The Treasury and the New Cambridge School in the 1970s

John Maloney*

With the release of Treasury papers from the 1970s under the 30-year rule we have a much more complete picture of the dispute in the 1970s between the Treasury and the Cambridge Economic Policy Group (CEPG), especially given the role of three Cambridge economists—Nicholas Kaldor, Wynne Godley and Francis Cripps—as ministerial advisers at the time. The records show some eventual closing of the gap between the Treasury and the CEPG regarding the latter’s proposition of stable private-sector NAFA (where NAFA stands for net acquisition of private sector assets) and its implications for demand management and the balance of payments. In contrast, the initial differences on counterinflation policy and, above all, on import controls versus free trade were wider at the end of the decade than at the start of it.

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1. Introduction

The 1970s and early 1980s saw the height of the Keynesian–monetarist controversy over economic policy. But for a while in the 1970s, Britain’s Treasury, still conventionally Keynesian at all but the most junior levels, faced a challenge that was more immediate and less avoidable than anything coming from Milton Friedman and his followers. The ‘natural rate of unemployment’ doctrine might nullify any permanent effects from demand management, but it did not of itself exclude attempts to smooth out fluctuations around the natural rate, or even to use monetary policy to cushion the effect of temporary changes in the natural rate (in the unlikely event of their being identified). The New Cambridge School, in contrast, proclaimed short-term demand management as unsettling and unnecessary. Whatever their differences from Friedman they shared his fundamental assumption that it was overactive government, not private sector instability, that needed reining back to give a stable macroeconomic background against which the economy would save, invest and grow.

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Address for correspondence: John Maloney, Department of Economics, Exeter University Business School, Streatham Court, Rennes Drive, Exeter EX4 4PU, UK; email: J.Maloney@ex.ac.uk
* University of Exeter.
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The Treasury was sceptical of this message and, as will be seen, some of its denizens would have liked to ignore it. They could not. For a while, the Times articles of Wynne Godley, Francis Cripps, Nicholas Kaldor and Robert Neild\(^1\) eclipsed even the monetarist journalism of Samuel Brittan and Peter Jay in the public attention they commanded. When Labour returned to power in 1974, Kaldor and Godley were appointed special advisers to the Chancellor, Denis Healey, while Cripps became special adviser to Tony Benn, Industry Secretary and the Cabinet’s most thoroughgoing advocate of import controls—basically a Cambridge cause, albeit one that exposed some divisions in the Cambridge school. The Parliamentary Committee on public expenditure summoned the Cambridge Economic Policy Group (CEPG) and the Treasury and told them to start debating. At the end the committee persuaded the two sides to meet for a series of seminars. And all the while, Treasury officials had the worry that their Chancellor, exposed almost daily to Cambridge ideas, might convert.

Although the figures identified as ‘New Cambridge School’ accepted the label, they made little use of it. (Godley and Cripps preferred to talk of a new Cambridge model or a new Cambridge equation.) Given the title was mainly bestowed by outsiders, there was inevitably imprecision as to exactly who and what it was supposed to cover. But to list Nicholas Kaldor, Wynne Godley, Robert Neild and Francis Cripps as the most prominent members of the school would incur little dissent. The last three names also dominate the work of the CEPG centred on the university’s Department of Applied Economics. Kaldor was not an official member of this group and his name does not appear in its annual Economic Policy Review, which started in 1975. In what follows we shall use the designation ‘New Cambridge School’ when members of the CEPG were not explicitly speaking or writing on its behalf.

As regards sources, this article uses the release under the 30-year rule of Treasury and Cabinet papers from the 1970s to look at the relationship between Cambridge and the Treasury inside as well as outside Whitehall. Much of the internal debate ended in consensus—so much so that Michael Posner,\(^2\) a Cambridge don but a fierce critic of New Cambridge who was on secondment to the Treasury, accused one Treasury forecaster of being more New Cambridge than New Cambridge. Indeed, for a while the Treasury was far more open to a Keynesian–New Cambridge synthesis than a Keynesian–monetarist one.

2. New Cambridge propositions

In the CEPG’s own words, New Cambridge ‘postulated an equilibrium relationship between private disposable income $Y_D$ and the private sector’s stock of financial assets $SFA$

\[
SFA = (1 - \alpha)Y_D
\]  


and a unit period over which stocks adjust to flows. Since private expenditure \( P \) is given by

\[
P = YD - \Delta SFA
\]

it follows that

\[
P_t = \alpha YD_t + (1 - \alpha) YD_{t-1}
\]

(2)' (CEPG, 1980, p.41)

Unable to find any significant link between current expenditure and income more than one year in the past, Cambridge took the 'unit period' to be one year (Cripps et al., 1976, p. 46). Thus the coefficients on this year's and last year's income were expected to add up to unity and in fact very nearly did so when estimated. Initially the expenditure equation was cast in real terms. In 1975, for example, it was taking the form (ibid., p. 46):

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PX_t = 0.533 YD_t + 0.416 YD_{t-1} + 0.899 HP_t + 0.790 BA_t + 0.962 S_t
\]

Where, \( PX \) is the total private expenditure including fixed investment, \( YD \) is income after tax, \( HP \) is the net increase in hire-purchase debt extended to the personal sector, \( BA \) is the net increase in bank loans to the personal sector excluding loans for house purchases and \( S \) is stockbuilding.

Given the identity \( \Delta SFA - PSBR = B \) (combined private sector and public sector surplus must equal current account surplus, \( B \)), it followed that, if equation (1) could be estimated 'with a reasonable degree of accuracy' then:

\[
\text{this enables an inference to be made (given the level of public expenditure and the conduct of credit policy) about the full employment yield of the tax system which is the necessary but not sufficient condition for simultaneously achieving over a sustained period any pair of targets for the current balance of payments and the level of employment and that the inference (in so far as it relates to underlying trends) can be made independently of external conditions such as the terms of trade. [This] entirely changes the principles according to which fiscal policy should be conducted The objection to the use of short-term forecasting as the basis of fiscal policy ceases to be that these forecasts are inaccurate; it is rather that short-term forecasts are the wrong basis in principle for budgetary policy. (Cripps et al., 1976, p. 46, quoting CEPG, 1975, p. 8)
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At the centre, then, was a relation between a flow (income) and a stock (financial assets). A change in the disposable income of the private sector would induce it to change its stock of financial assets by the same proportionate amount. The CEPG found that equation (2) had 'fitted the period 1954–72 reasonably well, with the estimated standard error of the equation as low as 0.34%' (Cripps et al., 1976, p. 46). And so far as the relationship was stable, instability in the economy would not be coming from the domestic private sector. Instead, in Godley's words, its sources must be 'the Government's own actions with regard to expenditure, taxation and credit on the one hand, and, on the other, foreign influences, particularly export demand and commodity prices' (House of Commons, 1974A, p. 5). Fiscal policy, therefore, was both acquiring the new role of securing current account and employment targets in the medium term, and shedding its old one of attempting stabilisation in the short term. But the fiscal policy needed to achieve a given current account would not normally coincide with that needed to achieve any employment target the government might have. If employment was currently below target any fiscal change in the right direction as regards the current account would be in the wrong direction as regards jobs. Reconciling the two targets required some additional policy to improve the current account. Exchange rate depreciation (if it did help the current account—we come
onto Cambridge’s doubts in a moment) would be good for employment as well. So would tariffs or quotas on imports, provided they were not neutralised by retaliation by other countries.

A second Cambridge policy position stemmed from its distinctive view of inflation. Successive issues of *Policy Review* stated their position unambiguously: deflation made inflation worse (CEPG, 1975, p. 13, 1976, p. 2, 1977, p. 6; see Cripps (1977) for the most comprehensive argument). This is because price inflation follows wage inflation, which is driven by the gap between workers’ actual and target real wages. So far as ‘counterinflationary’ fiscal and monetary policy damages productivity, the real wage is held down and money wage inflation gets worse.

