The 1981 Budget – Facts & Fallacies

Tuesday September 27th 2011

The Grocers' Hall, Princes Street, London EC2

Session One: Emerging from the 1970s.[1]

PETER JAY
Right, my lords, ladies, and gentlemen I hope you are now in the mood, so let's get on with it. First of all, the boilerplate – the rules of the game. They are very simple. We are in the business of making history. You, the witnesses, will tell it like it was, and the Churchill Archives Centre will take it all down and may give it in evidence against you at any time that suits them. No one else is allowed to record anything that is said, but you are allowed to write notes. If there is time, and if I feel like it, questions may be taken from the floor at the end. Those contributing from the floor must – or this is what I'm told – say who they are for the record, and anyone who speaks must sign the Archives consent form, spare copies of which Andrew Riley has at this moment. I'm not sure what sanctions there are for anyone who speaks and then refuses to sign, but, I imagine, intense academic odium. We are, in every sense, on the record. We are not, repeat not, on Chatham House rules. Speakers will have the chance to edit their transcripts but it will all be published and anyone may quote what anyone else has said. So, ladies and gentlemen, you have been warned. The title of this session is 'Emerging from the 1970s' or, as I would impartially put it, 'How the legacy was lost'. This, of course, suggests a focus on the inheritance with which the architects of the 1981 Budget supposed themselves to be resting. Given that the first rule of politics is to start by rubbishing the inheritance from one's predecessors in office, I expect some hard things to be said about the Labour Government which left office in 1979 not least because I detect a somewhat Conservative tilt in the composition of the panel. I therefore warn them from the impartial vantage point of the Chair that any remarks of a partisan nature will be severely frowned upon, and possibly ruled out of order. Fortunately, as I am also fully aware, Nigel, who will be with us soon, Charles, Brian, and Alan are all fully capable of scientific objectivity when it's required as, for example, today. In the interests of full disclosure, since this is a witness seminar, I declare that in 1981 I was sitting in Camden Town cobbling together what became TV AM, which had nothing whatever to do with Sir Geoffrey Howe's Budget-making in the Treasury. The purpose of the session is, therefore, to remind ourselves of the state of the economy at the end of the 1970s and what those who were active in these matters at the time thought were the problems and the solutions. To assist their recollections I merely recall the baldest facts, namely, that one, with the Prime Minister at the time having embraced in his September 1976 speech to his Party Conference a monetarist disinflationary strategy, inflation, which had threatened to reach 30 percent in the wake of Tony Barber's doubling of the money supply in three and a half years and Harold Wilson's valedictory dithering, was down by March 1979 to single figures. The last number published before the May election was, I recall,

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[1] This transcript was edited by Duncan Needham, Dr Michael J. Oliver and Andrew Riley.

just under 8 percent.[1] Two, unemployment rose sharply in 1976 to a million and stayed there. Three, the Government's attempts to persuade the monopolistic suppliers of labour not to price their clients out of their jobs as inflation came down culminated in the second 'Winter of Discontent', the first Winter of Discontent in terms of prevailing journalistic clichés having been in 1973-74 with the 3-day week. This had little effect on pay but wrecked the Government's reputation. Four, after the election, inflation shot up again, well into double figures, as a result of an explosion in broad money following the abandonment of the corset and the abolition of exchange control, the near doubling of VAT, and the feeble acceptance of the Clegg pay proposals. Fifthly, inflation was only eventually brought under control at the cost of the deepest recession in British post war history, at least up until now, devaluation, unemployment at over 3 million, and deep scars of social division, which are still unhealed. I shall now ask each participant on the panel to give his answer to those questions, culminating in an Olympian view from Lord Lawson when the empty chair has been filled, and I shall then expose them to your questions which may come from those who played a part at the time, or from those with a purely scholarly interest, or indeed from others.

I turn to you, Brian Reading, who, having famously slashed inflation at a stroke in 1970 on behalf of Prime Minister Edward Heath, witnessed the rest of the decade, at least until 1976, turn out very differently. He now looks back, like all of us, sadder and wiser. Brian, what was the legacy of the 1970s?

BRIAN READING
The legacy is, was, a disastrous decade. It was a decade in which everything seemed to go wrong. I wrote the background notes so I won't go into the detail here but you can see just how puzzled we ended up. We ended up confused about what was right to do and what was wrong to do. The world's changed a lot since then, but the thing is we're still today puzzled about what is right and what is wrong to do. And that's the point of this seminar, I think, to try and clear our minds. Certainly it is not the point to try and find guilty or innocent the 364 who signed that letter. I see I've got to sign another bit of paper now. Do I have to?

PETER JAY
Definitely, on pain of academic odium.

BRIAN READING
Oh well, anyway, I didn't sign the 364 letter. It may have been something to do with the fact that nobody asked me to. But, at that time, I'm not sure whether I would have signed it or not. And, with hindsight, I still am not entirely sure I would have signed it. Peter so kindly referred to me as cutting inflation at a stroke on behalf of Edward Heath. The 'behalf' is possibly more important than the fact that he excluded the point that the actual statement was 'to cut the rate of inflation at a stroke by eliminating selective employment tax'. It was not to cut inflation at a stroke. But, of course, Harold Wilson made hay forever after on the claim that it was to cut inflation at a stroke – or cut prices, actually. But 'on behalf' was totally true because I wrote this speech for the Rt Hon. Edward Heath, only he never delivered it. He never said it at all because he told me, 'Well, if it keeps you happy, Brian, put it out as background briefing'. So I rang up Conservative Central Office and said 'We're putting it out'. Now, in those days, you had to stencil everything, cut stencils, to put anything out. So they got it all ready, all in stencils, and

they put it out, not as a background briefing, but as 'Speech by the Rt Hon. Edward Heath'. And it got the headlines all the rest of the day because it said Wilson would devalue again. So it was a little bit of history to which I contributed. But to come back now to the main issues, I think I've already said that we were very confused. I've already said that times have changed and we are now confused. Well, that really is talking about the first, second and third sessions, so I won't say much about the second and third sessions except, so far as times have changed, a little anecdote. In 1973 they shut Downing Street to the general public. Before then, anyone could go in at any time. And I went, in the 1960s, to a party in the third or fourth floor of the Foreign Office, overlooking Number Ten. And during the party several people got champagne and shot champagne corks at the policeman outside Number Ten. He didn't seem in the least perturbed and nothing ever happened about that. But I wonder what would happen if someone did that today. Times truly have changed. Now I want to give a little model to show where the uncertainties arose from without going into all the details – Peter gave some – of the 1970s and that model is quite simply relating unemployment and inflation. The 1930s were, of course, the Great Depression – sorry, I'll go back further than that. The late nineteenth century was a falling price boom. It was called a Great Depression partly because prices were falling, and partly because most of the statistics related to the older industries in the developed countries and, as a consequence of structural change, they were declining. But it really was a falling price boom in the late nineteenth century. The 1930s was the Great Slump, the falling price slump. The 1950s and early 1960s was the 'great prosperity' – rapid growth with modest inflation and low unemployment, although both were in a secular upward trend. The 1970s, of course, was the 'great inflation' followed by the 'great stagnation'. We emerged just before the great recession with the great moderation and now we're emerging from the great recession - we don't know what the 'great' is going to be next. It could be the great stagnation, it could be the great stagflation, it could be the great inflation again. We don't know. But this model highlights the problems of policy. On the whole, policy is designed both to check inflation and to check unemployment and obviously that's easily done when the two are negatively correlated – inflation goes up when unemployment goes down – but very difficult when they're positively correlated, as with stagflation. And, faced with stagflation, we really didn't know whether the correct policy was to validate the rise in prices to save jobs, or negate the rise in prices and suffer higher unemployment. And, in that time, most of us, a lot of us, my generation, certainly the generation before mine, had been deeply impressed by the mass unemployment of the 1930s, either directly or through our families. And so, unemployment was regarded as great a sin, as great a problem, as inflation. And to cause one to solve the other was not regarded as solving anything. So we were very, very reluctant to take measures which would raise unemployment and, for myself, I always looked for a middle way. And in those days the middle way was prices and incomes policy. I never had any doubt that prices and incomes policy could only be a dam holding back inflation, it couldn't hold it forever. But I had hoped that, during the period of holding it back, it would be possible to make the structural reforms which had been planned in the days before the 1970 election, while we were in opposition. Charles Dumas was with me at that time when we were going through these plans. Heath, of course, never really did them and it took until Mrs Thatcher to complete the job. But by the end of the 1970s it's quite clear that you could not validate inflation to save jobs. The great contribution of the monetarist Friedman was to say that is not a solution. It won't work. The point is that with two targets we actually did have two instruments with which to attack the two targets. We had fiscal policy and monetary policy. And during the great stagflation, at first, both fiscal and monetary policy were easy. But, by the time we got to 1980, monetary policy was seriously tightened, at least when measured by nominal interest rates, and fiscal policy was seriously easy. It was then that the 1981 Budget actually reversed this. That was the importance of it. It made monetary policy much easier at the same time as fiscal policy became tighter. And that combination of tight money and easy fiscal policy was actually both driving up sterling, with the help of North Sea oil, but also it was crowding out private spending. High interest rates, while not necessarily high in real terms, were shortening the life of debt. And so, private expenditure was being crowded out by public spending. And when the policy was reversed, it was possible for private spending to take the place of public spending. And this was possible because balance sheets were strong. Personal household sectors had relatively little debt. Inflation had done a great deal of work to reduce the burden of debt. And real interest rates were relatively low, I think – I've maybe got it wrong – so there was scope for recovery. That is where we differ today. It differs in the situation of the finances of the household sector and, to a degree, the corporate sector's leverage. It means that, today, there is no easy reversal from tight monetary policy and easy fiscal policy to the reverse because both policies are, at the moment, easy. It also means that, today, both the private sector and the public sector wish to reduce debts and they cannot do so simply at the expense of each other. There is no way out of the present situation other than through net exports which means the problems today are truly global. Thank you.

