The Centre for Policy Studies

MYTHS AND MAGIC IN ECONOMIC MANAGEMENT

An analysis of the evidence given to the House of Commons Expenditure Committee in the summer of 1974 on Public Expenditure, Inflation, and the Balance of Payments

JOCK BRUCE-GARDYNE

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FOREWORD TO JOCK BRUCE-GARDYNE'S PAPER
BY SIR KEITH JOSEPH

Jock Bruce-Gardyne was one of those few who publicly and repeatedly predicted the inflationary consequences of the policies of 1971-2 while they were unfolding. As an MP, he was a particularly percipient observer and critic of governments of both parties and his forecasts were right on the central economic issues of our time.
He is therefore especially fitted to present the evidence given to the Expenditure Committee, as he does in this booklet.

Keith Joseph

Members of the General Sub-Committee of the House of Commons Expenditure Committee 1974

Michael English, Labour MP for Nottingham West *Chairman*
Michael Alison, Tory MP for Barkston Ash
Jock Bruce-Gardyne, Tory MP for South Angus
John Garrett, Labour MP for Norwich South
Gwynoro Jones, Labour MP for Carmarthen
Nicholas Ridley, Tory MP for Cirencester
Hamish Watt, SNP MP for Banff

James Boydon, Labour MP for Bishop Auckland *(ex officio* as Chairman of the House of Commons Expenditure Committee)

Professor Alan Walters of the LSE served as Specialist Adviser to the sub-committee

Witnesses

Department of Applied Economics, University of Cambridge
Wynne Godley
Francis Cripps*
Martin Fetherston

National Institute of Economic and Social Research
G.D.N. Worswick *(Director)*
Frank Blackaby *(Deputy Director)*
J.D. Whitley *(Research Officer)*

University of Manchester
Professor D.E.W. Laidler, Professor of Economics

University of Cambridge
Professor Lord Kahn
Michael Posner*

Bank of England
Christopher Dow
Charles Goodhart

HM Treasury
Sir Kenneth Berrill, *(Chief Economic Adviser to HM Government)*
P.R. Baldwin *(Deputy Secretary, Public Sector Group)*
F. Cassell *(Under-Secretary (Economics))*
Miss M.P. Brown *(Under-Secretary (Economics))*
A.P. Budd *(Senior Economic Adviser, Economic Assessment Division 1)*

*Part-time *Specialist Adviser to HM Government,* subsequently appointed *Deputy Chief Economic Adviser to HM Government.*

far too important to be restricted to arcane discussion between the professional economists of Treasury, Bank and Universities.

The special merit of the particular form of scrutiny applied to these issues by a select committee of the Commons lies in the fact that politicians instinctively strive to relate the specialist evidence given to the realities of their experience in Government and on the back benches. In this instance the answers they extracted have, at many points, a relevance to the continuing public debate about the nation's economic performance. That is the theme and purpose of this assessment.

Introduction

The House of Commons Expenditure Committee was conceived under the 1969 Labour Government, and brought to birth under the 1970 Conservative one. It took the place of the long-standing Estimates Committee; and its formation represented a compromise between the wishes of those on both sides of the Commons who wanted to have an Economic Policy Committee, and the determination of the Treasury to avert the prospect of politicians cross-examining civil servants about the formulation of economic policy. In theory, whereas the old committee was supposed to restrict itself to the examination of the estimates and to eschew the discussion of policy choices which lay behind them, the new and enlarged committee was more broadly to relate prospective public expenditure to prospective resources. In practice the old Estimates Committee had never shown itself to be notably inhibited about discussing policy implications; while on the other hand the Treasury has been no less successful in resisting demands from members of the Expenditure Committee for the unveiling of matters such as the revenue implications of given expenditure programmes than it was in the past.

In another important respect the course of the career of the Expenditure Committee has diverged from the intentions of the original promoters. It was always intended that the 49 members of the parent committee would split up into subject sub-committees investigating the forward programmes of the great spending departments: the Ministry of Defence, the Department of Health and Social Security, the Department of Education, the Department of Trade and Industry (DTI), and so on. But it was also envisaged that the chairmen of each of these sub-committees would together constitute a 'general' sub-committee whose role would be to relate the requirements and ambitions of the

respective spending departments to the totality of available resources.

Predictably, no doubt, if unfortunately, this is not what materialised. The chairmen of the various subject sub-committees tend to be selected in the Whip's offices for qualities of seniority, general acceptability and party balance. If any of them happen to be interested in the impact of public expenditure as a whole within the economy, that is by the way. Hence the notion that they could constitute themselves into a General sub-committee to relate the parts to the whole was still-born from the start.

Instead, the General Sub-Committee emerged very much as a subject-committee like the rest, although its remit was to examine the public expenditure programme in its totality. And just as the Defence Sub-Committee has attracted the Major-Generals, and the DHSS Sub-Committee the doctors, so the General Sub-Committee has attracted those MPs who fancy themselves as economists. Much of its time is occupied with the scrutiny of Public Expenditure White Papers as they occur. In between White Papers, however, the General Sub-Committee, like the other sub-committees, runs hares of its own choosing. Such was the background to the Report on *Public Expenditure, Inflation, and the Balance of Payments.*

A Quarrel at Cambridge

In the early spring of 1974 a flurry in the correspondence columns of *The Times* alerted students of economic policy to the fact that one of those family rows which from time to time disturb the placid harmony of the Cambridge University Economics Faculty had blown up. This one was of wider interest: for the protagonists included Professor Nield, Mr Wynne Godley, Lords Kahn and Kaldor, and Mr Michael Posner. All of these gentlemen had one thing in common: they were known to be to a greater or lesser degree involved in advising the newly elected Labour Government. Furthermore one of the chief protagonists, Wynne Godley, who had himself helped to set up the Treasury's short-term economic forecasting unit 10 years previously, now appeared to be saying that the Treasury had got it all wrong. Not only that: he also seemed to be standing the whole of post-war neo-Keynesian economic management on its head. For while the accepted doctrine said that if there was slack in the economy the

Government should boost its own spending, and that if there was trouble in the balance of payments the sensible course was to drop the parity of the pound, Godley seemed to be saying the opposite: that domestic demand should be stimulated or damped down by lowering or raising the exchange rate, while a surplus on the balance of payments was best secured by cutting public expenditure.

The General Sub-Committee formed in the short February 1974 Parliament had a Labour chairman, Michael English, who had been a consistently fierce critic of attempts to control wages and prices under Governments of all political colours, and three Conservative members – Michael Alison, Nicholas Ridley and the present author – who were usually attributed to the 'monetarist' wing of the party; plus two more Labour MPs and a Scottish Nationalist. It rapidly decided that the controversy which had blown up at Cambridge provided an excellent occasion to re-examine the relevance of public expenditure policies to the balance of payments (as highlighted by Mr Godley and what was becoming known as the 'new Cambridge' economic school, as opposed to the 'old', or orthodox neo-Keynesian, school), and also to inflation. The charm of the whole exercise was that while an invitation to the Treasury – let alone the Bank – to discuss the balance of payments and inflation implications of current public expenditure programmes would surely have met with a brusque refusal, neither body could very well refuse to participate in a discussion about the relevance – or otherwise – of what purported to be an almost magic new formula for the management of the economy at any given time. And so indeed it proved.

For those who are not familiar with the role and procedures of a select committee of the commons, it may be helpful to explain that it is entitled to summon witnesses before it of its own choosing, who are obliged to attend under pain of breaching the privileges of the Commons (unless, that is, they are Members of the Lords: peers can only be invited to attend, not obliged to do so). Witnesses may – and quite often do – include Ministers of the Crown, as well as civil servants. The normal practice is for witnesses to be invited to submit memoranda in advance of their appearance; and for cross-examination to take place in the presence of press and interested members of the public. The com-

mittee may, at its discretion, cross-examine witnesses in private, or order that sections of evidence be 'sidelined', which means that they may not be reported and are deleted from the published record. Witnesses are usually given copies of memoranda submitted by other witnesses, as well as the transcript of their oral evidence, before they appear.