The ‘stable NAFA proposition’ (where NAFA stands for net acquisition of financial assets and was the other name for ΔSEA) and the real wage resistance theory were logically independent of one another. Indeed, there were those who held the second doctrine and opposed the first one: notably the CEPG’s two main critics from within Cambridge itself, Lord Kahn3 and Michael Posner, whose views are examined in Section 5. Nonetheless, the two propositions dovetailed so far as both cast doubt on the ability of a lower exchange rate to achieve an improvement in the current account. The real wage resistance theory implied that that any competitive benefits from currency depreciation were likely to be undone by consequent pay demands. As for the Cambridge expenditure equation, it was not just that it suggested that the remedy for a trade deficit lay somewhere other than in a cheaper currency. There was also the point that if a change in income leads only to a stock adjustment as regards holdings of financial assets, and not a permanent change in their rate of acquisition, then the multiplier goes up and any rise in exports (however brought about) will lead to a relatively large rise in aggregate demand and hence in imports.

Falling in with both the above Cambridge propositions (though, again, logically distinct from either of them) was straightforward ‘elasticity pessimism’ about exports. Kaldor in particular, as will be seen, thought the Treasury’s estimate of the price elasticity of demand for exports (2.2) far too high and had some particularly sharp exchanges with Posner on the subject.4 Thus in New Cambridge hands, the stability of NAFA, real wage resistance and elasticity pessimism joined forces to centralise the balance of payments as a stubborn and chronic constraint on growth and jobs.


Selwyn Lloyd (1960–62) alternated with the genial and expansive figures of Derrick Heathcote Amory (1958–60) and Reginald Maudling (1962–64). Maudling stayed on as Chancellor under Sir Alec Douglas-Home, whose short premiership ended with a balance-of-payments deficit of £749 million (1.8% of GDP)—easily the highest figure since 1945 and a contributory factor to the Conservative loss of the 1964 general election to Labour. Within hours of entering Downing Street, Harold Wilson and his Chancellor, James Callaghan, had considered the case for devaluing the pound and rejected it. While both men had persuaded themselves that devaluation was not the way to cure the deficit, it is likely that there was some wishful political thinking behind this. Both Wilson and Callaghan were acutely sensitive to Labour’s continuing reputation as ‘the party of devaluation’—it was the Attlee government who had devalued the pound from $4.03 to $2.80 in 1949. But the result of the pound staying at $2.80 was that the level of aggregate demand consistent with a tolerable current account sank ever lower. A sharp emergency deflation in 1966, precipitated as usual by a run on the pound, brought the most temporary of reliefs: by the middle of 1967 the deficit was accelerating back through the £500 million mark again.

By now the pound had been fixed at $2.80 for 18 years. During this period the UK’s annual inflation rate had exceeded the OECD average by only 0.5%. But 18 years at 0.5% added up to a cumulative 9% competitiveness gap—far from trivial given the price elasticity of demand for developed countries’ exports, then estimated to be around 2. In November 1967 another speculative run on the pound finally forced devaluation to $2.40. A deflationary budget in March 1968 cleared domestic consumers out of the way of industry’s path to exporting. In 1969 Britain ran a current account surplus of £490 million (1.0% of GDP).

But the economy was already set for another bout of deflation—not, this time, to turn round the trade figures but to keep a lid on prices. The Labour government had kept on wage and price controls of varying degrees of severity ever since coming to power in 1964. In 1969–70 they effectively assassinated their own incomes policy with pay awards in double figures across much of the public sector. If this was an attempt to buy the votes of their most obvious clients, it failed to buy enough of them. Edward Heath and the Conservatives replaced Labour in June 1970, by which time it was already clear that Britain was heading for the fastest inflation since World War II. Worryingly, unemployment was showing no inclination to fall and it took only mildly deflationary policies in Heath’s first 18 months to push it above the million mark early in 1972. The government pinned as much blame as possible on the trade unions, opposing their wage demands with the mantra that inflation was not a cure for unemployment but the cause of unemployment. An increasing number of economists agreed. The early 1970s were the heyday of the ‘trade union pushfulness’ theory of inflation (Hines, 1964), even if economists were unhappy about having to measure trade union militancy by trade union membership for want of a better proxy (Laidler and Parkin, 1975). The unions were levered into pole position by theories that were less economic than sociological and even generational: the new generation of trade union leaders had never known anything but full employment and steady growth, which is why they were so confident and assertive in their demands for a larger share of the national income for the wage earner via higher wages.

5 They were right to worry: the devaluation of 1967 turned them into the most unpopular government since 1945, a record they held until John Major surpassed it after his own 30% devaluation of the pound following its exit from the European Monetary System in 1992.
Keynes had warned of an inconsistent triangle of full employment, steady prices and free collective bargaining as far back as 1943 (Kahn, 1977; see also Kalecki, 1971), and it provided the main rationale for prices and incomes policies from the start. The story was a consistent one: wage controls did bring inflation down for a year or so, but the unions soon ran out of patience with a situation where, as they saw it, wages alone were effectively controlled. (Real wages since 1945 had grown by an average of 1% a year when incomes policies were on, but by around 3.5% a year when they were off, according to Tarling and Wilkinson (1977)). Successive incomes policies also gave another downward push to Britain’s worsening strike record.

While management were also blamed for poor industrial relations, the most serious charge against them was their failure to invest. In fact successive studies found that amounts invested were not outstandingly low by European standards, but that the net year-by-year addition to the capital stock was (Pollard, 1982; Jones, 1978). A preference for patching up existing capital rather than replacing it with something more modern was identified as the culprit—a kind of physical short-termism in parallel with, and no doubt related to, the financial short-termism of which British industry was accused. Much of the industrial and microeconomic story was encapsulated by the empirical finding by Houthakker and Magee (1969) that the world had a disturbingly low income-elasticity of demand for British exports (0.9), not only compared with the exports of other European countries but, more to the point, compared with Britain’s own elasticity of demand for imports (1.7). In a series of works, Tony Thirlwall of the University of Kent argued that the gap between these two figures gave the UK the options of growing only half as fast as the rest of the world, letting her exchange rate slide down continuously to compensate for the unattractiveness of her goods, or implementing an active industrial policy to produce more of the things the world wanted (Thirlwall 1974, 1980).

The second of these options did not exist until the pound was floated in 1972, and even then it provoked the pessimistic view, not least in Cambridge, that any competitive gain from depreciation would be quickly wiped out by real wage resistance. The third option cannot be seen very clearly in any of the 1964–70 Labour government’s minor gestures towards a command economy. The (purely indicative) National Plan of 1965 failed to survive the deflationary storm of July 1966. If Labour responded at all to the problem identified by Thirlwall, it was in its imposition of a Selective Employment Tax—the idea was Kaldor’s—to reward job creation in manufacturing and discourage it in services. It was not just that ministers identified the fate of exports with the fate of manufacturing. Kaldor had by now become a convert to Verdoorn’s Law, which picked out manufacturing as the one sector featuring economies of scale. Kaldor drew the implication that a government that favoured manufacturing could set it on a dynamic path that could permanently raise the economy’s growth rate, provided they ensured that growth was led by export demand and not by consumption (Kaldor, 1966, 1971A). And because whatever made industrialisation a self-sustaining process did the same for deindustrialisation, all he had to do was put Verdoorn’s Law into reverse gear, predict that the UK would enter the European Community at a competitive disadvantage and produce a resonant economic case for not going in at all (Kaldor, 1971B).

