Thatcher's road to industrial extinction

David Goldman on how the British disease caught Milton Friedman, rendering the patient a terminal case.

Early in 1980, Milton Friedman received a triumphal welcome in London from Margaret Thatcher's Conservative government, including a visit in February to 10 Downing Street, the Prime Minister's residence, and British public television screenings of his American-made series, "Free to Choose." A year previously, at the end of April 1979, Margaret Thatcher came to power with the promise that she would deal with Britain's chronic inflation by application of Friedman's methods of monetary control.

There is a great deal of theater in this dicussion. After all, how can one blame poor Milton Friedman for anything the British do? They invented monetarism, both the Ricardo and Alfred Marshall varieties. For that matter, they invented the University of Chicago, Friedman's roosting place.

However, Milton Friedman has been adopted by the British government of Thatcher, Industry Ministry Sir Keith Joseph, and Chancellor of the Exchequer Geoffrey Howe as its official advisor, and Friedman has acknowledged this role enthusiastically. Therefore we are within our rights to enjoy Friedman's discomfiture at the disastrous turn economic events have taken since his policies were put into practice in Britain.

Not what was predicted

A year after Thatcher's election, the Bank of England had, indeed, brought money supply growth down from more than 15 percent per year to a mere 7 percent per year, at the direction of Mont Pelerin Society members Geoffrey Howe and his deputy, John Biffen. The result was not merely the opposite of what they and Milton Friedman had predicted, but the opposite by such a wide margin as to make British economic management the laughingstock of the industrial world—and it takes extraordinary events to get people to laugh at new jokes about the British economy.

In that year, the rate of inflation rose from 6 percent a year to 22 percent a year; the industrial production index fell by 10 percent, or from 108.2 to 98.1 (on a scale 1975 = 100), down to the trough-level of the 1975 world recession; unemployment rose from 5.6 percent to 6.1 percent of the employed workforce; and interest rates had nearly doubled to over 20 percent.

The British disaster is not only devastating in its own terms, but utterly unique among industrial countries—none of whom save the United States have applied Friedman's methods. The performance of the leading industrial countries in the past year is given by the accompanying table.

Worse than U.S.

Even the United States, subject (since October 1979) to Friedmanite monetary policy, has done better. When the American economy plunged off a sharp edge in late March 1980, following Federal Reserve Chairman Paul Volcker's imposition of unprecedentedly strict credit controls, at least interest rates fell with the production indices.

Dollar interest rates have fallen between early April and this writing by about half on the short-term side, i.e. from 20 percent for overnight interbank loans to less

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than 10 percent. British interest rates, despite a much sharper drop in credit demand with a much steeper falloff of production, have hardly fallen from the stratospheric range of 20 percent.

Even Milton Friedman's friends in London have begun to turn on him, which is somewhat unfair, since they put him and his school in business in the first place. The *London Economist*, the century-and-a-half-old British weekly now published by Evelyn de Rothschild, complained April 26, "Britain is not winning its fight against inflation."

"A year ago next week," wrote the *Economist*,"Mrs. Thatcher's government was elected with the firm belief that strict monetary control would be the long-run cure for Britain's endemic inflation. With wage and price inflation both around 20 percent, confidence has subsided to the point where honest and unremarkable reservations by a treasury minister have been uproariously greeted by open revolt.

"All that poor Mr. John Biffen [number-two man at the Treasury and a long-time Mont Pelerin Society member] admitted this week was that there is no God-or-Friedman-given 18-month lag between a slowdown of money growth and a drop in inflation. Sir Geoffrey Howe said as much months ago ... But there has, just the same, been a change for the gloomier in ministers' view of how the fight against inflation is going to work out. ...

"Nor will the medium-term plan for a monetary slowdown to 4 to 8 percent, unveiled with the (March) budget, cut much more ice. The economic forecast at the other end of the little red budget book is an open admission that the monetary restraint will bear harshly on output, and only sluggishly on inflation, this year."

Analyzing inflation

Britain's experience with Friedmanism is, we saw at the outset in the example of America under Paul Volcker, no accident but a *repeatable experiment*. Money supply is not an interesting parameter.

To understand inflation, we must look at two processes: the growth of total debt and equity capitalization in the economy, and the rate of growth of real tangible output.

The economy's *real* rate of profit is not a mere aggregation of the profits of individual firms. If it were, the Chicago School's contention would be true that real profit does not exist, and the profits of individual firms represent the mere chance distribution of income according to an uncertainty principle. It must be measured in terms of society's production of tangible wealth in excess of the requirements of maintaining the existing population at existing living standards, and maintaining existing productive plant and equipment at prevailing levels of applied technology.

