



Perspectives by Ruth Lea

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Three British recessions compared



As the British economy slows and inflation rises, hit by the twin problems of the credit crunch and the rapid rise in oil prices, speculation increases that we will experience a nasty bout of “stagflation” or even fall into a true recession. Concerning “stagflation” comparisons are increasingly being made with the horrors of the 1970s. Turning to the possibility of a “recession”, comparisons are increasingly being made with the early 1990s or the 1980s.

The term “recession” is conventionally defined as when an economy experiences two consecutive quarterly falls in GDP. But this can be criticised for being, on the one hand, too pedantic or, on the other hand, too inexact. Too pedantic because if an economy grows below trend (which is broadly 0.6% to 0.7% a quarter), or even stagnates, this can result in significantly higher unemployment. This state of affairs undoubtedly feels like recession for the many adversely affected, even though GDP does not actually fall on a quarter-to-quarter basis. Too inexact because an economy that experiences two consecutive quarters of modestly falling GDP and then recovers quickly would, obviously, be in better shape than one that experiences sharper falls in output and/or falls in output over a more protracted period. Yet both are called “recessions”.

But whatever the arguments about definitions, there is little doubt that Britain experienced unpleasant recessions in the mid 1970s, the early 1980s and the early 1990s. They were in many ways very different. But a notable feature of all these recessions was the loss of control of inflation. The economic disruption caused by high inflation and the costs involved in rectifying entrenched inflationary pressures were substantial in all cases and should serve as a timely reminder of the economic costs of losing control of inflation.

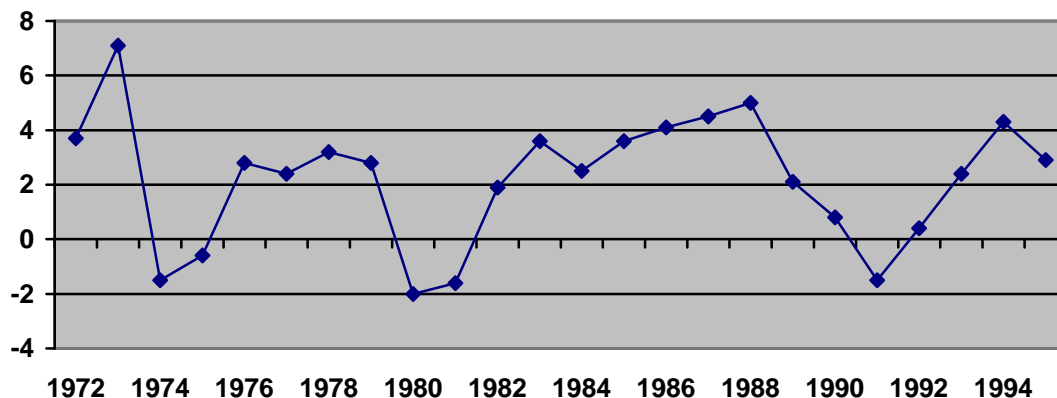
It is still expected that the economic difficulties that lie ahead will not be as bad as in the 1970s, 1980s and 1990s. In no small part this reflects the more robust anti-inflationary framework for monetary policy than in previous decades which was, arguably, dreadful.

Three recessions

Charts 1-3 show the key data from 1972 to 1995 for GDP, unemployment and RPI inflation. They clearly show falling GDP in 1974 and 1975, larger falls in 1980 and 1981 (the severest of the three recessions) and the decrease in GDP in 1991. Unemployment rose in all recessions, albeit with the customary lag, peaking at nearly 1.5 million in 1977, plateauing at nearly 3.3million in 1985 and 1986 and touching 2.9 million in 1993. (These are all annual data.)

