The Political Economy of New Labour:  
A Preliminary Assessment

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Despite a substantial body of literature devoted to characterising and describing the political economy of New Labour, there has as yet been little systematic attempt to assess and evaluate the economic policy record of New Labour in office. After two full terms in office years such as assessment is long overdue. My aim in this paper is to contribute to that assessment. I examine the internal tensions and contradictions which have come to characterise New Labour’s political economy since 1997, assessing the extent to which these either have or are likely to compromise the party’s ostensible strategic economic objectives in the third term for the third way that now seems assured. I identify clear tensions between the dual economic imperatives of credibility and competitiveness, point to the medium-term dangers of a supply-side agenda that is likely to prove strongly pro-cyclical, and examine the damage that membership of the Single European Currency might do to the new macroeconomic policy-making regime institutionalised in Britain since 1997. I conclude, perversely perhaps, by pointing to the clear advantages of membership of the Eurozone. This, I suggest, would effectively force the government to adopt a more active fiscal policy to compensate for sub-optimal interest rate settings by the European Central Bank. Serendipitously, such a fiscal policy would also prove strongly counter-cyclical, thereby potentially compensating for the pro-cyclical character of New Labour’s political economy to date.

The ethical veneer of ‘Third way’ political economy

In the search for the core of New Labour’s political economy it is perhaps obvious to start with the public philosophy of the third way itself. For it is invariably held by its advocates to provide a guiding ethic informing all aspects of political conduct for rejuvenated social democrats, wherever in the world they reside and seek office (see, for instance, Giddens 2001).

If it is perhaps wrong to expect it to supply directly a distinctive political economy, it would not seem to be asking a lot to expect it to provide an exacting ethical standard against which contending political economies might be gauged. Yet, it would be to ask too much. For the third way does not hold economic policy accountable to an ethical standard so much as to construct a standard of perceived political economic viability against which contending ethics must be scaled. Whatever else it may be, the third way is not an ethic capable of guiding or informing a political economy. Ethical considerations do not delimit the realm of political economic choice. Quite the reverse. Perceived political economic constraints (issuing largely from globalisation) delimit the realm of ethical choice. Consequently, were an ethically consistent political economy to follow this would be entirely serendipitous.
This may not seem like much progress is discerning the distinctiveness of New Labour’s political economy, but it does give us a series of initial clues as to the character of third way political economy.

1. In economic terms at least, it is far clearer about what it rejects than what it sanctions or embraces. It seeks to make (or at least claim) an ethical virtue out of a perceived economic necessity. Indeed, what is clearest about the third way is its rejection of social democracy. If the latter is taken to imply an unconditional right of access of all citizens to a comprehensive welfare state, a belief in democratic economic governance (as distinct from the governance by the economy of the parameters of political choice), and a commitment to egalitarian social outcomes (as distinct from opportunities) ‘third way’ political economy is post-social democratic.

2. There is a dearth of positive economic thinking in the third way. Yet this is not in itself a criticism. The point is rather different. The very need for an alternative to the first and second ways (neoliberalism and social democracy respectively) is presented in economic terms. This has serious implications for the conception of social justice that the third way is capable of articulating. For any consistent ethic or conception of social justice is compromised by the perceived need to scale one’s ethical aspirations in accordance with acknowledged (economic) constraints and imperatives. In other words, rather than defend, in its own terms and from first principles, a particular conception of social justice, the third way must choose its conception of social justice pragmatically, having first eliminated all those deemed incompatible with the harsh economic realities of a global era. It is disingenuous, then, to present the third way as an ethic; it is what you get if you relegate ethical considerations (such as those which animated social democracy) to economic imperatives.

3. This makes the status of the third way as a guiding political ethos somewhat unclear. In strictly ethical terms, is it normatively superior to the (traditional) social democratic ethos it seeks to replace? If so, this is surely by accident. Or is it merely the best one can aspire to when the (presumed) incompatibility between (traditional) social democracy and globalisation is acknowledged? Is the third way the best in this the best of all possible worlds? Or is it the best conceivable in a world of diminished expectations and radically circumscribed political autonomy? It is, again, disingenuous to present it as both.

In sum, the third way provides less an ethic which might inform prospective policy choices than a language with respect to which choices already made might be legitimated. Yet if the third way does not provide a consistent ethic such as is capable of informing a distinctive political economy, this does not mean that the third way lacks such a political economy. It is to the content of that political economy that we now turn.

**New Labour’s new Keynesian economics**

In what follows my aim is less to provide a distinctive or novel characterisation of Labour’s academic political economy than it is to provide an assessment of that
political economy based on the recent – and exemplary – characterisation provided by Philip Arestis and Malcolm Sawyer (2001).

At the outset it is perhaps important to emphasise that any characterisation of New Labour’s economic thinking is likely to prove controversial. Moreover, and, as is almost invariably the case when political scientists venture onto the jealously-guarded territory of academic economics, what debate there has been on such matters has tended to be accompanied by considerable conceptual confusion. New Labour has been labelled, variously, new monetarist, post-monetarist, new Keynesian, post-Keynesian, and even post neo-classical. Moreover, the term new Keynesianism has itself been misunderstood by authors as integral to the New Labour project as Giddens himself.¹

As a route map through this confusion, I follow Arestis and Sawyer. Whilst Labour’s thinking is decidedly non-Keynesian, neither, in any technical sense of the term, is it post-Keynesian. Moreover, its endogenous growth theory notwithstanding, the label ‘post neo-classical’ is, if anything, even wider of the mark. If only by a process of elimination, then, the academic political economy on which New Labour has consistently drawn is perhaps best labelled new Keynesian or new monetarist.