PETER JAY
Thank you, Brian, very much indeed. Alan? Just let me introduce you by reminding everybody here that, between 1970 and 1974, you were a senior economic adviser in the Treasury and then later made a name for yourself with a series of Economic Outlooks, which you co-authored with Terry Burns at the London Business School, which were decidedly monetarist in tone. It was, oddly enough, in 1981, the very year of the famous Budget, that you penned the nicest review I ever had of a book, a volume of essays that I published in that year, so ever since I've listened with rapt attention to anything that you say. And so, would you now please tell us what were, in your judgment, the key issues confronting the thinking economist as we emerged from the 1970s.

SIR ALAN BUDD
Well, thank you very much indeed Peter. And, in fact, I was thinking of your book while you were talking earlier because you did at that stage say that you thought no one would pay the political price of bringing inflation down. What was extraordinary was that the political price was paid somewhat inadvertently, but you were otherwise right in your analysis. Well, I am part of the 1970s from which we were emerging. I was in the Treasury from 1970 to 1974, a period which is a strong contender for the worst period of economic management in the post war period. And what it saw was crude Keynesianism to extremes. And some of the elements of all this – and this is as I saw it from the Treasury, it's been interesting for me to hear Brian Reading's account of how he was seeing it – but this is how I saw it from the Treasury, that the use of demand management, which meant fiscal policy, could have unlimited effects on GDP. There was no limit to the extent to which the economy could be made to grow through expansionary fiscal policy and unemployment could be reduced. There were no supply constraints, no thought of supply constraints, so that was one element. Inflation, and I again think that perhaps I'm now going to be unfair to Brian Reading, was seen as a social, rather than an economic, phenomenon, that it wasn't really anything to do with what was happening in the economy, it was to do with such things as the breakdown of order and discipline, the fact that London had become the

swinging city, and so on. It was an example of the sort of way in which people were losing respect for their elders and betters and this, amongst other things, was causing inflation to rise. And, if inflation was a social rather than an economic phenomenon, then economic remedies for it were irrelevant. You had to use other measures including, if need be, legislation. If nothing else works, send them to prison if they insist on being inflationary. I don't think that was included in the succession of prices and incomes policies, though Nick Monck who's here can remind us. And, if economics was to have any role – and this was said expressly by Anthony Barber in, I think, his 1973 Budget, that, if anything, faster growth would bring down inflation, that the Philips curve had been stood on its head. And then the third element for this was that the money supply was completely irrelevant, so that the extraordinary increase in the money supply that was a side effect of what was going on was not thought to be relevant in any way. And the low point of all this, to my mind, was the introduction of the threshold payment system, just before the quadrupling of oil prices in 1973-74. I won't talk about it any more, but it was a clever, clever way of trying to bring inflation down. It failed disastrously, of course. And the painful consequences of all this were inherited by the Labour administration of 1974–79. They inherited it and had, as Peter said, what was then, and remains so, the post war record for inflation and what was, at that stage, the post war record for unemployment more or less simultaneously, something that most people would not have believed could happen. Now, the results of this catastrophe were, of course, the rise of rival views of how economies behaved and these included the monetarists, Friedman at a distance, Laidler and Parkin, still in the UK at the time, I think, Patrick Minford, and of course our Chairman today, Peter Jay, and Tim Congdon writing in *The Times*. So there was the rise of the monetarists. There was also a rise of concerns about the public sector borrowing requirement. And this had two sources, really. First of all, there was Wynne Godley a former Treasury official, who particularly emphasized the flows. In his simple world, if you had a large budget deficit, you must have a large balance of payments deficit because the private sector had a more or less constant financial surplus. So there was concern about the PSBR. Gordon Pepper, who was the other person bringing attention to the PSBR at Greenwells, was, of course, emphasizing the relentless rise and rise and rise in the deficit. Deficits went up when times were difficult and were never later reduced, so they rose relentlessly and he, of course, was linking into the monetarists because of the possibly monetary effects of fiscal expansion. Now, of course, we did take these views seriously. I remember Donald MacDougall, who was the Chief Economic Adviser at the time, asking thoughtfully, 'Do we really have to care about the bloody PSBR? At one stage, we decided that the PSBR had to be cut and so Donald and I spent a day cutting the PSBR. That meant, of course, that we had all the forecasters in and persuaded them that they surely could raise their forecast of revenue, or cut their forecast of public spending completely, honestly of course, and at the end of the day, we had produced the required cut in the PSBR. That's not the sort of thing that happens now of course or ever happened since. So, we did take it seriously.

PETER JAY
Is that the example of budget responsibility?

SIR ALAN BUDD
Yes, indeed. So, I left the Treasury voluntarily in 1974 with these catastrophic consequences coming later. And it's worth filling in a bit more about the 1970s because, not only did we have the famous speech of Jim Callaghan in 1976, not unassociated, again, with the pen of our

Chairman, we had money supply targets being introduced by Denis Healey. We had, of course, the 1976 IMF event which was followed by a fiscal tightening and this was all being argued through the deficit to domestic credit expansion – remember domestic credit expansion – to the money supply. So there was a lot going on in the 1970s and, although this overlaps with the next session, I will mention the fact, as you have, that I went from the Treasury to the London Business School where I worked with Terry. I don't even claim really to be the monkey to Terry's organ grinder. My role there, as it's been through so much of my life, has been insisting on the correct use of the hyphen. But we did write a number of papers at this time. And, in October 1977, we wrote an article for *Economic Outlook* called 'How much reflation?' in which we proposed a medium term financial plan. And the thinking behind this – and this is still emerging from the 1970s – was monetarist, because the linkage was from fiscal policy, to domestic credit expansion, to the money supply, to inflation. That's what really motivated that paper. And, at that stage, our concern, as far as fiscal policy was concerned, was really with inflation rather than with fiscal sustainability. Could I stop there?

PETER JAY
Alan, thank you very much indeed. And now, as we keep things rolling in anticipation of the arrival of Hamlet himself so that we can get on with the play, Charles, you're a hero of the hour because you have leapt into the breach sadly created by Gordon Pepper being struck down. I don't want to give the impression he's mortally sick. I don't think he's mortally sick, but we're very sorry he can't be with us today. He has had an operation. And so, Charles, you find yourself with only a few hours of time to refresh your memory, but I suspect that you think about these things all day, every day, anyway. So, would you mind telling us what you thought were the problems, and the possible remedies, by the end of the 1970s?

PROF. CHARLES GOODHART
That comment reminds me of a quip of Bob Solow's. It was Milton Friedman who said (who was reputed to have said) that he spends his time thinking about the money supply to which Bob Solow replied, 'Well actually I spend my time thinking about sex'. I've always found Bob Solow a more amenable economist than Milton, particularly in that respect. Although I'm not Gordon Pepper I am, actually, in many ways, his alter ego. Because, during this period, Gordon was an extremely influential economist and adviser to Mrs Thatcher and he wrote regular Greenwell's Bulletins which came out, as I recall, once a month. And, after a bit, it was clear that Gordon was sufficiently important and influential, particularly in Government circles after the Conservatives got back, that every time that Gordon wrote a Bulletin I would write an internal memoir about what he was saying and whether or not I thought it was right or wrong, as was frequently the case. So for future Bank historians, or indeed historians of monetary thought, you will have a nice counterpoint with the thirty-year rule of looking at what Gordon said in his Bulletin, and then my internal replies which I hope are in the Bank archives, but I've no idea whether they are. Peter, you did say that 1981 was the deepest recession. Well, it was in terms of the number of unemployed, but I don't think it was in terms of the change in unemployment. And I certainly recall the period 1973-1975 actually being much, much, more frightening. If you recall the peak in the FTSE in, I think it was 1972, was 420. It went down to 140 in, I think it was January..,

PETER JAY
January the fifth.

PROF. CHARLES GOODHART
Yes. And that was a two-thirds fall in equity prices and, even if you correct for the quite rapid inflation, that was a far greater decline in asset values than I think we've ever had anywhere else. You could feel the fear in the City of London in 1973, 1974, 1975 and it certainly wasn't there to anything like the same extent in the early 1980s. Now this, of course, is partly because 1973-75 was very much a financial crisis, whereas 1981 was much more a crisis of manufacturing rather than of finance. But, again, even when you look at corporate finance, in 1975 we had huge inflation and none of the taxation terms had actually been adjusted. And all the companies at that stage had huge capital gains on their inventories because, depending on how you measured it, the value of the inventory was far greater than it had been in the previous year. And if you tax this effectively inflationary value, inflationary profit as it was, you would have a huge tax on real resources. And the company sector, at one stage in 1975-76, was really looking as if it could get almost destroyed by a non-indexed taxation which was a serious worry until Denis Healey actually did put that right. One of the points that Brian did correctly make was that the problem in 1981-82 was really nothing about fiscal policy, that was actually relatively less important. What was killing the country in 1981-82 was the exchange rate. And the exchange rate rattled upwards under the influence, the mixed influence again, as Brian said, of oil because North Sea oil was just coming on stream and people could see it coming along. Mrs Thatcher, was thought to be tough and she would therefore deal with the inflationary problems with very high nominal interest rates, much higher than those abroad. So the UK exchange rate was rising to a point where a huge slew of UK manufacturing simply went belly up. And also that led to quite a large increase in productivity, if you remember the term. Productivity had to increase because we were only playing the best six out of the initial eleven because the other five had simply disappeared, gone bankrupt. So, certainly from the Bank's point of view, the crucial issue was really the exchange rate. And there was a great deal of unhappiness in the Bank about having to keep interest rates so high at a time when the exchange rate was really killing the key manufacturing part of the economy. Central bank governors spend most of their time complaining about fiscal policy because how can we possibly be expected to control the money supply when the Government is allowing the deficit, and the debt, and the roll-over of bonds and all that, to be so damaging? While, equally, all Chancellors spend their time complaining about monetary policy, how can we possibly keep the economy going when interest rates are so high, or alternatively, if you've got inflation, while the money supply is rising so fast? So, the Medium Term Financial Strategy (MTFS) had a little bit for everybody because it was based on the credit counterparts which meant that, in order to meet the MTFS, you had to constrain the PSBR to the level which expected debt sales and expected bank lending could actually absorb, while it had something for Chancellors in terms that it would lead, if you were a monetarist, to a control of the money stock growth to a point at which, it was hoped, inflation would come down. But it did depend on control over bank lending. And, at that stage, of course, we had the corset on. One of the effects of the strong pound at this stage was that it enabled, or encouraged, Nigel Lawson, I think, quite properly and, to some extent, courageously, to cut, to abolish exchange controls, very quickly. And, as always happens when you do something like that, it had no effect whatsoever in weakening sterling; if anything the reverse, because people, markets tended to say if they're confident enough to get rid of exchange controls it probably means they have the