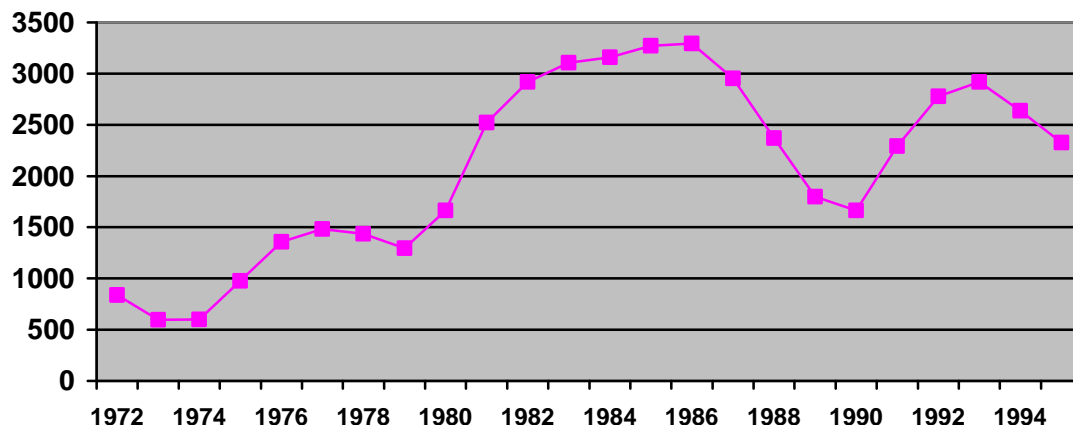
Associated with all three recessions was a rapid build up of inflationary pressures in the economy. RPI inflation in 1974, the first year of falling output in the 1970s, was nearly 16%. Despite an economy in recession, with rapidly rising unemployment, RPI inflation was nearly 25% in 1975. This wasn't so much a period of "stagflation" as a combination of recession and inflation. RPI inflation of 18% was recorded for 1980, the first year of the steep recession of the early 1980s, and was around 9½% in 1990, the second half of which saw the start of the early 1990s recession.

Chart 1: GDP, market prices, volume, annual changes (%): 1972-1995



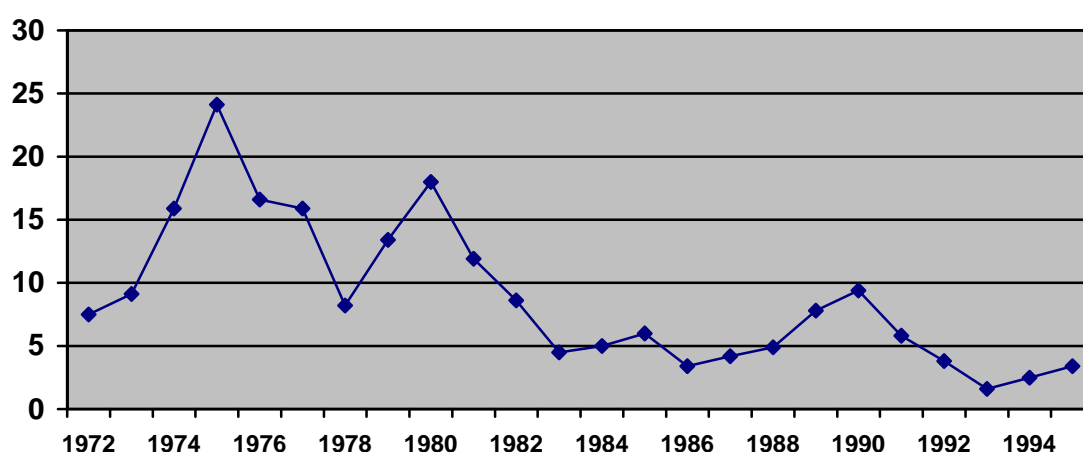
Source: ONS.

Chart 2: Unemployment, claimant count (thousands), annual data: 1972-1995



Source: ONS, note there were definitional changes to the claimant count during the 1980s, which reduced the numbers on the count.

Chart 3: RPI annual inflation (%), 1972-1995



Source: ONS, note the RPI annual inflation data are affected by changes in interest rates as they include mortgage interest payments.