None of this (least of all the last bit) cut any ice with Edward Heath, who abolished Selective Employment Tax as a preliminary to taking Britain into the EEC on 1 January 1973 and whose response to unemployment passing the million mark in January 1972 had been to pull every reflationary lever in sight. Anthony Barber’s budget in March 1972 came with the promise to raise real GDP by 10% over the next two years. ‘I do not believe,’ he
said, ‘that a stimulus to demand of the order I propose will be inimical to the fight against inflation’.6 Letting M3 (currency and bank deposits) rise 60% in 1972–73 was apparently part of the strategy and the floating (downwards) of the pound in June 1972 added to the impetus. There was little immediate opposition to any of this, the Economist even wondering if the 1972 budget had gone far enough.

4. Cambridge advice, 1972–74
Cambridge was an exception. Before the Barber boom had even properly got under way, the London and Cambridge Economic Bulletin (February 1972) had warned that simply reflating the economy to bring unemployment back down to half a million would produce an unsustainable trade deficit (Coutts, 1977, p. 91). In November 1972 the government, alarmed by the conjunction of world commodity price rises and their own boom, brought in a 90-day statutory wage and price freeze. This was succeeded by the ‘£1 plus 4%’ rule in which they steered a compromise between a flat-rate pay limit and one that preserved relativities. In July 1973 Neild, writing in The Times, explicitly related the unemployment/current account tradeoff to the NAFA concept. Given the size of the budget deficit, the boom in fixed investment and the upturn in stockbuilding, a tolerable balance of payments could be achieved only if vast corporate savings materialised. Profits, he calculated, would have to be 56% up on 1971—something not only wildly unlikely to happen, but certain to wreck Heath’s incomes policy if it did (Neild, 1973, p. 27). Meanwhile, Godley and Cripps (1973B, p. 21) called for a reduction in consumption to reduce the trade deficit. Since any fall in take-home pay would end the incomes policy, that left only credit controls. Profits might not have risen fast enough to help the balance of payments, but they had risen fast enough to be another threat—via a ‘sense of unfairness’—to the incomes policy. Corporation tax should be raised. Finally, Godley and Cripps called for import controls, though warning that unless they were ‘explained with extraordinary finesse, there could be bitter reactions’ from the USA, GATT (General Agreement on Tariffs and Trade) and the EEC.

In January 1974 Godley and Cripps (1974A, p. 19) set out the fullest public statement yet of New Cambridge’s ideas. They started with a sharp attack on balance-of-payments fatalism—the current account, they said, was no harder to forecast and control than the level of domestic economic activity. Indeed, their contention ‘that other than in the short term the private sector shows a small stable surplus’ implied that ‘the public sector’s budget deficit fully determines the balance of payments’. This being so, ‘changes in exports, import prices etc., make a lot of difference to real income and output, but none at all to the balance of payments, however paradoxical’. Hence fiscal policy should be used to determine the current account and ‘the budget deficit having been set in this way, success in achieving growth and full employment then depends on our ability to gain access to foreign markets and to commercial policy’.

The statement that the budget determines the current account was interpreted by critics, reasonably enough, to mean that the former was exogenous and the latter endogenous. This was obviously wrong. Even if NAFA is constant, the furthest it is possible to go is that fiscal initiatives will produce equal ex post changes in the budget deficit and the current account. Nor is it true, even in New Cambridge terms, that a shock to exports will leave the current account unaffected. Even if it were to have an identical ex post effect on the budget deficit and on the current account (which would itself require NAFA to be unaffected), this

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6 Hansard, 21 March 1972, Col. 1353.
effect will be zero only if the government neutralises the tax revenues coming in through increased export sales.

All this is uncontentious—no one from Cambridge has ever denied it. The *Times* article was simply carelessly worded and everyone took more care in future (Cripps and Godley, 1976, p. 335).

In the meantime, Heath’s incomes policy had gone on to a considerably less restrictive stage 3. Among its provisions was a system of ‘threshold payments’ whereby workers would get 40 pence a week (1% of the wage of the average worker) added to their pay for each percentage point rise beyond 8% in the retail price index in the 12 months from October 1973. It was meant to slow down inflation by removing the incentive for pre-emptive pay claims, but, coming in the very week that OPEC began its quadrupling of the price of oil, it could not have been worse timed. The New Cambridge model, as will be seen later, made out the effects as even more baleful than the orthodox Treasury analysis did.

But even with threshold payments, stage 3 was too restrictive for the National Union of Mineworkers who called first an overtime ban and then an all out strike. Heath called an election to get a mandate to defend his policy and lost. On 7 March 1974, three days after Denis Healey’s appointment as Chancellor, Godley, Kaldor and Neild attended a budget strategy meeting at the Treasury. Kaldor called for a ‘more or less neutral budget’ (Treasury, 1974A, p. 3), but the main weight of argument came from the written submissions the economists sent in after the meeting. Godley wanted both ‘a prolonged moratorium on living standards’ and a slow adjustment of the current account deficit (now running at £4 billion a year after the OPEC price rise) (T338/242, Godley to Healey, [no date] March 1974). The fact that even a slow adjustment ruled out any rise in living standards was a comment on the extent of the problem. Kaldor reversed his advice at the meeting. There continued to be no strict economic case for deflation but:

There is the ‘psychological aspect’ which one cannot ignore. The people know there is a crisis, and they are ready for belt-tightening measures; a second ‘mild budget’, coming after Barber’s December effort, would make them feel that this is another ‘popular’ budget in front of another election. Also from the point of view of our international credit it would not look good if a prospective borrowing requirement of £3150m. were not reduced in the budget. (T338/242, Kaldor to Healey, 9 March 1974, p. 1)

At a second meeting on the budget, Kaldor switched back to opposing higher taxes. Instead, the Chancellor should let consumption rise, ‘hope to get increased output later’ and borrow meanwhile (Treasury, 1974B).

One can hardly blame Kaldor for being so uncertain what to do given the situation Labour had inherited: wage inflation running at over 20% following the collapse of Heath’s incomes policy, a projected current account deficit of £4 billion (4.0% of GDP) for 1974 and unemployment on the rise as forecasters differed only over the depth of the forthcoming recession. There was, however, opposition to all the Cambridge advice from Sir Kenneth Berrill, the government’s Chief Economic Adviser. 7 The Chancellor, he said, was getting advice on the basis of the New Cambridge proposition about NAFA and, although they had mercifully taken oil out of the equation and were basing their fiscal recommendations only on the non-oil deficit, Healey ought to know that in the short term ‘the connection between the financial deficit of the public sector and the balance of

payments is very weak’ (T338/242, K. Berrill to Healey, ‘Outside Economic Advice’, 12 March 1974).

In the general election of February 1974, Labour had campaigned with promises of a ‘Social Contract’ with the unions, whereby public spending increases and pro-union legislation on one side would be bartered for self-restraint on the other. Most of the Treasury was sceptical from the start—including Healey, who recalled in 2008 that he realised the Contract was not going to work ‘the moment I became Chancellor and we used to have meetings with the unions ... I realised almost immediately that the unions were worse than a waste of time because you couldn’t totally ignore what they were saying’ (Lord Healey, personal communication, 9 April 2008). One implication of the Cambridge theories was that the Contract’s survival was extremely sensitive to the fiscal policy adopted—far more so than under orthodox Keynesian assumptions. On Cambridge assumptions, government spending cuts might actually assist the Contract’s survival. They would allow tax cuts without any net deterioration in the balance of payments; and tax cuts (indirect or direct) would raise workers’ real disposable incomes, thus blunting pay demands by paying off real wage resistance. The Treasury was sceptical of both halves of the Cambridge argument. In the first place, because they viewed the link between the PSBR and the current account as much weaker than New Cambridge did, they saw the whole idea of public spending cuts being required prior to tax cuts as being much more conditional on circumstances. Secondly, they had to some extent signed up to the idea of the ‘social wage’—the idea that workers and their unions took government spending into account when they decided how dissatisfied they were with their standard of living. Lower public spending with lower taxes might therefore just increase the private wage at the expense of the social one. If so, any real wage resistance would stay put.

