# The UK Economy

## A Manual of Applied Economics

Eighth Edition

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# A Manual of Applied Economics

## Eighth Edition

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# ABBREVIATIONS

## (1) Economic Terms

| | |
|---|---|
| CAP | Common Agricultural Policy |
| CET | Common External Tariff |
| c.i.f. | Cost including Insurance and Freight |
| DCE | Domestic Credit Expansion |
| FIS | Family Income Supplement |
| f.o.b. | Free on Board |
| GDP | Gross Domestic Product |
| GNP | Gross National Product |
| MCA | Monetary Compensation Adjustments |
| MLH | Minimum List Headings |
| NSA | Non Sterling Area |
| NS | North Sea |
| OSA | Overseas Sterling Area |
| PAYE | Pay as you Earn |
| PDI | Personal Disposable Income |
| PRT | Petroleum Revenue Tax |
| PSBR | Public Sector Borrowing Requirement |
| R and D | Research and Development |
| RPM | Resale Price Maintenance |
| SDRs | Special Drawing Rights |
| SIC | Standard Industrial Classification |
| SITC | Standard Industrial Trade Classification |
| TCF | Total Currency Flow |
| TFE | Total Final Expenditure at Market Prices |

## (2) Organizations, etc.

| | |
|---|---|
| CBI | Confederation of British Industry |
| CSO | Central Statistical Office (UK) |
| DE | Department of Employment |
| DI | Department of Industry |
| ECE | Economic Commission for Europe |
| ECSC | European Coal and Steel Community |
| EEA | Exchange Equalization Account |
| EEC | European Economic Community |
| EFTA | European Free Trade Area |
| FAO | Food and Agriculture Organization |
| GATT | General Agreement on Tariffs and Trade |
| IFC | International Finance Corporation |
| IMF | International Monetary Fund |
| MC | Monopolies Commission |
| NBPI | National Board for Prices and Incomes |
| NEB | National Enterprise Board |

| | |
|---|---|
| NEDC(O) | National Economic Development Council (Office) |
| NIESR | National Institute of Economic and Social Research |
| NRDC | National Research Development Corporation |
| OECD | Organization for Economic Cooperation and Development |
| OPCS | Office of Population Census and Surveys |
| OPEC | Organization of Petroleum Exporting Countries |
| PC | Price Commission |
| TUC | Trades Union Congress |
| UN | United Nations |
| UNCTAD | United Nations Commission for Trade and Development |
| WB | World Bank |

**(3) Journals, etc.**

| | |
|---|---|
| AAS | *Annual Abstract of Statistics* (HMSO) |
| AER | *American Economic Review* |
| BB | *British Business* (formerly *Trade and Industry*) |
| BEQB | *Bank of England Quarterly Bulletin* |
| BJIR | *British Journal of Industrial Relations* |
| BLS | *British Labour Statistics, Historical Abstract* (HMSO) |
| BTJ | *Board of Trade Journal* (HMSO) |
| DEG | *Department of Employment Gazette* (HMSO) |
| EC | *Economica* |
| EJ | *Economic Journal* |
| ET(AS) | *Economic Trends (Annual Supplement)* (HMSO) |
| FES | *Family Expenditure Survey* (HMSO) |
| FS | *Financial Statistics* (HMSO) |
| IFS | *International Financial Statistics* |
| JIE | *Journal of Industrial Economics* |
| JPE | *Journal of Political Economy* |
| JRSS | *Journal of Royal Statistical Society* |
| LBR | *Lloyds Bank Review* |
| LCES | *London and Cambridge Economic Service* |
| MBR | *Midland Bank Review* |
| MDS | *Monthly Digest of Statistics* (HMSO) |
| MS | *The Manchester School of Economic and Social Studies* |
| NIBB | *National Income Blue Book* (HMSO) |
| NIER | *National Institute Economic Review* |
| NWBQR | *National Westminster Bank Quarterly Review* |
| OEP | *Oxford Economic Papers* |
| QJE | *Quarterly Journal of Economics* |
| RES | *Review of Economic Studies* |
| REST | *Review of Economics and Statistics* |
| ROT | *Report on Overseas Trade* (HMSO) |
| SJPE | *Scottish Journal of Political Economy* |
| ST | *Social Trends* (HMSO) |
| TBR | *Three Banks Review* |
| TER | *Treasury Economic Report* (HMSO) |
| TI | *Trade and Industry* (HMSO) |

