IEA Discussion Paper No.65

BRITAIN'S BAKER'S DOZEN OF DISASTERS:

The UK's thirteen worst economic policy mistakes since 1900

Peter Clarke and Robert C. B. Miller

October 2015

iea
Institute of Economic Affairs

Acknowledgement

We are grateful for the most helpful critical comments of an anonymous referee.

Contents

About the authors

Peter Clarke is a graduate of Bradford and Oxford Universities. He is a writer and journalist. He was Economics Correspondent for the BBC and lives in Essex and Scotland.

Robert C. B. Miller is graduate of Trinity College Dublin and Edinburgh University. He is a writer and is a former Editor of *Economic Affairs* and of *The Fleet Street Letter*. He has worked in the City and lives in Wiltshire.

Introduction

Tribute bands are (or were) all the rage. And this is tribute book. Unashamedly we have stolen the idea of *Britain's Baker's Dozen of Disasters* from Burton A. Abrams's book, *The Terrible 10: A Century of Economic Folly,* which records the ten worst American economic policy follies in the last hundred years (Abrams 2013). Our book is about the thirteen worst economic policy decisions in British history since 1900, selected on the grounds of the ill consequences that flowed from them. We have chosen to describe 13 rather than 10 because of the sheer wealth of material. Indeed, we had difficulty in limiting the total to 13 as several other disasters have excellent qualifications for selection.

Like Professor Abrams we have not sought to apportion blame amongst political parties or individuals, most of whom are long dead or at best political 'has-beens'. We have though sought to describe the particular beliefs, situations and temptations of those responsible. We have not attempted detailed descriptions but only reminders of the terrible, but well-intended, mistakes of the past.

It was Enoch Powell who declared that countries can eventually become resistant to repeating the same economic mistakes. Thus he found it inconceivable that Germany should ever again depreciate its currency after the hyperinflations that followed both world wars. Similarly, he claimed that Britain would never repeat the catastrophe of an over-valued exchange rate that culminated in the humiliation of 1931. Mr Powell was over-optimistic as he made his comment before the Britain joined the Exchange Rate Mechanism – or 'Eternal Recession Mechanism' as it was christened by Norman Tebbit. Perhaps a mistake must be repeated before immunity is acquired. Britain has well-established form in making economic policy mistakes.

In comparing the economic policy disasters of Britain and America, a number of differences stand out. Of course, some are the result of the UK and the US having large differences in population, political institutions, geography and patterns of trade. America, not being as dependent on foreign trade, never suffered Britain's exchange rate travails.

But perhaps the greatest difference is that in the twentieth century Britain suffered from a strand of vehement socialism which ran from Sidney and Beatrice Webb and the Fabians until it was surgically removed by Tony Blair and 'New Labour', surely Mrs Thatcher's lasting monument.[1] Fabian socialism had two major themes, which distorted and damaged the British economy for the greater part of the 20th century. First was a belief that nationalisation and municipalisation were the best ways of organising industry and commerce. Second was a belief in equality, which was to be enforced by high marginal rates of taxation on incomes, inheritances, gifts and capital gains.

Economic policies based on these doctrines were destructive and kept millions of Britons (and others) in wholly preventable poverty. The consequences also affected Britain's standing in the world. While countries such as West Germany prospered in the 1950s, 1960s and 1970s, Britain lagged with slow growth, ever-quickening inflation and a declining reputation. Britain's economic weakness was even an important factor in deciding the outcome of the Suez imbroglio.

The other major source of economic mayhem in the last hundred years has been British policymakers' obsession with the exchange rate. As we shall see, in the 1920s there may have been some justification for seeking to return to the international gold standard as it existed in the happy days before World War I. But determination to protect an arbitrary exchange rate of $2.8 to £1 in the 1950s and 1960s seems quixotic, while the attempt to link sterling to the Deutsche Mark in the ERM in the 1990s appears in retrospect to be merely bonkers. The inevitable debacle of 'White Wednesday' destroyed the Conservatives' reputation for economic competence for three parliaments.

1 We say removed, but perhaps this brand of socialism is like a cancerous tumour, which, despite the best treatment, may grow back and metastasise. Recently Mr Miliband and his friends showed ominous signs of reverting to the errors of their predecessors in the 1940s, 1960s and 1970s.

No attempt is made to gauge which of the disastrous 13 was the worst or to estimate how much damage each caused. Such calculations may be possible but we have not attempted them. Can one draw any general conclusions about the Disastrous 13? Firstly, many of the errors stem from the rejection of Victorian individualism – numbers 1, 2 and 4, respectively *Trade Union Immunities, Edwardian Liberal Welfare Reforms* and *Abandoning Free Trade*, stand out. Secondly, the feebleness of the Conservative government 1951-1964 is extraordinary. Particularly striking is the fact that successive Conservative chancellors did not reduce the very high marginal rates of personal taxation they inherited from Mr Attlee's government. Their failure even to attempt privatisation (other than iron and steel) or to learn from the successes of the liberal economics of the German *soziale marktwirtshaft* is telling.

Are we sanguine that future governments will avoid repeating the mistakes of the past or making new ones? One fact inclines us to moderate optimism: the extraordinary transformation of China brought about by vigorous capitalism. Hundreds of millions have been removed from poverty in a few decades and there is no reason to think the process is close to an end. This example may prevent British politicians from a repetition of some of the worst errors of the past. Still, like Peter Cook's character, they may still be able to say: 'I have learned from my mistakes, and I am sure I can repeat them exactly'.

No. 1 – 1906: Trade Union immunities

> *'The outdated notion that the trade unions are the spokesmen for the underdog has inhibited British governments from removing the nearly 80-year-old legal privileges that have strengthened the unions' power to act as vested interests defending outdated occupations and restrictive practices in declining industries.'*
>
> Arthur Seldon[2]

The Liberal Government elected in 1906 created trade unions as privileged bodies largely exempted from the law. No Parliament had ever created a caste beyond the courts in this manner before.

To enact immunity from liability for any damages caused by the union to companies or to individual workers was a mistake with vast consequences. The jurisdiction of the courts ceased to apply. The Trade Disputes Act had a pernicious effect for the rest of the century.

It is worth reviewing exactly why trade monopolies are so damaging both to other non-unionised workers and to the economy as a whole. Trade unions increase the pay of their own members by negotiating high wages with their employers using the threat (sometimes carried out) of striking. The effect is to reduce the number of workers employed in the affected industries and to increase the supply elsewhere thus forcing down the wages of un-unionised workers or increasing unemployment. It is a case of insiders (unionised workers) disadvantaging the outsiders (the non-unionised workers). Also trade unions can (and often do) have the effect

2 Preface to second edition of *1980s Unemployment and the Unions* (Hayek 1984: 9)

of ‘locking-out’ investment. What investor or business manager would invest in a heavily unionised industry when he could invest in a non-unionised one? Thus, trade unions may advantage their members in the short run, but harm in the longer term the interests of other workers, themselves and the economy as a whole.

In part, this was the adoption of the fallacy that artificially increasing the marginal utility of labour would make for wider prosperity. How any combination ‘in restraint of trade’ can enhance commerce or exchange is baffling. Trade union activity makes everyone poorer than they would be otherwise, yet it nurtures the illusion that strike activity, restrictive practices and bullying of dissent tilt the advantage away from ‘capital’ to ‘labour’.

Yet this significant piece of legislation - it may even be termed un-legislation - as it created a law-free zone - was also a raw and calculating act of political tactics. The Liberals were in fear of the infant Labour Party, formed in 1900, and anxious to retain their support by conceding trade unions legal immunities.

Such union power - the power to coerce - and to fix prices - practically expropriates the owners of companies. This nourished the idea of industries being owned by the state - nationalisation. In time this created the double folly of a monopoly within a monopoly - such as the National Union of Miners and the National Coal Board.