By the end of 1974 Healey had had prolonged and thorough exposure to New Cambridge views. But attempts to portray him as anything like a convert are unconvincing. To Stewart (1978, p. 193), Healey’s first budget, deflationary when the world was on the brink of the worst recession for 40 years, ‘seemed more like the action of a Conservative Chancellor in the 30s’ and was plainly under the influence of the New Cambridge proposition that the budget should be used on the balance of payments. The trouble with this interpretation is that the budget was intended to be broadly neutral, and that no daylight can be discerned between Healey’s Cambridge and non-Cambridge advisers on this point. Dell (1996, p. 411) draws attention to the words of Healey’s budget speech of November 1974—‘a large balance of payments deficit is inevitable in the present circumstances and a large public sector deficit is the inevitable counterpart of this given that the private sector as a whole cannot be in substantial deficit without grave consequences’. It is hard to think of a much less contentious statement, but to Dell this represented ‘the theory of inevitable equivalences’ that Healey held ‘due to his special adviser Nicholas Kaldor’ (Dell, 1996, p. 411).

A more accurate summary of Healey’s position came from Sir Douglas Wass, Permanent Secretary to the Treasury. When he first came into office, said Wass, Healey:

attach[ed] a great deal of importance to the Public Sector Borrowing Requirement (PSBR), not just for monetary purposes but more widely in regard to management of the economy. He did not go so far as to embrace the New Cambridge School thesis, but there were clear traces of their
philosophy in his thinking. With the passage of time the Chancellor has, I think, become somewhat dubious about the PSBR as an indicator. (T338/246, D.W.G. Wass to Sir K. Berrill, 'Public Sector Borrowing Requirement etc.', 8 August 1974)

5. The Public Expenditure Committee

Healey was in fact so mildly infected with the New Cambridge virus that the rest of the Treasury might almost have been tempted to ignore it. The Commons Public Expenditure Committee had prevented them from doing so. In May 1974 its chairman, Tory MP Michael Alison, set up an inquiry into the effect of public expenditure on the balance of payments. ‘Essentially, the scope is provided by the propositions set out by Godley and Cripps in The Times on 22 January 1974’ (T338/334, Michael Alison, 22 May 1974).

Most Treasury officials were unenthusiastic. Patricia Brown, the under-secretary who oversaw Treasury forecasting, thought the committee was going well outside its remit and asked how far it was likely to get, given that the Treasury would maintain its refusal to publish either its forecasts or the model on which they were based (T338/334, Brown to Chancellor’s PPS, 11 July 1974). P.N. Sedgwick, in contrast, thought that a frank discussion of the Treasury model would not only flatter the MPs on the committee, but distract their attention from the truly awkward questions:

It would be wise to pander to the members’ intellectual aspirations. Put another way, the longer the implications or properties of our model are discussed, and compared with Mr Godley’s or Prof Laidler’s models, the less time there will be for embarrassing questions on current policy or intentions. A reading of the transcripts will show that the hearings frequently take on the characteristics of a tutorial as various members try to sort out puzzles in their own minds. This would be regarded as a fairly harmless way of killing time. (T338/274, Sedgwick to Brown, 2 July 1974)

In the Treasury’s actual submission to the committee the condescension remained, but its point of application understandably switched:

It is laudable that a public committee should enquire into a pressing problem of this nature and it serves admirably to force officials to focus their thoughts; nevertheless it is regrettable that it should be done in the context of a doctrine that has been presented primarily to the daily press and not in any reputable academic journals . . . a prolonged attempt to elucidate and cope with the implications of the unorthodox and rapidly changing Cambridge doctrine may be felt by some of us to be a misdirection of endeavour. (Treasury, 1974C, p. 1)

Having got the dignified rebukes out of the way, the Treasury settled down to its attack on Wynne Godley. The accusations were, first, that he had accused the Treasury model of treating investment as exogenous, when in fact it was his own model that lacked any theory of investment at all—an omission that eviscerated his contention that shocks to the economy did not usually originate in the private sector (ibid., p. 15). He had represented fiscal policy as the only exogenous influence on the economy and yet held a theory of inflation where wages were exogenous (ibid., pp. 25–6). He had ignored evidence that the overseas sector was a major source of instability in the economy—despite the fact that his own model, with its relatively high value for the multiplier, predicted this instability would be worse than the Treasury model did (ibid., pp. 29–30; Spencer and Mowl, 1974, p. 2). As for the ‘stable NAFA’ proposition at the heart of New Cambridge, the aggregate figure did
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seem to lend it some credence, but concealed the instability of the corporate component (T’338/274, ‘Draft from Honor Stamler’, 28 June 1974, p. 4). It had, in any case, been fatally weakened by Godley’s recantation of the doctrine that the marginal propensity to spend was unity, which alone was enough to bring down ‘what Kahn and Posner somewhat charitably described as “the elegant paradoxes of the New Cambridge School”’ (Treasury, 1974C, p. 23). In summary, Godley had ‘a highly aggregated relationship between disposable income and expenditure, that does not purport to describe behaviour directly or even say what behavioural patterns underlay it, and is not supported by empirical work on individual relationships’ (ibid., p. 20).

All these charges were levelled before Cripps, Godley and Martin Fetherston11 had actually appeared before the Committee, and some of them bore little relation to what they went on to say. Godley denied that they had said the budget deficit was the only determinant of the current account (House of Commons, 1974A, p. 146). He also stressed the difficulty of forecasting what the budget deficit was going to be. There could always be ‘new exogenous shocks … exports can rise or fall a lot which is going to change the tax yield’ (ibid., p. 148). They had always known that NAFA could vary substantially from year to year, and indeed accepted both David Laidler’s12 point that any stability in NAFA might proceed from ‘accommodating monetary policy’ and that a lot of the time the respective changes in NAFA of the personal and the company sector had cancelled out, for reasons no one had explained (ibid., pp. 149, 145).

But none of these concessions, Godley and Fetherston argued, provided one iota of rehabilitation for the short-term discretionary fiscal policy to which the Treasury remained wedded. The Committee’s report agreed with them: demand management over the last 20 years had been ‘extremely poor’, a view contested only by the Treasury and the Bank of England, ‘and they could hardly be expected to [agree]’ (House of Commons, 1974B, p. xii).

The failure of fine tuning had indeed been a constant theme from the committee’s witnesses. J.C.R. Dow of the Bank of England used his own magnum opus on the subject (Dow, 1964) to argue that no New Cambridge assumptions were needed to explain the poor track record of discretionary fiscal policy over the past 20 years (House of Commons, 1974A, p. 103 f.) In the meantime Lord Kahn and Michael Posner had been enlarging on the critique of the New Cambridge School they had made in the pages of The Times. Picking up on Godley et al.’s claim to the Committee that ‘no component of private expenditure exerts an independent (‘exogenous’) net influence on the level of output and fluctuations in it’, they disputed both this and its implication that ‘it would be right to set the automatic pilot and leave the 300,000 ton tanker of state blindly to find its own way through turbulent seas … We do not pretend that the objective of fine tuning can be achieved. On the other hand we do believe that some ironing out of fluctuations is both desirable and possible’ (ibid., p. 69).

