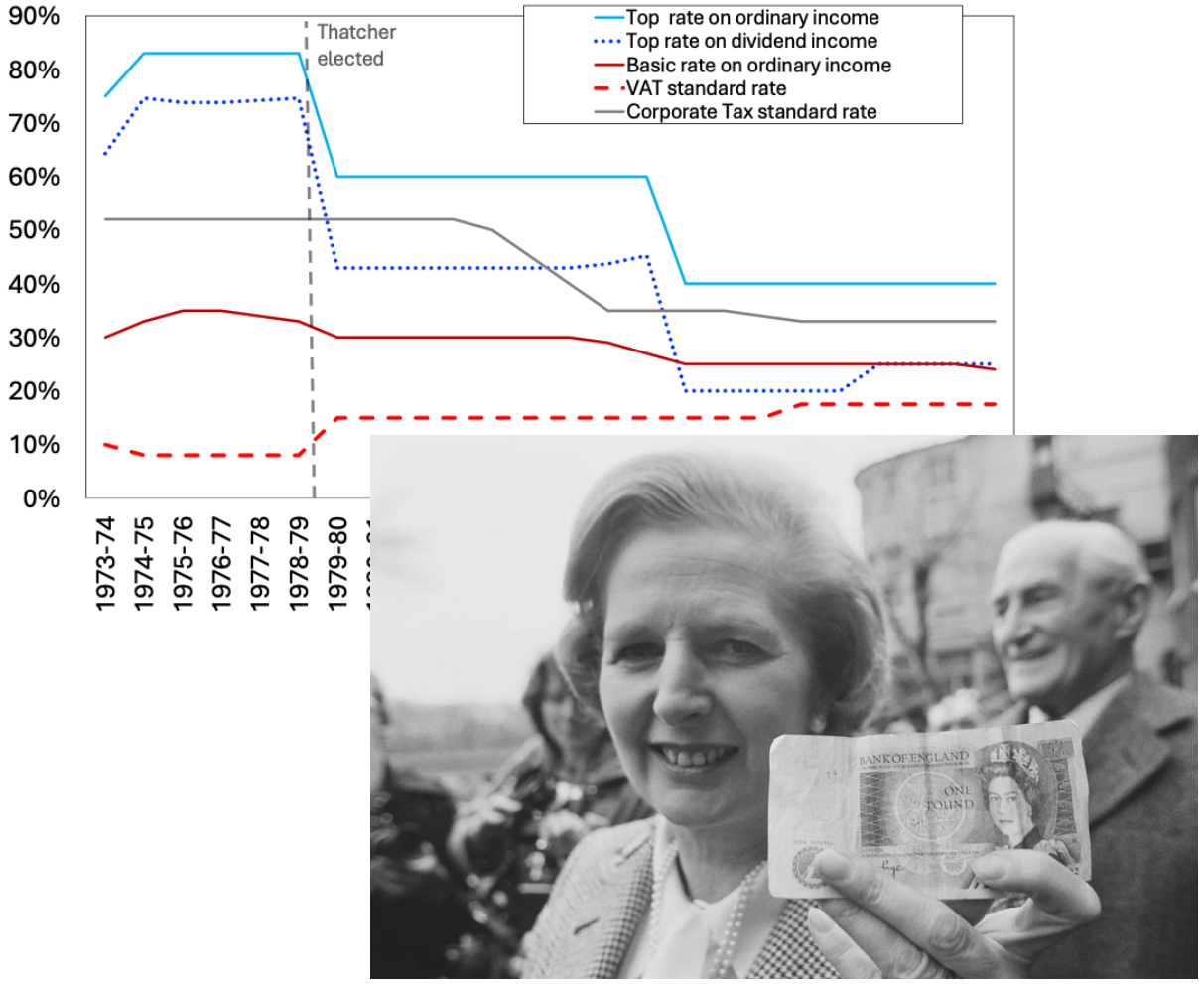


Source: IMF database

Fiscal & monetary policy in 1990-1996 in a graph

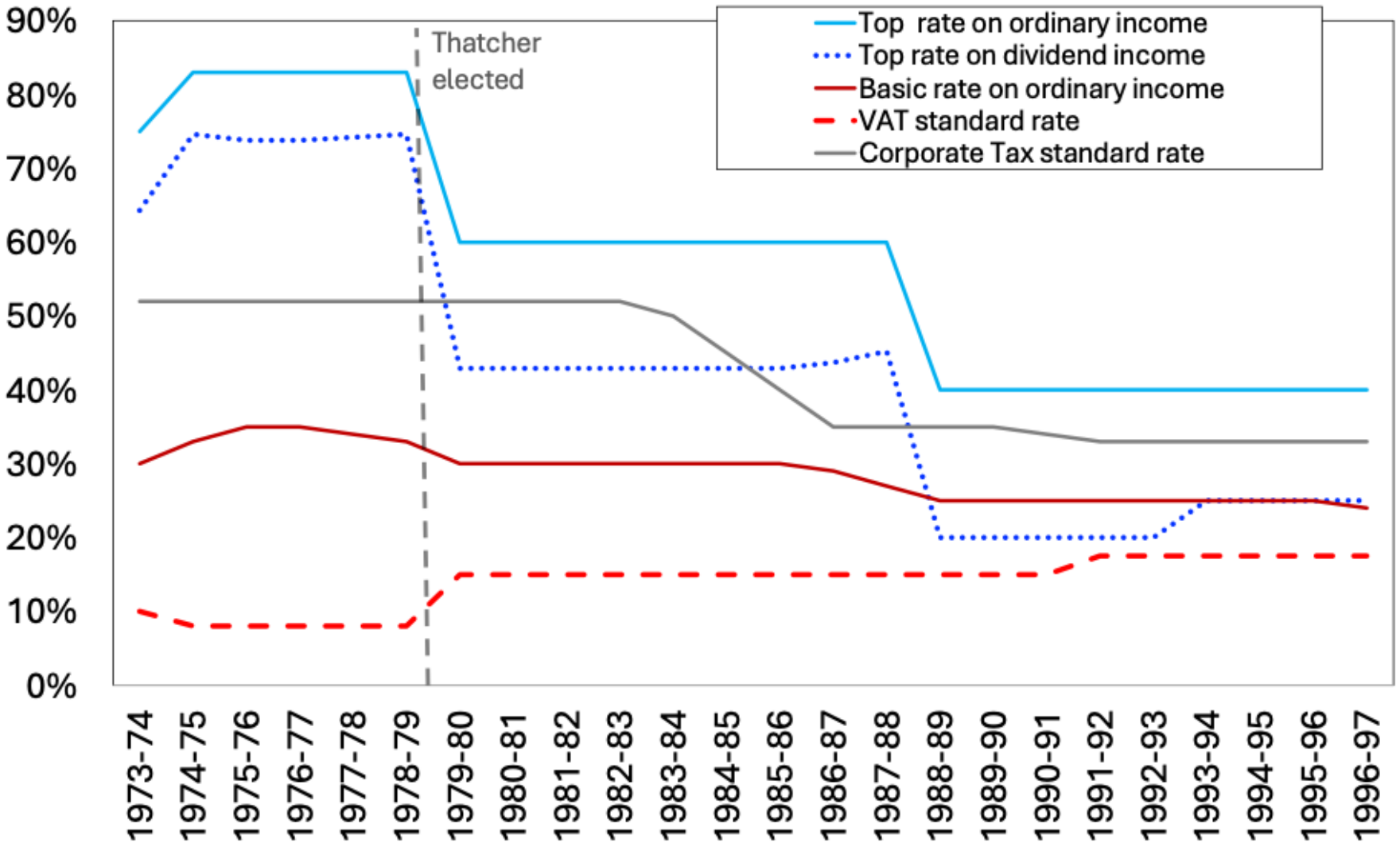


Other pillars of Thatcherism



- Tax reform
- Privatization
- Deregulation

Tax reform during the Thatcher era



- Income tax rates reduced and much less progressive.
- Corporate tax rates reduced.
- Sales taxes (VAT) increased.

Privatization

- Did not feature prominently in Tories 1979 economic platform or initial 1979-82 government action.
- Initially adopted as a 'path of least resistance' to reducing public deficits.
  - Estimated to have reduced spending about £2.5 billion a year (in 1979 prices)
- Gradually gained importance (especially since 1983) and became a signature policy.
- Privatized industries were often natural monopolies → Regulatory authorities to protect consumers (Ofcom, Ofgem, …)
  - British Petroleum [between 1977 and 1987]
  - Associated British Ports [1982-85]
  - British Aerospace [1980-86]
  - British Telecom [1983-93]
  - British Gas [1986-83]
  - British Airways[1986-88]
  - British Airports Authority [1987-89]
  - National Bus [1988-91]
  - Water [1989-92]
  - Electricity [1991-93]
  - British Rail [1993]
  - National Boal Board/British Coal [1994]
  - etc.

Deregulation

- Financial deregulation
  - Exchange controls abolished in 1979.
  - Hire-purchase restrictions gone in 1982.
  - No more quantitative limits on bank lending.
- Public services deregulation
  - Introduce business-like elements in provision of public services.
  - *Education Reform Act* (1988): Schools can opt-out of local authorities. Competition for students between schools.
  - *National Health Service and Community Care Act* (1990): hospitals as self-governing trusts competing for patients.

Concluding thoughts on 1979-1996

- Initial monetarist experiment failed, but Thatcher-Howe shifted to a more pragmatic approach.
- Success against inflation, but at the cost of mass unemployment.
- Was an alternative available?
- Did pro-market reforms increase efficiency enough to justify the social costs?
- Did abandonment of industrial policy intensify de-industrialization, and if so, was that good or bad in the long-run?

Thank you for your attention