Like most select committees and sub-committees in recent years, the General Sub-Committee has a 'professional adviser' whose job it is to help the members prepare themselves for the encounter with specialist witnesses by analysing the memoranda submitted in advance, suggesting lines of fruitful questioning, and also assisting in the preparation of the sub-committee's reports. For several sessions, the General Sub-Committee's specialist adviser had been Wynne Godley. But on this occasion, since Godley was clearly to be a prime witness, it was necessary to look elsewhere. The choice fell on Professor Alan Walters of the London School of Economics, one of the most articulate of contemporary British monetarist economists.

CHAPTER 1 The New Cambridge Blueprint

Since the propositions put forward by Wynne Godley and his colleagues formed the occasion for the sub-committee's enquiry, a simplified — and possibly simplistic — recapitulation of what they were saying in their initial memorandum to the sub-committee is required. The essence may be stated as follows:

1 Past experience teaches us that, in Britain at any rate, the private sector — ie, companies, and the rest of us as individuals — has a surplus of income over outgoings, in good years and in bad, which is 'fairly small and predictable'.

2 It also happens that the sale of British goods overseas increases when world trade is booming, and contracts when world trade is slack. But when world trade is slack, our imports cost us less to buy, so we have less need to sell abroad; whereas when world trade is booming, while we sell more abroad, our extra overseas earnings are neatly swallowed up by the extra cost of our imports from overseas.

3 If the Government decides to spend more, or to tax less, then we all — including Government itself — go off and buy more goods from abroad than we would otherwise have done; whereas if the Government decides to spend less, or to tax more, the main consequence is a reduction of demand which in turn will reduce the demand for labour at home.

4 Given that there is a magic stability about the surplus of the private sector, and that the export revenue-import cost ratio is governed by the condition of world trade, it is neither bad luck nor bad judgment that Government 'fine tuning' activities have turned out, as many critics have argued, to be ill-judged, exaggerating both slumps and booms: it is of the

nature of the beast – 'the observed fluctuations in output have . . . been *entirely* the conseuqences of the stabilization measures!'*

5 The course of wisdom for Government is to pick for itself an acceptable combination of employment/unemployment and external payments levels. This will produce a defined appropriate size for the public sector borrowing requirement** which alone will produce that acceptable combination, involving a 'par tax rate'. Then the Government should stick with it, ignoring temporary fluctuations in home demand or the balance of payments.

So far so good. Unfortunately the elegance of the equation was, to some extent, flawed by the coincidence of its timing. For in 1973/74 something nasty had happened on the external account. There had been a huge increase in the cost of an essential import – oil – without any prospect of an off-setting increase in demand for, and the value of, UK exports, at any rate in the short term. So we were experiencing a substantial deterioration in the trade balance.

Now the traditional response to such a situation would be to increase taxes, or to cut Government spending, or both, in order to damp down demand at home and oblige our manufacturers to seek outlets abroad instead. Then we would consume a little less oil, and a lot less of other imports, and we would get our accounts back into balance by selling more abroad.

Nothing could be more disastrous, according to the 'new Cambridge' school. The higher import cost of oil would hit home demand anyway: and on top of this there was the £1,200m. cut in public expenditure made by Chancellor Barber in December 1973. So while fiscal 'fine-tuning' was, in general, thoroughly misguided, on this occasion the course of wisdom would be to offset the whole of the added cost of imported oil by increasing the Government's borrowing requirement to a corresponding amount. Otherwise there would be a slump.

* This, and all other quotations, unless otherwise indicated, are from the evidence submitted to the sub-committee.

** The 'borrowing requirement' is the difference between what the state raises in taxation and what it spends.

As to the external balance, this would certainly only come right slowly against the background of such a domestic strategy. If progress were deemed too sluggish, devaluation might only do the trick if it were on such a large scale as to be inconsistent with keeping the rate of price inflation 'within acceptable limits' (otherwise unspecified). In that case, there would be nothing for it but to opt for 'unconventional trade policies' in order to sustain full employment. The sub-committee later confirmed in cross-examination, that 'unconventional trade policies' meant import controls, or export subsidies, or both.

Not all the members of the sub-committee found it easy to reconcile the 'new Cambridge' general proposition with the specific recommendations for contemporary action. Fortunately for the sub-committee's peace of mind, other witnesses also demonstrated a marked capacity to compartmentalize their thinking. They dissected the 'new Cambridge' automatic pilot first; and then went on to tell the sub-committee how to handle the impact of the change in oil prices. The next two chapters examine this evidence in more detail.

CHAPTER 2 The Automatic Pilot

The kindest verdict of other witnesses on the 'new Cambridge' strategy, as outlined to the sub-committee by Wynne Godley, was one of Not Proven. The Bank of England cheerfully conceded that there might well have been a tendency over the years for the Government's attempts to manage the economy to have been positively destabilizing. But they pointed out that even if the 'new Cambridge' strategy stood up to close critical analysis – and on that they were agnostic – the Government would still be unable to 'set the automatic pilot' until it had first steered the economy on to the desired course by hand. Clearly the Bank, composed of men of the world, saw little or no likelihood of the gentlemen of the Treasury ever achieving that preliminary feat. So, as far as they were concerned, the whole exercise was little more than an agreeable summer diversion suitable for the banks of the river Cam.

The Treasury itself presented the pose of the earnest seeker after truth. The 'new Cambridge' contribution was extremely valuable, and worthy of depth analysis. The Treasury economists had 'Doubts' (but then, like all good economists, they usually do). One thing had to be made absolutely plain. Even if, at the end of the day, it were to turn out that there was a magic key to the management of the économy hidden in the depths of the Wynne Godley analysis, he and his friends were quite wrong if they imagined that this would release the Treasury's 'fine-tuning' labour force for more productive employment elsewhere. On the contrary, it would simply mean that an exciting new dimension would be added to the dissection of the entrails, which would then proceed more vigorously than ever.

The witnesses who naturally bridled most at the 'new Cambridge' presentation were the representatives of mainstream

neo-Keynesian thought, and particularly the National Institute of Economic and Social Research. For the Godley memorandum to the sub-committee had opened with the bold statement that

> the record of demand management during the last twenty years has been extremely poor.

Since the neo-Keynesians had been in the driving seat – or at least doing the back-seat driving – throughout that period, this was a challenge they could hardly take lying down. Nor did they.

Mr Worswick, the Director of the National Institute, explained in effect that the fault was 'in ourselves, that we are underlings'.

To be precise he used the analogy of the car driven by an L driver, with his instructor next to him. The car was seen to veer from one side of the road to the other. This might indicate that the instructor was at fault; it *also* might indicate either that there was something wrong with the car, or

> that the instructor is giving proper recommendations, but the driver, who has excellent sight, allows himself to be distracted by pretty voters whom he sees now on this side, and now on that.

Somehow there did not seem to be much doubt which hypothesis Mr Worswick put his money on.

The defence of Lord Kahn and Mr Posner was more original. Yes, it was possible, they acknowledged, that demand management had left something to be desired. But this was not because there had been too much of it. On the contrary, it was because there had been too little.

> We believe that it should be possible under Act of Parliament to introduce an 'Autumn Budget' at any time of the year. To avoid forestalling, it should be possible to introduce it on any day without previous notice and to get the necessary Bill or Orders passed by both Houses on that day. The 'regulator' could be made more flexible and wider, but, even then, it would not always fit the bill.

(Where they got the idea that there is anything to prevent the Government introducing an 'Autumn Budget' once a week if it were so minded is not immediately apparent. No doubt after Denis Healey's four Budgets in 12 months during 1974-75 they know better.)