When the rate of growth of nominal claims on income, through debt service, dividends, and rents, exceeds the rate of growth of real profits in the economy, the result is inflation; the wholesale price of tangible goods must be increased to cover the additional income demands. The actual rate of inflation, as measured, for example, by the consumer price index, will vary somewhat from this basic underlying inflation rate.

Monetary inflation will produce speculative booms in the commodities markets, cartels may bid up the price of oil or other essentials, and the results will be transmitted through the economy's entire price structure. But the secondary forms of inflation only become a significant problem when the economy's credit process and production process are out of phase.

Productivity and prices

The "normal" condition of an industrial economy is a long-term trend toward lower prices, due to higher productivity through the introduction of new technologies. This is sectorally the case even in the American economy, where the cost of computer data-processing fell during the 1970s, on average, by 50 percent per year.

We can say, in general, that prices will fall whenever the rate of increase of productivity is higher than the cost of credit or equity required to employ additional labor at the new, higher level of productivity.

Inflation leads to higher interest rates—because creditors demand the addition of the inflation rate to their yield on lent money. Higher interest rates penalize capital investment in industry more than any other form of economic activity, because of longer investment lead-times. Inflation itself reinforces the negative tendency toward investment in "services" rather than goods-producing industries, in a self-feeding cycle.

At the point of economic breakdown, the self-feeding rise in inflation accelerates toward *hyperinflation*. That is the substance of the past year's developments in Britain.

The British economy is so depleted that the rise in interest rates authored by the Thatcher government not merely wiped out capital investment, but cut out the profitability of a huge chunk of Britain's manufacturing. British Steel was the first to go, for rather evident reasons; this is the national steel sector that only closed down the Bessemer furnace built a century ago by Dr. Bessemer in 1975. The Thatcher government laid off 60,000 workers from the nationalized steel sector, provoking an extended, bitter strike that lasted through winter and early spring 1980.

Overall, domestic costs in manufacturing in Britain rose by 20 percent in the past twelve months. The Bank

of England predicted in September, 1979 that "industrial companies may be faced with a financial squeeze as severe, if not as abrupt, as in 1974-75."

Effects of hyperinflation

Falling consumer sales have hurt them badly. In addition, the interest and exchange rate structure of the pound sterling have made it impossible for British companies to market abroad, producing a $7.3 billion trade deficit in the past year.

The pound sterling is currently worth about $2.30 on the foreign exchange market. It is vastly overvalued, according to *London Times* Editor-in-Chief William Rees-Mogg. Rees-Mogg calculates that sterling, measured by how much productivity investment in Britain will buy, is worth only $1.60, or barely two-thirds as much.

Nonetheless, the Bank of England maintains artificially high interest rates in order to attract international "hot money" to London, where it can get the highest rate of return in the world on very short-term investments. It uses this short-term money to finance Britain's budget deficit, which Sir Geoffrey Howe has been trying frantically (and unsuccessfully) to cut.

Without the artificial prop, the entire structure of British government debt would come crashing down as surely as it did in 1798, when Prime Minister William Pitt hired Parson Malthus to justify the repeal of the Poor Laws.

Cost structure

British industrial companies are losing money. The London *Economist* estimates that the deficit of manufacturing companies will rise this year to £5.1 billion from £2.2 billion in 1978 and £4.3 billion in 1979, and that the minimum the companies must borrow this year will rise to £7 billion—almost as much as the government's own borrowing requirement—from £2.5 billion in 1978 to £5.9 billion in 1979.

The result, predictably, is a scramble to raise prices. All that Milton Friedman's money crunch has accomplished is to drive up the cost structure of industry, including pay increases to workers (who are not keeping up with inflation in any case), and force the inflation spiral ever upwards.

General bankruptcy—Friedrich von Hayek's explicit proposal—will reduce the demands for income in the victim economy by wiping off the books masses of equity and debt capital. The assumption is that a chain-reaction will wipe out more paper than production, and therefore bring prices down. That is one way to do things. But civilized societies do not sanction doctors who claim to cure chronic diseases by killing their patients.

A 'new industries' plan

Deindustrializing Great Britain

by Luba George

Industrial shutdowns and mass unemployment have followed the "shock treatment" economic policy applied by Britain's Thatcher government. Industrial production has consistently decreased since Thatcher came to power in May 1979, and the rate of decline continues to accelerate. In the first quarter of 1980, manufacturing output fell by 11½ percent. Reporting this result with alarm, the June 23 *Financial Times* of London added that second-quarter figures will show an even faster rate of collapse.

