PART FOUR

The Debate on the 1981 Budget

The Keynesianism of the first post-war generation gave a warm embrace to fiscal policy and cold-shouldered monetary policy. But hovering in the background was the awkward topic of the relationship between money and national income. Suppose that a decrease in the budget deficit occurred at the same time as an increase in the quantity of money. Which of the two policy forces would win? Would fiscal policy overwhelm monetary policy or not? Would Keynesianism refute the monetarists' quantity theory of money, or vice versa*?*

For any observer of British macroeconomic policy in the mid-1970s these questions were fundamental. As an economic journalist on The Times, *I was intrigued by the inconsistencies in official policy-making and the theoretical issues which they raised. The striking similarity of the rate of money supply growth in 1972 and the rate of inflation in 1975, as well as my reading around the subject, convinced me that the monetarists' theories were largely correct. But what did that mean for fiscal policy and the income-expenditure model? I argued in an article in* The Times *on 23 October 1975 (reprinted as the first essay in this part) that, once a money supply target had been announced, 'reflating by fiscal means is like pumping air into a tyre with a puncture – the puncture being massive sales of government bonds to the non-bank public'. The conjunction in the mid-1970s of fiscal expansionism and persistent demand weakness was 'the* reductio ad absurdum *of Keynesianism'. (The article was very slight, but I think it is worth inclusion here because of its relevance to the subsequent debates. It is a period piece and, although it was written over 30 years ago, I have left the contemporary references in the present tense.)*

The article in The Times *also conjectured that cuts in public spending and increases in taxes would not necessarily deflate demand. The rather cryptic explanation was that, 'Fewer bond sales would ensue, lowering interest rates, and promoting both investment and consumption'. I had no notion when I wrote the sentence that – only a few years later – it would be relevant to the justification of possibly the most controversial episode in British macroeconomic policy-making. The introduction of the Medium-Term Financial Strategy in the 1980 Budget, and the shoring-up of the fiscal targets in that strategy by large tax increases in the 1981 Budget, provoked fury from academic economists. As mentioned several times elsewhere in this book, 364 economists wrote a letter to* The Times *to protest against 'monetarist polices'. The second essay, on 'Did the 1981 Budget refute naïve Keynesianism?', criticizes the Keynesian income-expenditure model for its inability to incorporate monetary influences on assets prices and expenditure. It was written for a set of* *papers, edited by Philip Booth of the Institute of Economic Affairs (IEA), analysing the 1981 Budget on its twenty-fifth anniversary. Professor Stephen Nickell – who was then on the Monetary Policy Committee of the Bank of England and is now Warden of Nuffield College, Oxford – also contributed to the IEA volume, claiming that the 364 had 'turned out to be completely correct'. I disagreed with this verdict in a short comment and a further exchange followed. It is for others to decide who had the better of the argument.*

(Addendum*: The 1981 letter to* The Times *from the 364 is mentioned several times in these pages. The contents of the letter were as follows:*

> *The following statement on economic policy has been signed by 364 university economists in Britain, whose names are given on the attached list:*
> *We, who are all present or retired members of the economics staffs of British universities, are convinced that:*
> *(a) there is no basis in economic theory or supporting evidence for the Government's belief that by deflating demand they will bring inflation permanently under control and thereby induce an automatic recovery in output and employment;*
> *(b) present policies will deepen the depression, erode the industrial base of our economy and threaten its social and political stability;*
> *(c) there are alternative policies; and*
> *(d) the time has come to reject monetarist policies and consider urgently which alternative offers the best hope of sustained recovery.*

The letter was signed by 76 present or past professors, a majority of the Chief Economic Advisers to the government in the post-war period, and the President, nine of the Vice-Presidents and the Secretary-General of the Royal Economic Society.)