Lord Kahn went one stage further. He suggested that a geographical dimension should be added to the Treasury's 'fine-tuning' fork. This would be done by allocating Government contracts to firms according to their location, ie, in or out of a development area. Could ingenuity go further?

This left the only witness from the monetarist school, Professor Laidler. Since it is basic to the monetarist case that fiscal manipulation of the economy is of minor importance by comparison with the impact of monetary flows, it is not perhaps surprising that he should have ignored the 'new Cambridge' testimony in his memorandum to the sub-committee altogether. Yet at two points the evidence of Messrs. Godley and Laidler tended to converge, and to depart from that given by the other witnesses. Since the monetarists attach over-riding importance to the impact of the borrowing requirement, and since in practice the 'new Cambridge' school's 'par tax rate' (the automatic pilot) relates to the size of the borrowing requirement, there was an obvious linkage here. Furthermore 'new Cambridge' and the monetarists are at one in doubting the wisdom of attempts to 'fine-tune' the economy – although, as we shall see, for markedly different reasons.

CHAPTER 3 The Impact of the Increase in Oil Prices

It has been necessary to describe the somewhat arid debate about the practicality of using a 'par tax rate' as an automatic regulator of the economy because this was the starting-point for the sub-committee's investigation of witnesses. However once the witnesses were called in before the sub-committee, the line of questioning rapidly branched off on to other matters. First among them – not least because this was a practical question posed by Wynne Godley in his written submissions to the sub-committee – was the likely impact on the UK economy of the sudden dramatic increase in oil prices in the latter months of 1973 and in 1974.

As explained above, Mr Godley's contention was that the increase in oil prices was *deflationary* in the same manner and to the same extent that a corresponding increase in domestic taxation of petrol would be deflationary: the fact that the revenue accrued to oil sheikhs rather than to HM Government was neither here nor there. Unless action were taken to correct the domestic balance either by cutting taxes or by increasing state spending, home demand would be drastically curtailed, and a slump would ensue.

For the National Institute, Mr Worswick was somewhat less pessimistic. Whereas Wynne Godley expected the whole additional cost of oil to be reflected (other things being equal) in a cut in domestic demand, Mr Worswick suggested that the wealthy would be likely to maintain unchanged that part of domestic demand for which they were responsible, because they would dip into their savings to pay the higher petrol bills. In addition, however, he demonstrated the sophistication of neo-Keynesian economics by insisting that the increase in oil prices was both *inflationary* and *deflationary* at the same time. It was deflationary because it reduced the purchasing power of the existing wage packet: it was inflationary because the worker would demand, and the employer concede, higher wages to make the

wage packet's value good again.

Lord Kahn and Mr Posner took a more unequivocal view. The increase in oil prices was *inflationary*, and – as Dr Johnson would have said – 'there's an end on't'. Oh yes, they acknowledged, it was possible to devise a dream-world where, because people got no more money to pay for the extra cost of petrol, they had less to spend on it or on other things. Then, because British Leyland found people could not afford to buy its cars, they were obliged to cut the price of those cars. But that had nothing to do with the real world. In the real world all that happened was that it cost British Leyland more to produce fewer cars, so they put up the prices of their cars too. An increase in the price of one commodity meant an increase in the price of all commodities.

Professor Laidler took almost precisely the opposite view. First, the increase in oil prices meant that we were all worse off, and this was something we could not avoid more than temporarily by trying to obtain higher money wages for ourselves. And second –

> the falling exchange rate and balance of payments deficit which we have experienced since 1972 are *prima facie* evidence that the inflation we have suffered over the last two years has been domestically generated and, if anything, *has been mitigated rather than accentuated by events in the world economy.*
>
> *[Author's italics]*

This is because through operating a 'dirty float' we have been able to some extent to export our domestic inflation.

To round off this part of the story it should perhaps be added that both the official witnesses – the Treasury and the Bank – although particularly cautious in their response to the sub-committee's prodding, did seem to come down on the side of the National Institute in regarding the oil price increase as *inflationary* and *deflationary* at the same time. But it was perhaps revealing of the deeper instincts of Threadneedle Street that Christopher Dow, the senior-ranking witness from the Bank, told the sub-committee that

> the rise in the price of commodities obviously increases the cost of imports, increases the cost of living and *increases earnings.*
>
> *[Author's italics]*

Whose earnings were increased by an increase in commodity prices was not explained.

CHAPTER 4 The Impact of the Borrowing Requirement

It may have been noticed that so far there has been almost no reference to domestically-generated inflation. This is not coincidental. For one of the more striking characteristics of the evidence submitted to the sub-committee in the summer of 1974 was the extent to which the attitude of witnesses towards inflation recalled that of Baldwin to unemployment: they thought about it night and day. But somehow other things seemed more exciting.

Thus Wynne Godley acknowledged that none of the papers setting out the 'new Cambridge' propositions 'deals extensively with inflation as such', although this was admittedly 'the most serious problem facing the country'. And Mr Worswick cheerfully asked the sub-committee to consider the reasons for

> the much better performance of capitalist or mixed-enterprise economies in the post-war period against the pre-war... Their levels of resource use and the growth of output are better than in pre-war years. They have also been more stable: the scale of fluctuations is less and their durations tend to be shorter...

When asked whether this list of criteria by which the performance of advanced economies could be deemed so far superior to that we had known in the past was comprehensive, Mr Worswick made haste to agree that

> the rates of inflation – our monetary measure of real things – have been more rapid than previously. I am personally very concerned at present about it. Some people are not. They say: look at the real things. There the performance is very much better than pre-war.

However, the title of the sub-committee's inquiry invited the witnesses to spare a passing thought for 'unreal' things, and this they were prepared to do. Essentially the investigation into the causes and treatment of domestic inflation concentrated on two questions: the relationship, if any, between public expenditure and inflation; and the desirability or otherwise of

legislative control of prices and incomes. In between came a grey area: the significance of the manner in which public expenditure was financed.

Mr Godley launched the discussion with a fairly categoric statement:

> There is likely, *under normal circumstances*, to be no more than a tenuous relationship between public expenditure and price inflation, so long as the level of taxation is adequate to contain the overall pressure of demand.

Most of the committee's other witnesses agreed that the actual *level* of state spending was irrelevant to domestic inflation. Mr Worswick produced scatter-diagrams which, he argued, showed that from international experience there was no correlation between a high level of domestic taxation and a high level of domestic inflation: and since – according to the same witness – levels of taxation and of public expenditure moved in parallel, it followed that there was no connection between state spending and inflation either. Professor Laidler took the same view: he saw no necessary link in economics between high public spending and high taxation, although in practice politicians did find it more agreeable to spend money than to raise it, and hence 'high levels of Government expenditure tend to be associated with deficits which need financing . . .' The Treasury, once again, firmly endorsed the National Institute's conclusion.

But if the level of public spending was irrelevant, the rate of change in that level might not be. All the witnesses except Professor Laidler, who was exclusively concerned with the method of financing the Government's deficit, and the Bank which, unfortunately, was not questioned about this and did not express a view, agreed that sudden shifts in state spending were liable to be inflationary. This was because too little was left for private consumption: and that, in turn, meant that it became that much more difficult to operate a prices-and-incomes policy – something to which, as we shall see, the majority of the witnesses attached over-riding importance.

Deficit Financing

When it came to the *way* in which the Government financed its deficit, agreement very rapidly disappeared. To Laidler this was all-important, whereas to Lord Kahn and Posner it was very nearly irrelevant. Lord Kahn in particular deplored the fact that the Government had ever become committed to the presentation of a borrowing requirement in the first place. It was absurd to lump together productive investment in the nationalized industries and transfer payments: instead of highlighting, as he had done in his first Budget statement in March 1974, the daunting size of the borrowing requirement, Denis Healey should have taken proper credit for the fact that he was planning a current account surplus of almost £ 3,000m. (This is a viewpoint with which Denis Healey's Conservative predecessor very much agreed. Chancellor Lord Barber often complained about the excessive interest shown in the size of the borrowing requirement.)