It is not possible to estimate the damage to British commercial life in the years following the 1906 Act. Nor is it calculable how the adoption of similar acts in other countries altered their patterns of trade or suppressed or distorted comparative advantage. Trade union activity is a form of protectionism and enhanced protectionist tendencies more widely.

Hayek explained:

> ‘It cannot be stressed enough that the coercion which unions have been permitted to exercise, contrary to all principles of freedom under the law, is primarily the coercion of fellow workers. Whatever true coercive power unions may be able to wield over employers is a consequence of this primary of coercing other workers; the coercion of employers would lose most of its objectionable character if unions were deprived of this power to exact unwilling support - and extort fees’
>
> (Hayek 1960: 235)

The legal immunities created in 1906 reduced the productivity of labour for everyone. Real wages were diminished as a result. Above all the 1906 Act created an aura of legitimacy for trade unions. But for their efforts the ‘workers’ would be poorer. The claim is as sound as a tribal rainmaker but the belief inhibited reform across the century.

Trade unions are most powerful where capital investments are at their most extensive, so they become, in time, a deterrent to investment. The unions in printing and publishing were a caricature of price-fixing and corruption, including hereditary rights transmitting a restrictive practice across generations. The legislation passed by Mrs Thatcher’s government freed companies, mostly under new ownership, to create a new newspaper industry.

Reading the reports of the House of Commons discussing the 1906 Act, the preponderant view was that trade unions were largely benign and would help the poorest. The opposite is the truth but the Edwardian political imagination failed to see the dangers.

No. 2 – 1908-1911: Edwardian Liberal welfare reforms

'Taffy was a Welshman, Taffy was a thief'

– chant objecting to Lloyd George's proposals for National Insurance *employee* contributions

The Liberal government elected in 1906 introduced a series of reforms that were the foundation of the modern welfare state. Only two will concern us here, the Old Age Pension and National Insurance. We focus on these because they are the origin of the vast array of social services and benefits which exist today, and which as we shall see continue to have long-term destructive effects. The reforms were largely the result of the New Liberalism (i.e. non-Gladstonian and anti-individualistic) led by Winston Churchill and Lloyd George.

In 1908 old age pensions were introduced for those over 70. Single men received 5s a week and married couples 7s 6d. The pensions were kept low to encourage self-provision, they were means tested and pensioners had to have lived in the country for 20 years. They also had to prove that they were not drunkards, were of good character and had not been in prison for 10 years. Over the years these sensible tests have been removed.

National Insurance was introduced in 1911. It was a stroke of promotional genius to combine the words 'insurance' with 'national'. Who could dissent from the wisdom of everyone being insured against unemployment and sickness? A national organisation was bound to be efficient and equitable. It commanded the resources of the state and the almost limitless power of taxation.

Lloyd George's paternity claim to the 1911 National Insurance Act is unchallenged. He always said that he had been impressed by the German model instituted by Bismarck in 1889, intended to nurture national solidarity from Germany's disparate states. Lloyd George had made a celebrated trip to Germany in 1908 to investigate the system.

In an elegant expression of the politician's art of offering 'free' rewards, Lloyd George described his new Bill as 'Ninepence for Fourpence'. The four pence was the weekly deduction from employee's wages, with three pennies from the employer and two pennies from the taxpayer. Expressed in this manner it seemed attractive. Lloyd George traded many favours to get his act through both Lords and Commons. An important one, to secure the infant Labour Party's support, was to pay MPs a salary. The deal struck with Ramsay MacDonald was to offer MPs £400 a year.

The National Insurance Act 1911 emerged through naivety about how institutions evolve from the original plans of their designers. Lloyd George and his supporters supposed themselves to be lifting many from destitution. He declared that his 1909 'People's Budget' was a 'war budget' which would '…wage implacable warfare against poverty and squalidness'. Yet the long-term effect has been to numb saving and investment and to encourage the false belief among many people that security in old age and freedom from the fear of unemployment or sickness can only be provided by the state. If those paying Income Tax and making National Insurance Contributions could have opted out of the state provision their pensions and other 'benefits' would have been far greater.

What could possibly be wrong with reforms that made immediate improvements in the lot of workers and the poor? National Insurance Contributions and the Old Age Pension and the many barnacles of subsequent legislation have blunted or dissolved the will of people to save. Once the state provides old age pensions, unemployment and sickness benefits regardless of people's ability to pay, it reduces the incentive for individual savings and creates an ethos of dependency.

One unintended consequence of the OAP and National Insurance is that they have destroyed the Victorian friendly societies, which had evolved to fill the roles we term broadly as welfare. It is now forgotten that friendly societies, charities and some trade unions opposed the reforms because they weakened individual responsibility (Hay 1975: 38). *The Economist* opposed the reforms on similar grounds. Their objections should now be remembered. Lloyd George's state system has indeed 'crowded out' private welfare provision.

Sir Keith Joseph, a former Secretary of State for Social Services, described National Insurance as 'a chain letter across the generations'. This is worse than a Ponzi scheme - it is a Ponzi scheme with access to the state's taxing powers. The principle of insurance was lost long ago and benefits are now financed from taxation.

State provision for old age, unemployment and sickness has meant that a large part of the savings 'industry' has been destroyed. Funds, which might have been contributed to friendly societies, trade unions and insurance and life assurance companies, have been absorbed as taxation by the state. The result is that a massive source of saving and investment has been lost with a consequent reduction in economic growth and individual wealth. Suppose that motor insurance was provided by a state insurance company with uniform contributions and claims paid out of general taxation - it is easy to imagine the inefficiencies and absurdities that would result.

National insurance has another serious ill effect. Ben Gummer MP has proposed in the interests of 'transparency' that National Insurance should be renamed 'Earnings Tax'.[3] More accurately it should be renamed 'Employment Tax', or perhaps an 'Unemployment Creation Tax'. By increasing the cost of employment, it leads businessmen to make investments which employ fewer people than would be the case otherwise. Without National Insurance Contributions earnings would be higher and employees would be able to save efficiently for old age, unemployment or other misfortunes.

3 For example, 'Goodbye National Insurance. Hello Earnings Tax', *Daily Telegraph*, 23 February 2014.

No. 3 – 1925: Mr Churchill and the return to gold

> *'Only God could tell whether it [$4.86] was or was not the correct figure'*
>
> Montagu Norman,
> Governor of the Bank of England 1920-1944

Britain's return to the gold standard at the pre-World War II parity in 1925 is almost universally agreed to have been a disastrous error. But at the time, when Winston Churchill was Chancellor of the Exchequer, the case appeared quite different. The international gold standard had been suspended at the beginning of World War I. Prior to 1914 the classic international gold standard had become almost universal amongst the most advanced countries and may rightly be considered one of the great achievements of the Victorian era. To go onto the gold standard was a sign that a country was stable politically and economically and wished to join in international trade and investment. Thus America re-joined gold in 1873 after the Civil War. Austro-Hungary went onto gold in 1892 and the Russian Empire in 1897. The system was centred on London and gave enormous prestige and importance to the City. It provided a stable medium of exchange for trade and investment which allowed transactions without fear of an alteration in the exchange rate.

All this changed in August 1914 with the outbreak of war. As the nations mobilised and war became inevitable, a spectacular financial crisis developed with investors seeking to redeem promises of gold for actual 'portable property'. As a result gold payments were suspended by the combatants.

Fast forward to the end of the war. Central and eastern Europe were in chaos and even the victorious powers (except America) were economically and financially exhausted by war spending. A major change was that British financial pre-eminence had been replaced by America and Britain owed America over £4 billion – a sum equivalent to £400 billion today. This changed everything but it was accompanied by inflation as the allied powers had only limited success in financing their enormous war outlays without money printing.