No doubt is was this last statement that David Laidler (representing monetarism) had in mind when he told the committee that whatever arguments might be going on inside Cambridge, its whole way of thinking about stabilisation was misconceived. The horizon for macroeconomic policy makers should be five to ten years and used purely for the purpose of setting an appropriate target for monetary growth (ibid., p. 50). Recalled by the

12 David Laidler (b.1938): Professor of Economics, University of Manchester, 1969–75; Professor of Economics, University of Western Ontario since 1975 (Emeritus since 2004).
committee, Godley and Fetherston resisted attempts to line them up with monetarism and Laidler, attacking both the latter’s contention that trade unions had nothing to do with inflation and his belief that with a long enough time horizon the effects of monetary growth on prices could be predicted independently of ‘world commodity prices, incomes policy, fiscal policy from now on—the whole works’ (ibid., pp. 146, 150).

Kahn and Posner, in contrast, were not encouraged to give their opinions on monetarism. Had they done so they would have sounded little different from the New Cambridge witnesses. (Posner had already done one spell at the Treasury, when he had been the early leader in its opposition to Milton Friedman, attacking his view of the monetary transmission mechanism, his ‘x % rule’ for macroeconomic (non-)management, and the idea that the long-run Phillips curve was vertical.13) And where Godley and Fetherston did get some support was in Kahn and Posner’s version of the real wage resistance theory. Kahn and Posner thought that both low unemployment and high unemployment made wage inflation worse: the one via excess demand, the other because it created ‘bitterness and resentment’ encouraging ‘militant action at local level’. Trade unionists might even feel that if the government would not stimulate demand, they should do it themselves by securing pay rises and then spending them (House of Commons, 1974A, p. 73).

None of this prevented the Committee reaching a notably lame conclusion: ‘We do not feel capable of making judgments on the efficacy of the Godley hypothesis and the performance of Mr Godley’s model relative to the behaviour of rival models’ (House of Commons, 1974B, p. xvi). The trouble was that that was exactly what they had set themselves up to do. Any sense of Schadenfreude felt by the Treasury would have intensified after they read ‘We are not experts and do not claim to be’ (ibid., p. xxi). The main recommendations were, first, that people should not talk about inflation when they meant reflation and, second, that there should be Treasury/New Cambridge seminars, though ‘the Treasury might not want to organise them’ (ibid., p. xvii).

6. Development of the Cambridge model

But the Treasury did eventually organise them and the seminars got under way in the summer of 1975. The Cambridge expenditure equation was now undergoing an important change: it had been recast and would shortly be re-estimated, in money not real terms. As its creators pointed out, this would have been the logical thing to do all along: lagged income, like everything else, should be deflated by the current price level, not a lagged one, in order to find out its effect on current spending. But the improvement excited little applause from the Treasury. Patricia Brown pointed out that you would simply have a new set of problems if, as was likely, ‘different components of expenditure were differentially sensitive to inflation’ (Treasury, 1975, p. 7). Nor could she agree with Godley’s proposition that the Cambridge formula left less of a role for short-term forecasting. On the contrary, she said, the shortness of the lag in the Cambridge picture required that more effort be put into short-term forecasting, while the centrality of bank lending and hire-purchase expenditure called for some ‘sophisticated flow-of-funds forecasting’, which the Treasury currently lacked and needed to develop (ibid., p. 31).

Lastly Brown argued that the ‘stagflation’ of the 1970s had made life harder for New Cambridge and ‘conventional’ forecasters alike. Not only might inflation and employment uncertainties deter expenditure in the future, inflation had already led to a personal savings ratio of 7% over the past few years as savers tried to replenish their depreciated funds (4% had been the maximum between 1963 and 1973) (Treasury, 1975, pp. 17–18). Deflating lagged income by current prices, as Cambridge was now proposing, could not deal with this inflation tax effect, for the simple reason that neither the level of funds to be replenished nor the attrition of their value due to inflation was anywhere in the equation.

Nonetheless the Treasury’s verdict on New Cambridge was less aggressively negative than it had been the previous year. They had, after all, found an aggregate relationship between private sector income and private sector expenditure that other forecasters had failed to notice. But, the Treasury’s report concluded, ‘the empirical evidence provided by New Cambridge does not support much of the argument derived from it, and is at best consistent with rather than a confirmation of the mechanism suggested’ (ibid., p. 20).

Treasury criticisms, together with those made by J.A. Bispham (1975) in the National Institute Economic Review, were answered by Cripps, Fetherston and Godley in their article ‘What is Left of New Cambridge?’ This appeared in the Cambridge Economic Policy Review, March 1976. The article first took up the charge that the Cambridge income–expenditure equation had ‘insufficient theoretical underpinning to be convincing’ (Cripps et al., 1976, p. 47). Cripps et al. conceded something to this charge in their statement that aggregate NAFA ‘comprises so many separate elements that it cannot be thought of en bloc in behavioural terms: therefore much empirical work on component relationships needs to be done’ (ibid., p. 47 n.). They did, however, reiterate the point that only the New Cambridge model—in which a change in income led to a proportionate adjustment over time in the stock held of financial assets—avoided the implausible conclusion that if income flows changed once, asset stocks would go on changing forever:

For if private expenditure did not increase one-for-one (subject to time lags) with private disposable income it would follow that a step change in the flow of income would result in a continuing rise or fall in net stocks of financial assets held by the private sector relative to their disposable income. It is precisely this implication, built into most conventional forecasting models, to which we object. (ibid., p. 47)

The second charge was that the CEPG had neglected stockbuilding and shocks to imports and exports as exogenous sources of fluctuations. Yes, said the article, they had, but so what? The omission had led to no policy mistakes since it would be impossible to use fiscal policy to correct shocks to stockbuilding (too short lived and hard to predict) or shocks to imports or exports (because whatever stabilised output would further destabilise the current account) (ibid., p. 47).

Lastly there was the allegation that ‘the experience of the period since 1972 has been such as to destroy the equation originally put forward’. Again, said the article, the issue was whether destroying the equation, if indeed it had been destroyed, did anything to rehabilitate fine tuning. As Bispham said, the equation’s errors were down to unpredictable changes in stocks. But these were most likely due to the unprecedented level of, and variability in, inflation that the economy had suffered since 1973. Recasting the Cambridge equation in nominal terms would link stockbuilding to inflation. In fact this had now been done, and the prediction errors for 1973 and 1974 were very much less. The key table is reproduced here as Table 1.
The main Treasury reaction to the article came from Andrew Britton, in a paper that limited itself to alleging that the proposition that *ex post* changes in the current account would match those in the PSBR ‘holds only as a very rough approximation indeed according to the Treasury model at least’. Extraordinarily, even this was too much for Honor Stamler, who told Britton ‘I believe it is a mistake to sneer at the New Cambridge propositions.’ Posner meanwhile told Britton he was looking increasingly New Cambridge himself. Britton had pointed out that, although particular changes in government spending and taxation produced very different effects on the PSBR and the balance of payments, when you added up the effects of these changes, the PSBR and current account effects were almost identical. When he called this ‘fortuitous’, Posner asked him if he was sure about this. ‘I am not the only one, I am sure, who has been struck by the very New Cambridge nature of the [Treasury] model simulations in the medium term.’

But the Cambridge economists were by now more preoccupied by the fact that the public sector deficit and the current account deficit had been moving sharply in opposite directions. While the former had widened from 7.2% to 9% of GDP between 1974 and 1975, the latter had shrunk from 4.5% to 1.7% with the non-oil deficit disappearing altogether. NAFA, Kaldor warned in July 1976, was currently abnormally high and its reversion to a more usual value would worsen the tradeoff between the PSBR and the current account, which meant the former needed to be cut sharply and immediately. His pessimistic view on the balance of payments, he said, ‘has not been shaken by the fact that I have been consistently wrong in prophesying balance-of-payments doom ever since the budget of Autumn 1974’. The intervening period, Kaldor said, had been one of recession in which ‘“New Cambridge” does not hold’. Pessimistic animal spirits had broken the link between savings and investment.