As for the inflationary impact of this tiresome and basically irrelevant statistic, it could theoretically be a worry if an increase in the credit base of the banks resulted because Governments were reluctant to allow interest rates to rise to the extent needed to enable them to sell sufficient gilts to the non-bank public. But

> 'there is a large variety of measures which can nowadays be applied to restrain the banks' power to increase their advances by more than is regarded as desirable'

and Lord Kahn and Mr Posner were very stern indeed about those who used emotive phrases like 'recourse to the printing press'.

Mr Godley, as already explained, considered that the impact of an increase in the borrowing requirement was going to be felt essentially on the balance of payments – which was why, in the circumstances of mid-1974, 'big was beautiful'; paradoxically, though, to expand the borrowing requirement by increasing Government spending would dangerously complicate the task of operating an incomes policy. So the right thing to do was to cut taxes, and leave it to the Arabs to pick up the tabs for the adventures of Mr Wedgwood Benn *et al.*

The National Institute evidently attached more importance to the borrowing requirement than did its fellow neo-Keynesians from Cambridge; and it was particularly concerned with the way it was financed. It was no good raising the cash by borrowing, even from the non-bank public, because those who bought gilt-edged stock simply sold some other assets to do so: their propensity to spend was unaffected. Furthermore it was dangerous to try to turn the trick by increasing indirect taxation. The pragmatic unions were likely to hit back with higher wage

Quarter		Unemployment Rate	Average Earnings	M3
1968	1st	2.4	7.6	9.3
	2nd	2.5	7.9	9.9
	3rd	2.4	7.7	8.3
	4th	2.4	7.5	8.1
1969	1st	2.4	7.3	8.0
	2nd	2.4	8.0	3.6
	3rd	2.4	7.7	3.1
	4th	2.5	8.2	3.1
1970	1st	2.5	10.2	2.1
	2nd	2.5	11.6	7.0
	3rd	2.6	12.9	8.5
	4th	2.6	13.6	9.4
1971	1st	2.9	13.8	12.2
	2nd	3.3	11.6	10.3
	3rd	3.6	11.2	10.4
	4th	3.8	9.6	11.9
1972	1st	4.0	10.2	15.1
	2nd	3.8	11.4	21.2
	3rd	3.7	12.2	23.4
	4th	3.4	15.8	25.6

NOTES: These figures excluding school-leavers and adult students: Average earnings refers to all employees in GB (*i.e.* excluding N. Ireland. M3 – Currency and coin, bank deposits whether current or deposit account, certificates of deposit in the credit of UK residents.

demands. The thing to do was to raise *direct* taxation.

But might not the unions try to recoup increases in their PAYE payments as well? The response to that inquiry was magisterial – Mr Worswick told the sub-committee that he had spent most of his life in the academic world.

> I cannot remember any occasion when the University Grants Committee has approved a rise in the pay of university teachers on the grounds that income tax had risen and they ought to be compensated

Of such is the conventional wisdom. Needless to say the Treasury concurred.

The Bank, however, did not. Or more precisely, it dissented firmly from the neo-Keynesian attitude towards the manner of financing the deficit described by Kahn and Posner. Mr Christopher Dow, who played a classic straight bat to most of the sub-committee's questions, came out of his crease when asked about the Kahn-Posner view that there was no need to worry about the sales of gilts to the banks because it was simply a question of clapping on controls:

> I imagine that something like what you are suggesting might apply in Russia, where the financing of the budget deficit I presume does not cause any great concern to anybody.

CHAPTER 5 # Prices and Incomes Control

It is time to turn to what, in the opinion of most of the sub-committee's witnesses, was the key to national survival: the statutory control of wages and prices. Wynne Godley was dubious about the practicability of a long-run prices and incomes policy, conceding that it was subject to the law of diminishing returns. What was needed, therefore, was rather a temporary expedient designed to change inflationary expectations. The Bank of England was reluctant to express a view, confining itself to the proposition that 'a complete incomes policy was difficult enough without adding the extra dimension' of comprehensive credit controls *a la* Kahn and Posner. As for the Treasury, the then Economic Adviser, Sir Kenneth Berrill, who led the Treasury team, was discreet when asked about the Treasury view of the need for control of wages and prices:

> I do not think that I am able to answer that because the present view of the Government, and, therefore, of the Treasury, is that a voluntary incomes policy will work.

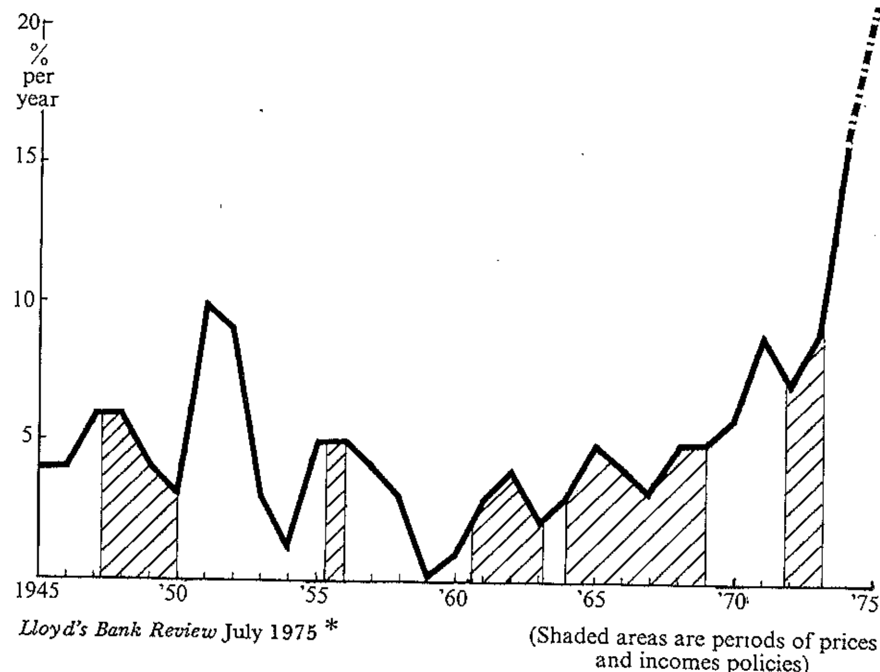
Yet the rest of the Treasury's evidence was sufficiently dissociated from such pious wishful thinking. Maybe even Sir Kenneth's discretion in response to the direct question was not enough to satisfy his masters: within weeks he had been moved to less sensitive spheres at the Central Policy Review Staff (the 'Think Tank').

One witness, and one witness alone, Professor Laidler, dismissed prices and incomes regulation as irrelevent to the control of inflation, and on balance positively harmful.

High Priests of Wage Control

It was, however, in the evidence of Mr. Worswick, Lord Kahn, and Mr Posner that the full panoply of price and wage control was arrayed. All three agreed that, in the words of Mr Worswick: 'If we do not like inflation, we must have what is called a 'prices and incomes policy'.' To which Mr Posner added that he would

Chart 1 UK Inflation Rate *



Lloyd's Bank Review July 1975 *

(Shaded areas are periods of prices and incomes policies)

'envisage relatively new institutions' for the purpose.

The sub-committee was unkind enough to ask for evidence that 'what is called a 'prices and incomes policy'' had ever worked, anywhere. It received some very interesting answers. Lord Kahn was positive that it had worked, in Holland, until 'the Liberal Party, which represented the big industrialists' got into the woodwork in the late 1960s, and the policy collapsed:

> In fact it was really in the Netherlands in the second half of the 60s that the infection of wage inflation started and spread to most of the main industrial countries.