To those unfamiliar with neoclassical economic fashion, narrowing the field of choice in this way might not seem to represent significant progress. New Keynesianism sounds decidedly more progressive than new monetarism and one might be mistaken for thinking that they are poles apart. Besides, and perhaps unremarkably, it is the former that is Labour’s chosen badge of self-identification. Ed Balls, for instance, goes to considerable pains to distance himself from monetarist connotations, enlisting the support of his former tutor in such matter, Greg Mankiw, in branding New Labour’s monetary policy stance new Keynesian (1998: 121; see also Brown, Mais Lecture, 19 October 1999). What he overlooks, however, is Mankiw’s comment, elsewhere, that “new Keynesian macroeconomics could just as easily be labelled new monetarist economics” (cited in Kirschner 1999: 611; see also Greenwald and Stiglitz 1993). As this perhaps serves to indicate, there is in fact precious little to choose between the contending terms.

Putting the labels to one side, the important point is surely this: what is distinctive about Labour’s political economy in office to date is the extent to which its economic policies have been informed by the assumptions that both perspectives share. That list includes the acceptance of the NAIRU (the non-accelerating rate of unemployment), a rejection of the notion of any long-term trade-off between inflation and unemployment, and an acceptance that there is no role in macroeconomic policy for adjustments in aggregate or effective demand. In addition to the policies which flow

¹ In The Third Way and its Critics (2000: 37), Giddens makes but one reference to new Keynesian economic thought. This he treats as synonymous with ‘third way’ political economy. Sadly he refers, in so doing, to ideas that are both profoundly antithetical to new Keynesian economics (see Greenwald and Stiglitz 1993; Romer 1993; de Long 2000) and which Labour has made clear it categorically rejects – in, for instance, its proposals for a new Bretton Woods. As Matthew Watson makes clear, these proposals only make sense if it assumed that “capital markets display a natural tendency to equilibrium” such that “speculative dynamics do not unnecessarily prejudice market outcomes” (2002: 7). Giddens’ error, it seems, originates in an earlier article on New Labour’s new Keynesianism by no less a commentator than Will Hutton (1999).
directly from the internalisation of such assumptions, New Labour has embraced an endogenous growth theory (post-neoclassical or otherwise). This is consistent with, but by no means reducible to, the new Keynesian or new monetarist approach.

If the above paragraphs have not already made us suspicious enough of labels, there is one additional danger against which we should guard. A single characterisation – whether new monetarist or new Keynesian – might, wrongly, be taken to imply coherence and consistency. Indeed, that in essence seems to be the assumption of Arestis and Sawyer. It is an assumption that should be resisted. Whilst the latter’s (largely normative) critique of New Labour’s political economy proceeds directly from their characterisation of it as new Keynesian, that which follows builds from the contradictory character of the economic priorities and policies New Labour has pursued. Few of these can be derived directly from, or are endemic to, new Keynesian or, indeed, new monetarist thinking.

‘Open economy macroeconomics’

Labour’s new Keynesian/new monetarist economics is reflected most clearly in its public rationale for the ceding of independence to the Bank of England. This is couched, in orthodox fashion, in terms of the time-inconsistent inflationary preferences of public authorities. Labour’s theoretical route to operational independence is, as Ed Balls makes very clear, via public choice theory, Friedmanite monetarism and the rational expectations revolution (1998: 120-1; HM Treasury 2002) – though adaptive expectations assumptions are in fact sufficient to derive operational independence as an institutional solution to the time-inconsistency problem. Given a short-term trade-off between inflation and unemployment, rational politicians will seek to orchestrate a political business cycle, trading inflation in the immediate aftermath of their anticipated re-election for growth and employment in the run-up to that election. This can only serve to dampen the aggregate long-term growth potential of the economy whilst, at the same time, driving up the natural or equilibrium rate of unemployment (Kydland and Prescott 1977; Sargent and Wallace 1975; and, on political business cycles, Alesina 1987). It is, in short, rational for politicians to set for themselves inflation targets that they have no intention of keeping. Yet, in a world of rational (or, indeed, adaptive) expectations, market actors will anticipate such defection, (rationally) adapting their investment behaviour accordingly. Consequently, so long as control of monetary policy rests in the hands of public officials, unemployment, the aggregate rate of inflation and interest rates will all be higher than they need otherwise be.

If anti-inflationary credibility is to be restored, the public authorities need to be able to make a credible pre-commitment to a given inflation target. This entails an institutionally-guaranteed depoliticisation of monetary policy – in other words, an independent central bank mandated constitutionally to deliver a specific inflation target (typically in low to mid-single digits). In such a scenario (rational) inflationary expectations are diminished with consequent beneficial effects both upon the cost of borrowing and the equilibrium rate of unemployment.

The pedigree of New Labour’s new open macroeconomics could scarcely be clearer. Though, in the strictest terms, post-monetary (no emphasis is placed upon control of the money supply), New Labour’s open macroeconomics is a clear and direct

However conventional in international terms, the adoption of such a monetary policy stance has a series of specific implications for Labour’s ability to deliver its stated economic objectives. In fact, as we shall see, these derive more from the elevation of monetary policy as the sole instrument in the control of inflation than they do from central bank independence per se.

First, as I have elsewhere suggested with David Coates, “interest rate hikes are an extremely blunt instrument of monetary policy, imposing deflationary pressures across the entire economy” (Coates and Hay 2001: 460). In an economy, such as Britain’s, which is a now far from optimal currency area with, arguably, ever more divergent regional and sectoral business cycles, this has a series of negative externalities. With the co-existence for much of Labour’s tenure in office of a manufacturing recession and a housing boom centred on the south-east of England, a single policy instrument approach to the control of inflation can only serve to establish and reinforce a deflationary bias in the most disadvantaged sectors and regions of the economy. This is merely compounded by the decision to give operational independence to the Bank of England. For if the Chancellor intervenes to ameliorate the region- or sector-specific consequences of a given interest rate setting, he challenges the spirit of operational independence, with potentially damaging consequences for the credibility of the Monetary Policy Committee. Yet if he remains true to the spirit of independence, he remains powerless to intervene at all.