The CEPG’s 1976 *Policy Review* broadly concurred with Kaldor’s analysis but not with his inference that New Cambridge had ceased to hold. If the public sector and current account deficits had moved in opposite directions, this ‘was entirely due to short-term influences’ (abnormally high private saving, heavy destocking and the impact effect of an improvement in the terms of trade) (CEPG, 1976, p. 9 n.). The full-employment deficit had not increased during 1975; any increase in the actual deficit had been due to the deepening recession, itself a reminder that any reduction in the PSBR must be

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**Table 1. Prediction errors (total private expenditure: £ million at current prices)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Original equation (real variables) estimated 1954–72</th>
<th>Revised equation (nominal variables) estimated 1954–72</th>
<th>Revised equation (nominal variables) estimated 1954–74</th>
</tr>
</thead>
<tbody>
<tr>
<td>1973</td>
<td>-2242</td>
<td>-1262</td>
<td>60</td>
</tr>
<tr>
<td>1974</td>
<td>-7086</td>
<td>-3131</td>
<td>-1015</td>
</tr>
<tr>
<td>1975</td>
<td>NA</td>
<td>-230</td>
<td>-34</td>
</tr>
</tbody>
</table>


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accompanied by ‘measures to increase exports or reduce import penetration if recession was to be avoided while the balance-of-payments deficit was being reduced’. ⑬

Nonetheless, the CEPG’s 1977 review divorced the budget and current account deficits further, concluding on this basis that fiscal policy since 1974 had been ‘about right’ but ‘largely by mistake’. In particular, the Labour government’s deficits between 1974 and 1976 ‘now look to have been appropriate, mainly because the rise in personal savings and large-scale destocking provided an unexpectedly large deflationary impulse which the budget deficits served to offset’ (CEPG, 1977, p. 5).

At first this sounds like a simple admission that ‘it’s lucky they didn’t listen to us’. But the review went on to point out that the principal distinction had been not between what the CEPG had wanted and what the government had done, but rather between what the government had wanted and what it had ended up with. In 1974/5 the deficit had been larger than the government had intended and thus even further away from what Cambridge had advised. In 1976/7 the deficit would be smaller than the government’s estimate at the time of the 1976 budget, so that ‘our criticism of the size of the 1976 budget was exaggerated’ (ibid., p. 5).

7. The real wage resistance theory of inflation

Meanwhile the ‘real wage resistance’ theory of inflation had come to enjoy some support in the Treasury too. But the official who said it was now ‘the Treasury orthodoxy’ was exaggerating. ⑭ And a further wedge driven between the Cambridge and Treasury positions was the CEPG assumption that any wage increase would be passed on in prices, irrespective of the state of demand. This stemmed from their Normal Price Hypothesis, which said that prices were formed on the basis of costs regardless of the state of the business cycle (Godley and Nordhaus, 1972). Unemployment, then, would not only make wage inflation worse but would do nothing to stop any wage rises translating into price increases.

All this was why Healey’s Cambridge advisers regarded Heath’s threshold payments (see above, section 4) with even greater horror than the Treasury did. But, as Kaldor told Healey, the threshold payments were there and could not be abolished or watered down without terrible union resistance. So the best thing would be that ‘threshold payments should be met by the Exchequer, and not by the individual employer’ (T338/242, Kaldor to Healey, 9 March 1974, p. 2). Kaldor then said that as long as the threshold payments lasted, the Price Commission ‘would have to be instructed’ not to allow threshold-induced wage increases to be passed on as prices (Treasury, 1974B, pp. 2–3). Healey said ‘he would wish to reflect on this’ (ibid., p. 3); Patricia Brown sent him ‘a dampener’ on the idea (ibid.,

⑬ Since this is exactly what Kaldor was recommending (we look at his position on measures to improve the current account in detail in Section 8), it might seem that any disagreement over how ‘New Cambridge’ the economic situation was was semantic and not very interesting. All the same, it could be significant that Kaldor and the Review used different language to describe the position. Kaldor had never endorsed Godley’s claim that ‘the only potentially destabilising agents are the Government’s own actions with regard to expenditure on the one hand, and, on the other, foreign influences’ (House of Commons, 1974A, p. 5). Nor had he rejected it. Indeed, as his biographer points out, he ‘never expounded at length in print on the [New Cambridge] doctrine’ at all (Thirlwall, 1987, p. 251). Thus, while abnormally high saving, heavy destocking and an improvement in the terms of trade might be events that the CEPG view had to accommodate, to Kaldor they may still have been (as they would have been earlier in his career) basic features of an inherently unstable economic system.

p. 3, note in margin)—justifiably, given that even the existing Price Code, whereby firms could pass on up to half the wage increases they were paying, would by the autumn produce the worst corporate liquidity crisis for 40 years and bring a swathe of industry to near-bankruptcy. Kaldor’s hope that his proposal would force firms to find productivity gains—with the bonus that workers could be ‘released’ from the service sector into manufacturing (ibid., p. 3)—sounds distinctly utopian in the light of what actually happened. And by the end of 1974 further ground was opening up between Cambridge and the Treasury on inflation. The former were sticking by the real wage resistance theory more emphatically than ever: the latter, mostly, had swung round to the view that unemployment was not a cause of inflation but, if no other remedy could be found, it would have to be used as a cure. In the words of Sir Bryan Hopkin, recently appointed Chief Economic Adviser:

To check inflation by operating on demand is of course a barbarous and wasteful method of achieving the objective. It is only justifiable if as a community we are insufficiently enlightened or have insufficient sense of community interest to accept restraint on the pursuit of individual or group money incomes, which ever is the alternative. Nevertheless, realism forces one to admit that the degree of enlightenment is inadequate. (T338/262, W.A.B. Hopkin, ‘Inflation: Where Next?’, 4 December 1974, p. 1)

But by now, as far as the Treasury was concerned, all the other Cambridge policies were a little-regarded sideshow beside their advocacy of import controls.

8. Import controls

Godley and Cripps (1973A, p. 17) had called for consideration of import controls back in January 1973. The problem was how to secure restraint of consumption (needed to keep the current account acceptable) without cutting real wages (which would wreck the current incomes policy whereby workers were to get no more than ‘£1 plus 4%’). But after this the profile of import restraint waned for a while. In ‘Payments Deficit: The Strategic Options’ published in The Times a year later, the only reference to import controls is that they ‘would be likely to provoke retaliation, particularly because at the present time other industrial countries also face large trade deficits’ (Godley and Cripps, 1974B, p. 19). The OPEC price rise had intervened.

Treasury officials expected import controls to be on a Labour government’s agenda, at least for possible consideration. On 1 March 1974, the day after the general election, and before Heath had even resigned, they judged direct action on imports ‘attractive’, insofar as bringing imports down by tighter macroeconomic policy involved taxes rising ‘perhaps four times the import saving sought’ (PREM16/707, ‘Note by Officials’, 1 March 1974, p. 1).