It seems the good burghers of Amsterdam have much to answer for.

What about the United Kingdom then? Well, in Mr Posner's words,

> the number of one percentage point a year was bandied around as the possible attenuation of the rate of inflation

during the period of the Aubrey Jones Prices and Incomes Board. Hardly, perhaps, a very convincing justification for embarking on 'relatively new institutions' of a permanent nature, even if the figure 'bandied around' had any validity. At which point the incomes policy enthusiasts retreated rapidly to the preferred position of those who attribute mystic virtues to government interventionism. The sub-committee was quickly told that asking how effective previous attempts at incomes policy had been was the wrong question. It should have been asking what would have happened if there had *not* been statutory control. Messrs. Kahn, Posner and Worswick had no doubts about the answer to that question: the great virtue of hypothetical questions related to the past being that nobody can possibly prove the answer wrong.

The trouble with our past attempts at prices and incomes control, however, was that we had always been terribly unlucky. Mr. Posner was engagingly frank:

> I think the fates have been against us and that chaps — with no offence to Lord Kahn — like myself and him have cried wolf a bit too early.

The time when we ought to have had an incomes policy to display its full beauty was the time we did not have one: from 1969 to 1972.

What Happened in 1971?

This was a most delicate matter, because the sub-committee directed a good deal of attention to this particular period. The irreverent suggestion was advanced that here was a period when the rate of domestic inflation had shown signs of contraction: indeed the only period in recent years when domestic inflation *had* shown signs of contraction. Great sensitivity was shown all round about this. For this happened to be the last occasion (the moment of the sub-committee's investigation was another, but it was obviously too soon to draw conclusions from that) when there had been a sharp contraction in the rate of growth in the money supply.

In the financial year 1969-70 the growth of the money supply had dropped from around 9 per cent in 1967-68 and 7 per cent in 1968-69 (largely in excess of the prevailing rate of inflation) to little over 2 per cent; and the Government had produced a budgetary surplus. Broadly speaking the monetarists would argue that this would lead to a contraction in the rate of inflation after an interval of around 18 months. If this was indeed what happened then not only would it suggest that prices and incomes control, far from being the cure for inflation, was positively to be avoided if inflation was to be curbed; it would also suggest that both the Treasury and the Bank of England, who showed a measured disdain for monetary policy, had egg on their faces. So there was a lot at stake: and it is instructive that the Treasury and the Bank were, if possible, even more vehement in their rejection of the apparent significance of the course of events in 1970-72 than were the neo-Keynesians.

The first question was whether there was indeed a slowing-down in the rate of inflation towards the end of this period — ie, between the summer of 1971 and the summer of 1972. Very reluctantly the neo-Keynesians agreed eventually that there was, and that it did have 'something to do' with the rising level of unemployment that preceded it. It was a painful admission, for Lord Kahn and Mr Posner were very insistent that

> if unemployment is within the range of what we today regard as politically feasible then there may be a perverse relationship between unemployment and the behaviour of money wages . . . if unemployment is fairly high, but not completely unacceptable, this causes resentment and militancy, and results sometimes in bigger pressure for high wages

Nevertheless the admission was made (although Lord Kahn and Mr Posner did their best to retract it with a footnote suggesting that 'the history of wages in 1971 and 1972 requires closer examination').

The Treasury was more robust. They had no doubt that the downturn in inflation towards the end of the last period of 'free collective bargaining' — which they also conceded — was due to extraneous factors

> import prices were in our favour during that period. Nationalized industry prices were reduced during that period, and so on.

As for the slowing-down in unit labour costs, this was, in the words of the Treasury's Miss Brown, 'partly the N minus one incomes policy, the leaning'. In short if the existence of an incomes policy fails to produce results, then the important thing is to think about what might have happened without it; while if the non-existence of an incomes policy produces results, then the right answer is to assume that an incomes policy was really in operation after all. Catch-22, in fact.

The evidence of the Bank of England concerning this historical cycle was, if anything, even more instructive. Messrs. Dow and Goodhart were careful to avoid the trap of explaining what *had* happened in 1969-72: their purpose was to destroy the monetary thesis. Mr Goodhart informed the sub-committee that he personally had 'always used 1969-70 as a fairly clear argument against' the monetarist case.

> In 1969-70 we, indeed, did have a considerable reduction in the rate of growth of domestic credit and money supply. What then happened was a very sharp increase indeed in the rate of increase of wages, in particular the fourth quarter of 1969 continuing into the winter of 1970. The rate of increase in prices was expanding through the early 1970 period. If the movements in money stock are meant to have a clear and direct effect through on to price changes, you then have in this particular period a good example of no relationship or even the reverse kind of relationship.

The monetarists have always insisted that there is a time-lag between cause and effect. Mr Goodhart gave that short shrift

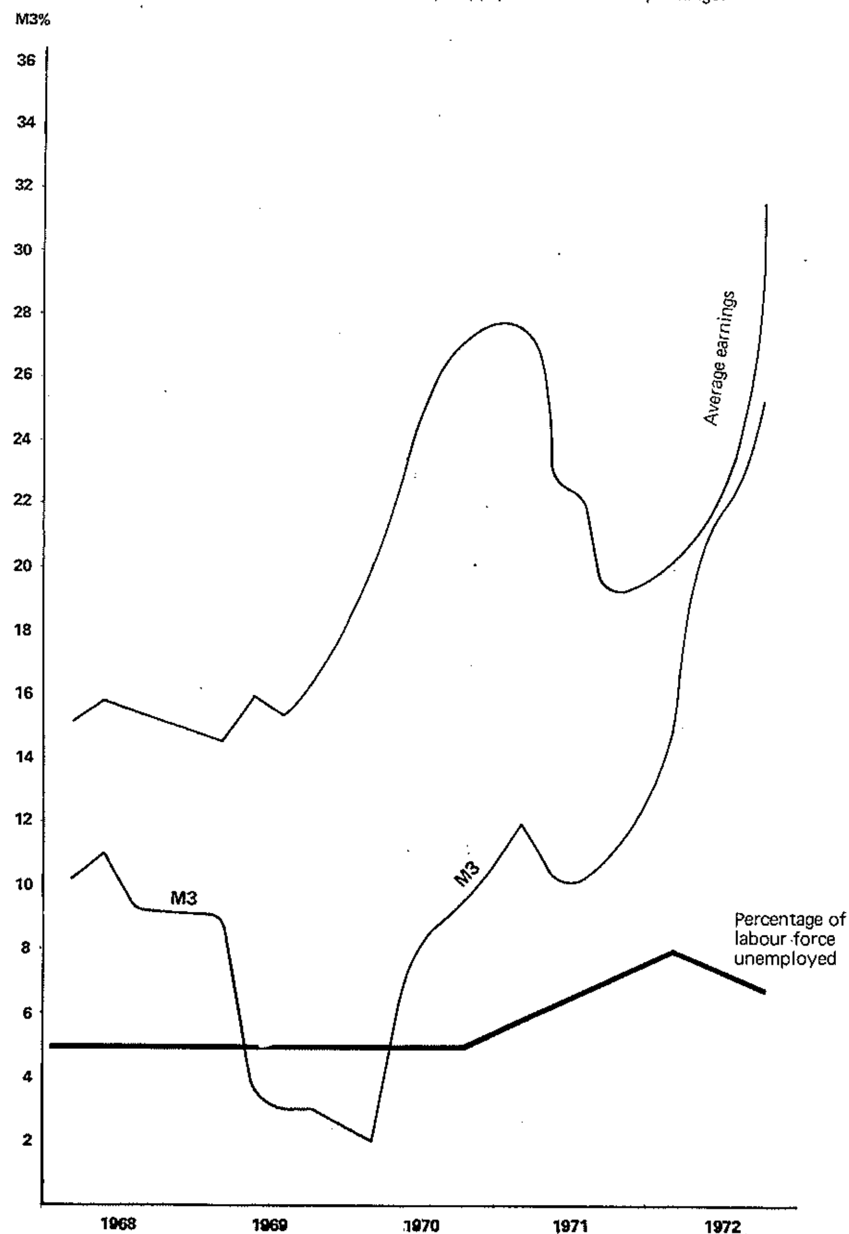
> If you take long and variable time lags, you can get relationships between any two economic series you would like to choose.