situation under control and, therefore, put money into the UK rather than take money out of it. However, what the abolition of exchange controls did was it made the continuation of a corset absolutely impossible because you could avoid it with no difficulty at all simply by disintermediating through banks, or even branches or subsidiaries of British banks abroad. And that led to the monetary blow-up when the corset was abolished. I was doing the forecasting in the Bank of England at the time and I'm no better, though I hope not much worse, a forecaster than any of you, with the result that my forecast that money stock would rise on the abolition of the corset by about two to two and a half percent was a wild under-estimate in the event, because there had been more disintermediation than we had thought. One of the problems about direct controls is you never know how much disintermediation there is, how much has been dammed up and would come out in a rush. And we got four and a half percent in, I think it was, July. And this, of course, drove an absolute coach and horses through Mrs Thatcher's and Geoffrey Howe's MTFS target for money, monetary growth. I could see that this was going to cause a huge problem and I tried as best I could, as a medium rank official, to actually get either one of the Governors or someone more senior to go and talk to Mrs Thatcher to try and tell her what had happened and give some indication of what we might do about it. But everyone was on holiday and/or didn't think it was that important. Meanwhile Mrs T, of course, was holidaying in Switzerland and went to speak to her great friend Fritz Leutwiler at the Swiss National Bank who went and spoke to Karl Brunner, and both of them said that the Bank of England was either a knave or a fool, or more likely both, and Mrs Thatcher came back to London at the end of her holiday spitting blood. I was then required to organise, when I got the order, events, when Karl Brunner and Mario Monti and, I can't remember, about three or four other fairly senior foreign, somewhat monetarist, economists came and spoke to Number Ten, I think, to the Treasury and to the Bank of England and they shuttled around and I was actually acting as a travel agent, the only time I acted as travel agent. And, fortunately, there was no fog and so everyone turned up at the right time. And that, of course, led to the memorable sessions at Number Ten when the Bank of England was required to come monthly and explain what it had failed to do, why it had not done those things that it should have done, and done those things that it should not have done, and all the rest of it. And they were among the most extraordinary occasions in which I have ever participated. They would begin, usually, with Gordon Richardson trying to give an overview of where things were in his view, and he liked to pontificate. And Mrs Thatcher hated middle-aged pontificating males. She really did. She couldn't stand it. So she would jump in and say 'Well what about x?' and 'What about y?' After a bit she would just shut Gordon Richardson up and explain why the Bank had been so terrible, and ask it what it was going to do about things, and all of that. And we would be ritually spanked at the Bank in this exercise. And then we would say to Mrs Thatcher, well actually, if we're going to try and control monetary growth and keep bank lending down, unless you actually want to go back to some direct controls…, and Mrs Thatcher, to her credit, always said, 'No. You've got no other course than to raise interest rates', at which point the whole tenor and tone of the discussion changed because Mrs Thatcher hated raising interest rates. I think that, basically, Mrs T really did not understand either monetarism or monetary base control (MBC) and she thought that monetary base control and monetarism was a wonderful way in which you could control inflation without anybody suffering any pain. And she never actually realised that MBC was a way of forcing very volatile, extremely changeable interest rates. And the moment interest rates were mentioned in these discussions the whole tone of the argument changed. And so the policy measures that came out were usually quite mild, because she would never consider the kind of increase in interest rates that those around thought were necessary to bring the monetary growth down to the kind of levels that met the MTFS.

I must, since we're on the record and I want to have this recorded – I don't know whether Nigel was at this occasion - it was one of these occasions where the Bank was being ritually spanked. It happened to coincide with Mrs Thatcher's birthday and, after the Bank had been ritually spanked, there was wheeled out into this room a cake, a large cake. I have to say it was one of the most hideous cakes I've ever seen in my whole life. As I recall, it had brown icing sugar on top of which was a picture of the House of Commons picked out in green icing sugar. It looked absolutely revolting. But, anyhow, Mrs Thatcher, being the hostess, offered it to all of us around the table and I recall Eddie George telling me in a *sotto voce* tone, 'I just don't think I can eat this', which was rather splendid.

And I'm going to end on that point with one other slightly surreal recollection, which is that you probably know that Theresa May was, for a short time, in the Bank of England and she worked in my area for a short time. And at one stage in the early 1980s – I think it may have been when I was about to leave – she penned a verse on M3, a sort of comic verse, and I was trying to find it this morning and, unfortunately, I failed. But if I do find Theresa May's verse to 'Oh M3, you capricious variable', I think it started, I shall certainly want to try and get it into the public domain.

PETER JAY
Charles, thank you very much indeed. Nigel, may I recognise you and welcome you to the panel. We're very glad to see you.

LORD LAWSON
Well, thank you very much, and I apologise to everybody for being late.

PETER JAY
We're very sorry that you had difficulties, but we're very glad to see you. Now, my introduction to you says that I thank you for listening patiently to the opinions and recollections of the scribblers – not any longer teenagers alas and chatterers – but I don't know how much of the chattering and scribbling you've actually been able to listen to. But, I suspect from your long experience you know what they would have said even if you didn't hear what they actually said. In 1981 you were a Treasury minister, Financial Secretary I think, and you shared responsibility for making policy rather than just opining about it like the rest of us. Later, as Chancellor, and in your classic handbook on that job you did, I think, as much as any politician since Gladstone, unless possibly Keynes in the House of Lords counted as a politician, to imbue the work of the Treasury with a discernible intellectual vertebra. So, can I ask you, as of 1980, what did you think the problem was?

LORD LAWSON
Well, I'm very happy to try and address that, but do you think that since I missed it you might summarise in a few brief words the main points you think that I've missed so I can address those. I'm happy to talk in general, but if you could?

PETER JAY
I shall certainly fail in that assignment. Basically, Brian spoke to his paper which you may have seen, but not had time to study, and gave a highly individual account of his perception of the economic model at work which he saw, to some extent, in terms of the interaction of inflation and unemployment and the relationship at the Phillips curve, or not-Phillips curve, which different politicians had struggled to deal with and concluded that we were still as uncertain today as we were then. I hesitate to summarise what Alan said because he's sitting next to you. He can do it himself. Do you want to give Nigel one sentence of your own thought?

SIR ALAN BUDD
Well, I was really describing how economic policy was conducted in 1970-74, which was catastrophic, and tried to explain the ideas behind it, and the response to those ideas which produced, from the mid-1970s onwards, attention to monetarism and attention to the PSBR and the ideas behind it that were emerging after the Barber experiment.

PETER JAY
I think Alan awarded the prize for the worst period of economic policy in British history to the period 1970-74, if I understood him correctly.

SIR ALAN BUDD
Yes.

PETER JAY
You probably heard what Charles said.

LORD LAWSON
Yes, I did hear what Charles said, yes.

PETER JAY
Does that spark you off?

LORD LAWSON
Fine. Well, it was an appalling inheritance that we had in 1979. It was, I think, not just from 1970 to 1974, I would say the whole of the 1970s was an appalling period in the conduct of economic policy. One or two good things came out of this.

First of all, it was quite obvious that there needed to be a major change in direction and that made it easier for us, because it's very difficult politically to introduce a major change in direction. I sometimes think that things need to get really bad, and they were really bad, before any necessary reforms will ever be undertaken because the inertia and the political difficulties are always too great. There needs to be a realisation that there's been a disastrous failure.

The second good thing was, although the Treasury officials also recognised it had been a disaster, they hadn't the faintest idea what the right course was. So we were able to say, when we came in, what we were going to do. They didn't believe us of course, they didn't believe either it was the right thing to do, or that we would stick to it. But at least they had nothing else to put forward. I'm looking at it very much from a political point of view, but you have to, in the conduct of economic policy, it's just as much politics as it is economics. And those two things made the political difficulties, which were enormous, rather less than they would otherwise have been. The 1970s was a disastrous period. It was a disastrous period in economics. Not only was there a huge failure – and indeed it was not merely that it was when inflation took off, and inflationary expectations became embedded, which is the real problem, when inflationary expectations become embedded that makes the task very much harder to deal with – but it was also a period of practically no growth. If you strip out North Sea oil – which came into existence during the 1970s and became of increasing importance – if you strip out North Sea oil, there was virtually no growth in the economy at all. So it was very bad and, in addition, there were things which aren't captured in the financial and monetary statistics.