This epitomises New Labour’s dilemma. It is perhaps not surprising, then, that having dismissed the idea of a regionally-differentiated stamp duty, the Chancellor has toyed with compensating core public sector workers for house prices that are in many regions incommensurate with their salaries. Needless to say, this would merely serve further to exacerbate the problem, injecting additional revenue and demand into those regions where demand is already the highest, whilst further inflating house prices and contributing to Britain’s most intractable labour-market rigidity – house-price differentials. As this serves to indicate, the granting of operational independence to the Bank of England may well have resolved the time-inconsistency problem, contributing significantly to the government’s anti-inflationary credibility; but it may have come at a price.

A second problem is reflective of the longer-term structural frailties of the British economy. This is more hypothetical in nature as its effects are, at present, largely obviated by the consequences of the significant reductions in public debt that occurred between 1997 and 1999 (Watson 2003). These have served, amongst other things, to push up the value of Sterling and to reduce the interest rate hike required to correct given inflationary pressures. It is nonetheless the case that for decades Britain has been characterised by persistently low levels of productive investment. That this is so is, in turn, a combination of the traditionally high cost of capital and the risk-aversion of its financial institutions (Bond and Jenkinson 1996; Kitson and Michie 2000; Watson and Hay 1998). This is reflected in poor figures for manufacturing output and significant capacity constraints which persist to the present day (see Table 1).
Table 1: Manufacturing output growth, 1965-1999

<table>
<thead>
<tr>
<th></th>
<th>Average annual percentage growth</th>
<th>Total percentage growth (peak-to-peak)</th>
</tr>
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<tbody>
<tr>
<td>UK</td>
<td>1.1</td>
<td>31.1</td>
</tr>
<tr>
<td>Italy</td>
<td>2.9</td>
<td>70.6</td>
</tr>
<tr>
<td>France</td>
<td>2.3</td>
<td>2.3</td>
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<tr>
<td>Germany</td>
<td>2.3</td>
<td>2.3</td>
</tr>
<tr>
<td>USA</td>
<td>3.7</td>
<td>3.7</td>
</tr>
<tr>
<td>Japan</td>
<td>4.5</td>
<td>4.5</td>
</tr>
</tbody>
</table>

Source: (Kitson and Mitchie 2000: 115)

Consequently, modest growth rates for the economy as a whole (typically 2 to 2.5% per annum during the first term) have seen the economy operating at full capacity (see also Driver 2002). Growth rates in excess of this figure can only result in additional inflationary pressures and, in turn, increasing interest rates. Capacity constraints raise the level of structural unemployment in the economy and, for want of a better term, the natural rate of inflation, increasing the level of unemployment ‘required’ to deliver a given inflation target. Yet, once again, it is the feedback effects which are the most potentially crippling. For, with a monetary authority charged with hawkish anti-inflationary preferences, capacity constraints mean higher interests rates and, ceteris paribus, a rise in the value of the currency, further suppressing investment in physical capital with consequent effects on the stock of productive capital. A potentially vicious circle might thereby established, compounding Britain’s long-term structural weaknesses as a productive economy.

A third point is perhaps no less important, though at this stage it is prospective (and, arguably, likely to remain so). The very rationale for ceding operational independence to the Bank of England would be undermined, in the most fundamental way, by any decision to join the Eurozone. Indeed, the core tenets of New Labour’s new Keynesian economics would be profoundly compromised. As I shall suggest presently, this may be no bad thing. For now, however, it is important to spell out the sharp tension between Labour’s ‘open economy macroeconomics’ and its ostensible (if clearly waning) preference for membership of the Single European Currency.

The argument itself is simple. If Britain’s business cycle is not perfectly aligned with that of the Eurozone and/or the British economy’s rate of inflation is more or less sensitive than the Eurozone to interest rate adjustments, then the interest rate setting of the European Central Bank will differ from that which would have been set by the Bank of England. In such a scenario, interest rate variations would no longer prove sufficient to deliver a given target rate for inflation (whether set in Frankfurt or London). Consequently, responsibility for delivering such a target would effectively revert from a quasi-independent authority (the Bank of England) to the government. For, in the absence of government intervention, the target would simply not be met. Yet, within the terms of new Keynesian/new monetarist economics, we know that governments have time inconsistent inflationary preferences and, as a consequence, cannot be trusted to deliver a given target rate for inflation. That, after all, is why operational independence was granted to the Bank of England in the first place.
There is no way out of this paradox. Either Britain joins the Single European Currency and New Labour’s open economy macroeconomics is abandoned – in favour, as I will argue presently, of a post-Keynesian macroeconomics – or, if it is to remain true to the spirit and letter of its open economy macroeconomics, it must refuse to contemplate membership of the Eurozone. It would be rather perverse, however, for a government that has already warned us, and the markets, of its time-inconsistent inflationary preferences, to take renewed responsibility for the delivery of its target rate of inflation.

**Fiscal passivity**

If central bank independence is the most obvious theme of Labour’s open economy macroeconomics, then no less significant is what might be termed its ‘fiscal passivity’. A number of points might here be made. First, and as is by now already clear, the role for fiscal policy is heavily circumscribed in Labour’s political economy. Consistent with the core assumptions of new Keynesian economics, Labour privileges monetary policy over fiscal policy as the appropriate instrument for macroeconomic stabilisation, whilst acknowledging the limits of both monetary and fiscal policy as stabilisation devices (de Long 2000: 83-4; Greenwald and Stiglitz 1993; Romer 1993). Since responsibility for monetary policy is, in turn, delegated and depoliticised, this serves to render macroeconomic stabilisation an almost entirely technical matter – a subject which it is simply not appropriate to render accountable in democratic terms to the electorate. Given that Labour rejects any correlation between aggregate or effective demand and growth, this is not at all surprising. Yet it has three important implications.