When the war ended it was assumed that the gold standard would be restored. This had happened in 1821 after its suspension during the Napoleonic wars. Prices had risen during the war and the government engaged in a process of cutting government expenditure, the ‘Geddes Axe’, and reducing prices. In February 1920 the sterling dollar rate had touched $3.60 and efforts were made by higher interest rates to edge up the exchange towards ‘par’ which was £1/$4.86. The result was an economic depression with unemployment reaching 1.5 million in 1922.

The difficulty was that there had been such large changes in the course of the war that it would be the merest good luck that deflation would be sufficient to bring British prices back into line with what they had been in 1914. What is more, to get prices back down to those levels would have required a Herculean effort. The cost of living index in 1920 was 249 compared to 100 in 1914. By 1925, when Britain returned to gold, the deflationary process had only reduced the index to 176 (Moggridge 1972).

There were few to challenge the view that sooner or later Britain would return to the gold standard and that it might as well be done when the exchange rate was close to $4.86. It was also argued that even if sterling were over-valued by 10 per cent then the necessary price adjustments would be easy to make after the price falls which had already taken place. Preparations for the return to gold had been made under the first Labour government and with Philip Snowden the Chancellor of Exchequer. He was replaced by Churchill in October 1924 when the new Conservative government under Stanley Baldwin came to power.

Britain went back on to gold on the pre-war $4.86 parity in April. In the event the ‘adjustments’ proved impossible to achieve and Britain suffered six years of high unemployment and negligible growth until 1931 when the financial crisis resulted in a run on sterling and the abandonment of an unsustainable exchange rate.

What was Churchill’s responsibility? His critics have listed the return to gold as one of his three major errors, the others being the 1915 Gallipoli expedition and the Norwegian campaign of 1940. But Churchill became Chancellor with little economic expertise despite a strong prejudice for free trade. Virtually all professional opinion, including the legendary governor of the Bank of England Montagu Norman, was in favour of the move and only figures such as Keynes and Reginald McKenna, Chairman of the Midland Bank, were against it. Keynes‘s view was that while he did not object to a return to the gold standard at some stage, economic conditions were not right in 1925. The overvaluation had the effect of stopping Britain sharing in the boom of the ‘roaring twenties’. One insidious consequence was that American central bankers may have permitted the American boom to develop partly to reduce pressure on sterling. So the return to gold may have been a partial cause of the bubble which exploded so disastrously in October 1929.

No. 4 – 1932: Abandoning free trade

'It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy... What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom.'

Adam Smith, *The Wealth Of Nations*

Britain's move to *unilateral* free trade with the suspension of the Corn Laws seems almost a miracle of wisdom. Unilateral free trade was one of the greatest achievements of the Victorian age and it was the Conservative Party which under Sir Robert Peel stole the Whigs' clothes when they were bathing and repealed the Corn Laws in 1846.

The clamour for reform was directed by the Anti-Corn Law League. Cobden and Bright are no longer heroes to our modern Liberal Democrats. The League is lost to public memory. Only its weekly bulletin, *The Economist,* survives.

Most advocates of free trade since the 1840s have only dared to urge reciprocal relaxation of tariffs. We may blame Richard Cobden for this. He devised the policy of reciprocity and persuaded Gladstone to accept the Anglo-French Free Trade Treaty of 1860. The French adopted liberalisation *only* if other nations matched them in opening their markets.

This compromise with the principle of unilateral free trade can be seen as the origin of the idea of Imperial Preference espoused by Joseph Chamberlain in the closing years of the 19th Century through to the many protectionist measures of the 1930s initiated by Stanley Baldwin and others. The genesis of the Common Market, European Community and now the European Union was pre-figured in the deal struck between Cobden and Chevalier.

Mutual free trade is better than mutual tariff barriers. Unilateral free trade ignites the comparative advantages of open borders without the endless negotiation of protocols that is the regular grind of WTO rounds. Astonishingly, contemporary China is the most striking example of prosperity blossoming with unilateral reductions in tariffs. Its average import tariff level was 59 per cent in 1982. Now it is about 10 per cent (Tseng and Cowen 2005). The formal truth is that China acquired Hong Kong in 1997, yet the reality is that Hong Kong's Cobdenite free trade conquered China.

Joseph Chamberlain's second son, Neville, introduced the Import Duties Bill on 14 February 1932. There was an immediate general tariff, a tax on trade, of 10 per cent. Sir George May chaired an 'advisory committee' to raise further tariffs. It did so. Raw materials and most foodstuffs were exempted. By the end of the year the average tariff was 15 per cent. Some reached 20 per cent.

Perhaps there is some word magic in the word 'Protection'. Everyone believes in protecting the elderly, the young or the infirm. Was the government not merely helping elderly British firms - or assisting young ones?

Neville Chamberlain claimed all tariffs would be reduced or abolished if other nations relaxed their taxes on trade in a reciprocal manner. It did not happen. The 1932 Act was a reversion to mercantilism and the absence of understanding.

Impediments to free trade (would not 'Liberty of Trade' have been a happier term?) alter the operation of prices and distort specialisation or comparative advantage. They disrupt what Hayek terms 'the extended order' by which people who know nothing of each other can still exchange to their mutual advantage. The Import Duties Bill impoverished Britain. It impoverished the wider world.

Neville Chamberlain explained his higher tariffs would increase tax revenue. He forgot that patterns of trade would change and the volume would falter. He ended the first year of protectionism with a sharp fall in revenue. The new taxes reversed the trend towards direct taxation too. In 1917-18, 82 per cent of revenue came from direct taxation. Chamberlain reduced this to 55 per cent.

Given the depression that defined the 1930s, protectionism was the worst possible policy. It is analogous to the medical fallacy that an ill person ought to be bled. Instead of opening up trade to everyone's enrichment Neville Chamberlain weakened Britain's recovery. The National Government, of which he was a leading member, carried the infection of mercantilism to all three parties, Liberals, Labour and Conservatives. It is a useful rule of thumb that when all three parties concur in a policy it must be wrong.

In a sense the European Union is the lineal descendent of these illusions. It may favour liberalisation of trade between member states yet it is mercantilist in its specific policies. It may be more sophisticated. Protectionism is often hidden by non-tariff barriers. Only in the case of the Common Agricultural Policy is it overtly protectionist and mercantilist.

No. 5 – 1945-1979: Post-World War II nationalisation

> *'To secure for the workers by hand or by brain the full fruits of their industry and the most equitable distribution thereof that may be possible upon the basis of the common ownership of the means of production, distribution and exchange, and the best obtainable system of popular administration and control of each industry or service.'*
>
> Clause 4, Labour Party Constitution

The nationalisation of industry, the control of the 'commanding heights of the economy', was one of the chief policies of the 1945 Labour government. It was a disaster and was finally admitted as such when the Labour Party under Tony Blair abandoned 'Clause 4' in 1995. The Clause was drafted by Sidney Webb in 1917 and when translated into nationalisation in the late 1940s it was the source of great waste and inefficiency. The list of major industries brought into 'public ownership' is set out in Table 1:

Table 1: Nationalisation in Britain

	Date of nationalisation
Post Office telegrams	1868
Post Office telephones	1912
Forestry	1919
Airlines	1939
Coal	1947
Electricity generation	1947
Cross-Channel shipping	1948
Canals	1948
Railways	1948
Road haulage	1948
Buses	1948
Steel	1949
Gas	1949

When elected in 1950 the Conservatives made no attempt at denationalisation except for iron and steel. The Conservative government of Ted Heath, elected in 1970, also made no serious attempt to privatise. It was left to Mrs Thatcher's government to start the counter-revolution in 1979.

Nationalisation created two different but related problems. In the first place, because the firms were monopolies they had no strong incentive to serve their customers. Furthermore, their monopoly was institutionalised as interlopers were prohibited. It must be admitted that their monopolies were to an extent limited. The railways had to compete with road transport and gas and electricity were competitors. Still, new competition between suppliers for the custom of consumers was severely limited. Private monopolies may serve consumers better than those owned by the state, as they are more easily regulated, criticised and threatened than those in the ‘public sector’.