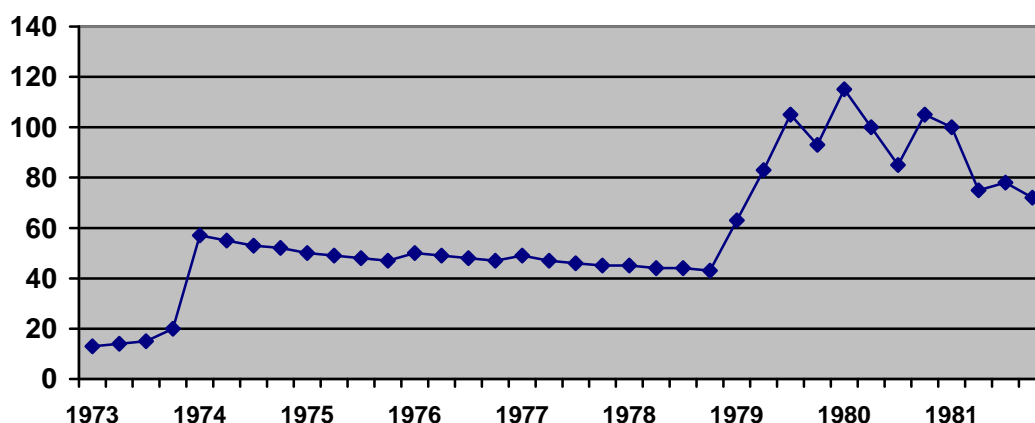
The 1970s

The 1970s was an economically turbulent decade. Britain was known as the “sick man of Europe” and sought salvation in membership of the European Economic Community. Wildcat strikes, “working to rule” and other manifestations of quasi-anarchic industrial relations were known as the “English disease”.

In the early 1970s Britain’s economic problems intensified when the Heath Government sought to control rising inflationary pressures by capping pay rises. Powerful unions reacted with industrial action, culminating in the NUM’s “work to rule”. Coal stocks dwindled and at the beginning of 1974 the “three-day week” was introduced to conserve electricity. GDP fell 2½% in 1974Q1 compared with the previous quarter.

But it was not just powerful unions¹ and quasi-anarchic industrial relations that troubled the British economy at this time. The oil crisis, triggered off by OPEC’s oil embargo (starting October 1973) on shipments to Israel’s allies in the Yom Kippur War, led to a near quadrupling of oil prices. This gave a significant kick on UK prices inflation which provided further impetus to higher wage settlements. A destructive “wage-price spiral” intensified through 1974 and 1975, which only eased when recession and higher unemployment curbed inflationary tendencies.

Chart 4: Crude oil prices, \$ per barrel, 2008 prices (deflated by the US CPI), quarterly data 1973Q1 to 1981Q4



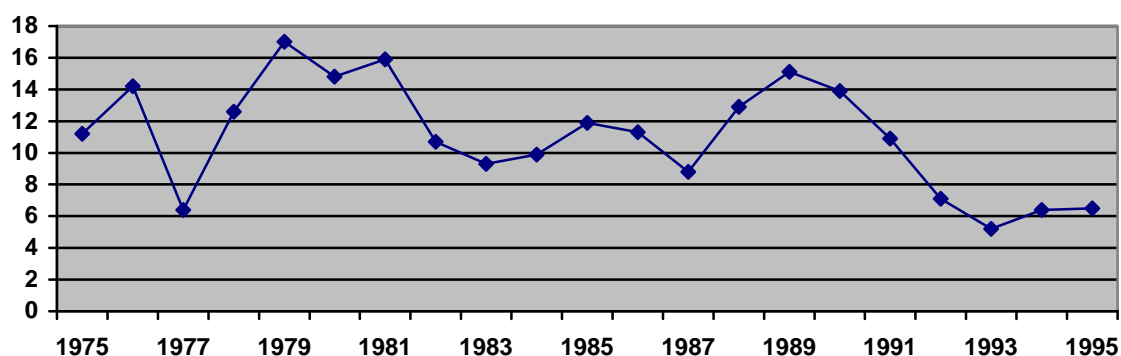
Data source: Ruth Lea, “The days of cheap oil have gone, but the ‘peak oil’ theory is far too bleak”, Arbuthnot Banking Group Perspective, 2 June 2008.

The economy picked up in the second half of the decade and unemployment fell. But industrial relations deteriorated towards the end of the 1970s when the Government sought to contain inflationary pay awards, culminating in the “winter of discontent” of 1978-79. One consequence of the 1980s retrenchment of organised labour and the trade union reforms of the Thatcher Government is that trade unions can never hold the British economy “to ransom” as they did in the 1970s.