# Foreword to the Eighth Edition

In 1966, when the first edition of this book was published, the foreword began as follows:

> The central idea behind this book is to give an account of the main features and problems of the UK economy today. The hope is that it will fulfil two functions simultaneously, in that it will be as up to date as possible and yet will not be simply a bare catalogue of facts and figures. There are many sources of information, official and otherwise, about the structure and progress of the UK economy. There are also many authors to whom one can turn for subtle analyses of the problems before us. Our effort here is based on the belief that there is both room and need for an attempt to combine the functions of chronicler and analyst in the confines of a single book.
>
> The contributors to these pages subscribe rather firmly to the belief that economists should practise, as well as preach, the principle of the division of labour. The complexity of a modern economy is such that, whether one likes it or not, it is no longer possible for any individual to be authoritative on all its aspects; so it is inevitable that the burden of producing work of this kind should be spread among a number of people, each a specialist in his or her particular field. Such a division carries with it obvious dangers of overlap and inconsistency. It is hoped that some of the worst pitfalls of this kind have been avoided and there is reasonable unity of purpose, treatment and layout. At the same time, it is wholly undesirable to impose a monolithic structure and it is just as apparent to the authors that there are differences in outlook and emphasis among them as it will be to the readers.
>
> The general intention was to base exposition on the assumption that the reader would have some elementary knowledge of economics – say a student in the latter part of a typical first year course in economics in a British university. At the same time, it is hoped that most of the text will be intelligible to those without this degree of expertise. We may not have succeeded in this; if not, we shall try to do better in the future.

Despite the usual extensive re-writing, we should still regard this as an accurate description of our intentions.

Chapter 1, 'The Economy as a Whole', is concerned with questions of applied macroeconomics: fluctuations in demand and employment, the management of demand, inflation and economic growth. The chapter ends with a section on the economic prospects in the near future. Chapter 2, 'Monetary, Credit and Fiscal Policies', starts with a brief discussion of the general theoretical background and then analyses in detail the theory and practices of monetary, credit and fiscal policies in the UK in recent years. The final section discusses the policy record and some policy implications of membership of the EEC. Chapter 3, 'Foreign Trade and the Balance of Payments', deals with the importance of foreign trade and payments to the UK economy and assesses UK balance of payments performance over the last two decades or so. It then looks at current problems and policies in this field and ends with a discussion of the reform of the international monetary system. Chapter 4, 'Industry and Commerce', starts with a brief summary of various theories of the behaviour of firms and the structural characteristics of UK industry. Various aspects of public policy towards nationalized industries, competition policy and consumer protection, regional problems and so on are then discussed, all with due regard to the implications of EEC membership. A final section deals with industrial efficiency, including such issues as planning agreements and price control. The last chapter, 'Labour', analyses employment and unemployment among the UK labour force, and then discusses problems of wealth, income distribution and pay. The final sections are concerned with trade unions and wage inflation.

Whilst we try to minimize unnecessary overlapping between chapters, we quite deliberately aim at complementary treatment of some topics. Thus different aspects of EEC membership are discussed in the relevant chapters; similarly, wages-inflation relationships appear in both Chapter 1 and Chapter 5. To minimize the use of space, factual material or definitions appearing in one chapter but relevant to another are not always duplicated and so it must be understood that to this extent any one chapter may not be self-contained.

Each chapter is accompanied by a list of references and further reading. The Statistical Appendix has seven tables dealing with different aspects of the UK economy. There is an index as well as the detailed list of headings and sub-headings given in the Contents pages.

We acknowledge the great help given to us by all those who have rendered secretarial or computing assistance.

London School of Economics — A.R. PREST
University of Manchester — D.J. COPPOCK

April 1980

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# 1

# The economy as a whole

M.C. Kennedy

## I INTRODUCTION

### I.1 Methodological Approach

This chapter is an introduction to applied macroeconomics. It begins with a brief description of the national income accounts and goes on to discuss the multiplier, the determination of national expenditure and output in the short run, the policy problems of maintaining full employment, the causes of inflation and of economic growth. It cannot claim to give all the answers to the questions raised, but aims to provide the reader with a basis for further and deeper study.

In principle there is no essential difference between applied economics and economic theory. The object of applied economics is to explain the way in which economic units work. It is just as much concerned with questions of causation (such as what determines total consumption or the level of prices) as the theory which is found in most elementary textbooks. The difference between theoretical and applied economics is largely one of emphasis, with theory tending to stress logical connections between assumptions and conclusions and applied economics the connections between theories and evidence. Applied economics does not seek description for its own sake, but it needs facts for the light they shed on the applicability of economic theory.