But the most serious cause of nationalised inefficiency was that they did not have to compete for capital with other businesses. For example, in 1966/67 investment in nationalised industries amounted to £1.7 billion (or just under 5 per cent of GDP), of which half was provided by the taxpayer with the balance being self-generated (Miller c.1982). Each supervising department - for example the Ministry of Power in the case of the National Coal Board (NCB) - would apply to the Treasury for funds with a justification that gave an indication of the likely return. The problem was that each nationalised industry would only get funds for investment from the Treasury by painting a rosy view of its prospects. And the rosier the picture, the larger was the allocation. This triumph of theory over common sense led critical economists to invent the phrase ‘appraisal optimism’ to describe this process. With none of their own funds at risk, and certainly not their jobs and salaries, the managers had every reason to paint as optimistic a picture as possible to ensure they got as much as they could from the Treasury.

The results were dismal. Between 1970 and 1980 (inclusive), the nationalised industries lost money hand over fist – with losses ranging between a minimum of £543 million in 1970 and a maximum of £4,148 million in 1980. Over these years, losses totalled £22 billion, equivalent to £173 billion in 2014 money (ibid.). Nor was this period exceptional. In the period 1955-1970, the financial results were similarly unsatisfactory (Polanyi and Polanyi 1971). Despite the high level of state investment, in 1980 productivity was 45 per cent greater in the private sector (Miller c.1982). It was this kind of performance that prompted one politician to suggest that nationalised industries should be grouped together under one sponsoring government department, the ‘Ministry of Economic Waste’.

The nationalisation experiment did not lack from want of attempts to make it work satisfactorily. Both Labour and Conservative governments did their best but neither proved equal to the task. Apart from practical efforts to make them operate efficiently economists attempted to find develop rules that would guide the managers of the nationalised industries to success. After much analysis it was concluded that the only sensible way to run nationalised industries was to do so *as if* they operated in a competitive environment. The difficulty was that without actual competition it was impossible to discover what the results of competition would be. This conclusion removed the intellectual justification for nationalisation, such as it was, and paved the way for privatisation.

No.6 – 1945-2015: The Town and Country Planning Act

> *'[Town Planning] …often fails to achieve in practice what is claimed for it in theory; … it has often produced colossal errors (as in high-rise flats and tower blocks); and it takes short-sighted decisions under political pressures.'*
>
> Entry under 'Town Planning' in Arthur Seldon and F. G. Pennance, *Everyman's Dictionary of Economics*.

Cities are such complex, diverse, confusing, thriving places that it seems almost self-evident that they cannot be left to the 'chaos' of the free market. They must, it seems, be consciously planned – co-ordinated - harmonised.

The Town and Country Planning Act of 1947 was one of the high water marks of socialism - the idea that the coerced is always better than the spontaneous - or unplanned. The legislation empowered the planners - local authorities - to direct land use and the nature and location of buildings.

The powers given to this mixture of councillors, architects and engineers were so draconian that many were repealed after seven years, yet the bulk of the powers remain. Nobody may erect or even alter a building without detailed consents. New build would only be permitted as authorised and only for designated uses.

It is striking that the best townscapes we enjoy pre-date the Act. Central Bath and Edinburgh New Town spring to mind. Towns such as Eastbourne or Harrogate or distinct parts of London such as Pimlico, Belgravia or Hampstead are admired. It is true they were planned, but the directing or organising agencies were private owners or landlords.

It is possible to coordinate third party rights by contract. More than possible - it is better done by agreements between parties than by the caprice of a town planning official.

Town Planning is only a local version of the core socialist belief that all matters must be directed by an authority with access to wisdom hidden from market participation. Hayek terms this courteously as ‘administrative despotism’. It is an apt description.

The phenomenon called ‘planning blight’ is familiar in British towns and cities. A sort of curse of mortmain is imposed on locations whose use or zoning is altered. Many acres are frozen into a semi-permanent dereliction.

This same mind-set can perhaps be seen in the present government’s determination to push thought the ‘HS2’ high-speed railway from London to Birmingham and beyond. The entire project has no voluntary commercial investment. Compare this to the Victorian creation of the railway network in which not a penny was invested by the taxpayer.

The Town and Country Planning Act of 1947 has gained many further barnacles of legislation despite few critics being able to praise its success. The development of the Docklands areas of London was only achieved by over-riding the municipal planners by creating a higher authority to overrule the decay nourished by the local councils. The obvious conclusion, that planning controls were generally a handicap on business and development and should consequently abolished, was never drawn.

The Act reached every corner of the country. Remote villages atrophied. Incongruent estates were sometimes added. Another feature of the compelling idea of planning was the creation of National Parks to deter or impede all spontaneous developments. They evolved rapidly into reservations for the middle classes and ever more of the retired.

There are two fundamental flaws in the planning system. Firstly, it puts major restrictions on individual freedom, the freedom to do what one likes with one’s own property. Restrictions on ownership are right only when they are clear, simple universal and non-discretionary. The current rules are none of these things. Secondly, planning controls operate as a tax on economic growth. Insofar as they make it more difficult to build factories, supermarkets and houses, everyone is impoverished. Surely, it might be claimed, planning has at least prevented the creation of eyesores and the destruction of historic building and landscapes. There is room for scepticism. Most of the major planning scandals and disasters took place *after* rather than *before* 1947. One has only to think of the social catastrophe of local authority housing in tower blocks, and the destruction of numerous city centres, Birmingham for example.

No. 7 – 1945-1979: Britain's experiments with economic planning

'…in matters of economic planning we agree with Soviet Russia...'

Clement Attlee (House of Commons, 18 November 1946)

Britain had two experiments with economic planning, one in the 1940s and one in the 1960s. Both were abject failures but it is still remarkable that since the days of Harold Wilson there have been no attempts to bring planning back from the ideological rubbish dump which it shares with phrenology, eugenics, Marxism and Social Darwinism. The case such as it is for economic planning, was demolished before World War II by economists largely of the Austrian school, notably Ludwig von Mises and F. A. Hayek (Hoff 1981). In addition to failing to achieve what it promised, Hayek argued in his famous book, *The Road to Serfdom*, that planning threatens freedom by the restrictions on individual liberty that it entails (Hayek 1944).

National economic planning rests on the belief that the market is chaotic and wasteful and that planners using 'scientific' methods should be able to organise production to meet the needs of the people more efficiently. The difficulty is that the idea is based on the false assumption that information about the economy is free and easily available. Consumers are fickle and matching production to meet consumer demand at mutually agreeable prices and quantities is difficult. As the planners had foresworn the trial and error method of markets and prices they could only flounder in a sea of ignorance. For without prices they have no means of knowing what they ought to do. By contrast, in a market economy consumers and producers can use the price information about relative scarcities and values to adjust continuously what they demand and what they supply. Planners have no such ability.

1940s

Britain's first experiment with planning grew out of the experience of World War II when all the nation's resources were concentrated on one end and it was (relatively) easy to give priorities to economic activity. After the war the apparatus of planning remained and it was easy for the incoming Labour government to adapt the controls to do away with what they fancied was the chaos of capitalism and introduce an era of economic stability, high employment and steady growth. The trouble is that in peace time there is no clear ordering of economic priorities, only a flux of changing consumer demand. Undaunted, Mr Attlee's Labour government equipped itself with a panoply of powers to introduce economic growth and stability, which by 1947 included a short lived attempt to control labour (Jewkes 1968). This was the infamous Control of Engagements Order, which made it illegal to obtain work other than through a Labour Exchange and gave power to the authorities to 'direct labour' or force people to take particular jobs.

Finally (and ironically) as soon as applied the plan was blown off course by unforeseen shortages, 'bottlenecks' and incipient and actual exchange rate crises, the sort of instability which planning was supposed to mitigate.