British industry had become hopelessly inefficient. This was for a number of reasons. The power of the trade unions had meant that a lot of managements just gave up, or at least the only enterprises which they thought would pay off would be trying to get subventions from the Government. And so there was a great boom in lobbying Ministers and lobbying civil servants and lobbying in Whitehall in those days, but there was very little attention to managing their own businesses efficiently, because they felt that a combination of a Government which was imposing all sorts of restrictions, and controls, and trade unions, which made their lives intolerable, meant it wasn't worth the candle. British industry and British management were extremely inefficient. British industry was extremely inefficient. And, of course, there grew up too, which was a problem we had to face when we came in in 1979, a problem of massive over-manning, as a result. A part of that inefficiency was seen in the huge over-manning which was most prominent in the nationalised industries. But it wasn't confined to the nationalised industries. There was considerable over-manning in the private sector as well. So, it was a complete dog's breakfast and Britain's reputation overseas was correspondingly reduced considerably to worse than I could ever recall, and I don't think it has ever been as bad at any time. We were the sick man of Europe, pitied, not disliked, but deeply pitied. And, I think it's really worse to be pitied than to be disliked. So that was what it was. The Bank of England was pretty useless. With the exception of Charles Goodhart, nobody believed in monetary policy at all there. And in Kit McMahon, who's a delightful fellow, there was somebody who was actually strongly opposed to monetarism in any shape or form. And, therefore, the Bank of England, instead of attending to what should have been its business, namely monetary policy, was lecturing the Government of the day all the time, whether they were Conservative or Labour Governments, on the need for an incomes policy and a pay policy. That was the big cry. That was the big thing at the time. And the Bank of England was among those emphasising that this really had to be done. There was some pressure on the Bank of England for control of public expenditure, which, of course, was not their job anyway. Their own job, they neglected completely. There was some, as I say, some pressure from the Bank of England on Governments being firm about control of public expenditure but, again, that was one thing that the Treasury has always been hot on, and was hot on then, if perhaps not very effectively. My memoirs are more complete because they were written closer to the time, and I forget things which I didn't forget when I was writing my memoirs. But it was an appalling time.

In the early years of the Thatcher Government, incidentally, the Bank of England made a big mistake in always trying to short circuit the process by appealing to Margaret Thatcher.

Margaret Thatcher, first of all, had no time for the Bank of England most of the time, rightly or wrongly. Secondly, the Bank of England thought that it was too grand, really. I had a great difficulty, incidentally, when I was Financial Secretary in 1979. Geoffrey was Chancellor, and he delegated, I mean he obviously had responsibility for everything, but he delegated some responsibilities, in particular, for monetary policy. And that meant that I used to have to, sometimes, when things happened which were minor crises, to speak to Gordon Richardson. And Gordon thought it was absolutely unspeakable that a Financial Secretary to the Treasury should be speaking to the Governor of the Bank of England. The Governor of the Bank of England was far too grand for that. The Governor of the Bank of England would normally converse with the Prime Minister and occasionally, on a poor day, with the Chancellor of the Exchequer. But with the Financial Secretary to the Treasury - absolutely intolerable. So I had great difficulties. Geoffrey always backed me up. So Gordon didn't get very far. But, anyhow, that's an aside but it gives you a flavour of the Bank of England in those days.

The problems were many and the Bank of England did completely fail to predict the consequences for intermediation, disintermediation, and re-intermediation on the results for the M3 number of, first of all, the abolition of the corset but also, the abolition of exchange controls. That had an effect too. It was quite obvious to us that monetary conditions were a great deal tighter than the M3 figures were showing. But, anyhow, the Bank of England got all that wrong, Margaret was very cross, but coming back, if the Bank of England had concentrated on speaking to Geoffrey, maybe even to the Treasury mandarins, instead of trying to have a short cut through Number Ten they might have got a little bit further, but I'm not sure that they had a great deal to contribute anyway.

This brings me to a thing which is perhaps forgotten about the MTFS. As Geoffrey Howe has written, I was the principal architect of the Medium Term Financial Strategy. And there are various things about it which are not fully understood. There was a great deal more than the numbers on a piece of paper. It was saying these are the things that matter. The monetary conditions and fiscal conditions, you focus on these, not on incomes policies, or all these other things, all these diversions which were actually the main theme of the 1970s insofar as you'd credit it with having a theme at all. And you look at the conduct of economic policy in a medium term context. And you've got to also stick to that to get credibility. Now, one of the things that happened, of course, was the effect on the M3 numbers, as I said, as Charles has said, as a result of the re-intermediation following the abolition of the corset, which was absolutely the right thing to do, to abolish the corset, I doubt whether anybody would say that it was a mistake. I wouldn't agree if they did. But I doubt whether anybody would say that. And also, as I say, the abolition of exchange controls was, again, a very good thing. As the result of that, there was a danger that, because the M3 growth figures were all over the place, this would discredit the MTFS. And it was very important that the MTFS should not be discredited. And that is why the fiscal side of it became doubly important because, if that had gone haywire, then the MTFS would never have had any credibility at all. And that is one of the reasons why the 1981 Budget was so important, because it was addressing the fiscal problem at a time when that was absolutely essential to the credibility of the whole MTFS, the credibility of the idea of having a medium term policy, and not lurching from expedient to expedient which had been what had happened throughout the 1970s. That way of conducting economic policy was one of the big disasters. That, in my judgment, and in Geoffrey's judgement, was what we had to get away from. Anyhow, I think I've spoken enough.

PETER JAY
Nigel, thank you very much indeed. I'm now going to ask the folks upstairs who control the lighting to alter it so that I can actually see the people in front of me, because I'm aware that sitting along the front here at least is a kind of Treasury bench of a different kind and people who were in the Treasury during the key periods which the platform's been speaking about and, all, or some of them may have things they would like to raise at this point. Ian Byatt?

SIR IAN BYATT
Picking up the point about the structural problems of the British economy, that manufacturing was in a mess and the whole labour market was in a mess, I wanted to reinforce that by saying that I think the trouble with the policy response in the 1970s was that it was counter productive and made the situation even worse. The incomes and prices policy increased the rigidities in the economy and subsidising or supporting industry also increased the rigidities in the economy. All that simply made the problem very much worse. It was almost as though we thought of, what I would call, a priceless economy. There was only one price that mattered in the economy and that was the exchange rate. In fact, it turned out to be very difficult to influence or change and it was in the hands of other people anyhow, i.e. the outside markets. So here we were pursuing a set of policies which were inherited from the past, not in any way adapted to the circumstances which were there. Of course, the whole situation was very confusing too, and that I readily admit.

PETER JAY
Nigel, would you mind if I took a few more interventions, then you come back? Tim Lankester?

SIR TIM LANKESTER
I was in the Treasury in the late 1970s and was in an office with Andrew Turnbull during the IMF crisis in 1976. And then I was Callaghan's private secretary in 1978 - 79 and Mrs Thatcher's for the following two years. So I was fairly close to the events. I can certainly vouch for Charles Goodhart's description of the ghastly monetary seminars we had at Number Ten in 1980. The atmosphere was pretty poisonous because, by that time, Margaret Thatcher had lost confidence in the Bank of England. And the problem was that she was that she was thoroughly hooked on the MTFS. She believed in the MTFS and she believed in the M3 numbers which were going haywire. She had been warned by the Governor of the Bank of England in March that it was going to be very hard to stick to those numbers, and he didn't like the MTFS, but she and Geoffrey Howe overrode him. They were very difficult seminars. I took off the web last night, from the Thatcher archive, my notes of those meetings and they are a tribute to the intense interest Mrs Thatcher took in monetary policy. We discussed things like lender of last resort, the reserve asset ratio, monetary base control and its various families. And it's hard to believe there's a modern Prime Minister, except possibly Gordon Brown, who would have got into this sort of detail. We came out of those seminars without much to show for them. The Bank of England and the Treasury were told to go away and control the money supply. I don't think anybody except Charles Goodhart, Peter Middleton, and Nigel Lawson really understood the various monetary base control options. It was very all very complicated. And it was unfortunate

that when Mrs Thatcher went off to Switzerland for her summer holidays Karl Brunner and Alan Meltzer and various others, supported by Gordon Pepper in this country, and one or two others who thought that monetary base control - which was really in my view a will-o'-the-wisp - was capable of achieving the appropriate degree of monetary tighteness, with lower interest rates and at lower short term cost, than more orthodox monetary policy tools.

It seems to me that in the 1970s there were two core problems. The first was a declining share of profits in national income and a decline in competitiveness. The trade unions were extracting an increasing and unsustainable share of our national income into wages and away from profits. And there were a host of other problems relating to our loss of competitiveness: lack of competition, lack of market pressure, over-regulation, a lack of enterprise culture and more. And all this caused rising structural unemployment, what in the jargon is called the non-accelerating inflation rate of unemployment (NAIRU). So the NAIRU was going up, year by year.

The second core problem was that, at least until 1976, the Treasury, as Alan Budd has so eloquently described, believed in an accommodative macroeconomic policy. If you had an unemployment problem you spent your way out of it. That changed, I think, in 1976 with Jim Callaghan’s speech and with the IMF rescue package later that year. And, I think, from 1976 onwards the policy was not accommodative in that sense. But we failed in the 1970s to deal with the supply-side problems. We had the so-called Industrial Strategy which was an appalling spatchcock of measures which basically came down to subsidising and coercing industry in a vain attempt to make it more competitive.

The fundamental problem was that the Labour Government of the late 1970s was incapable really of addressing the excessive power of the trade unions, companies’ lack of profits and various competitive issues. I think when the Conservatives came in in 1979, with the help of Keith Joseph, John Hoskyns and other advisers to Mrs Thatcher, the incoming Government did understand these problems – the lack of competitiveness, the fact that profits were in secular decline. Ironically, it was the Marxist economist, Andrew Glyn, who had first spotted the secular decline in the profitability of British industry, which, unless corrected, would spell doom for Britain’s economy. Geoffrey Maynard in the Treasury in 1977, wrote a paper on similar lines for Denis Healey but Denis Healey took no interest in it.