But had not certain eminent commentators of a monetarist colouration – Samuel Brittan in the *Financial Times*, for example – predicted *before* they happened more or less precisely the course of events which ensued in 1970-72 (accelerating inflation for about another year, accompanied by rising unemployment, followed by falling inflation from the summer of 1971 onwards) basing themselves on the significance of monetary phenomena? The answer sidestepped the question: according to Charles Goodhart

> I am not saying at all that monetary policy has no effect. I am saying that it does not have any very clearly predictable effect within a short period.

If it were not so obviously disrespectful one would be tempted to speculate that the Old Lady of Threadneedle Street, having had a romp in the hay, would dismiss all that scientific nonsense about the relationship between coition and parturition by pointing out, the morning after, that she had not had a baby. As to suggestions that she might have one in nine months' time, that was the sort of idle speculation one would expect from the medical profession.

Chart 2 Unemployment, Earnings and the Money Supply 1968–72 Yearly Changes



CHAPTER 6 The Mystique of 'Fine Tuning'

It has already been explained that the 'new Cambridge' school and the monetarists, from totally different premises, both arrived at the conclusion that attempts at 'fine-tuning' the economy had been counter-productive. Consequently the sub-committee devoted a certain amount of attention to the way in which the Treasury conducted its short-term demand management exercises: and it was fortunate to have before it a veritable orchestra of 'fine-tuning' experts. In their written evidence they explained that

> the primary objective of the Treasury's short-term forecasting system for the domestic economy as it developed was to forecast the outlook for employment and unemployment . . . In parallel, forecasts were made for the balance of payments, traditionally for both the current and long-term capital account . . . Over the years the possibility of improving the system in order to . . . elaborate the financial and monetary aspects of the forecasts has been made more feasible by the availability of computers . . .

This seemed to correspond closely with the observed practice of the Treasury at work over the years, playing off its departmental responsibility for the balance of payments against the ambition of its political masters to get themselves re-elected by the satisfaction of rising expectations. As for the rate of domestic inflation, this was what you were left with when you had taken care of what Mr Worswick would call 'the real things'.

Needless to say, the Treasury witnesses reacted sharply to any such suggestion. Forecasting became an activity

> to give substance to active demand management policies by the Government. It was the application of Keynesian ideas of regulating the level of employment . . .

However, 'almost the first paragraph of any short-term report in this situation starts with the inflationary prospects'.

Unfortunately, though, the Treasury strongly shared the view expressed by Lord Kahn and Mr Posner that fluctuations in the level of demand would not affect the rate of growth of prices 'over quite a large band'.

> Starting at the top end, when you reduce unemployment you can begin to see shortages of skilled labour, bottlenecks and so on developing which affect the balance of payments and also earnings and prices. Then there is a large flat band. What happens at the heavy levels of unemployment we do not know because we have not had that since the 1930s.

To assess how 'active demand management policies' are supposed to operate in practice the sub-committee turned once again to the period 1971-72 and received some thought-provoking answers. Given the scale of idle resources which had become apparent by the summer of 1971, it was told

> an injection of purchasing power could be fairly rapidly spent and could generate a fairly substantial and desired increase in the level of domestic activity.

So from the end of July 1971 onwards the Government began to embark on a cascade of extra spending programmes in the public sector; by November of that year, indeed, the *Financial Times* carried a report of the Treasury reversing its usual role and doing the rounds of Whitehall pleading with the various departments to step up spending.

Sure enough, by March 1972 unemployment had peaked and begun to fall. The monetarists would attribute this to the impact of the rapid relaxation of monetary stringency which started virtually as soon as the Conservatives took office in June 1970. Not so the Treasury. Its view was that the massive increases in public expenditure on which the Government embarked in the autumn of 1971 were intended to lead to an early turn-around in unemployment, and the Treasury saw

> no reason to suppose that it *[the sharp increase in state spending of the previous autumn]* was not a major contributing factor to the down-turn of unemployment in 1972.

The possibility of time-lags between the launching of public works programmes and their execution simply did not enter into Treasury thinking. When even such an enthusiastic demand manager as Mr Posner acknowledged in passing that he had 'been around and knew the stories: for example that work is being done in St. James' Park at the moment and it is because there was a recession in 1971/72 which one is trying to put right by increased public expenditure', he got a sharp rap over the knuckles from the Treasury. There was 'no truth whatsoever' in this particular story. That was the sort of malicious gossip which no 'fine-tuner' with a sense of mission could be expected to tolerate.

How Deep the Waves?

Yet the Treasury witnesses were themselves constrained to admit that, somehow or another, when the books were closed, the course of public expenditure was usually found to have proceeded pretty well on its own way largely uninfluenced by 'reflationary packages' and 'massive expenditure cuts'. Naturally they did not quite put it that way: the most they were prepared to concede was that 'the waves are not so deep'. But once again, as with incomes policy, the right question was not whether there was stastical evidence of promised increases or retrenchments materializing, but whether, if it had not been for the boosts and cuts, state spending would have gone much further out of line than it did.

One comment seems in order at this point. As already explained, the monetarists and the 'new Cambridge' school are superficially at one in doubting the wisdom of 'fine-tuning': but from fundamentally different angles. To the monetarists it is essentially ineffective anyway, because it is based on a disregard of the long-run monetary impacts, which are much more important than the 'fiscal' adjustments – by which are meant increases and reduction in public spending as well as increases and reductions in tax rates. But to the 'new Cambridge' schoolmen it is effective, all right, but in a 'de-stabilizing' direction. Now if the Treasury's own evidence on the absence of 'deep waves' is to be believed – and it was all the more convincing for being reluctantly given – it would seem that the monetarists have a point. Yet while the Treasury witnesses were no more than agnostic to the 'new Cambridge' thesis, they evidently had no patience at all with the monetarist argument.

It also transpired that the Treasury had another small worry about the 1971-72 experience which is worthy of note. As has been noted, the Treasury witnesses, good neo-Keynesians to a man – and woman – fully subscribed to the notion that, short of a real old 1930s-style slump the only effect of curbing domestic demand was a loss of productivity and an increase in union militancy. Yet the Treasury witnesses were obliged to agree that in 1972, when output was slack and unemployment very high by previous post-war experience, productivity improved quite sharply. Their answer was that the economy must have been misbehaving: 'We would regard that as unusual and not the type of reaction we normally expect.'

CHAPTER 7 A Choice of Crystal Balls

The monetarist and 'new Cambridge' witnesses to the sub-committee had one last matter in common; both of them offered their own short-term forecasts for the evolution of the British economy from the basis of the official policies pursued prior to the sub-committee's inquiry. Once again they arrived at markedly similar prognoses from markedly dissimilar premises. It is instructive, with the benefit of 12 months' hindsight, to see how they have fared.

In his written evidence, Wynne Godley told the sub-committee that the failure of Denis Healey, in his first Budget, to offset the large deterioration in the payments balance resulting from the increase in oil prices with a corresponding enlargement of the borrowing requirement and his decision to implement a 'moderately contractionary' package instead, coming on top of his predecessor's imposition of hire purchase controls and cuts in public spending, was likely to mean that

> the pressure of demand now starts to ease, and the balance of payments to improve. The strategy adopted is, on balance, probably more favourable to the control of inflation in the medium term than the slow adjustment strategy so long as it is properly carried through, although at the end of 1974 wages and prices, because of threshold arrangements, may well be three per cent or more above what they would otherwise have been . . .