1960s

By the 1960s, planning 'with teeth' was judged unworkable and it was replaced by 'indicative' planning which sought to cajole, inspire, urge or predict what path the economy was to take. The Labour government under Harold Wilson sought to establish an expansionist ministry as a counterweight to the Treasury. The Department of Economic Affairs was set up in 1964 and published a 'National Plan' in 1965. There was an irony that on publication, the government failed to print enough copies to meet demand. It became immediately apparent that the plan fell between two stools. Was it an 'is' or an 'ought' statement? In other words, it was not clear whether it was a prediction of what was to happen or a prescription of what ought to happen. Before this puzzle could be resolved the department's minister, George Brown, was moved to the Foreign Office, the Treasury retrieved such powers as it had lost and the ministry was wound up in 1969 in time for the General Election of 1970. Such British attempts at indicative planning were not heard of again. The concept, though, lingers with calls for an energy plan or a transport plan. But, if introduced, such plans would be bound to fail. No planner has (or can have) the information required even to approach rationality (or common sense). The inevitable result of this ignorance is waste.

No. 8 – 1960-2015:
The development aid fallacy

> *'Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice: all the rest being brought about by the natural course of things.'*
>
> Adam Smith, *The Theory Of Moral Sentiments*

Foreign development aid must be distinguished from humanitarian aid. The latter is part of the duty which civilised governments owe to each other and it is not the subject of this chapter and the two must be carefully distinguished. Failure to make the distinction between humanitarian and development aid can be seen as the cause of the British government's failure to deal with the Irish famine in the 1840s. Insofar as support for development aid is at the cost of humanitarian aid, it ceases to be a virtue.

Humanitarian aid is the action by governments and private charity to help those afflicted by famines and all manner of natural disasters. It is done best jointly in this way and it is naturally of limited term in each particular case. Once the immediate needs of the people afflicted have been eased, the aid is withdrawn. When your house burns down there is no value in the fire brigade remaining on the scene once the fire has been put out.

Development aid is different and has its origins in some elements of colonial rule. The purpose of development aid is to accelerate economic growth in the territory concerned. But the idea that government is a necessary or even a sufficient condition for rapid economic growth can easily be shown to be false. Hong Kong, which is one of the richest countries in the world, was a poverty stricken territory on the coast of

China. In 1945 it had a population of 600,000 and there was a massive influx of refugees following the victory of the Communists in the Chinese civil war. Hong Kong now has a population of 7,154,000 (2012). It became rich without subsidy from Britain (or anyone else) but it did have the advantage of good government, low taxes, absence of exchange controls, secure property rights, low taxes and relatively sound money. One of the great un-recognised giants of the twentieth century, Sir John Cowperthwaite, deserves much of the credit. As Financial Secretary to the Hong Kong government between 1961 and 1971, he was the author of the Hong Kong's extraordinarily rapid growth. When Milton Friedman visited the colony in 1963, he mentioned to Cowperthwaite the shortage of statistics. He replied, 'If I let them compute those statistics, they'll want to use them for planning'. Milton Friedman described Hong Kong's success in the following way:

> '….in 1960, the earliest date for which I have been able to get them, the average per capita income in Hong Kong was 28 percent of that in Great Britain; by 1996, it had risen to 137 percent of that in Britain. In short, from 1960 to 1996, Hong Kong's per capita income rose from about one-quarter of Britain's to more than a third larger than Britain's. It's easy to state these figures. It is more difficult to realize their significance. Compare Britain - the birthplace of the Industrial Revolution, the nineteenth-century economic superpower on whose empire the sun never set - with Hong Kong, a spit of land, overcrowded, with no resources except for a great harbor. Yet within four decades the residents of this spit of overcrowded land had achieved a level of income one-third higher than that enjoyed by the residents of its former mother country.'
>
> (Friedman 1998)

All this is highly relevant to development aid. If the theory of development aid were correct Hong Kong should be as poverty stricken as any depressed African country. The argument can be generalised. How is it that without foreign development aid economic growth in China has burgeoned to such an extent that for the first time in history hundreds of millions of Chinese people are no longer poor?

The fallacy was demonstrated by Peter Bauer (later Lord Bauer) (Bauer 1976). He explained that aid was generally likely to be ineffective and that it often meant the transfer of money from poor people in rich countries to rich people in poor countries. He also pointed out that the more poor countries trade in world markets the richer they become. In fact development aid may actually impede economic growth. It tends to entrench corrupt governments, without leading to the sustained savings and investment from which growth comes. Governments both domestic and foreign are as unlikely to make the best decisions in what, when and where to invest in developing countries as they are elsewhere. Poor countries need free and easy access to capital markets. And this can only be achieved by secure property rights, low taxes and absence of exchange controls. Investors will only invest if they can liquidate their investments and repatriate the proceeds. If you were to make a list of the poorest countries in Africa you would find that they were those where these conditions do not obtain. What these countries actually need is not development aid, but good government on the model of Hong Kong under Sir John Cowperthwaite.

There are three evil evils which foreign development aid perpetuates. Firstly, it diverts attention from the real conditions for economic growth – free markets and limited government. Secondly, it uses resources that might otherwise have been used for emergency aid. Suppose only half the £11 billion which Britain spends annually on development aid had been used for emergency aid on droughts, famines, refugee crises, earthquakes and tsunamis - far more good would be done. Third, it perpetuates in poor countries the false and destructive idea that prosperity can only come from government.

No. 9 – 1950-1960s: ‘Butskellism’ - Keynesian macro-economics

> *‘We now have the worst of both worlds - not just inflation on the one side or stagnation on the other, but both of them together. We have a sort of “stagflation” situation. And history, in modern terms, is indeed being made.’*
>
> Ian Macleod (House of Commons, 17 November 1965)

After World War II there was unanimity that there must be no return to the unemployment of the 1930s. All political parties accepted the Keynesian assumption that lack of demand caused unemployment. If unemployment appeared, the government increased demand by spending more and reducing interest rates. Keynesian demand management was only moderated by adhesion to a fixed exchange rate and the resulting series of ‘sterling crises’. The policy successfully reduced unemployment to an average of 1.9 per cent in the 1950s and 1960s and led to the creation of what could be described as a Keynesian Golden Age. It became known as ‘Butskellism’ after Hugh Gaitskell, Labour Chancellor between 1950 and 1951 and ‘Rab’ Butler who was his Conservative successor between 1951 and 1955.

Harold Macmillan as Chancellor continued the policy from 1955 to 1957. Doubts appeared in 1958 when Macmillan’s successor Peter Thorneycroft (accompanied by Nigel Birch and Enoch Powell, respectively Economic and Financial Secretary to the Treasury) resigned over excessive government spending. Macmillan’s inflationary boom gave success to the Conservatives in the General Election of 1959. But by the mid-1960s, doubts became general when it was discovered that inflation could be combined with unemployment. For instance in 1968, unemployment was 2.5 per cent and inflation 4.7 per cent. The policy continued, however, until Labour was replaced by the Conservatives in 1970. Table 2 shows that Butskellism achieved very low unemployment for nearly 20 years.

Table 2: UK unemployment rate in the Keynesian 'golden age'

	Period	%
Pre-golden age	1921-1938	13.4
Keynesian golden age	1950-1969	1.6
Post-golden age	1970-1993	6.7

Source: Sloman (2004: 811)

Butskellism may have kept unemployment low but it gradually became apparent that it had some alarming flaws. First it seemed unable to stop British economic growth lagging behind that of its major competitors. In the 1950s and 1960s Britain's economic performance was lamentable. Table 3, taken from the classic book on the period *The Treasury under the Tories 1951-1964* by Samuel Brittan[4] (Brittan 1964), shows that between 1955 and 1963 British economic growth was the weakest of all the major European countries and the United States. Some economists and Labour politicians attributed this slow growth to 'stop go ' because of the constraints of a fixed exchange rate and advocated more 'go' and less 'stop'. Other economists attributed the slow growth to the fact that European economies were 'catching up' after the damage inflicted on them during the war.