It should be noted that official British industrial output figures and so-called profit figures are highly misleading, as they include North Sea oil production, which has doubled in a year, with a 150-200 percent price increase in the space of 18 months. The price of British oil ranks with the highest-priced OPEC oil at over $38 a barrel. Hence, with every increase in the price of oil, what Mrs. Thatcher's statisticians report to the world as the monetary-equivalent of "manufacturing output" goes up accordingly. The Thatcher government's statistics would show "manufacturing output" soaring, even as the last factory in Britain closed its door—so long as the oil kept flowing.

Permanent plant closures account for a high proportion of this decline. A wave of bankruptcies is wiping out small and medium-sized manufacturing companies, and large-scale plant shutdowns have been undertaken by the nationalized industrial sector, including British Steel.

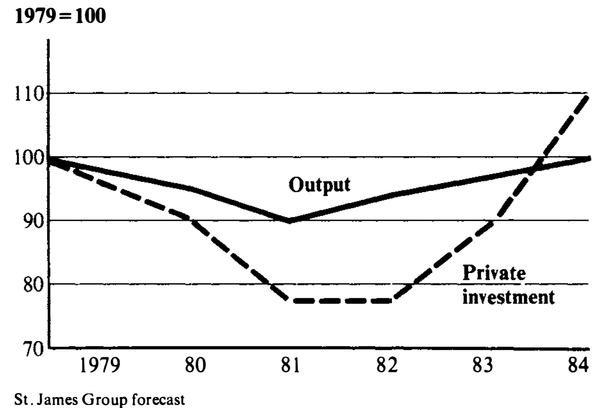
In the first three months of this year, 1,488 small and medium manufacturing companies were liquidated, an increase of 17 percent over the first quarter of 1979. Additionally, in the same category of firms, over two hundred went into receivership, an increase of 37 percent over the corresponding quarter of 1979.

Unemployment in Britain now stands at over two million. The official 1.6 million figure represents only

British economic performance under Thatcher: An international comparison

Country	% change in industrial output		% change in consumer prices	
	3 mos.*	1 yr.	3 mos.*	1 yr.
Britain	−11.5	− 5	+25.5	+22
United States	− 9.5	− 4.5	+17.5	+14.5
West Germany	+ 5.5	+ 4	+ 8	+ 6
France	+ 4	+ 5.5	+16.5	+14
Japan	+17.5	+10.5	+12	+ 8.5

*Average of latest three months compared with average of previous three months.



those forced out of work who still reside in Britain, thus excluding a huge increase in emigration by British subjects since Thatcher assumed power. The two million-plus figure corresponds to the number of unemployed at the end of the last Great Depression.

And the rate of increase of unemployment is now astronomical. From the beginning of 1978 through June 1979, the total increased by an average of 5,000 a month. For the second half of 1979, following Thatcher's advent, it increased at an average of 20,000 per month. During the first quarter of 1980, unemployment was rising at an average of 37,000 per month. Yet all British sources predict a further whopping increase for the second quarter.

In addition to the smaller-scaled industry, industrial devastation has hit the following major sectors of the British economy:

Steel: The collapse of British Steel production and its workforce began in the early 1970s; but steel has been almost totally triaged by Margaret Thatcher.

Two case studies illustrate the point. In Scotland, British Steel Corporation (BSC) employed 15,000 workers before Thatcher became Prime Minister. Steel employment is now 10,000 in Scotland. On June 10 British Steel announced that it will cut an additional 1,500 jobs in Scotland by March 1981, bringing Scottish steel employment to a level of 55 percent of what it was before Thatcher.

In Wales, BSC's division employed over 70,000 workers in the early 1970s. By the end of 1979, the Welsh division's employment was at 46,000. BSC recently announced that it will eliminate 30,000 more jobs in Wales and scrap three and a half to four million tons of steel-making capacity.

By next January there will be only 16,000 steelworkers in Wales, one third of the workforce that existed at the start of this year. British Steel's new chairman Ian McGregor, a Scottish-born Lazard Frères investment banker, is on record declaring that his goal is to immediately cut total British Steel capacity from 21.5 million tons a year to 15 million tons.