In oral evidence he was less guardedly pessimistic:

> A very substantial amount of demand deflation is in the pipeline and a very substantial recession in demand will emerge between now and this time next year unless the Government changes its policy rather rapidly.

Professor Laidler was both more specific and more apocalyptic. In his written evidence he estimated that:

> unemployment should begin to increase by the end of this year and the end of 1975 should see a major unemployment problem. The inflation

> rate should, on past form, continue to accelerate for about another year before beginning to fall off.

In oral evidence he forecast that 'the rate of inflation will be over 20 per cent' by the summer of 1975; and he could not believe that 1975 'would not see more unemployment than we saw at the time of the last drop' in the rate of growth of the money supply. These forecasts were specifically based on what Professor Laidler regarded as a 'sudden collapse' in the monetary expansion in the early months of 1974.

The sub-committee did not invite the Treasury or the Bank to produce their current forecasts, interesting though these would have been, for the obvious reason that they would not have been forthcoming even if requested. However the Treasury witnesses, sceptical though they were about the significance of monetary factors, did go out of their way to cast doubt on the validity of Professor Laidler's evidence. They argued that

> during the final months of 1973 we know that there were certain factors inflating money . . . quite a lot of the slackening in the demand for money which we have seen in the first half of this year has been an unwinding of that situation.

So while there had been 'some slowing down' it had not been as marked as the crude figures seemed to imply.

How the Forecasts have Performed

So how do things look now? Both forecasts have come out reasonably well in that both predicted recession coupled with rising inflation. Indeed Professor Laidler's forecast has so far proved almost uncannily accurate, although at the moment of writing it was still too early to be sure that inflation had indeed peaked out around midsummer 1975. But it is worth noting that while Mr Godley's predictions have stood up quite well, the factors on which they were based have turned out very far wide of the mark. For instead of the contraction in the borrowing requirement which alarmed Mr Godley so much, 1974, as we now know, witnessed an enormous expansion – far greater indeed than was needed to offset the impact of the higher oil price, according to the 'new Cambridge' school. And it is also noteworthy that Wynne Godley's predictions for the balance of payments have turned out pretty perversely. He forecast a

marked improvement in the external deficit, and that has duly materialized; but this was expected to happen because the Government had opted for a sharp contraction in the borrowing requirement, whereas in the event it has occurred notwithstanding its vast distention.

The evidence to date suggests that the 'new Cambridge' school's thinking has had a significant impact on Government policy, helping to stifle the Chancellor's evident personal distaste for massive deficit financing. At the moment of going to press there appeared to be a lingering risk that it might also persuade the Government, with the help of the Economic Committee of the TUC, to fall for 'unconventional trade policies' should the monthly trade deficits worsen.

As for the monetarists, their evidence appears to have been studiously ignored. The fact that Professor Laidler's forecast has so far been just about spot on leaves the Treasury and the Bank of England cold because, once again as in 1970, we have been experiencing rising inflation and rising unemployment at the same time; for reasons best known to themselves the inhabitants of Great George Street and Threadneedle Street have always said that this proves the monetarists must be wrong.

CHAPTER 8 **The Verdict of the Masters**

Like all right-thinking persons nowadays the members of the sub-committee were careful, before completing their inquiries, to submit transcripts of the evidence received to the CBI and the TUC, with a request for the benefit of their advice.

The TUC's answer was short and to the point. Mr Len Murray told the sub-committee that there had been a deal of careless talk about pay policy and collective bargaining.

> This is not an area where the committee, or the witnesses called, can be expected to speak with the type of authority that can only come from experience in the field of collective bargaining, and superficial comments in this field will detract from the report as a whole.

The CBI's answer, compiled by its Economic Director, Mr D.R. Glynne, was somewhat lengthier and engagingly muddled. The Confederation wanted to see economics in public expenditure in order, among other things, 'to increase the proportion of the economy in which decisions are based on 'market' rather than 'administrative' criteria'.

So presumably it would prefer the monetarist cure for inflation, which harnesses 'market' criteria, to the neo-Keynesian cure, which vastly extends the application of 'administrative criteria'?

Well, actually not. The Economic Director found himself 'in general agreement with Professor Kahn and Mr Posner . . . rather than with those who lay most stress on monetary factors.'

But then when philosophies are left behind and they descend to practicalities, somehow or other the TUC usually does seem to display a more robust faith in the market than the CBI.

CHAPTER 9 **Conclusions**

Most of the witnesses heard by the sub-committee in the summer of 1974 must be well satisfied with the education of Ministers under their tutelage since then. However reluctantly, Government has been driven to accept that inflation can only be controlled by legislation, and the Chancellor of the Exchequer, formerly one of the most outspoken sceptics, has talked of the permanency of incomes control in terms which must have brought a rosy glow to the cheeks of his Deputy Chief Economic Adviser, Mr Michael Posner.

The legend that at some stage in recent British economic history prices and incomes policy succeeded in reducing the rate of inflation is eagerly propagated, even if the evangelists tend to disagree which period to take. On the whole the fashionable view today is that the 1966-67 operation was the more successful because there was accompanying slack in the economy; whereas in the autumn of 1972 the Conservative attempt at statutory controls was said to be going to succeed precisely because the economy was moving into top gear. But then since the economy is plainly not moving up today it is presumably regarded as more persuasive to look back nostalgically to the last Labour attempt.

As regards the 1972 attempt, the conventional view is that this was doing very nicely until the sheikhs cut loose with the price of their oil. If challenged with the point that the West German economy, although markedly more dependent on imported oil than ours is, somehow experienced a far lower rate of inflation and brought it swiftly under control, the neo-Keynesians point to the impact of floating rates on import prices. And, in the words of Mr Worswick, to blame the freeing of the exchange rate on the incomes policy introduced in 1972 'would be, in a certain sense, perverse.' In fact, it would be nothing of the kind: when Chancellor Barber floated the pound he specifically attributed his decision to the desire to persevere with '5 per cent growth' – which in turn was supposed to be the

precondition for success of the incomes policy.

By contrast, evidence that the last real slackening in the rate of domestic inflation came at the end of the last period *without* wage and price controls brings the pillars of the conventional wisdom out in ugly red spots. It can't be true, they shout: and if it is true then it was all due to the weather.

Why the Lessons of Experience are Ignored

To what, then, are we to attribute this passionate defiance of the lessons of past experience? The attitude of the neo-Keynesians has at least an inner consistency. Their standpoint is essentially collectivist. (It is true that Lord Kahn was very fierce about the need to curtail state expenditure on consumption, but this was only in order to make room for more state expenditure on investment.) What matters to the neo-Keynesians is the inherent stability which, they imagine, is imparted to an advanced industrial economy by a dominant public sector. And since the dominance of the public sector means, in the words of the CBI, that more and more of the economy is subect to 'administrative' rather than 'market' criteria, it is only logical to believe that the same criteria should increasingly apply to the determination of wages as well.

Yet these same neo-Keynesians would be the first to shy away from the inescapable consequence of their own logic. It is not only the financing of the budget deficit which creates no problems in Russia, as Mr Dow of the Bank of England pointed out: the same could be said of wage control – at any rate until there is a riot. But then the Russians have no need to worry with Prices and Incomes Boards, with Aubrey Joneses and Lord Wilberforces and Sir Frank Figgureses. They have something far more effective: tanks.

The attitude of the CBI, at least superficially, is more difficult to explain. Here perhaps one should see the influence of what Galbraith calls 'the mature corporations': those companies which look to Government to maintain a continuous expansion of domestic demand so that they can grow for the sake of growing. It was, after all, the CBI which set the last Conservative Government on the path which led to prices and incomes control. Nor is it unduly cynical to reflect on the attractive opportunities for public exposure offered to the 'spokesmen for industry' by

the traditional tripartite haggles which accompany the introduction of prices and incomes controls. Reliance on restraint in monetary and public expenditure policies to curb inflation offers none of those agreeable opportunities for television interviews on the steps of No 10.