4 Now Sir Samuel and the doyen of British financial journalists.

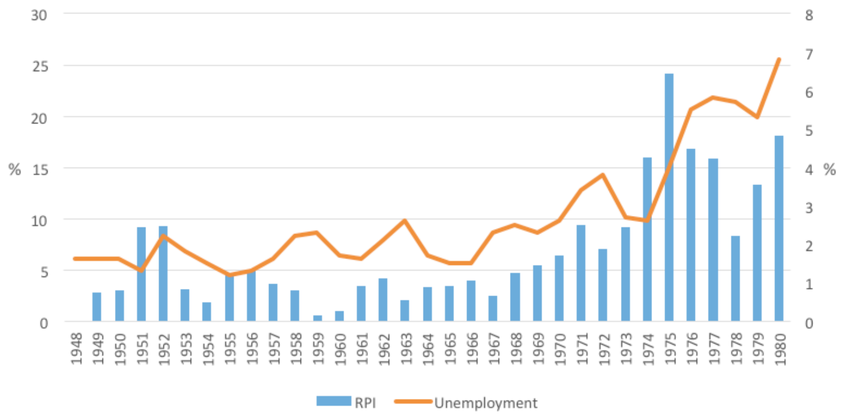
Table 3: Average annual increase in national product per man-year, 1955-1963

	%
West Germany	4.2
Italy	4.1
France	3.8
Netherlands	2.6
US	2.0
UK	1.9

Source: Brittan (1964: 138)

More important, Keynesian demand management became increasingly unable to prevent unemployment from increasing, and Figure 1 shows as unemployment steadily increased through the 1960s and 1970s, inflation increased from a walk to a trot and then to gallop, reaching a peak of more than 24 per cent in 1974.

Figure 1: UK unemployment and inflation, 1949-1980



The inconvenient truth was that the low unemployment could only be bought for a time and that the price in the not-so-long term was ever higher rates of inflation. Workers, it seemed, were bargaining for real rather than nominal wages, which meant that increasing nominal demand could no longer keep down unemployment. Monetarist economists pointed to this obvious truth and argued that in the words of Milton Friedman: 'Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output' (Friedman 1970). In other words inflation is caused by increases in the quantity of money faster than the growth of output, and unemployment is caused by wage fixing.

A counterpoint was added by F. A. Hayek who argued that governments were like a person who held a tiger by the tail and could not let go (Hayek 1975; 1976). If they let go, the tiger would eat them. Governments felt that they had to mitigate unemployment with inflation only to find that both the inflation and the unemployment got worse. Hayek argued that the inflation required to reduce unemployment caused distortions in the real economy which could only be mended by a reshuffling of assets and employment to an undistorted pattern in line with consumer preferences. This meant that unemployment was the inevitable and unavoidable result of the inflation that it was supposed to cure. Hayek also argued that insofar as trade unions prevented this re-ordering process they would only perpetuate unemployment.

No. 10 – 1945-1979: High marginal tax rates post-World War II

> *'Why should a man already earning, say £5,000 a year take the trouble to earn an additional £1,000 of which the Inland Revenue take 13s 3d [66p] in the pound, leaving him with only an additional £337 10s* [£337.50]*? Why not take long holidays or long weekends instead of exerting himself more, for the benefit of the tax gather?'*
>
> Professor Frederick Benham writing in 1961 (Benham 1961: 101)

> *'That's it. So long as the government keeps bleeding me dry, I shan't be in much of a hurry to work again!'*
>
> George Formby, 1950

It is hard now to believe that the marginal rate of income tax in Britain was over 90 per cent for much of the 1950s, 1960s and 1970s. These rates were among the highest in the world. In some other countries it was 100 per cent but in those unhappy lands evasion was so prevalent that it was collected only in part. What is telling about these high marginal rates of tax is that business and enterprise still continued, suggesting that businessmen believed that they would be reduced or that financial return is less important than critics of capitalism have thought. The high rates were justified on general grounds of distributive justice, but they also relied on the labour theory of value. The case for progressive taxation is uncertain and was based on a crude and unconvincing utilitarianism (Blum and Kalver 1970 [1953]).

High marginal rates of income tax were endemic during the post-World War II period until the advent of Mrs Thatcher's government of 1979. For example under the Labour government of 1974 to 1979, the highest rate of income tax was 98 per cent. This comprised a maximum of 83 per cent on earned incomes with an additional 15 per cent on 'unearned' incomes, making 98 per cent on top slices of income. While the Labour government under Harold Wilson and James Callaghan has by far the worst record, the Conservative government between 1950 and 1964 did little to reduce the high rates of marginal income tax they inherited from Clement Attlee's immediate post-war government. Thus when the Conservatives left office in October 1964, the top marginal rate of income tax was 88.75 per cent and had never been less since the Conservatives came to office in October 1951.

Labour's love affair with hyper-taxation

In 1947-48 a special contribution was payable on incomes over £2,000. For investment income over £5,000 it was 50 per cent. Combined with income tax at 45 per cent and surtax at 52.5 per cent, the effective rate was 147.5 per cent.

In 1967-68, there was another special charge. For investment income over £8,000, the rate was 45 per cent which - with income tax at 41.25 per cent and surtax at 50 per cent - meant a total rate of 136.25 per cent.

Source: http://webarchive.nationalarchives.gov.uk/+/http://www.hmrc.gov.uk/history/taxhis7.htm (Accessed 3 April 2014)

One motive for high marginal rates of income tax was that they would increase revenue. In 1955 a Royal Commission assumed '… that the present tax rates are related to a present necessity of raising a given sum of money from the direct taxation of income' (Royal Commission 1955). But this assumption is most unlikely. Marginal rates of tax above 50 per cent will almost certainly reduce economic activity and revenue.

High rates of personal taxation were not limited to incomes but applied similarly to inheritances. Marginal rates on inheritances were very high and had a number of unfortunate consequences. Two of the most serious come to mind. Firstly, the high marginal rates of Estate Duty tended (or perhaps were intended) to destroy the accumulation of wealth individually owned and separate from the state. Individual sources of power and patronage as a counterweight to a powerful state and corporations seem eminently desirable in a free society. The most serious effect was to discourage saving in general and long-term investment in particular. And insofar as capital assets are not maintained it can amount to capital consumption. Why maintain an asset when neither you nor your heirs will benefit. One important motive for saving is to provide an inheritance for *children and grandchildren and even more remote successors. A high marginal rate of tax on inheritances will encourage the wealthy and high earners to live extravagantly for the present and to eschew prudent saving and investment. Others will just move abroad.*

It may be said that such taxes are voluntary, as transfers can be made during one's lifetime, but this is merely to incentivise those with tax avoiding skills and inclinations – scarcely a sensible aim of taxation policy. The top rates of Inheritance Tax and its predecessors, Capital Transfer Tax (which also taxed lifetime gifts at half the rate on death) and Estate Duty were applied at very high rates for most of the post-war era with top marginal rates as high as 75 per cent. This expropriation only changed when Mrs Thatcher's government reduced the top marginal rate to a still onerous 40 per cent, with complete exclusions for farming and business assets. It is time IHT was abolished as it has been in Canada (1972), Australia (1979), Israel (1981), New Zealand (1992), Hong Kong (2006), Russia (2006), Singapore (2008), Sweden (2008), Austria (2008) and Norway (2014). Switzerland has never had such a tax.