And so I think what was going on in the late 1970s was the Treasury actually did understand the underlying problems. They understood that fiscal and monetary policies could no longer be merely accommodative. They did understand the trade union problem and the lack of competitiveness, but for political reasons they didn’t feel anything much could be done. There wasn’t the political will. The new Government in 1979 did take a grip on these issues. Doing so was extremely painful, and it caused lots of problems and some mistakes were made along the way. Grasping the nettle of trade union reform and the other supply-side issues was absolutely crucial.

I was the note taker at a meeting in late 1978 between Jim Callaghan and the trade union chiefs - beer and sandwiches at Downing Street, as it was known. Inflation was in the teens and we were trying to bring it down through an incomes policy that wasn’t working. Moss Evans, who was the General Secretary of the Transport and General Workers Union, thumped his fist on the

Cabinet Room table and said 'Jim, it's my job to get eighteen percent for my members, it's your job to get inflation down to two percent'. Callaghan looked at me and his expression was as if to say, 'We're finished, aren't we?'

PETER JAY
Andrew, Lord Turnbull?

LORD TURNBULL
Thank you. In discussing the 1970s, of course, there was this brief interlude between 1976 and 1978 when it looked as though we might be getting on top of things. And the real tragedy was that it was let slip. John Biffen had a view of the economic history of Britain. He said it all broke down at the time when Macmillan refused to support Thorneycroft. And from then on, no Prime Minister ever really supported wholeheartedly his Chancellor of the Exchequer. And this was finally ended when, after a rather skilful process, your father-in-law allowed all the Peter Shores and the Harold Levers to talk themselves out, and he then finally backed the Chancellor of the day. Biffen's view was that was a restoration of the proper order of things. But then, of course, it didn't last.

A couple of anecdotes. Charles, you referred to the way in which inflation was crippling the private sector. Of course, inflation was actually working the other way for the public sector and particularly this question of how public expenditure was controlled. In 1970, my first job was in the general expenditure division. I was summoned to a meeting. In those days, I could speak French reasonably well – I've completely lost it since. And I was asked to take the notes of a meeting between the very grand Sir Sam Goldman and Sir Bryan Hopkin, who were receiving a deputation from the Directeur du Budget in Paris, Monsieur de la Genière, a man with a handshake like a half frozen trout. And in the course of this, we were explaining why we controlled in volume terms and how it sort of took inflation out so you didn't get the distortion. De la Genière asked, 'Do you know how much cash comes in and out of the Treasury each week?' and Bryan Hopkin said 'Why on earth should we want to know that?' And in a sort of *sotto voce* way de la Genière said, 'I think that's your problem'.

The second anecdote was in 1979 with Mrs Thatcher, when I was working then in the overseas side of the Treasury and writing the briefs for meetings she had with heads of state and Government. And her first was with Helmut Schmidt almost in the first week. And I wrote the absolutely standard brief that I would have written for the Labour Government, about how we should press the Germans to accept their responsibility to be a locomotive and to relax their policies. And a message came back – which probably you sent it back to me (looking at Sir Tim Lankester] – saying 'Mrs Thatcher has no intention of telling the Germans how to run their economy as they do it so much better than we do'. Anyway, it took us a while to learn that.

PETER JAY
Thank you Andrew very much indeed. Any more from the front bench? Yes?

SIR ADAM RIDLEY
I was helping run the Conservative Research Department's economic policy work in the years 1974 to 1979, and was watching all this very closely and occasionally talking formally or

informally to old friends and colleagues in Whitehall. Given that context, I want particularly to talk about Clegg, because I think this was probably the biggest single element of what went so disastrously wrong. It confronted us with an insoluble problem for reasons I'll explain; and I want also to make two other smaller points.

Clegg was announced, I suspect, in February or March 1979. It was quite a complex package, which was not really revealed or disclosed at any great length. Clegg was asked first to talk about the validity or utility or appropriateness of using comparability as a method of determining public sector pay. His first report was to be on whether this could be used. The implied representation was that, of course, he would only take a few minutes to agree that it was right.

He was then asked to apply that technique by implication both to all the claims that were coming in and to some that were already, if you like, festering or igniting in front of him. Now when we, in opposition, tried to find out details of what on earth was going on, there were none. This was incredibly difficult because it was a chaotic time anyway. You'll remember that the Government was in a position of great weakness. There was a devolution referendum. There was a civil service strike, or partial strike. There were no economic statistics at all from January 1979 onwards, so we didn't really know what the hell to do. But one thing was absolutely clear to Geoffrey Howe, to Jim Prior, and to me and one or two others: that we had to have a position that would deal with the electoral challenge that was sure to arise.

The work we did suggested that we could partially safeguard the future Government's position. But when you thought about it, it was almost immediately obvious that those who were pushing Clegg had what one might call a first mover advantage. The mere fact the thing had been proposed in such attractive circumstances put us in grave difficulties. The only thing to do was to take an initiative. So we worked out a sort of triage system which one might use in public. The first thing was to say you've got to see whether or not the methodology works, and you don't accept the validity of the methodology without the old boy coughing up his reasons. Second, you had to say that where there is a deal already concluded you can't really overthrow it but you need to moderate it. And where there are no actual claims that had been formally submitted, those you can put on one side and say 'we will have to stop and think'. Now that was the only basis we could think of for a public posture, and which we felt in private should be put on the table pre-emptively before the election came.

The Shadow Cabinet meeting at which the paper proposing this was taken was the last meeting of the Shadow Cabinet. As I recall it was the day of the confidence debate which the Labour Party lost. My colleague who took the minutes of the meeting never wrote them up because he was too busy doing something else but we were given instructions as to what to do thereafter because the egregious Teddy Taylor, who was always one for a short quick political answer to everything, said, 'Margaret, I don't think all this complicated stuff is any use when you're standing on the platform. We need something short and simple. So I think we need a two liner: all deals that have been agreed will be accepted subject to cash limits' and I thought, bloody hell, how are we going to get this to fly. Anyway we went off, we tried to work it up; it became policy guidance. And then as sure as eggs is eggs, even before the first election press conference, up comes Jim Callaghan and says: 'I have a little question for Mrs Thatcher. Will she tell me in the interest of all the countless millions of public sector employees whether or not the Conservative Party will honour the Clegg awards?' Panic. What the hell can we do? So Ministers or Shadow Ministers said we must accept because they recognised there were probably a quarter of the labour force directly affected if you took central Government, local Government, the National Health Service, and all the other parastatal bodies. They said the political consequences of saying 'we won't' would be inviting one to be stoned every day morning and night on the hustings. Now, what did that mean? Difficult to say. At the time I remember calculating it was probably worth one and a half billion pounds at least of extra expenditure in 1981, two and probably two billion pounds or more in 1982-3. Remember – and we'll come back to this later – that the prospective overshoot of the PSBR was only five billion pounds and public expenditure was of the order of seventy billion pounds at that time. Those were days when prices were low. Now there is a lot more you could say about what we could have done, but that is what actually happened and there are one or two papers around from the time.

May I now digress very quickly to two other things? First of all Alan (Budd) and I will remember in the autumn of 1975 an extraordinary meeting, held by the CBI to discuss the end of capitalism. We gathered in a small hotel in Sussex. Alan presented a paper and I remember it vividly - I think I can find it - about what do we do when the FTSE shrinks to ten. The point is not that we were right or we were wrong, but it's a measure of our extraordinary sense of despair. We sat down absolutely rationally, it was a very private discussion. Donald MacDougall was there and various other senior parties, Bryan Rigby - I don't know whether he's here yet - may nor may not remember it.

But in a sense that discussion had its origins partly in research by yet another economist whose name begins with A, namely my Eton contemporary, Andrew Glyn.[2] Actually Alan and I spent a happy time in the Treasury in 1970 and 1971 studying the decline in the industrial profitability. And we tried to get people interested in it. I then went off to the Central Policy Review Staff (CPRS), I don't know what Alan did, but, as Tim says, it was those two outrageous Marxists who in a sense first provoked us do it.

One other point. People talk about the astonishing rise in unemployment after 1979 and they point to the exchange rate. What they don't point to is the staggering irrationality of the union movement at that time. It didn't take a genius to see that the exchange rate was rising. It didn't take a genius to see that the rate was affected by oil and other pressures. And yet you had, for example, the engineering unions, who I think succeeded in a twenty two percent wage claim. And then they were surprised when exports collapsed and imports shot up. You had the steel industry, stimulated by Michael Foot's lunatic commitments during the previous campaign in which the Unions went on a strike that lasted ten months. They had two hundred thousand employees at the beginning of that strike. The year after it ended they had under a hundred thousand. Now this fall was partly thanks to reduced over-manning but it was also stark, staring lunacy. And it wasn't only in those sectors that these things were happening. We had madness, we had over-manning and we had no one willing to believe that the Government would stick to their guns. That's something which, Chairman, I'd like to revert to later on. Thank you.

PETER JAY
Thank you, Adam, very much indeed. Now are there any other live witnesses? Yes, please? Patrick, yes. I didn't recognise you because of the lighting. Patrick Minford.

PROF. PATRICK MINFORD

So I'd like to take the thing back to the ideas, really, since I think that Alan started the ball rolling very nicely by explaining the dominant ideas of that time. The extraordinary Keynesianism of the time has really got to be understood because this permeated the whole establishment. And if we were to have quotes from that period you wouldn't believe them today. And I'll leave it there because he explained all that.