The Treasury, too, has a plausible excuse for its current obsession with 'fine-tuning'. Back in the 1950s virtually all the commentators agreed that the three Tory election victories in a row were attributable to the party leaders' skill in picking what came to be known as 'the window in space' to go to the country. This was the moment at which inflation had boosted earnings and not yet hit prices. The combination of sophisticated Keynesian demand management with the Prime Minister's prerogative of election timing could give to Governments the secret of perpetual life. The fact that it did no such thing did not destroy the myth. Hence the growing penchant for regulators and mini-Budgets which gathered momentum throughout the 1960s as the performance of the economy visibly deteriorated. This was what the political masters wanted for their electoral purposes: and this was what the Treasury mandarins made haste to offer them. It was all grist to bureaucratic empire-building.

The objection to the monetarist approach is the fact that it discounts the very possibility of 'fine-tuning'. Thus when Professor Laidler, having expressed deep gloom about the implications of the drastic contraction in the growth of the money supply in the spring of 1974, was asked what should be done about it, he replied that an effort should be made to get the rate of growth back up again. But he was evidently not sanguine about the practicality of achieving this, and admitted that it was, by the summer of 1974, almost certainly too late to avert a slump in 1975.

The Treasury's answer would no doubt be that this is not a line worth trying to sell to the politicians, who will never accept that they may be powerless to avert a slump which is still a year to 18 months away. Yet if there were validity to the monetarist case then surely the permanent Treasury bureaucracy would have some obligation to forewarn their political masters of the limitations on their ability to command the waves, instead of eternally assuring them that there is a bigger and better wave-repellent on

the stocks. Maybe the monetarists should dream up a panoply of M_1 and M_3 Control Boards, providing well-paid employment for former Treasury knights. For at present that is one area where the prices and incomes school has a pronounced edge.

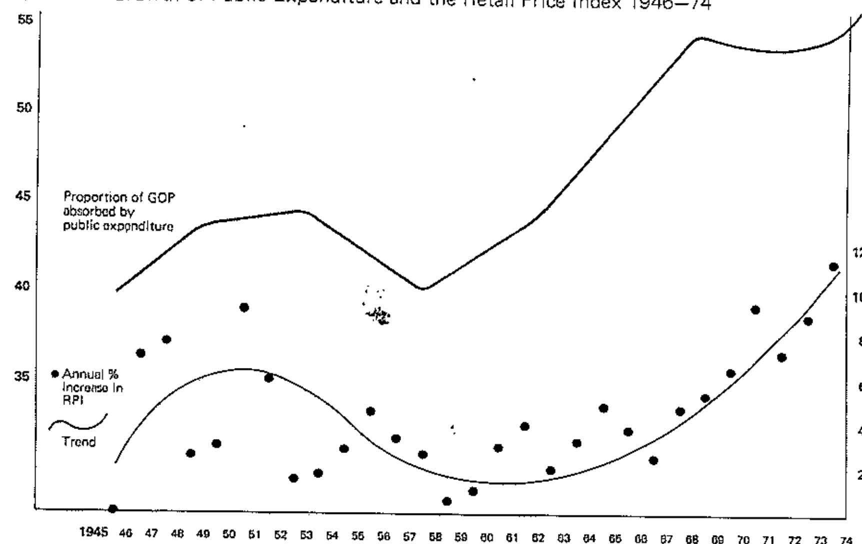
The Bank of England, unlike the Treasury, is under little temptation to tell Ministers what they want to hear: on the contrary it is under the strongest temptation – to which it regularly succumbs – to demonstrate its vestigial independence by telling them what they do *not* want to hear. This usually takes the form of telling them they are spending too much. Yet the Bank's witnesses to the sub-committees were – if that were possible – almost more dismissive of monetary cures for inflation than those from the Treasury.

In this case the explanation surely has everything to do with the division of responsibilities between Treasury and Bank. The Bank is responsible for the orderly marketing of Government debt: but it has no say in deciding how much of that debt it is going to have to market. If the Government embarks on a massive spending spree while the Bank is supposed to be helping to restrain the growth of the money supply, it is liable to find itself with a very disorderly gilt-edged market indeed, and its intimate friends down the way in the discount market are liable to get their fingers burnt and to shout 'foul' at the Governor. Other Central Banks – the Bundesbank, for example, or the Federal Reserve Bank in the U.S. – effectively control domestic monetary policy (though not the size of the central Government borrowing requirement). The Bank of England simply copes with its consequences.

When Monetary Policy was Given a Try

With all this going against it, the miracle is not that monetary policy is energetically discounted, but that it was once successfully applied. Admittedly it took the International Monetary Fund, armed with a floating charge upon the British economy, to apply it. Nor was it enough for the Fund executives to warn the Treasury that the fulfilment of specified targets for domestic credit expansion would be a precondition for the use of credit tranches: they had to stage a weekend seminar to try to explain to the knights of Great George Street what domestic credit expansion meant. As one of the younger generation of Treasury

Chart 3 Growth of Public Expenditure and the Retail Price Index 1946–74



officials explained to the present author at that time, habits of neo-Keynesian fiscal manipulation were so ingrained at the top in Great George Street that it was far too late to hope for understanding of monetary disciplines. Listening to a senior Treasury witness telling the General Sub-Committees with a perfectly straight face that the fall in unemployment in the spring of 1972 was attributable to all those new schools and motorways launched in panic six months earlier, it was not difficult to see what this young man had had in mind. It is also salutary to remember that within months of the successful application and fulfilment of the IMF's d.c.e. targets in 1969-70 the Governor of the Bank was leading the clamour for a prices and incomes policy, while hastily relaxing the severity of monetary control.

It remains to consider the one matter about which all the 'unofficial' witnesses before the General Sub-Committee agreed: the absence of an economic linkage between the level of public expenditure and the rate of inflation. Admittedly they conceded that a rapid *change* in the level of public expenditure was likely to have an inflationary effect (while disagreeing about why this

should be so). But provided the Government did what each of them recommended elsewhere – ie, set a 'par rate of tax', regulate the money supply, or run a prices and incomes policy, according to taste – the actual proportion of the nation's resources pre-empted by the state was neither here nor there.

Is it really so? Certainly the rate of domestic inflation has steadily accelerated ever since Harold Macmillan launched the state on a career of expansion at the end of the 1950s. Is it sufficient to attribute this coincidence to the sudden access of beastliness by union leaders, a rise in world prices, or a failure to adjust tax rates to finance the higher levels of state spending? Is it not at least empirically probable that if a higher and higher proportion of total employment occurs in areas where job security is assumed to be absolute, and where Governments are in a position to dictate the level of both investment and prices, and hence the return on investment, or lack of it, an increasingly inflationary climate will be created?

Even if we assume that Governments do nerve themselves to cover their extra outgoings with higher taxation, and even if they opt for higher direct taxation rather than higher indirect taxation because the sons of toil, like the University dons who advise Whitehall, will grin and bear the former but not the latter, is it really true that there will be no inflationary secondary effects: that the Government will not find its revenue expectations are unfulfilled because, for example, more and more people decline to accept the inconveniences of night-work for the miserable increment that is left to them after deduction of extra tax?

Maybe we shall soon know the answer to these and other questions. For if the present Chancellor's words are to be believed – his deeds to date are another matter altogether – we may now be in for the first effective clamp-down on state spending since 1968, coupled once more with a period of monetary restraint. If so it will represent a remarkable assertion of political will over the entrenched position of officialdom and its friends, and the economy will be set once more on a healthier course, as it was in 1969. When the results can be identified, no doubt the Treasury will be on hand to explain that they were all due to the weather.