No. 11 – 1970-1975: The great 1970s inflation

> *'Inflation over any substantial period is always and everywhere a monetary phenomenon'*
>
> Milton Friedman

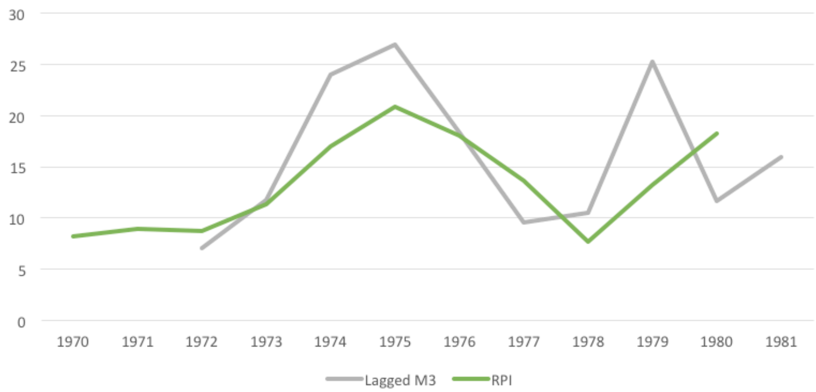
The inflation of the early 1970s was the nearest that Britain has ever approached hyperinflation. It precipitated a political crisis, which made some doubt that democracy could or even should survive, and it caused widespread misery and mass unemployment. It was entirely avoidable and was the result of the incompetence of Anthony Barber, the Chancellor of the Exchequer, who presided over the disaster, and of Ted Heath the prime minister. After losing office in 1974, neither Barber nor Heath ever held office again.

In preparation for the general election of 1970, the Conservatives had adopted a free-market and monetarist manifesto following the famous Selsdon Park meeting of the shadow cabinet. Harold Wilson denounced the advent of 'Selsdon Man'. Had it been carried out, it would have anticipated Mrs Thatcher's reforms by a decade.

When the Conservative Party unexpectedly won the General Election of 1970, Ian Macleod became Chancellor, but on his death six weeks after taking office he was replaced by Anthony Barber who was a tax barrister with little evident interest in economic theory. All went well until early 1972 when unemployment, which had been around half a million, increased to over 970,000 – close to 1 million, a figure which would make for alarming headlines. Under the Conservatives unemployment had jumped from 2.5 per cent in June 1970 to 4.8 per cent in January-April 1972. As a result

Ted Heath lost his nerve and he and Anthony Barber instituted what at the time would have been called a ‘reflation’.

Figure 2: M3 growth lagged 2 years and inflation



It was unlucky that the reflation coincided with a liberalisation of the monetary system by moving from direct controls on banks and instead controlling monetary conditions solely by interest rates. The new system was known as *Competition and Credit Control*. Reliance on interest rates proved insufficient particularly because the reserve ratio of the banks was reduced from 30 per cent to around 15 per cent. In other words, whereas previously banks had to retain 30 per cent of every deposit in cash (or equivalent), they now had only to retain 15 per cent. The result was that banks found themselves with excess cash, which they did not delay in lending. The result was an explosion in bank deposits and the money supply.

The consequence was that monetary growth of 24 per cent in 1972 and 27 per cent in 1973 was followed after a lag of 24 months by inflation that peaked at 26.9 per cent in August 1975. Figure 2 shows the expansion of the money supply according to the M3 measure and annual percentage changes in the Retail Price Index. The money supply figure has been ‘lagged’ by two years to show more clearly the strong relationship between excessive monetary growth and subsequent inflation. Perhaps in the 1950s and early 1960s there might have been some excuse. By the 1970s, there were numerous economists, led by Milton Friedman, who had confirmed the common sense belief that inflation was caused by excessive monetary growth.

The result was an economic crisis as severe as any in British history. It led to the ‘three-day week’, a miners’ strike and the collapse of the Heath government. Some attributed the surge in inflation to the contemporaneous increase in the oil price. This explanation was wholly unconvincing as countries such as Switzerland suffered the same increase in the price of oil but without the inflation.

The reaction of the Conservative government was to revert to the nostrums of the 1960s and to apply wage and price controls on the grounds that price increases cause inflation. It was restrictions on increases in the wages of the miners which led to the strike and the Conservatives’ humiliation in the first General Election of 1974.

In the end, the disaster had some good consequences. A number of leading Conservatives rapidly came to the conclusion that inflation could only be contained by a strict monetary policy. They also concluded that Ted Heath had made a disastrous mistake in abandoning the free-market philosophy which had been accepted as the basis of government economic policy when it came to power in the summer of 1970. This was a mistake which the incoming government of Mrs Thatcher would not repeat.

No. 12 – 1990: Entering the Exchange Rate Mechanism

'…experience hardened me into a bitter opponent of the exchange rate mechanism - or what I called the eternal recession mechanism.'

Norman Tebbit[5]

The Conservative government's fixation with pegging the exchange rate originated in the late 1980s. There were two strands. Firstly, there was a determination by pro-EU members of the cabinet to promote as far as possible Britain's commitment to the EU, including any unified monetary system. Secondly was the fact that monetary targeting was proving difficult in practice. There seemed to be no stable relationship between money and inflation and economic activity – another mechanism was required. The alternative method of containing inflation was to link sterling to the most stable (and successful) European currency, which was the Deutsche Mark. The result was that under the Chancellorship of Nigel Lawson, sterling began to 'shadow' the Deutsche Mark at around DM3 to £1 in early 1987.

The financial mechanics are important. If sterling is undervalued, then the funds flow in, relaxing monetary conditions and causing rising prices and a boom. Conversely, if sterling is overvalued money flows out, prices tend to fall and the economy contracts. With sterling at around DM3 the currency was undervalued, money flowed in and the Lawson boom of the late 1980s commenced. This led to tension between Mrs Thatcher, who was influenced

5 An electoral curse yet to be lifted. *The Guardian,* 10 February 2005, http://www.theguardian.com/politics/2005/feb/10/freedomofinformation.economy

by Sir Alan Walters a staunch supporter of floating exchange rates, and her chancellor. In the event, Lawson resigned and was replaced as chancellor by John Major.

The pro-European faction in the cabinet was successful however and Britain joined the ERM in October 1990 at an effective rate of DM2.95. But this time sterling was overvalued, money flowed out and a severe recession began. The position was exacerbated by the fact that interest rates in Germany were high as the German government had to borrow to finance re-unification. The result was a recession that failed to mend. In November 1990, Mrs Thatcher was ejected as prime minister and replaced by John Major, who in turn was succeeded by Norman Lamont as Chancellor.

The crisis came in the summer and autumn of 1992. Sterling remained stubbornly at the bottom of its 6 per cent trading band despite massive expenditure of reserves and a hike in interest rates. In addition, the recession following the end of the Lawson boom showed no sign of ceasing. The end came in September when pressure on sterling reached a crescendo and currency speculator George Soros made enormous bets against the pound. This shows one of the great weaknesses of fixed exchange rates. If a currency is either significantly under or over valued at the fixed rate then traders have a mouth-watering, risk-free bet. If the rate changes in line with their bets then they make significant profits; if it the rate remains unchanged they are no worse off.

Britain was summarily ejected from the ERM on 16 September 1992. Interest rates fell and the recovery began just as it did in 1931 when Britain went off gold. In both cases, the supporters of the fixed rate were humbled and what appeared to be disaster was in fact a liberation. The government had no difficulty in forming a monetary and interest rate policy that led to a decade of steady growth and low inflation – all without the ‘anchor’ of a fixed exchange rate which so many experts and enthusiasts for European monetary union thought necessary.

‘Black Wednesday’ should properly be known as ‘White Wednesday’ as it marked the day when the British economy was released from the dire effects of a fixed exchange rate regime. The result had been a continuous recession with low growth and high unemployment. Norman Tebbit had rightly christened it ‘The Eternal Recession Mechanism’. Of all the ‘Baker’s Dozen of Disasters’ the decision to join the ERM was the worst example of an unforced error. It was predicted by Sir Alan Walters, who played much the same role in the 1990s as Keynes in the 1920s during the similar disastrous episode of the return to gold (see Chapter 4) (Walters 1990).