The other point that's been made by various people, quite rightly, is the abysmally poor growth record of the period – you made this point Nigel. There was very slow productivity growth. And it never occurred to anybody that the Keynesian formula, which was that demand created growth, was actually being disproved, that supply was creating growth and what demand was doing was creating inflation. So this is the key basic point which really underlay the growth of monetarism, providing an alternative set of ideas to organise policy around, because policy, of course, completely lost its way. I think Brian Reading made the point that nobody knew what to do and I know that the main feeling – I was in the Treasury in the early 1970s with Alan and I kept in touch with many Treasury people like Sir Bryan Hopkin and they were just baffled by what to do. Their ideas actually no longer had any traction on the problems of the time. And so monetarism came in, from Milton Friedman originally. Alan Walters brought it, writing papers on the role of money and the determination of demand and inflation, but it was our kind of monetarism that was used here. It went further than money and inflation: here I'd like to pick up something that Nigel Lawson said about the MTFS and its crucial role in anchoring expectations. Now this actually didn't come from Friedman. I think it was partly to be found in the London Business School's 'international monetarist' MTFS espousal because they had grasped this idea that if you had a dissolute fiscal policy, you couldn't possibly rely on monetary policy being carried through because, in the end, you'd be borrowing so much that inevitably the costs of this would be overwhelming and you would have to resort to the printing presses. This is the easiest way I think to understand the role, the connection between fiscal and monetary policy. And when it came to the 1981 Budget – because throughout the 1970s fiscal policy was simply seen as an instrument of demand management, controlling unemployment and output – I think the big shift, in fact, was not really to Milton Friedman's monetarism because it, and indeed much of the monetarist writings of that time, didn't emphasise fiscal policy at all. It was really a kind of British monetarism that brought fiscal policy into the picture as a kind of key support to monetary policy and the credibility of monetary policy long term. And I think I'm right in saying that the Medium Term Financial Strategy came into being as a way of, not merely producing a set of credible long-term targets for the monetary environment and monetary growth, about which there were all sorts of problems with measurement which I'll talk about just briefly in a moment, but also producing a path for borrowing and fiscal policy that would be seen to make it possible to adhere to the monetary policy. Later on, there were various academic articles talking about 'unpleasant monetarist arithmetic' in the context of rational expectations theory where you tried to see what the policy environment could logically lead to people expecting. But I think the Medium Term Financial Strategy was the first practical policy implementation of that idea, that people weren't stupid, they could see what policy would imply, they could see that, if there was inconsistency between fiscal and monetary policy, the whole thing would fall apart. And so the 1981 Budget can be seen as a watershed, in terms of delivering the Medium Term Financial Strategy and ensuring credibility; it has to be seen against this background of a completely different intellectual framework in which money is determining inflation but fiscal policy is supporting money. And this has also to involve people in the sense of determining their expectations and creating a credible environment that they can then see logically and rationally will lead to these policies being successful. And so this was, I think, the main background. The government of Margaret Thatcher, with Geoffrey Howe as Chancellor and Nigel as Financial Secretary, were the first implementers of what I would call modern macroeconomic policy (and rebuilding macroeconomics out of the ruins of Keynesianism fundamentalism).

Just a last word about M3, M0, and all these things. One of the things that was quite unfortunate in all this, and Charles will know this too, is that the actual instruments that were used to define monetary policy were being undermined by a hugely competitive banking system at that time and the liberalisation of the banking system. And so it turned out, as we know looking back on it, that M3 in this period of the 1980s – and in parts of the 1970s too – was highly unreliable as a guide to what was actually going on in terms of monetary tightness. As it happened, I argued, and Alan Walters argued, I think rightly, that M0 was a much better indicator of monetary tightness, though obviously it couldn't be an instrument of policy but, in the context of a world in which you were setting interest rates, it actually mirrored rather more accurately – in a world where banking was very deregulated – what was happening on the ground to monetary policy. And, indeed I remember Keith Joseph saying at a debate in Oxford, where I was supporting him, at the Union, 'Well, M3 may be out of control but we certainly have…' – I can see him wringing his hands at the time in that characteristic way of his – '…we certainly have a very tight monetary policy'. And this was at the beginning of 1981 when it was clearly biting. So, I think that was an important debate at that time. It was unfortunate, perhaps, that the MTFS was couched in terms of M3, given this problem. But it had to be couched in terms of something and, in the event, the policies did create credibility particularly after the 1981 Budget which, as I say, was a watershed in determining credibility and showing that the MTFS did mean something in practice.

PETER JAY
Thank you, Patrick, very much indeed. Before I come back to the platform as we move to the winding up phase, Steve Nickell, can I ask you whether you feel moved to say anything at this moment by way of what you were thinking at the time? Steve Nickell, Warden of Nuffield.

PROF. STEVE NICKELL
Yes. There's one feature of the economy which hasn't been discussed, and that is the fact that, within the labour market, wages were effectively indexed to prices. Indexation was deeply embedded in the economy. In 1972, I remember listening on the radio to Milton Friedman who, I think, was in Britain actually, and, whether or not he was in Britain, he was asked a number of questions, and he was very strongly recommending that wage indexation was an excellent policy. The reason, of course, he thought it was an excellent policy was that it is indeed an excellent policy if you're confronted with monetary shocks. Unfortunately, whether or not they were following him, I don't know, but, in 1973, indexation was formally introduced into the British economy and wages were indexed to the retail price index. Now, anyone who knows anything about how the world works will recognise that, if you have an oil shock, this is absolutely disastrous, because real wages relative to the retail price index have to fall if there's an oil shock.

So, if you don't allow them to fall all that can happen is that you get this extraordinarily rapid wage price spiral, which is indeed what we saw. And that was followed, of course, by a succession of incomes policies and these, of themselves, I think, helped to embed indexation, wage indexation, into the British economy. So, by 1979, for example, you had the retail price index, in the third quarter of 1979, rise by no less than five percentage points because of the VAT and the exchange rate. But, the most amazing thing was that, in the fourth quarter, private sector wages rose by five percentage points. So, nothing to do with Clegg, because that was in the public sector. And it is absolutely the case that, if you live in an economy where wages just respond for one reason or another almost automatically to prices, then you are in a terrible situation if the real wage has to fall which it will do if you raise VAT or if oil prices go up, or food prices go up, or anything like that. You get this embedded inflation, and it makes monetary policy fantastically difficult to operate. And now, for example, we can have real wages falling as they are at today without any great difficulty. Real wages, of necessity, have to fall again because of the huge rise in oil prices, but that hasn't led to dramatic increases in inflation which you would have seen had there been huge indexation.

PETER JAY
Steve, thank you very much indeed. Right, now I come back to the platform. Nigel would you like to come in now, or would you like to give the others just on the platform a quick opportunity to say their last word before you wind it up?

LORD LAWSON
Fine.

PETER JAY
All right, Charles, last words?

PROF. CHARLES GOODHART
Two. First, the problem of which M (money stock definition) is the M that you ought to be looking at, and of course there are problems with all of them. But the one name that I'd like to remind you of is Jurg Niehans. Alan Walters came over, to be Mrs Thatcher's personal adviser in economics, and Alan, I think, was not a great M3 or £M3 supporter, and Alan got Jurg Niehans to write a paper on how tough, tight was British monetary policy. And my memory of that time was that it had a very considerable effect, and it actually was the paper that persuaded Mrs T that sticking with M3 was not necessarily, that M3 was not necessarily the key to giving the right signals. And I don't think that paper has actually ever been published. It's available. But, in my view, it was one of the most important unpublished papers of our times. The other very quick comment talking about the late 1970s, the battle between, are we going to try and be reasonably tough on inflation, or are we going to be accommodating, certainly continued after the IMF in 1976. What was one of the remarkable things was, given how much bloodshed, particularly political bloodshed, was spilt over the 1976 IMF terms that the UK economy, for reasons that I've never been quite sure about, actually met the IMF conditions relatively easily in 1977. And 1977 was rather a good year. And I think it was Andrew who was saying that we failed to take advantage of that. And I remember a fairly bitter battle, both within the Bank and also, I think, within the Treasury. Because what was happening was that we were doing so well that sterling was beginning to appreciate after having fallen dramatically in 1976. And there

were those in the Bank, Christopher Dow and, I think Kit McMahon, who were desperate to try and maintain the competitive advantage that had been achieved in 1976 to support manufacturing in net exports. But that was leading, at the same time, to an absolute collapse in nominal interest rates to a point at which real interest rates were dramatically negative, and we were beginning to get signs of monetary expansion. And so, within the Bank, John Fforde and I were desperately trying to say enough is enough, and you've got to keep monetary control under some kind of limits and if that means that you get sterling appreciation at this pointm you should do that. And there was a battle throughout much of 1977, which eventually those of us who wanted to be somewhat on the tougher side, actually won.

PETER JAY
Alan Budd?

SIR ALAN BUDD
I'd like to comment briefly on two things that have been said. I've found it all extremely interesting and I think they're linked. Tim Lankester's point about the industrial relations and the power of trade unions through the 1970s, which I didn't refer to. Of course, it was all part of the background, which we didn't really understand, because we were trying to do other things. And the problem with the trade unions is that, to a large extent, what they were trying to do was with the collusion and support of the employers. This was a cosy relationship between these two groups. And an example of this was a story – I was trying to remember the name of the man who was head of ICI at the time. I will remember it before the end, I think it begins with H but ..

CHRISTOPHER COLLINS, AUDIENCE
Maurice Hodgson.

SIR ALAN BUDD
That's right, Maurice Hodgson, I was right about the H. A group of them went to see Mrs Thatcher and, no doubt, it wasn't beer and sandwiches, but tea and cake, or whatever, to tell her to stop doing what she was doing because they'd have to sack people if this went on. And Mrs Thatcher kept saying, apparently, 'You're paying too high wages' and then they would go on and on and say, 'Please help us. Please help us'. And she would again say 'You're paying too high wages'. And Maurice Hodgson I remember describing this, and he felt, after he'd listened to it for a time, what he was very tempted to do was to say 'Eee give us a kiss love' but unfortunately he didn't actually say this. But it wasn't the employers versus the unions, it was two people in a cosy relationship with each other expecting to be helped up by the Government if things went wrong, which also brings me to Steve Nickell's comment. I did refer to the threshold payment system which embodied this. And not only was this indexation, it was indexation as a natty device to prevent inflation by promising the unions three percent real increase in earnings. The scheme was, they were told to accept ten percent, rather than the thirteen percent that they wanted with the promise that, if inflation went above seven, they would get an extra one percent on their pay. Not only was this indexation, it was combined with a promise to give real earnings increases to workers, which is not in the Government's power to give to anybody. And, to me, this is a demonstration of how weird the economics was that was behind some of these policies.