First, fiscal policy is not regarded as an instrument in the fight against inflation, which should be controlled through interest rate rises by an independent authority not tax increases by the government. As a consequence, where significant inflationary pressures are present within the economy, Britain will tend to pay an, arguably unnecessary, interest rate premium over its immediate European competitors whilst British exporters suffer a significant loss of competitiveness owing to an over-valued currency. As already noted, this effect is (temporarily) obviated both by the absence of such strong inflationary pressures and by the sizeable reduction in national debt that occurred between 1997 and 1999. It is nonetheless important to note that such debt repayment contributed significantly to the appreciation of Sterling, with consequent effects on British competitiveness.

Second, it leaves New Labour powerless to influence the business cycle, save other than by supply-side and microeconomic interventions designed to correct specified market-failures and to eliminate supply-side rigidities. Arguably such measures are far more likely to accentuate rather than ameliorate the business cycle, compounding rather than resolving Labour’s problem (a theme to which we return presently). Indeed, and again in one sense consistent with new Keynesian assumptions, it is almost as if New Labour discounts the business cycle altogether (though see Mankiw 1989). In so far as it is seen as an issue, it is an issue for the Monetary Policy

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2 Of course, New Labour may accept the argument put forward by some influential commentators, practitioners and theorists that the US offers a ‘new economy’ model of sustainable non-inflationary
Committee (MPC) of the Bank of England, for they control interest rates. It is not, principally, an issue for the Treasury (at least for now). In the absence of a simultaneous rise in both inflation and unemployment (something the government regards as unimaginable), it is simply assumed that recession would precipitate a fall in interest rates sufficient to re-inflate the domestic economy (the MPC’s ‘constrained discretion’ in such matters notwithstanding). Fiscal policy is not, then, viewed as an instrument to be deployed in either the fine or coarse tuning of the economy (Arestis and Sawyer 2001: 259; Grieve Smith 2001: 14; Westergaard 1999: 430). Provided that the Chancellor’s golden fiscal rule is met – the government should only borrow to source investment – and the current account is balanced over the duration of the business cycle, it is assumed, full or near full employment can be sustained over the entire cycle without recourse to demand management (save other than prudential adjustments in interest rates by an independent authority).

Sadly, this is likely to prove excessively optimistic. For this is all very well in times of sustained economic growth, like those Labour has thus far been fortunate enough to preside over. Yet in recession, interest rate reductions excepted, demand will surely fall, economic activity will drop and taxation revenues will plummet. Moreover, this is only likely to be exacerbated by the inauspicious combination of two factors: (i) a substantial and increasing reliance of the manufacturing economy upon inward investors and (ii) a highly flexible labour-market. For, given that it is easier to shed labour and hence excess capacity in a flexible labour-market, and given that Britain boasts the most flexible labour-market in Europe, recession is likely to precipitate a significant haemorrhaging of invested funds, producing a potentially alarming rise in unemployment. Given Labour’s understanding of unemployment as an essentially supply-side phenomenon (a point to which we return below) there is precious little if anything it can do about this without abandoning altogether its new Keynesian economic assumptions. As John Grieve Smith concludes, “where the Chancellor has short-sightedly reduced his room for manoeuvre is in ostensibly ruling out any expansionary fiscal measures (i.e. tax cuts or increases in public expenditure) if the economy is threatened with recession” (2001: 14).

If fiscal passivity is likely to prove problematic in times of recession under the current monetary policy regime, it is simply unsustainable under EMU. For, as already noted, with a common interest rate throughout the Eurozone, the control of British inflation simply cannot be left to the European equivalent of the MPC in Frankfurt (the Governing Council of the ECB). For reasons already alluded to, in times of significant inflationary pressures the interest rate set by the European Central Bank is unlikely to prove sufficient to control domestic inflationary pressures. Britain’s still prospective predicament within the Eurozone closely mirrors that of Ireland in recent years. It has important implications for the conduct and coordination of macroeconomic policy. For, however reluctant it may be to do so, any disparity between the interest rate set by the ECB and that which would have been set by an independent Bank of England would force the Treasury to deploy other instruments of stabilisation, principally fiscal policy. Herein, one might surmise, lies some of the growth leading to the permanent elimination of the business cycle (Watson 2001: 504-5). However enticed by such a logic it may well be, it is nonetheless difficult to reconcile this fanciful delusion with the Chancellor’s commentary on the British economy as offered in successive budget speeches since 1997.

3 Though something the most recent economic data suggests might be beginning to materialise.
Chancellor’s ambivalence towards membership of the Single European Currency. Arguably, and ironically, given the benefits which Britain might accrue from greater fiscal activism even outside of the Eurozone, this might be seen as one of the potential benefits for Britain of membership of the single currency – certainly if the analysis of the previous section is accepted. For it would serve to pass the burden of deflating the economy in times of potentially unstable growth from monetary policy to fiscal policy, allowing greater flexibility and sensitivity to regional and sectoral dynamics (through a series of fiscal transfers) whilst contributing to the alleviation of capacity constraints (by reducing the historically high cost of capital). It would, in essence, serve to impose upon the government a rather different set of assumptions about the coordination of fiscal and monetary policy to those which currently circumscribe its (fiscal) autonomy (for a more lengthy elaboration, see Hay 2003). Many of the problems identified in the previous section would be overcome at a stroke.