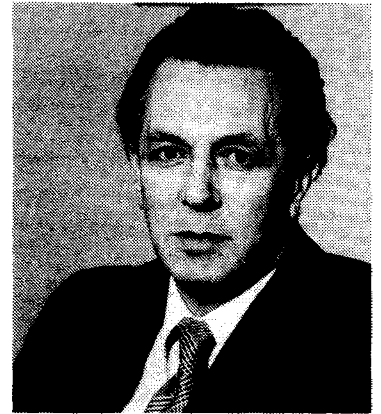
Construction: Overall construction in 1979 declined by 6 percent from 1978 and is projected to drop a further 5 percent during 1980. The most optimistic *Financial Times* projections see the 5 percent annual rate of decline persisting through 1981-82. The brunt of the collapse thus far has occurred in housing where private-sector starts are expected to drop 18 percent from 1979's 140,000 level. Public-sector housing completions for 1980 are anticipated to be 7 percent below last year's 102,000 total.

The Thatcher government's projection for 1982 is 50,000 housing completions, which means that Thatcher and her policy advisers have determined to deliberately collapse public housing.

Tractors: Britain has traditionally been a significant producer and exporter of farm machinery. Under Thatcher, the tractor industry is being substantially phased out. Tractor sales in Britain fell by 20 percent from March 1979 to March 1980, and tractor exports collapsed. Through March, tractor exports, primarily to North America, were two-thirds of the corresponding 1979 figures. Starting in the second quarter, tractor exports were down to almost half of the 1979 unit figures, although in normal years tractor exports significantly increased from the first to the second quarter.

The industry slayer

The 'exhilarating mission' of Sir Keith Joseph



The Thatcher government's plans are aimed at "restructuring" and rationalizing British industry around a smaller industrial base. The only sectors slated to increase production under this "post-industrial" perspective are defense, aerospace, electronics, specialized equipment industries such as coal-cutting equipment and oil and gas pipelines and platforms to service North Sea production.

Under the Thatcher program, Britain will also continue restricted expansion of nuclear power. However, expansion of the non-productive military sector on a shrinking industrial base will tend to further aggravate Britain's inflation. Just as the "deindustrialization" of Britain has proven less controllable than Sir Keith Joseph anticipated, the "post-industrial" phase will be far more difficult.

In search of U.S. capital

Minister of Industry Sir Keith made a two-week tour of the United States May 22-June 2, meeting with top-level American banking and corporate spokesmen as well as some of Ronald Reagan's key advisers. The goal of the visit was to draw U.S. investment into Britain, particularly into the risky and highly competitive electronics field. During his stop in Chicago, Sir Keith emphasized to the Mid-America Committee and others the desirability of multinational corporations' expansion in the United Kingdom. Corporate executives and bankers attending a June 2 Barclays Bank dinner for Sir Keith in Chicago came from Alcoa, Engelhard Minerals, ITT, Exxon, Standard Brands, Grumman, Sun International, Chemical Bank, Norton Simon, Marathon Oil, Coppers, Texaco, and General Motors.

At a one-and-a-half-day gathering at Georgetown University, sponsored by Georgetown's Center for Strategic and International Studies (CSIS), discussions focused on the desirability of importing Thatcher's economic policies to the United States, and the necessity of breaking the trade unions to make those policies work. Sacrifice, Sir Keith said, is essential to increasing productivity; there can be no retreat from credit restrictions.

Larry Martin of CSIS, former National Security Council member Brent Scowcroft, and David Watt of the Royal Institute for International Affairs pursued the second theme of the conference—the need for redoubled sacrifice in order to undertake a military buildup, given what Watt and Scowcroft agreed was the striking similarity of the decline in U.K. and U.S. power. Many of the speakers and participants (see box) have been engaged for months in studies of military conversion of U.S. industrial capacity, much of it rendered "excess" through Federal Reserve Chairman Paul Volcker's economic policies.

More specifically, according to sources at Georgetown, Bechtel, the Hoover Institution and the Hudson Institute, Sir Keith's private discussions in the U.S. centered around potential Anglo-American agreement on military reconversion, creation of a coal export cartel run by English-speaking producers along lines proposed in the recent World Coal Study by Carroll Wilson of the Massachusetts Institute of Technology, and concentration of private credit flows into both areas.

Sir Keith described this "exhilirating mission"—a term coined by Prime Minister Thatcher—in his remarks at the Georgetown seminar as part of the present U.K. government's campaign to promote the resurrection of an imperial British Commonwealth. This is Britain's "last chance," he said, "the last stop on the decline-and-fall line."