PETER JAY
Brian.

BRIAN READING
Well I'm really the imposter here because, while everyone else was at the centre of affairs, I was very much at the periphery and only for the first two years, when I was a special adviser to Edward Heath. I have to say I'm quite pleased that was the most disastrous period of policy because he never took any of my advice. In fact, I was fed up and left after two years. And where Alan Walters was serving that year – I'd served Heath for six years by then – got a knighthood when he left, I got a glass of sweet sherry. And, I must say, that really did correctly measure the relative contributions. But on a personal note, apart from the fact that Heath got off on the wrong foot because the Treasury forecast when we came into office was way out and I argued with that. Also, the death of Iain Macleod was a terrible blow in terms of where we went. But most important of all, what hasn't been mentioned, was that there was, with the oil price explosions, commodity price explosions, a very real loss of real income for, real national income, for Britain and somehow that loss had to be shared out. And it was partly the battle of who was going to be the losers which explained the way inflation so rapidly escalated. Inflation was the solution not the problem.

PETER JAY
Thank you Brian. Nigel, all yours.

LORD LAWSON
Well, it's been fascinating, and I agree with pretty well everything that has been said, particularly, I suppose, the insights that have been given by Ian, Tim and Andrew. But, I don't find myself disagreeing much with anything that has been said. One or two things – this is rather impressionistic. One or two things, which I think are relevant to one's judgment of that period. First of all, it is impossible now, almost impossible, and certainly impossible I think for anybody who didn't live through it to understand the mood of that time, to understand the mood of deep defeatism which had become embedded. Everybody was aware that we were doing incredibly badly. They didn't know how to get out of it, and most people had come to the conclusion that it was inevitable, and all that Britain could do would be to manage decline as gracefully as we possibly could. And I remember going around in the early days when I first became a Minister in 1979, going around, going abroad a bit, and staying at embassies and the ambassadors saying that, for the first time during our tenure of office, we haven't had to be apologising all the time, and trying to put a brave face on failure. And the mood was really very bad and that is one of the things we were very conscious of, because, as I say, the conduct of economic policy is not just monetary policy, or even fiscal policy, but in, addition, it's political and psychological. And we had to create a change of mood. We were very conscious of that. Incidentally, if I may say so, although academics produce a lot of insights into various aspects of this issue, the idea that everything that happens is a result of some academic getting it right or whatever is not something which tallies with my own experience. Anyhow, the mood was absolutely appalling, and we had to change that mood. And, incidentally, there was one particular aspect of that mood which is important because it affected particularly, I think, the official Treasury. And those who were in the official Treasury during that period can confirm or deny it. But I think the fact that we went to the IMF in 1976, the first industrial nation that had ever done so, that was a huge blow, a huge

blow psychologically and as I said it led I think to a lack of confidence among senior Treasury officials, which is very rare and something one doesn't want to see.[3] One wants to have confident Treasury officials because they are a very able group of people, and their confidence was very badly affected, I think, by 1976, having to go to the IMF. One or two things did change. I think that there was a genuine change as a result of that shock in Jim Callaghan's thinking, probably largely as a result of the influence of his son-in-law (Peter Jay) but, nevertheless, there was a change. I think it was less pronounced, I must say, in the case of Denis Healey. I don't think Denis ever really changed his mind. He wasn't particularly interested in this area of policy, really. It was not his main interest anyway. He was always referring to 'Sod Off Day', looking forward to the time when they were no longer constrained by the IMF. The idea that these were irksome constraints never left him. The one other change which was very important, which happened during that period was, and there should be some mention of this and I wish to give credit to the then Labour Government, particularly of course Leo Pliatzky– although it's the politicians who have to take the decisions – was the move, it wasn't a total move, but the move away from the appalling idea of volume planning in public spending, funny money, and onto cash limits. Cash limits were introduced during the latter years of the Labour Government. We of course carried them a great deal further. It was absolutely vital to have cash planning and also to shorten the time horizon. Edwin Plowden, who I knew, was a very clever man, and a delightful man. But one of the biggest errors that any British Government has ever introduced in the economic sphere was the introduction of public expenditure planning five years ahead in volume terms. A complete disaster. Incidentally I should say that Charles was absolutely right in saying that Margaret Thatcher – I said this would be impressionistic – that Margaret Thatcher thought that monetary base control was a wonderful way in which you could control inflation without having to raise interest rates. It was clear to everybody else – or almost everybody else – it was clear to Geoffrey and me and so on, that that wasn't so, and we never did anything about it. There was another reason, of course, why I did not favour monetary base control, even though Paul Volcker in the US had, for a short period, introduced monetary base control. If you know what you're doing, you know that it's not a clever way of avoiding high interest rates. And you'll certainly have more volatile interest rates; but it probably could work. But it was clear to me that, not only had she got it completely wrong, but the practicalities were that, if it were to be implemented, it would have to be the Bank of England that was implementing it. And, since the Bank of England was absolutely passionately opposed to it, they would clearly have implemented it appallingly badly. Whether that would have been deliberate or not is another matter. It would have been implemented appallingly badly. So, it would have been crazy for any Government to go along the route of monetary base control and we didn't do that. And, on the question of the aggregates, incidentally I might point out that the original Medium Term Financial Strategy in 1980, which I oversaw, had a footnote saying we may need, in the light of experience, to change the target aggregates. This is frequently forgotten. What was it really all about? There are two things. First of all, Ian Byatt is absolutely right, we were as much concerned with improving what is known as the supply side of the British economy, every bit as much as getting inflation under control. Both were paramount. It's not that one was more important than the other. Both were absolutely essential. And what we did on the supply side to get the British economy performing better, was not only something which we attached as much importance to but, it tends to be forgotten, it tends to be neglected in accounts now, maybe because, instead of being one or two big things like the money supply and the budget deficit, it's a whole lot of little things. But we did all those little things, I mean, dealing with the trade unions, taxation (I'll come onto taxation again), removing controls and restrictions of one kind or another, above all pay policy, incomes policy. Incidentally there is a parallel – I wouldn't like to press it too hard – between the incomes policy and monetary base control. Monetary base control was thought of as a way of controlling inflation without raising interest rates - you dealt with the quantity instead of the price. The idea that these are separated is a bizarre one. Similarly, the incomes policy was thought of as a way of controlling inflation without raising unemployment. That was the attraction of incomes policy or pay policy to Governments at the time, because they were scared stiff of unemployment. And that comes to something which is absolutely fundamental. But before I do that, if I may Peter, Milton Friedman thought that fiscal policy didn't matter at all. All that mattered was monetary policy and the supply side. He was interested in that, letting markets work, which was the essence of it. But he was extremely hostile to, and critical of, our concern about the fiscal position and, therefore, very critical of the MTFS. This didn't have any impact on Margaret because ,of course, Margaret felt that borrowing was wicked and, therefore, the idea that you should have no concern at all for the budget deficit was something that she found absolutely unacceptable. So, there was no need really to talk her out of Friedmanism. And Friedman really had very little impact or influence on any of the policies that we were pursuing. The thing that is fundamental, which I'll come to, is this. That people, Governments and commentators weren't entirely stupid. They realised that there was a trade union problem and, indeed Harold Wilson, made some totally ineffectual attempts to deal with it. They realised that inflation was a problem. But they felt that tackling the trade unions, which meant allowing, not wanting, but allowing unemployment to rise if trade union behaviour did not change would be the inevitable consequences. And they felt that it was politically impossible. Incidentally, we were helped by something which was not planned, and therefore critics have sometimes suggested that somehow it came to our rescue and it was nothing to do with policy. It's not true it was nothing to do with policy. What I'm talking about is the rise in the exchange rate, which put enormous pressure on the British economy, on the private sector, and helped to squeeze inflation out of the system. And, of course, we hadn't predicted this. We didn't expect it. It happened for a whole lot of reasons, partly North Sea oil, and partly because the financial markets suddenly were taking a new view of the British Government, of course it was a new British Government, and they took a more positive view than they had of its predecessor. But, although we hadn't sought to push the exchange rate up, and even if we had I'm not sure we'd have been able to do so – the exchange rate doesn't do what politicians would like it to do – what we very consciously did was took advantage of this and paid no heed to Douglas Wass, who was Permanent Secretary to the Treasury, who was saying 'oh, this is a terrible thing because all the businessmen are getting completely uncompetitive and are suffering terribly– you must get the exchange rate down'. We said no, that it is doing the job that we want done, even though we hadn't envisaged the job being done in that way. And in the conduct of economic policy, you do have to be opportunistic. You have to take advantage of developments as they come, and we certainly consciously took advantage of that. So, it was very deliberate when, as I say, Treasury officialdom, certainly in the person of Douglas Wass, was horrified by the rise in the exchange rate and was urging us to do something about it to get it down. But as I say, what we were doing really, most importantly was changing the game by pushing forward the boundaries of the politically possible. That was really at the heart of it. It is obviously the case that some things you might like to do are politically impossible to all practical purposes in a democracy, because you know that quite apart from the possibilities of riots and unrest and so on you need to be re-elected in order to be able to carry the policy through, and to have it really embedded for a period of time. And the judgment that we made, and I certainly was very conscious of this, but I think there were a number of us, was that Governments had been far too timid. They had had far too restrictive an idea of what is politically possible. We had to be very careful. We had to do what was politically possible but you could push the boundaries further out and do things which had previously been thought to be not politically possible– well, Peter says I've said too much and I will stop.