Unemployment, labour-market flexibility and endogenous growth

New Labour’s political economy may well be characterised, this side of any referendum on membership of the Single European Currency, by fiscal passivity. Yet it would be wrong to generalise too broadly from this. If the government’s instincts, to date, have been for macroeconomic stability and a relegation of considerations of capacity and demand, then they have also been for (comparative) microeconomic activism and supply-side interventionism. To understand the perceived need for this, and to assess the distinctive policy set to which it has given rise, it is important, first, to examine Labour’s conception of unemployment and the responsibilities of the state with respect to the labour market. That conception is deeply conventional in neoclassical economic terms and serves to differentiate New Labour’s domestic agenda very clearly from that of all previous Labour administrations.

Despite the Chancellor’s periodic rhetorical gestures to the contrary, the government cannot credibly claim full employment as a deliverable economic priority. As John Grieve Smith pointedly notes,

“there is an embarrassing discrepancy between Gordon Brown’s statements about achieving ‘full employment’ and the continued suggestions in successive Treasury reports that output and employment were already above the level compatible with the inflation target … [T]he March 2001 Budget Report suggested that the economy was ‘currently operating just above potential’, i.e. that unemployment needed to rise, rather than fall any further, to avoid any acceleration in the rate of inflation” (2001: 16).

The disparity to which Smith points persists to the present day. What New Labour does accept is the NAIRU (the non-accelerating rate of unemployment). Set within this more orthodox framework, it is the responsibility of government, in the short-term, to keep unemployment to this equilibrium rate whilst, in the longer-term, it strives to bring down the non-accelerating level of unemployment through a series of supply-side structural reforms (Layard, Nickell and Jackman 1991). This tightly circumscribes the government’s perceived responsibilities with respect to the problem of unemployment to the point that any residual reference to full employment as an economic goal is, frankly, disingenuous.
Unemployment is, then, for New Labour recast as an exclusively supply-side phenomenon, and one whose determinants are to be found in the character of the labour market rather, say, than in perverse investment incentives and capacity constraints (see also Driver 2002). Much of the distinctiveness of New Labour’s political economy and, indeed, many of its silences and tensions flows directly from this. Its package of welfare and labour-market reforms is thus tightly integrated. It is comprised of the following three elements: reform of the welfare state to remove all disincentives to labour market participation; measures to address (market) deficiencies in the supply of human capital; and labour market flexibilisation.

1. Welfare conditionality. Welfare expenditure is no longer justified principally in terms of its contribution to social justice but in terms of its contribution to competitiveness. Work needs to be ‘made to pay’ through reform of benefit eligibility criteria, eliminating disincentives to labour-market participation.

2. Human capital formation. In addition to the elimination of the labour-market rigidities associated with generous benefit entitlements and eligibility criteria, the welfare state is to be recast as a ‘social investment state’ (in Giddens’ terms), compensating for the market’s characteristic under-investment in human capital, promoting ‘employability’ and ensuring a supply of suitably en-skilled (or, indeed, de-skilled) labour to satisfy the demands of a flexible and competitive economy. Here Labour has drawn extensively upon its much-vaunted post-neoclassical endogenous growth theory (see, for a useful review, Crafts 1996).

3. Labour market (as distinct from workplace) flexibility. It is the responsibility of government to promote competition and entrepreneurialism by lifting burdensome restrictions and regulations wherever possible, whilst guarding against their external imposition from Brussels (Byers, speech to the Mansion House, 2 February 1999). Labour has been keen to defend what it proudly claims to be the most “lightly regulated labour market of any leading economy in the world” (Blair, foreword to Fairness at Work, 1998). This allows employers to respond rapidly to changing demand, hiring and firing labour as the vagaries of the market dictate. As this suggests, and as argued elsewhere, “if flexibility can be achieved either within the workplace, as highly skilled workers adapt themselves to a range of flexible tasks, or externally, within the labour market itself, as employers avail themselves of the opportunity to hire and fire, then it is clear that Labour in power has prioritised the latter” (Coates and Hay 2001: 463).

4 The ‘de-skilling’ dynamic is easily described. It arises from the combination of Britain’s high rates of labour turnover and strong elements of welfare conditionality. Together these effectively force those who lose their employment, at pain of loss of benefit, into whatever employment is immediately available. This establishes a strong tendency for skilled workers, especially those within a decade of retirement age, to down-skill. Such temporary de-skilling, however, often proves irreversible, as labour-markets are sticky with respect to skills. In other words, the human capital expended in ones previous period of employment is the single most significant factor determining the skill level of ones next period of employment. The result is that the British labour-market is characterised by the very poor matching of the skill levels of the worker with the task for which they are employed.
Whilst this might seem a coherently articulated and consistent package of reforms animated by an array of common and distinctive themes it is, nonetheless, characterised by a series of internal inconsistencies, oversights and contradictions. First, as a growing number of commentators have noted, in treating unemployment as an exclusively supply-side phenomenon, the government leaves itself powerless to address variations in the rate of unemployment linked to the business cycle (see, for instance, Grieve Smith 2001; Peck 1999). Moreover, as has already been argued, there are good reasons for supposing that Britain’s highly flexible labour market is arguably more prone to significant labour shedding in recession than any of its immediate European neighbours. And, what is more, the government’s policies have further served to reinforce this pre-existing propensity to rapid increases in unemployment in times of recession. Finally, a series of tensions and inconsistencies can be identified in Labour’s application of endogenous growth theory to the British case. First, if levels of human capital formation within the British economy are low a principal reason for this is high levels of labour turnover, a product of precisely the labour market flexibility the government otherwise venerates. Second, there is now a considerable body of evidence to suggest that investment in human capital is not the panacea that it is sometimes mistaken for. The British economy is less characterised by skills shortages than it is by the under-utilisation of the skills already present within the labour force. The problem, as Ewart Keep and Ken Mayhew rightly observe, may principally lie on the demand side (1998: 379, 1999). And third, no amount of investment in human capital can compensate for a persistent lack of investment in the physical capital which a highly skilled workforce might deploy.