But the note went on to turn import controls down for the usual reasons (they would distort resource allocation, probably involve leaving the EEC and provoke a tidal wave of imports in the inevitable period between announcement and implementation). Healey, the new Chancellor, wanted to keep the option open, but not to do any preparatory work on it, which would ‘increase the risk of leak’.18


18 PREM16/707, Healey to Peter Shore, 25 March 1974. Shore had circulated the officials’ note to the Cabinet, though it was anything but an endorsement of his own position.
There the matter largely rested until Healey called a meeting on the subject in December 1974. Discussion centred on the prospects for getting away with controls without provoking retaliation or too much international hostility. A few days later Healey commissioned a Treasury paper on import restraints. Its author, Mary Hedley-Miller, pointedly contrasted ‘the attraction’ with ‘arguments against’ (and said the latter were conclusive before she even spelt them out). Simultaneously, Kaldor was agreeing with Hopkin that ‘if we can do without import restrictions this would be much better’. His preferred policy towards the balance of payments was now a dual exchange rate system, with a more competitive pound for exporters and importers of manufactures. (This would be achieved by crediting the former and debiting the latter with an amount of sterling equal to the difference between the two rates of exchange.) However Kaldor also spelt out the circumstances in which this would not be enough and the import quotas required: ‘What if the whole of British industry is threatened with collapse? ... What else could we do?’ As for retaliation, ‘I do not see what the Germans could reasonably do if we cut off unnecessary imports like motor-cars, television sets and many other things ... over a longer period we must bring our trade with other manufacturing exporters into a state of balance.’

In February 1975 Industry Secretary Tony Benn made his first push at Cabinet level for import controls (CAB134/3929, Benn to Ministerial Economic Strategy Committee, ‘A Choice of Economic Policies’, 11 February 1975). The same month Wass sent a paper to the Chancellor that looked at a number of options for improving the current account. Quantitative import controls were quickly ruled out. But Wass told Healey that the Treasury ‘with one or two exceptions’ preferred an import surcharge to doing nothing, especially as it would necessitate even larger cuts in public borrowing than the ones the Chancellor ought to be bringing in anyway. ‘This was because an import surcharge on its own would not only add to domestic demand at the wrong moment, but debar the grudging acquiescence he thought our ‘major partners’ would give the scheme ‘if they were satisfied we were doing something about borrowing’ (Wass, 2008, pp. 96–7).)

Wass had also opposed a managed depreciation of sterling—indeed doubted if it were feasible—but by the summer of 1975, as a temporary improvement in the current account started to go into reverse, the Treasury was changing its mind. H.H. Liesner, at Hopkin’s request, compared this option with different types of import control, coming down on the side of devaluation and claiming that the CEPG case for import controls had nothing to do with their income–expenditure model but rested on their pessimism as to what a falling pound would do to inflation. Replying, Kaldor and Godley went no further than saying that it ‘may be necessary to resort to schemes which embody some element of protectionism such as a revenue-neutral tax-subsidy scheme’. This was preferable to ‘import quotas or import deposits which reduce the propensity to import without helping exports’. They turned down depreciation, both because of the inflationary consequences and because the devaluation of a floating currency could be neither planned nor managed. But over the summer of 1975 Kaldor and Godley moved to a much more decisive position. In July Kaldor restated his anti-devaluation arguments, adding that by now the pound had in any case fallen enough to rule out price factors as the cause of poor export performance. The

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trouble, rather, was that ‘we are not capable of producing up-to-date products with the
design and quality required’. With further depreciation not a useful option, the balance of
payments would remain the barrier to full employment until industry was modernised. But
this in itself would require ‘large imports of machinery of a kind that we are not at present
able to produce at home’. All the more reason, therefore, to restrict inessential imports to
make room for the essential ones.22

Godley agreed: ‘there is no exchange rate that will solve our problems’, which perforce
drove policy back on ‘special measures’ to restrict imports (T277/3057, Godley, ‘Methods
to Improve the Balance of Payments’, 30 July 1975, p. 4). Hopkin agreed with Kaldor and
Godley that Britain needed ‘big policy changes designed to raise the efficiency and
progressivity of our productive machine’. But the villain was not free trade; rather it was
a state of affairs ‘in which commercial enterprise enjoys neither appreciation nor reward, in
which the mobility of resources is impeded and in which practices hostile to technological
improvement and favourable to inflation are permitted and encouraged’. Many changes
were possible in ‘taxation, price control, industrial relations, housing policy and social
security arrangements’: should public opinion get in the way of these reforms, Britain
might have to ‘fall back on Lord Kaldor’s protectionism as the lesser evil. But . . . it would
be a pretty miserable prospect’ (T338/345, Hopkin to Wass, ‘Economic Strategy’,
19 September 1975, p. 1).

Except for the last bit, Hopkin’s diagnosis and prescription could have come straight
from Mrs Thatcher. This did not stop Kaldor agreeing with much of it, but he thought
Hopkin’s reforms needed a ‘favourable economic environment’ where firms thought
investment worthwhile and workers could be confident that less overmanning and
restrictive practices did not simply mean more unemployment. For this reason import
restrictions ‘may be needed not as a “last resort”, but as a precondition for a programme of
manifesto Hopkin wrote ‘No further action (in case go on for ever!)’

In October 1975 the first Treasury minister jumped ship and came out for import
controls. Denzil Davies, a Minister of State, told Healey ‘However unpalatable, it seems to
me that both the political and economic considerations point emphatically in favour of
Generalised Trade Restrictions.’ Healey himself had now been converted to the case for
limited selective import restraints and sank his differences with Peter Shore, the Trade
Secretary and a convinced supporter of import quotas, to co-author a Cabinet paper on the
subject. Quotas were introduced in December to cover all of 0.16% of Britain’s total
imports.23

Meanwhile Kaldor was getting into another debate with the Treasury, this time about
the efficacy of devaluation. When Kaldor presented many pages of country-by-country
statistical tables and picked out numerous countries that had devalued and done
themselves no good, A.J.C. Edwards of the Treasury weighed in, insisting that multiple
regression must be used—as in the Treasury model, which showed devaluation to be
effective. Kaldor retorted that the Treasury model had been used to do something very
different and much less useful—namely to derive price elasticities on the basis of
time-series evidence for the UK alone. His was an international cross-section study that

23 T364/19, Davies to Healey, ‘The Conjuncture’, 27 October 1975, p. 2; CAB129/185, Healey and
Shore, ‘Selective Import Controls’, 4 November 1975. Controls were put on textiles from Spain and
Portugal, and television sets and tubes from the Far East; the government sought voluntary restraint on
footwear imports from Eastern Europe.
showed there were long-term differences between countries’ export performance that exchange rate changes did nothing to address. In any case, time-series analyses like that of the Treasury were exceptionally sensitive to the data and assumptions used—the CEPG had performed the same exercise and reached an opposite conclusion. Hopkin intervened to pour cold water on both time-series and cross-section studies of the exchange rate effect, but gave judgement against Kaldor, whose work was ‘extremely crude and over-simplified. It takes no account of lags; none of the effects of divergent experience of different countries, in regard to levels of activity; and none of the structural differences of national behaviour in the face of trade opportunities’. Treasury studies showed these differences of national behaviour (measured by elasticity of exports with respect to world trade) were especially important. This, said Hopkin, might seem like a victory for Kaldor, but ‘for a country like the UK, facing various adverse structural factors which are difficult to influence, it is an important consideration that changing competitiveness is one of the few ways of influencing trade flows’.24

It sounds like a draw, which is maybe why both sides moved on at this point. At a meeting of the Policy Co-ordinating Committee in February, ‘all’ (Kaldor was there) wanted the exchange rate to fall, though divisions emerged over the size of the fall and on how, indeed if, it could be managed. At the Ministerial Economic Strategy Committee in March, Shore proposed a reflationary policy to bring down unemployment, damage to the current account being contained by controls that would hold imports of consumer goods and some semi-manufactures at their 1975 level until 1980. Foreign critics would be told that any solution to Britain’s problems would involve holding down imports one way or another.25

Healey vigorously opposed Shore’s scheme and the Committee rejected it. But the Treasury’s March Medium-Term Economic Assessment was far more sombre than anything so far. It predicted that bringing unemployment down to 3% by 1980 would involve a current account deficit of £10 billion. This led to another interdepartmental inquiry, this time to look at ‘a medium-term protectionist strategy’, not temporary tide-over expedients. The inquiry stayed close to the macroeconomics, avoiding, in particular, getting into the argument over whether British industry would wilt under the featherbedding or re-equip itself behind the windbreak. They found the Shore scheme could produce a fall in unemployment of about 200,000 by 1980. However they worried what would happen after 1980 (assuming the scheme was taken off by then) and ruled the idea out on the usual grounds of the international repercussions.26

Kaldor was part of Wass’s Short-Term Policy Group that endorsed the report. In particular, he did not think ‘we could get away with an import standstill’. He also wanted the Chancellor to ‘emphasise that the case for a scheme of this sort is now much weaker because, with our improved competitiveness, he is hoping to obtain satisfactory output and employment targets without import restraints’ (T389/23, Kaldor to Healey, ‘Import Restraints’, 27 May 1976, p. 2). Depreciation was working after all.