The 1980s

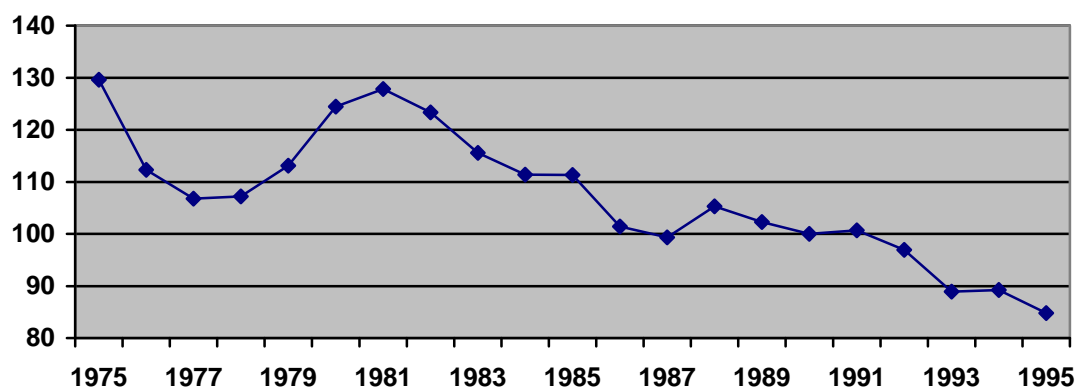
RPI inflation was around 10% when the Thatcher Government took office in May 1979. Inflationary pressures were being exacerbated by the 2nd oil price shock (triggered by OPEC’s raising its guide prices). Subsequently the inflationary “Clegg Commission pay awards” for the civil service was agreed and the near doubling of VAT rates in Chancellor Howe’s first Budget in 1979 added to higher prices. In 1980 RPI inflation was 18%. Interest rates were raised aggressively in order to control the money supply and, hence, inflation (this was the high-point of “monetarism” in which inflation was seen as a monetary phenomenon). And, partly as a consequence, the pound appreciated strongly.

Chart 5: Short-term interest rates (%), annual averages, 1975-1995



Source: ONS/BoE, data refer to Sterling certificates of deposit, 3 months offer rate.

Chart 6: Sterling effective exchange rate index (1990=100), 1975-1995



Source: ONS.

The combination of high inflation and a strong currency led to a catastrophic loss of external competitiveness. Manufacturing, the sector most vulnerable to external competition, was hammered. Manufacturing output in 1981 was nearly 15% lower than in 1979. And between 1979 and 1983 1.65 million jobs in manufacturing were lost – about a quarter. The collapse of swathes of the manufacturing sector was a major factor in the recession of the early 1980s.

Chancellor Howe's 1981 budget, deflationary in the middle of a recession, was controversial to put it mildly. But it, arguably, enabled sharp cuts in interest rates which led, in part, to a significant depreciation of the pound, which, in turn, gave some relief to the hard-pressed manufacturing sector. "Monetarism" was effectively abandoned. Economic growth resumed but unemployment continued to rise until 1985-86 – to well over 3 million. The 1980s recession was a very severe recession. By the middle of the 1980s the economy was recovering and RPI inflation was easing. By 1986 RPI inflation was around 3½% - lower than it is today.

The 1990s

The seeds of the early 1990s recession lay in the policy mistakes of the late 1980s.² Chancellor Lawson cut income taxes in his 1988 budget even though the economy was already growing strongly. In addition he reduced interest rates in the first half of 1988 in order to maintain his exchange rate policy of tracking the Deutschemark at 3DM to the pound (the pound kept overshooting its target), thus overstimulating the already buoyant economy. In the second half of 1988, interest rates were raised very aggressively to cope with the inflationary pressures which were then building up. Retail prices inflation was in double digits by the fourth quarter of 1989. (Even though this seems shockingly high by today's benchmark, this was well down on the inflation rate experienced in the mid 1970s.) The base rate had touched 7½% in mid 1988. By the end of that year the base rate was up to 13% and in 1989 it increased further to 15%.

Membership of the EU's Exchange Rate Mechanism (ERM) provided the final turn of the screw on the economy, which was falling into recession in the second half of 1990. Britain was locked in to Germany's high interest rates and the Chancellor, by then Norman Lamont, was extremely constrained in his room for manoeuvre.

The pound's expulsion from the ERM in September 1992 was, without exaggeration, the economy's salvation. Interest rates could then be reduced. And reduced they were. Base rate was reduced from 10% in September 1992 to 7% by the end of the year. By the end of 1993 the base rate was 5½%. The pound fell significantly which gave the export sector a significant competitive advantage. The economy recovered and has grown since. So far, that is.

References

1. See Ruth Lea, *Labour relations: a summer of discontent?*, Arbuthnot Banking Group Perspective, 7 July 2008.
2. See Ruth Lea, *The credit crunch is hitting the housing market: but it should not be as bad as the early 1990s*, Arbuthnot Banking Group Perspective, 21 April 2008.

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