Despite this, the government’s labour market agenda does cohere as a package, giving a highly distinctive character to New Labour’s political economy. Yet, as a package, it is in a relationship of some tension to the macroeconomic regime New Labour has established. It is to these tensions, contradictions and conflicting priorities that we turn in the following concluding section in which an overall assessment of New Labour’s political economy is presented.

**Overall assessment, contradictions and long-term pathologies**

If we are to provide an overall assessment of New Labour’s political economy and its conduct, to date, of economic policy in office, we need answers to three key questions. Does New Labour possess a distinctive and consistent political economy? How has it performed with respect to the two principal economic imperatives it has outlined for itself – macroeconomic credibility and international competitiveness? Can tensions, contradictions and competing priorities be identified in Labour’s economic policies and economic policy discourse? And, if so, to what extent might these compromise economic performance in the ‘third term for the third way’ that would now seem guaranteed? It is to each of these that we turn briefly in conclusion.

*Does New Labour have a distinctive and consistent political economy?*

Of the four questions this is probably the most difficult to answer definitively. With respect to the monetary policy regime the government announced, without a mandate, within a week of its election in 1997, there has undoubtedly been consistency. Moreover, the new macroeconomic regime which it has served to establish and institutionalise, though in once sense a return to an older liberal traditional on which
the Bank of England was founded, is, in the context of postwar British political economy, highly distinctive. The government’s labour market reforms, despite their internal tensions detailed above, are also distinctive and they have been consistently pursued.

Whether the same can be said of fiscal policy is less clear. The government has certainly revealed if not time-inconsistent inflationary preferences, then certainly time-inconsistent fiscal preferences. This is somewhat ironic. For, arguably, it was always likely to prove itself hawkish in pursuit of anti-inflationary credibility, even in the absence of a decision to confer operational independence on the Bank of England – as was effectively confirmed by the decision itself. Consequently, were Labour in power to reveal time-inconsistent economic preferences of any kind these were always more likely to relate to taxation and expenditure than they were to inflation. Of course time-inconsistent fiscal preferences are not in themselves a problem in contemporary neoclassical economic theory. The reason for this simple. Time-inconsistent inflationary preferences only pose a problem because of the vested interest politicians have in making – and then breaking – strong anti-inflationary commitments. Fiscal preferences are (generally speaking) revealed preferences. Consequently, they hold no secrets to market actors. Yet, whilst not in itself a pathology of Labour’s political economy its time-inconsistency with respect to taxation and expenditure does raise questions about the character and coherence of its political economy.

Two rather different interpretations might be offered. In the first of these Labour’s decision to keep to the outgoing Conservative administration’s excessively stringent spending targets for the first two years of its first term was a purely strategic electoral judgement. This effectively imposed upon it time-inconsistent fiscal preferences, delaying expenditure which Labour was committed to all along. This suggests a consistent political economy strategically implemented. It also suggests that we should expect to see no such time-inconsistency replayed in the government’s second term – nor, indeed, in a prospective third term. An alternative, and altogether less sympathetic, interpretation would see instead a rather cynical electoral expediency to which economic policy has consistently been subordinated. By such a reading the Chancellor’s task has been to accumulate a sizeable fiscal surplus in the first years of the administration which might be invested strategically in the outcome of the subsequent election (or, less strategically, in the cost of war in the Gulf). This suggests a political rather than an economic rationale for fiscal policy, with the Chancellor responding defensively and reactively to the changing mood of the electorate (as gauged in focus groups and opinion polls) or to perceived security concerns. Though such a judgement is probably overly harsh, it is one to which New Labour has left itself open – it would, for instance, seem perfectly consistent with its first and second term performance. For where important changes to economic policy have been made, as in the second term in the decision to invest significant resources in the national health service, they have not been heralded long in advance and have been justified largely in their own terms as a technical solution to a specific problem and not as part of a coherent reform package.\(^{5}\) This reflects the government’s rather alarming habit of claiming a mandate to govern based on the electorate’s sense of its

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\(^{5}\) It is difficult, then, to see this seeming public spending explosion as heralding a decisive change in economic thinking on the government’s part.
perceived credibility and competence, rather than a mandate for specific policies outlined in advance of an election (in, say, a manifesto). \(^6\) Whilst this fits well with New Labour’s rather technocratic vision of its role as one of stewardship of the economy, it can only serve further to depoliticise economic policy making.

Can we speak of a distinctive New Labour political economy? As this paper has hopefully made clear, the government does indeed have a relatively consistent academic political economy – one that might be labelled new Keynesian or new monetarist. Yet, partly because of this, it has no clear vision of political economic purpose. Macroeconomic orthodoxy is increasingly technocratic. It is about doing the right things in response to specific endogenous conditions and exogenous pressures. It is not proscriptive, forward-looking or, indeed, capable of animating a vision of strategic purpose and reform – save other than one of clearing the market of rigidities which impede its efficient operation and supplying public and quasi-public goods, such as human capital, which it tends to undersupply. New Labour’s political economy is highly conventional. As such it lacks a vision – for vision is a dangerous thing.

One caveat, however, must be entered at this point. New Labour certainly has had a distinctive academic political economy that is, broadly, new Keynesian/new monetarist. Indeed, this has been clearly laid out by the Treasury and senior economic advisors to the government in terms of an ‘open economy macroeconomics’ (Balls 1998; HM Treasury 2002). Yet, as I have sought to demonstrate, if the government is indeed wedded to membership of the Single European Currency, that academic political economy will be left in tatters. This may, in part, explain the Chancellor’s, Treasury’s and Bank of England’s seeming ambivalence, even antipathy, to the Euro. What it most certainly does suggest is that the official rationale for the conduct of macroeconomic policy and, in particular, the coordination of monetary and fiscal policy will need to be significantly revised if Britain is ever to join the Eurozone. How that is revised will have a crucial bearing on whether membership of the Single European Currency is ultimately in Britain’s interest (Hay 2003).