Or was it? The surprising thing is that Kaldor did not sound any kind of inflationary alarm, still less (given his continued adherence to the real wage resistance theory) warn of

what might happen to wage demands via the real income effect. But the further fall in the pound in the autumn of 1976 (it touched $1.57 in October and was widely predicted to go below $1.50) had Kaldor worrying about imminent hyperinflation, not least through the channel of falling real wages (Thirlwall, 1987, p. 253.) In the meantime, he fired off to Healey a succession of increasingly desperate remedies for the dire state of current account/unemployment tradeoff—remedies that, he hoped, might also avoid an IMF loan and the consequent end of all possibility of import restrictions. Kaldor proposed a £1 billion cut in public spending, a 5% payroll tax, a car tax surcharge, a marginal employment subsidy, further controls on capital exports and an import deposit scheme whereby those importing manufactures would place 200% of their value at the Bank of England for 12 months. The Treasury made the £1 billion cut, briefly considered a much smaller import deposit scheme and ignored the other proposals. Kaldor had by now had enough and in August 1976 he resigned from the Treasury (ibid., pp. 252–4).

Kaldor was right about real wages, if not about consequent hyperinflation. Thanks to the combination of the falling pound and Labour’s £6-a-week limit on pay increases (introduced in July 1975), real wages fell faster in 1976–77 than at any time since 1945, Healey actually boasting to the Cabinet that by the late summer of 1977 they would be down by 7%. Some of his colleagues, to put it mildly, saw this figure less positively. Tony Benn used it in his argument for a much bigger scheme than Shore’s involving a 30% tariff on all imports of manufactures. Healey repeatedly warned Benn that his policies would require as much deflation as any of the alternatives if they were to work. By August he was invoking Cambridge authority for this: ‘Indeed the Cambridge School of Economists, which advocated import controls, had also said that such controls should be accompanied by tax increases worth £3000 million.’ He made the same point, although omitting a specific figure, the following month. In a meeting in October it was even suggested (probably by Healey, though the remark is unattributed) that Benn’s ‘Alternative Economic Strategy’ would involve more deflation than any other option. It is hard to see how anyone arrived at this conclusion and surprising that the record does not show Benn challenging it.

9. IMF crisis and after

As the government approached and then survived the IMF crisis of December 1976, the imports issue became the sole focus of the Treasury’s disagreement with the CEPG. This is understandable. But the other disagreements between the two institutions had in any case waned. One reason was that the ‘natural rate of unemployment’ doctrine had become uncontentious to many of the younger Treasury economists. In December 1975 the ‘Steering Group on the Development of the [Forecasting] Model’ had actually voted on whether the long-run Phillips curve was vertical and decided by a majority that it was. In one sense, admittedly, this widened the gap between the Treasury and New Cambridge,
1970s dispute between the Treasury and the CEPG

whose hostility to the natural rate doctrine was undiminished. Godley attacked it in The Times, arguing that it required one to believe that the natural rate had risen by one million in the last ten years and that ‘the only explanation the monetarists have’ was the rise in unemployment benefits at the end of the 1960s (Godley, 1976). And when senior Treasury forecaster Andrew Britton sent colleagues a policy document appearing to take the natural rate for granted, Kaldor alone challenged him, countering with standard Cambridge view that the long-run Phillips curve was not vertical but positively sloped on account of real wage resistance.34

None of this, however, alters the fact that the Treasury’s straightening of the Phillips curve moved it closer to the Cambridge position on demand management. Opposition to fine tuning now depended on something more fundamental than the inaccuracy of short-term forecasts and the unpredictability of lags. And, while it would be wrong to say that the influence of New Cambridge prepared the ground for monetarism at the Treasury—there is not the least hint of evidence that things worked in this direction—more of a case can be made with regard to the government itself. Thus Mosley (1984) characterises Cambridge School as a ‘Trojan horse’ for monetarism: its leftish political orientation made the hands-off message more palatable to the Labour government than doctrines associated with Enoch Powell and Sir Keith Joseph.

But certainly there was a huge contrast between the Treasury’s tone in 1974, when any engagement with the New Cambridge School appeared to be seen as a form of intellectual slumming, and that in 1976, when a mild glancing criticism of the CEPG could have the critic rebuked for ‘sneering’. Because the focus of this article has been on Cambridge and the ‘Treasury, it has dealt rather briefly with non-Treasury ministers. In particular much more could be said about Tony Benn’s campaign for import controls. Given that (as both men confirm) Benn’s views can be taken as a reliable indicator of those of Francis Cripps, the division between the CEPG and Kaldor can only widen.35 In the end Britain managed without import restrictions—had to, as part of the price of the IMF loan—and 1977 and 1978 saw falling inflation and a halving of the PSBR. But unemployment fell only slightly, staying above 1.25 million, and the Cambridge message continued to be that current policies could not get past the balance-of-payments constraint on full employment and the only solution was protection by means of import controls (CEPG, 1977, p. 10). And the recession of the early 1980s was just around the corner. Then, as manufacturing output shrank by one-sixth in a single year, and unemployment passed 2.5 million on its way to its eventual peak of more than three million, the Left’s Alternative Economic Strategy—a macroeconomic if not always a microeconomic descendant of the CEPG—emerged as the most coherent of the alternatives to the policies of Margaret Thatcher.

The Alternative Economic Strategy included import controls (and therefore, it was accepted without much sorrow, withdrawal from the EEC), but other main planks were industrial democracy, compulsory planning agreements with large companies, a large extension of public ownership and the strongest feasible controls on capital movements as a preventative against the flight of capital the other measures were expected to provoke. While the strategy was developed within—and intended as a programme for—the Labour Party, it was more than just a party political affair and drew on friendly expertise wherever

35 Tony Benn, personal communication, 12 December 2007; Francis Cripps, personal communication, 13 October 2008.
it could find it. As the CEPG continued its support for import controls and made ever more pessimistic predictions about what would happen without them, it appealed both as a supplier of ammunition against Thatcher’s government and a counter to her assertion that ‘there is no alternative’. But by 1982 the CEPG’s influence on the Left was on the wane. In the first place, while it had not wholly abandoned support for import controls, the message was that what was needed was not a policy of shutting out European goods, but a policy of coordinated reflation with the rest of Europe (Cripps and Ward, 1983). Secondly, the Economic and Social Research Council cut off the CEPG’s funding after a review of the Council’s support for macroeconomic modelling in the UK. December 1982’s Cambridge Economic Policy Review was the last one. And the Alternative Economic Strategy itself became marginalised after Labour’s heavy defeat in the 1983 general election started it on its long march to the political centre.

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