In California, Sir Keith met with top executives from U.S. microelectronics and aerospace centers, including the Bechtel group, Hewlett-Packard, and Texas Instruments. Bechtel has since become a consultant to Britain's Central Electricity Generating Board.

Britain has already launched its "post-industrial strategy" of buildup in the electronics sector, with heavy emphasis on defense-related output. The microelectronics venture set up by the Labour government, called INMOS, is waiting for £25 million from the Thatcher government, while Joseph decides how to obtain foreign

capital and what the optimal public-private mix in this area is to be.

Scottish reconversion

Meanwhile, Scotland provides a case study of the "post-industrial" conversion effort, in the context of an even higher rate of traditional industry's collapse than England's. Shipbuilding, steel and wood pulp in particular have been obliterated, creating the U.K.'s highest unemployment rate—up to 20 percent in some of the traditional manufacturing areas, and still climbing.

The architect of Scotland's post-industrial policy is Sir Monty Finniston, who accompanied Sir Keith to the United States. Overall, 35,000 jobs have been created around the "New Technology" or "New Industries" centers in the last 15 years, centered around electronics and defense. In 1966 Scotland had 100 people in electronics. Now the total is 8,000, and the Scottish Development Agency predicts another 1,000 next year.

Marconi Space & Defense Systems at Hillend, near Dunfermline, is the U.K.'s largest electronics firm. Marconi works exclusively on defense contracts. Britain's second largest firm, Phillips, is now abandoning manufacturing of TV components and focusing on the defense field. Ferranti, another major and almost wholly electronics-based company, has over 60 percent of its business in military electronics at this point.

Apart from electronics, Scotland's largest employer is the Royal Navy dockyard at Rosyth, with a labor force of 6,000 civilians. In Fife, conversion of shipbuilding into oil-platform production has taken place.

Anderson Strathclyde, the U.K.'s primary manufacturer of coal mining equipment, is now expanding production for export to the Commonwealth. Last week, Sir Monty Finniston became head of the company. In a recent article praising Anderson Strathclyde, the *Financial Times* emphasized the MIT coal study as a basis for developing this sector of industry.

English-speaking reunion

Among the participants at the Georgetown University Center for Strategic and International Studies conference in May featuring British Industries Minister Sir Keith Joseph were:

Anne Armstrong, former U.S. Ambassador to the United Kingdom; former co-chairman, Republican National Committee; member, Council on Foreign Relations; director, Atlantic Council; professorial lecturer in diplomacy, Georgetown University; staff member, CSIS; advisor to U.S. presidential candidate Ronald Reagan.

Samuel Brittan, economic commentator.

Geoffrey Chandler, C.B.E., Director General of Britain's National Economic Development Office; former senior executive of the Royal Dutch Shell Group.

Frank Chapple, General Secretary of the U.K.'s Electrical, Electronic, Telecommunications and Plumbing Union; member, National Electronics Council and National Economic Development Council.

Melvin A. Conant, consultant on strategic raw materials to the U.S. Congress, Rockefeller Foundation, U.S. Defense Department and CSIS; member, Council on Foreign Relations and International Institute for Strategic Studies; former government relations adviser to Standard Oil and Exxon Corporation; former assistant administrator for international energy affairs in the U.S. Federal Energy Administration.

Sir Monty Finniston, F.R.S., chairman, U.K. Policy Studies Institute; chairman, Council of the Scottish Business Institute; industrial consultant; former adviser, U.K. Atomic Energy Authority, Harwell; former chairman, British Steel Corporation; former director for magnetohydrodynamics research, International Research and Development Company.

Joseph Godson, former U.S. Consul General, Edinburgh; European Coordinator for CSIS, London.

Sir Nicholas Henderson, British Ambassador to the United States; former ambassador to France and West Germany.

Laurence W. Martin, head of department of war studies, King's College, University of London; research associate, Johns Hopkins University; consultant, Sandia Laboratories, Los Alamos Scientific Laboratory, Hudson Institute; member, CSIS International Research Council.

George Melloan, deputy editorial page editor, *Wall Street Journal.*

Rudolph A. Oswald, former economist, AFL-CIO; member of the board, National Bureau of Economic Research; president-elect, Industrial Relations Research Association.

Lieutenant-General Brent Scowcroft (retired), assistant to the President for National Security Affairs under Henry Kissinger; member, President's General Advisory Committee on Arms Control.

Hugh Thomas, historian.

David Watt, former political editor, the *Financial Times* of London; director, Royal Institute of International Affairs.