**How has Labour performed with respect to credibility and competitiveness?**

With respect to the two principal performance criteria that New Labour has set for itself, namely macroeconomic credibility and the competitiveness of the British economy, performance has been mixed. In terms of credibility, the government’s performance has been impressive, if largely by virtue of the decision to cede operational responsibility for the setting of monetary policy to the Bank of England and its ability to establish for itself a reputation for moderation and self-imposed constraint.

Three factors, however, have posed or may still pose challenges to that enviable and, for a Labour administration, unprecedented reputation. The first of these was the

\(^6\) The decision to cede operational independence to the Bank of England is a case in point – as, arguably, is the government’s more recent foreign and security policy with respect to Iraq, where lack of public support failed to dissuade the government from the policy track it had chosen, with consequent implications for its popularity.
Chancellor’s widely-perceived ‘gamble’ with the national health service (or, more precisely, with the lead-time required to deliver improvements in the national health service). In the absence of a coherent vision for the reform of the public services, including the national health service, the Chancellor’s strategy certainly appeared risky (and, with a rather more effective opposition party, it may well have proved more so). The government, it would seem, staked its credibility on its ability to translate a significant increase in expenditure (which did not come on-line immediately) into clearly perceptible improvements in performance prior to the 2005 general election. However laudable, the strategy appeared to some at the time rather foolhardy. Two additional factors may pose more significant if longer-term problems. They are the likely advent of a more difficult phase in the economic cycle and the question of membership of the Single European Currency. Yet what is clear is that, having already established an enviable reputation for macroeconomic credibility and competence, the government may be better placed to deal with these challenges than would have seemed possible to anticipate in 1997.

Yet, if the government’s performance with respect to macroeconomic credibility has been impressive, then its performance with respect to competitiveness has been poor. Indeed, there are good reasons for suggesting that these are linked, as competitiveness has been sacrificed on the altar of perceived credibility wherever the two imperatives have clashed (Hay 2001). Three factors have here conspired to undermine competitiveness: (i) the continued overvaluation of the currency, a consequence to a significant extent of, first, the exclusive use of monetary policy to control inflation and, second, the sizeable reduction in national debt between 1997 and 1999; (ii) persistently low levels of productive investment, especially in the manufacturing sector – a factor linked historically to the high cost of capital; and (iii) an alarming increase in unit labour costs relative to Britain’s principal competitors. Of course, these are not unrelated tendencies. Indeed, the rise in unit labour costs is, to a significant extent, a consequence of the appreciation in the exchange-rate.

This notwithstanding, the evidence is unequivocal, especially when set in a comparative context. Gross capital formation as a share of GDP continues to lag significantly behind the G7 average, the contrast being particularly stark with Britain’s nearest European neighbours; growth rates in industrial production have been approximately half the G7 average; and unit labour costs have, since 1995, risen at approximately twice the G7 average.

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Table 3: Investment (gross fixed capital formation) as a share of GDP

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Table 4: Year-on-year growth in industrial production (%)

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Table 5: Unit labour costs in manufacturing (1995=100)

Source: All data from HM Treasury, Pocket Databank, April 2002

The contradictory character of New Labour’s political economy

This brings us neatly to the contradictory character of New Labour’s political economy. As previous sections have hopefully served to make clear, though distinctive and to an unusual degree reflective of a consistent academic political economy, New Labour’s conduct of economic policy has been characterised from the outset by a series of tensions, contradictions and competing priorities. Ten emerge particularly clearly from the above analysis. They can be summarised as follows:

1. Much of New Labour’s political economy is pro-cyclical. This is especially true of its labour-market agenda. The government is proud to boast and to defend a more flexible labour market than any of its European competitors. This undoubtedly has its benefits, but these are unevenly distributed across the business cycle, occurring principally on the ‘up’ phase. The advantages of flexibility when demand is high rapidly give way to disadvantages as demand falls and excess capacity emerges. The absence of ‘labour market rigidities’ – such as works councils, compulsory consultation processes and generous compensation where labour-shedding occurs – means that it is, in Bob Anderton and Ken Mayhew’s terms, “probably easier and less expensive to sack a worker in Britain than any other major European economy” (1994: 37). In a relatively integrated European market, then, Britain can expect a high proportion of European labour-shedding in response to excess capacity to occur on its shores. Labour market flexibilisation thus accentuates the business cycle, stretching it from peak to trough. This effect is reinforced, as I have sought to demonstrate, by European economic integration, though it is also tempered by the declining
significance of manufacturing to the British economy. Given the government’s clear antipathy to counter-cyclical demand management, this is worrying indeed.

2. The use of monetary policy as the sole instrument in the fight against inflation has a series of negative externalities for the productive economy, threatening competitiveness. All things being equal, it may serve to reinforce the historical tendency for Britain to suffer an interest rate premium over its competitors in contexts in which significant sources of inflationary pressures exist, suppressing potential levels of productive investment and, thereby contributing to capacity constraints. At the same time, ceteris paribus, it tends to drive up the value of sterling, further penalising British exporters. Moreover, interest rate variations are a blunt instrument of monetary policy, especially in an economy characterised by significant regional and sectoral divisions.

3. Labour market flexibility militates against human capital formation. Highly flexible labour markets, like the British, tend to be characterised by high rate of labour turnover. This is a significant disincentive to investment in human capital. Put simply, why invest in the skills of your workforce when you can poach those trained by others? Similarly, why invest in the skills of your workforce when, by so doing, you merely improve their mobility in the labour market? New Labour’s political economy identifies, as an endemic market failure, the tendency of private employers to undersupply skills and human capital. Yet its programme of labour market reform provides yet further incentives for the market to fail to provide that investment.

