

ECONOMIC POLICY

A Special
Report

The Conservative Revolution

myth or reality?

Alan Budd, Robert Solow and Christian von Weizsacker

german recovery

Martin Hellwig and Manfred Neumann

the swiss case

Jean-Pierre Danthine and Jean-Christian Lambelet

mrs thatcher

Kent Matthews and Patrick Minford

reaganomics

Olivier Blanchard

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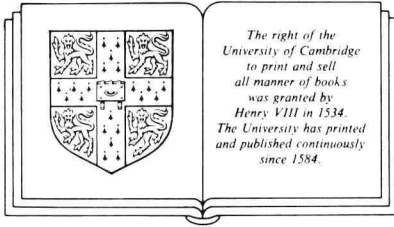
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Statement of purpose

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Editors' introduction

This special issue has a single theme: assessing the conservative economic policies of the eighties. We commissioned four studies of individual countries: the US, the UK, Germany and Switzerland. In addition, we asked three distinguished guests to provide their own perspective and lead a roundtable discussion on the lessons of the eighties. All these contributions were discussed at the fifth Panel meeting on 23–24 April 1987 in Paris.

During the 1980s many of the major industrial democracies experienced a significant reversal in the direction of economic policy. New priorities and new paradigms emerged to reshape macroeconomic and microeconomic strategies. Inflation replaced unemployment as the principal concern. It became a prominent objective to reduce the scale of government, the size of its budget deficit, and the rates of tax it levied. In many markets, regulations were simplified or curtailed, and public corporations were transferred to private ownership.

Often these new directions were adopted by newly elected governments on the right of the political spectrum, as in the UK, the US, and Germany. But some changes cut across political lines. The common determination to reduce inflation and enhance competitiveness also led many governments of the left to adopt budgetary austerity, monetary restraint, and deregulation, as in France, Italy, and Spain.

In this sense, our title 'The Conservative Revolution' refers to a revised economic judgement about the goals of policy and how these might feasibly be attained rather than to a purely political alteration in the balance of power. Indeed, the new conservative consensus has much in common with liberal revolution of the nineteenth century, with its emphasis on market forces, sound finance and a sound currency.

As the terms of some of the governments associated with these new directions come to an end – elections have occurred within the last year

in Germany and the UK, and will soon take place in France and the US – it seems appropriate to take stock, and engage in a careful evaluation of the initial results of 'The Conservative Revolution'. It is particularly appropriate and useful for such an evaluation to be comparative, and to confront the experiences of different countries. To this end, we commissioned four in-depth studies of countries whose experience was particularly relevant: the UK because it was the first to implement a consciously new and market-oriented programme, the US because of the radical intent of the Reagan programme and the importance of the American economy, Germany because of the history of its success against inflation and its economic leadership within the European Community, and Switzerland because its policies have long been a paradigm of conservative-liberal economics. We asked authors from each country to consider how effective the new conservative policies had been.

We also asked three noted authorities on economic policy in the US and Europe – Robert Solow, Alan Budd and Christian von Weizsacker – to join our regular *Economic Policy* Panel meeting and to lead a roundtable, comparative discussion of these four countries and of the new departures in the monetary, budgetary and structural policies which have marked the decade of the eighties. We asked the roundtable discussants and panelists to identify the common elements of these experiences and to define what constitutes the core of 'new conservative' policy.

We begin with the country studies which set the scene for that discussion. Olivier Blanchard unravels the strands of Reaganomics. Although he does not take seriously the early promises of balanced budget tax cuts (the Laffer curve era), he broadly approves of the distinctive Reagan policy mix. Tight money – for which Paul Volcker gets much credit – disposed of inflation. The simultaneous fiscal expansion not only stimulated domestic output and employment but also made the process of disinflation more efficient by pushing up the dollar and cutting import prices. Though real interest rates soared, an investment tax credit shielded investment and capital accumulation. What about supply-side economics? It was meant to increase productivity, savings and labour supply. Blanchard examines the data, surveys recent empirical work, and remains agnostic. He finds ambiguous effects on savings, investment and productivity, and disappointingly small effects on the supply of labour. Yet he recognizes that supply-side policies take a long time to work and that the jury is still out.

Blanchard focuses a good deal of his attention on fiscal policy, which he views as a political bet, a clever ploy to halt decades of expansion of government spending: cut taxes early, let budget deficits spiral, and

force the US Congress to come to grips with spending cuts. If Gramm-Rudman succeeds, the bet will be won. Blanchard believes the budget game has been changed for the foreseeable future. Congress can contemplate spending cuts or tax increases but not unending deficits and debt growth. He also concludes that Europe can learn from Reaganomics: together, fiscal expansion and supply-side policies are a good recipe for dealing with high unemployment. A larger level of national and foreign debt does bring costs, but this may be a price worth paying.

The political bet interpretation did not cut much ice with Bill Branson, for whom it was simply a revisionist rationalisation for a major policy failure. Examining US economic performance as a whole, he argued that the economy was in no better shape than at the end of the Carter administration; nor was the outlook any rosier. David Currie saw dangers in Europe trying to learn the Reagan lesson. It was by no means clear in theory or in practice (e.g., Mitterrand) that fiscal expansion caused an exchange rate appreciation for European countries; a depreciating currency made the output-inflation tradeoff much less attractive. Furthermore, as a prescription for the OECD as a whole, all countries together could not enjoy an exchange rate appreciation.

In the second country study, Kent Matthews and Patrick Minford examine the UK under Mrs Thatcher. Like Blanchard, they pay close attention to the political economy of how the policy reversal was achieved. They caution against interpreting the programme as a grand and immediate onslaught; rather it was a series of carefully planned tactical victories, each paving the way for the next assault. Only when inflation had been defeated did supply-side policies begin in earnest.

Matthews and Minford attempt a comprehensive and ambitious evaluation of the programme using the Liverpool macroeconomic model. From this they construct both the counterfactual – what would have happened had previous policies remained in place – and a decomposition of the difference into its component effects stemming from monetary and fiscal policy, external shocks, and supply-side policies. They conclude that the recession of 1980–81 was made abroad, not in Britain, although pursuit of the defeat of inflation made it impossible to use domestic policy to offset these adverse shocks from the world economy. Since 1981 they tell a story of strong and steady improvement, largely achieved by supply-side means, with tight domestic demand policies gradually bringing inflation under control but at the expense of temporary Keynesian unemployment. In a dramatic revision of their previously published estimates, Minford and Matthews argue that by 1986 equilibrium unemployment in the UK had been reduced to half