In fact Nigel Lawson's shadowing of the DM and the period in the ERM proved that fixed exchanges can (and often do) lead to economic instability. If the currency is undervalued than the resulting cash inflows will create an unsustainable inflationary boom. If it is overvalued then the result will be that a pre-existing recession will be deepened and perpetuated. If there were no recession to start with, an overvalued exchange rate could well create one. For a country like Britain, which is economically dissimilar to its neighbours, it may be impossible to know the right exchange rate, and, in any case, the right exchange rate may change from week to week. One good consequence of 'White Wednesday' is that Britain may have been immunised against similar experiments for a generation. One politician who learnt his lesson was Gordon Brown and his resistance to pressure for Britain to join the euro saved the United Kingdom from many of the travails endured by the euro zone countries since 2008.

No. 13 – 2000-2008: The Gordon Brown bubble

'Why did no one see this coming?'

HM The Queen, London School of Economics, November 2008

The consequences of the economic crisis which began in 2007 and culminated in 2008 are still being felt. It is widely but mistakenly assumed that Britain was caught up in a worldwide economic disaster which was caused by greed, folly and inadequate regulation, and that most of the blame is to be attributed to the banks. This is a complete misunderstanding of the events and it fails to fix responsibility for the disaster where it properly belongs.

Orthodox economists were completely bemused by the crisis. They did not expect it and had no means of explaining it. When the Queen went to the LSE in November 2008 she asked, 'Why did no one see this coming?' The assembled cream of British economists were embarrassed. They had not seen it coming and had no theory to explain why it happened. There was a rush for exits and excuses. If the economists were non-plussed, the politicians and especially New Labour politicians and Gordon Brown in particular were perhaps even more embarrassed. But embarrassment does not do justice to the discomfort they deserved but successfully avoided. Instead of taking the responsibility themselves it was easy to blame unpopular bankers and their bonuses. Those who were in charge of setting monetary policy, interest rates and credit conditions side-stepped the blame, including politicians such as Gordon Brown who failed to intervene when Mervyn King tolerated the runaway boom.

The crisis was the result of a monster worldwide credit expansion in which British politicians and central bankers were enthusiastic participants. The boom was allowed to develop to an extraordinary degree. This bubble blindness was caused by most mainstream economists, central bankers and finance ministers believing that an economic depression could always be avoided by ensuring the money supply did not collapse or decline to any material extent. This indeed was one of the important lessons of the Great Depression when the Federal Reserve, the American central bank, permitted the US money to decline by a third[6] (Friedman and Schwartz 1963). This understanding appeared to be confirmed by the Long Term Capital Management (LTCM) crisis of 1998 which did not damage the real economy. But come Bear Stearns in March 2008 and Lehman Brothers in September and the unfolding of the international economic crisis, it became clear that the disaster was not limited to the banking sector. Much of the trouble was found to be the result of excessive lending for property investment, much of it in a particularly risky form. The long period of low interest rates applied by central banks throughout the industrialised world had distorted real economies. In other words the long period of over-easy money misled businessmen, bankers, house buyers, and mortgagees and mortgagors into believing economic conditions were better than was the actually the case. It appeared that more resources were available and business conditions less risky than the reality. No wonder they made extravagant plans which could never be completed.

The mistakes of central bankers and politicians reflected two underlying errors. Firstly, interest rate policy was often asymetric, with central banks reducing rates in the face of a crises like 9/11 and LTCM or in periods of potential or actual recession. On the other hand, when stock markets and house prices showed ‘irrational exuberance’ they were reluctant to increase rates to stifle a potential bubble. This asymmetry meant that the financial system of the major industrialised countries became a giant bubble-making machine. Secondly, mainstream economists failed to understand (or predict) that a bubble could affect not just financial markets but cause major disruption to the real economy.

Much fault must lie with Alan Greenspan, the once much-admired Chairman of the Federal Reserve, who invented the term ‘irrational exuberance’ but failed to see that it required action by him. His predecessor as Federal

6 The other lesson of the 1930s was that protectionism must be avoided if the depression was not to be turned into a catastrophic slump (see Chapter 4).

Reserve Chairman between 1951-1970, William McChesney Martin, was clear about the responsibilities of central bankers in such circumstances and famously stated that the central bank should be prepared '…to take away the punch bowl just as the party gets going…'. Instead of removing the punch bowl, Alan Greenspan added more vodka to the brew. Gordon Brown and Mervyn King looked on approvingly.

Gordon Brown and Mervyn King must take much of the blame as far as Britain is concerned. If they had wished, they could have easily restrained the boom. Of course, as Professor Tim Congdon has been relentless in pointing out, central banks exacerbated the crisis by increasing required bank capital ratios just as the economy needed as much support from savers and lenders as it could get.

References

Abrams, B. A. (2013) *The Terrible 10: A Century of Economic Folly.* Oakland California: The Independent Institute.

Bauer, P. (1976) *Dissent on Development.* London: Weidenfeld and Nicholson.

Benham, F. (1961) Taxation. In A. Seldon (ed.), *Agenda for a Free Society* (pp. 101-117). London: Hutchinson for the Institute of Economic Affairs.

Blum, W. J. and Kalver Jr., H (1970) [1953] *The Uneasy Case for Progressive Taxation.* Chicago: University of Chicago Press.

Brittan, S. (1964) *The Treasury Under the Tories 1951-1964.* London: Penguin.

Friedman, M. (1970) *The Counter-Revolution in Monetary Theory.* London: Institute of Economic Affairs.

Friedman, M. (1998) The Hong Kong Experiment. *Hoover Digest*. Available at: http://www.hoover.org/publications/hoover-digest/article/7696

Friedman, M. and Schwartz, A. (1963) *A Monetary History of the United States.* Princeton University Press.

Hay, J. R. (1975) *The Origins of the Liberal Welfare Reforms 1906-1914.* London and Basingstoke: Macmillan.

Hayek, F. A. (1944) *The Road to Serfdom.* London: Routledge and Kegan Paul.

Hayek, F. A. (1960) *The Constitution of Liberty.* Routledge and Kegan Paul.

Hayek, F. A. (1975) *Full Employment at Any Price?* London: Institute of Economic Affairs.

Hayek, F. A. (1976) *Tiger by the Tail* (S. Shenoy, ed.). London: Institute of Economic Affairs.

Hayek, F. A. (1984) *1980s Unemployment and the Unions* (2nd edition). London: Institute of Economic Affairs.

Hoff, T. J. (1981) [1938] *Economic Calculation in the Socialist Society.* Indianapolis: Liberty Fund.

Jewkes, J. (1968) *The New Ordeal by Planning.* London: Macmillan.

Miller, R. C. (c.1982) *National Failures.* Unpublished paper for the Institute of Economic Affairs.

Moggridge, D. (1972) *British Monetary Policy 1924-1931: The Norman Conquest of $4.86.* Cambridge University Press.

Polanyi, G. and Polanyi, P. (1971) The Ailing Giants. In R. Boyson (Ed.), *Goodbye to Nationalisation* (pp. 33-54). Enfield: The Churchill Press for the Constitutional Book Club.

Robbins, L. (1934) *The Great Depression.* London: Macmillan.

Royal Commission (1955) *Royal Commission on the Taxation of Profits and Income.* London: HMSO.

Tseng, W. and Cowen, D. (eds.) (2005) *India's and China's Recent Experience with Reform and Growth.* Basingstoke: Palgrave Macmillan for the IMF.

Walters, A. (1990) *Sterling in Danger: The Economic Consequences of Pegged Exchange Rates.* London: Fontana.

The Institute of Economic Affairs
2 Lord North Street
London SW1P 3LB
Tel 020 7799 8900
email iea@iea.org.uk

Institute of Economic Affairs