4. New Labour’s emphasis upon human capital formation is, in the absence of a similar emphasis upon physical capital formation, somewhat misplaced. Whilst there are undoubtedly skills shortages in the economy, a more significant problem is the under-utilisation of extant skills and a persistent shortfall in investment in the capital stock which skilled workers might employ. Human capital formation in the absence of physical capital formation may be putting the cart before the horse. What the workers at Rover’s Longbridge plant suffered from was, in the first instance, not under-investment in their human capital, but a persistent lack of investment in the new plant and machinery that might test their stock of human capital.

5. The devolution of monetary policy authority to the Bank of England in combination with the government’s reluctance to deploy fiscal policy as a stabilisation device is difficult to reconcile with an ostensible (if waning) commitment to membership of the Single European Currency. An interest rate set in Frankfurt is likely to prove insufficient to suppress inflationary pressures within the British economy. Consequently, membership of the Eurozone would force upon the Treasury a degree of fiscal activism which it has thus far strongly

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7 In the context of the Blair’s government’s second term, this is largely theoretical point. For most of this period, Britain has not suffered an interest rate premium with respect to the Eurozone. That this is so owes its origins largely to the reduction in national debt that the commitment to the Conservatives’ spending targets between 1997 and 1999 inadvertently facilitated. This resulted in the further appreciation of Sterling, thereby undermining British competitiveness in international markets. It has, however, at least temporarily reduced the interest rate level required to deliver an inflation target at or below 2.5 per cent.
resisted. In so doing, however, it may serve to alleviate many of the tensions identified above.

6. Supply-side and labour market reforms are unlikely to prove sufficient to prevent a significant rise in unemployment when British or, indeed, Eurozone demand falters. Given already low levels of capacity and the proneness of the economy, in recession, to the shedding of capacity and labour in the context of a relatively well-integrated European market, this may pose very significant problems for the government.

7. New Labour’s ostensible commitment to labour-market flexibility has been compromised, more so than by anything else, by its failure to control house price inflation (and, indeed, on occasions by policies that have further stoked house-price inflation). The result is that house price differentials are a very considerable and growing structural impediment to labour-market flexibility in the UK economy today.

8. Relatedly, much of the modest but sustained economic growth that New Labour and, before it, the Major government has benefited from is a consequence of demand injected or dripped into the economy in the form of a consumer boom lubricated by the release of equity. The result is a very unstable equilibrium, fuelled by unprecedented levels of personal debt. Indeed, the anxiety engendered by this sense of fragility is, arguably, now beginning to interfere with the Bank of England’s ability to control inflation in a hawkish fashion through punitive interest rate hikes (for the fear of puncturing an unstable house price bubble and, with it, the consumer boom it has sustained almost uninterrupted since 1992).

9. The substantial and increasing reliance of the manufacturing economy on inward investment threatens to generate an unhealthy relationship of dependency, especially when it is considered that perceived labour market flexibility is a significant determinant of such high levels of inward investment. As already argued, Britain is the easiest place to shed capacity when demand falls in the Eurozone (irrespective of levels of British demand). Since Britain is a volume producer of consumer goods for the European market, this is a potentially significant problem. It points, again, to the frailty of New Labour’s political economy under conditions of negative growth.

10. Finally, and closely related to points 1 and 9, the increased flexibility of the labour market is likely to result in a greater fluctuation in employment levels across the business cycle, since it facilitates both labour-recruitment and labour-shedding. The result is likely to be higher peak levels of unemployment when demand is at its lowest. This can only exacerbate the problems associated with existing low levels of physical capital, which see available capacity fully utilised at considerably less than peak levels of demand. As this suggest both peak and trough levels of employment are considerably lower than they might be.

In the context of sustained economic growth, Britain’s poor competitive performance notwithstanding, these various tensions and contradictions have proved manageable. Yet, both individually and collectively, they raise significant concerns about the
longer-term viability of the course on which New Labour is currently embarked as it prepares for a third term.

This assessment may seem rather bleak. However, there are some seeds of optimism in the argument about British membership of the Eurozone. For, as I have been at pains to demonstrate, this would severely compromise the ‘open economy macroeconomics’ on which New Labour’s political economy has thus far been publicly predicated. It would force the government, once again, to take responsibility for delivering a given inflation target to compensate for the likely interest rate disparity between that of the ECB (set for the Eurozone as a whole) and that which would be set by the MPC of Bank of England (for the British economy).

For a variety of reasons, outlined above, the inflation-deflation dynamic of the British economy has tended to be less sensitive to interest rate variations than the Eurozone as a whole. Consequently, if fiscal policy is to be used as the principal means of adjustment to a sub-optimal interest rate, the fiscal stance that the British government will be forced to adopt is likely to prove strongly counter-cyclical. The argument is simple. The interest rate set by the ECB when demand is high and rising in the Eurozone is unlikely to prove sufficient to temper inflationary pressures in Britain. In such a scenario excessive demand might be removed from the economy by targeted fiscal policy. Similarly, in recession, interest rate adjustments by the ECB are unlikely to be sufficient to restore confidence and demand to the British economy. Here a fiscal stimulus from the Treasury would be called upon. As this suggests, fiscal adjustment in the case of Britain is likely to prove strongly counter-cyclical. This might compensate for the pro-cyclical character of New Labour’s supply-side reforms, whilst militating against the sectoral and regional fragmentation of the British economy which has been exacerbated by open economy macroeconomics.

As this suggests, membership of the Single European Currency may force the government to abandon new Keynesian/new monetarist economics in favour of post-Keynesian economics. On the evidence of the present analysis that would be no bad thing.
Bibliography