At one time it used to be thought that scientific theories were derived from factual information by a method of inference known as *induction*.[1] Thus it was supposed that general laws about nature could be deduced from knowledge of a limited number of facts. From the logical point of view, however, induction is an invalid procedure. For example, the fact that ten men have been observed to save one-tenth of their income does not entail the conclusion that the next man will do so. The conclusion may be true or false, but it does not rest validly on the assumptions. Inductive conclusions of this kind simply have the status of conjectures and require further empirical investigation.

More recently it has come to be accepted that scientific method is not inductive but *hypothetico-deductive*. A hypothesis may be proposed to explain a certain class of event. It will generally be of the conditional form 'if $p$ then $q$', from which the deduction follows that any particular instance of $p$ must be accompanied by an instance of $q$. Thus the hypothesis is tested by every observation of $p$; it is corroborated whenever $p$ and $q$ are observed together; and falsified if $p$ occurs in the absence of $q$.

---

1 For a highly readable introduction to the problems of scientific method the reader is referred to P.B. Medawar, *Induction and Intuition in Scientific Thought*, Methuen, 1969, and the more serious student to K.R. Popper, *The Poverty of Historicism*, Routledge and Kegan Paul, 1961, and *Conjectures and Refutations*, Routledge and Kegan Paul, 1963. For a treatment of methodological problems in economics, see I.M.T. Stewart, *Reasoning and Method in Economics*, McGraw-Hill, 1979.

It will be clear that this concept of scientific method places the role of factual information in a different light from the inductive approach. Facts, instead of being the foundation on which to build economic or scientific theories, become the basis for testing them. If a theory is able to survive a determined but unsuccessful attempt to refute it by factual evidence, it is regarded as well tested. But the discovery of evidence which is inconsistent with the theory will stimulate its modification or the development of a new theory altogether. One of the purposes of studying applied economics is to acquaint the theoretically equipped economist with the limitations of the theory he has studied. Applied economics is not an attempt to bolster up existing theory or, as its name might seem to imply, to demonstrate dogmatically that all the factual evidence is a neat application of textbook theory. Its aim is to understand the workings of the economy, and this means that it will sometimes expose the shortcomings of existing theory and go on to suggest improvements.

The discovery that a theory is falsified by factual observation need not mean that it must be rejected out of hand or relegated to total oblivion. Economists, as well as natural scientists, frequently have to work with theories that are inadequate in one way or another. Theories that explain part but not all of the evidence are often retained until some new theory is found which fits a wider range of evidence. Frequently the theory will turn out to have been incomplete rather than just wrong, and when modified by the addition of some new variable (or a more careful specification of the *ceteris paribus* clause), the theory may regain its status. The reader who notices inconsistencies between theory and facts need not take the line that the theory is total nonsense, for it may still hold enough grains of truth to become the basis for something better.

It is often argued that our ability to test economic theories by reference to factual observations is sufficient to liberate economics from value judgments, i.e. to turn into a *positive* subject. This position has more than an element of truth in it: when there is clear evidence against a theory it stands a fair chance of being dropped even by its most bigoted adherents. Nevertheless, it would be wrong to forget that a great deal of what passes for factual evidence in economics is infirm in character (e.g. the statistics of gross domestic product or personal saving), so that it is often possible for evidence to be viewed more sceptically by some than by others.

The discussion of economic policy which also figures in this chapter is partly normative in scope, and partly positive. The normative content of policy discussion consists in the evaluation of goals and priorities. But the means for attaining such goals derive from the positive hypotheses of economics. They involve questions of cause and effect, the hypothetical answers to which are appraisable by reference to evidence. In making recommendations for the achievement of policy goals, however, the economist treads on thin ice. This is partly because his positive knowledge is not inevitably correct, but also because it is seldom possible for him to foresee and properly appraise all the side-effects of his recommendations, some of which have implications for other policy goals. When economists differ in their advice on policy questions it is not always clear how much the difference is due on the one hand to diagnostic disagreements, and, on the other, to differences in value judgments. Indeed it is seldom possible for an economic adviser to reveal all the normative preferences which lie behind a policy recommendation. Thus policy judgments have to be scrutinized carefully for hidden normative assumptions. The reader of this chapter must be on his guard against the author's personal value judgments.