PETER JAY
Just enough.

LORD LAWSON
I will stop.

PETER JAY
Thank you, Nigel, very much indeed. I thank you warmly for your contribution. It illustrates how right I was, I think, to say that the real title of your great work on the Treasury should have been 'How I invented Thatcherism and She ruined it'. You're absolutely right about Callaghan and Healey. Absolutely wrong about Plowden, in my opinion, but we need another seminar for that. I remind all the participants to sign their bits of paper on pain of academic odium if they don't. I thank the panellists, all four of them, for making it and being here and for their contributions. I hope you've all enjoyed, and been interested in, what you've heard and I'm sorry there wasn't time for more people to participate. Thank you very much indeed.

The 1981 Budget – Facts & Fallacies

Session Two: The 1981 Budget.

JOHN PLENDER

Welcome back everybody to this afternoon session in which we first of all come to the substance of the 1981 Budget. But, before we engage with that, perhaps I should just repeat for those of you who weren't here this morning what the rules of engagement are. Apparently I have to remind you that no one else is allowed to record what is being said although you may obviously take notes. Questions may be taken from the floor at the end, subject to my discretion, and those contributing from the floor must say who they are for the record. Anyone who speaks must sign the Archives consent form. They're these things which we have to put our name to if we speak, and there are spare copies available around the room. These are not Chatham House rules. The purpose is actually to record what is said, and speakers will have a chance to edit their transcripts. But it will all be published and anyone may quote what anyone else has said. So, those are the rules of engagement. Now, because this is a Witness Statement, I should say where I was at the time. I was actually in the Foreign Office. I was an outside member of the Policy Planning Staff there, and so was slightly at a remove from economic affairs before going to *The Financial Times* as a leader writer in 1982. And I thought it might be worth coming back to what Lord Lawson was saying in the earlier session, to remind you just how extraordinarily depressed people were in Whitehall, but particularly in the Foreign Office, because, to use his phrase, these people were, so to speak, at the frontier of being pitied around the world, and that is not very good for morale. And one of my personal recollections was being approached by a senior diplomat who said, 'I'm wondering what to do with my money. You know about the markets. Do you think the Japanese market is worth buying at the moment?' and I said, 'Well, look, I'm not sufficiently competent in that area to be confident of my judgment. But, what I will tell you, is that long term gilts yielding sixteen percent at a time when Governments on both sides of the Atlantic are seriously tackling the problem of inflation and in addition...' – this was at a time of over-funding so the market was distorted with yields higher than they were going to be in the future – I said '.. you're going to make a serious capital gain if you're prepared to just wait a little while'. And he looked at me as though I was stark raving mad. The idea that you could buy an IOU from the British Government and think of doing anything other than losing your money was beyond him to understand. And I think a lot of people had that attitude at that time. Now, just before we kick off I thought I probably ought to, as somebody from the *FT,* put cards on the table and tell you where we stood. This is what we had to say, or some of the things we had to say, about the Budget when we published on Wednesday, March 11th 1981. We were not with the 364 economists. Among the things we said was, 'This will be widely denounced as a Budget which will undermine any possible recovery from what is already an unprecedentedly sharp setback in manufacturing. We would, on the contrary, agree with the judgment that painful fiscal decisions were required to create the conditions for the easing of credit pressures and interest rates which is the central pre-condition for recovery'. We also said 'Praise is due for the courage to be deflationary at such a time and by such unpopular means, that is, for imposing burdens on the personal sector and for relying mainly on reduced public borrowing to provide a balancing relief for the supply side of the economy'. So that is where the side of the argument that the *FT* was on. I think I should also mention that, of course, our chief economic commentator at that time was Samuel Brittan who was a pioneer, with Peter Jay, of monetarism in the media and was also very close to the thinking of the Treasury, and particularly Lord Lawson, at that time. So, having said that, let us turn to the issue of the 1981 Budget and, perhaps, I could start off by turning to Sir Tim at the outset and say, I wonder if we could just settle one issue which I don't want to dog the conversation which is the issue of authorship of this Budget, because much has been said about the role the Number Ten Downing Street Policy Unit played in it, which people did what, and so forth. Could you tell us where does responsibility for this Budget lie in your view?

SIR TIM LANKESTER

As Private Secretary to Mrs Thatcher, I was on the inside. I did see what the Treasury were doing and what Mrs Thatcher's advisers, Alan Walters, John Hoskyns, and David Wolfson were up to. I think the Treasury and the Number Ten advisers, with the support of the Bank of England, were driving in the same general direction. They were all aiming for a restrictive Budget. The only issue really was whether it was going to be – I forget the exact figures – a three billion reduction in the PSBR or a four billion reduction in the PSBR. And, I have to say, my recollection is, and I think it's borne out by the records, that the Walters/Hoskyns duo were more hawkish than the Treasury. Mrs Thatcher was torn between the two views, and it wasn't a smooth operation at all. In fact it was extremely fraught. Walters would take Mrs Thatcher aside and say, 'It's got to be four billion'. And Mrs Thatcher said, 'Yes, it must be'. Then Geoffrey Howe would come in and say, 'It's got to be three billion. Four billion's impossible' and she would then say, 'Well, maybe it is politically impossible', so it was a close run thing. Eventually the more hawkish view prevailed.

JOHN PLENDER

Lord Lawson, could I turn to you just on this point? I checked with your memoirs, which I regard as a marvellous bible, a wonderful insight into the policy making process at a time of radical change. It was a terrific read. But I didn't see any reference to Jurg Niehans, the famous paper which was supposedly produced to try and influence policy. Was that because you thought it was inconsequential nonsense or what was it?

LORD LAWSON

I'm not sure it was inconsequential nonsense, but it was certainly inconsequential, so no point in referring to it. As far as what Tim has just said is concerned, I was very much there at the time because, although Geoffrey was Chancellor and deserves all the credit, Geoffrey believed in a very collegiate form of budget making, and so at every meeting of any significance he had all these Treasury Ministers present, and I am not unduly reticent, so I piped up. But there was no disagreement between us. The problem was Margaret and, therefore, I don't think the advisers, as Tim refers to them, made a difference They were able to influence Margaret in a way that we, the Treasury Ministers, wanted to go. Her concern was that, although we were bearing down as hard as we could on public expenditure, it wasn't enough. Incidentally in the earlier session, if I may go back to this, perhaps we devoted, on the fiscal side, a little bit too much attention to the deficit at the expense of the size of public expenditure. We were just as concerned to get public expenditure down. Because, if you address the deficit simply by putting up taxation that would have hugely adverse supply-side consequences. So, it was not just a matter of the deficit, it was a matter of the level of public expenditure as well. Anyhow, what concerned Margaret was that, as we couldn't do it all on public expenditure, we had to do something on the tax side. And she loathed the idea of taxes going up. She said 'I didn't become Prime Minister in order to raise taxation'. So this was why she needed to be influenced and the advisers did that.

JOHN PLENDER
So she was turned by the advisers?

LORD LAWSON
No, no, she wasn't turned by the advisers.

JOHN PLENDER
She changed her mind?

LORD LAWSON
She had parallel advice, both from the Chancellor and from her advisers. There was no conflict. And it was useful to have them on side. That's all I'm saying. I remember these meetings vividly. There was an economist, I think his name was Shepherd wasn't it?

SIR ADAM RIDLEY
Jim Shepherd.

LORD LAWSON
Jim Shepherd, who looked after the Treasury model – that ridiculous creation – he was the guardian of the Treasury model. He would come to each meeting and say that it now shows the deficit was, whatever it was, and we decided what needed to be done in order to get it down, and then the next meeting he'd come and say 'The model now shows the deficit's going to be even bigger'. So we then had to increase what we were going to do. So there was this progression. In fact, at the end of the day, the deficit turned out to be less than we had been told, but it's no bad thing that we got it down even more than we thought. But that was what happened. So, progressively, we decided on tougher and tougher measures because, as I mentioned earlier, it was essential to maintain our credibility. This was essential to a whole range of policies that we were engaged in. But the credibility of the Government in the economic sphere was paramount and we therefore had to progressively adjust the extent of the fiscal contraction, if you like to call it that, but it was actually, and what we're talking about is the reduction in the deficit. And that is what we did. And I think the attempt by Alan Walters to claim singlehanded credit for this is somewhat disreputable. But, anyhow, Geoffrey's given his own account, I've given my own account, and it's up to those others to decide what is accurate. But, the important thing was not whether the retrenchment was x or y, the important thing was to retrench at the depth of the recession. That was what was really radical and that was what we were attacked for by the 364.

JOHN PLENDER
Indeed. Well could I just turn to...

SIR TIM LANKESTER
Could I just make a quick comment?

JOHN PLENDER
Yes, please.

SIR TIM LANKESTER
In fact the retrenchment did come mainly through tax rather than public spending. That was the bulk of the package which led Patrick Minford, I think, to say that it was good in macro terms but bad on micro terms.

LORD LAWSON
That's right.

SIR TIM LANKESTER
But on the particular point, as I said, the Treasury and the advisers were moving in the same direction, but there was a moment – I remember it well – in late February when Hoskyns and Walters were pushing very hard for a tougher stance, and Geoffrey told the Prime Minister that it wasn't possible to go beyond what he'd suggested. They weren't actually present at the meeting, but I reported to them and they went away in high dudgeon. They seriously considered resigning on the issue. But then, the next day, Geoffrey came back to the Prime Minister and said yes, we'll go for the tougher package..

LORD LAWSON
Geoffrey had come back and spoken to us.

SIR TIM LANKESTER
OK, and you said 'Do it'.

LORD LAWSON
Mmm.

SIR TIM LANKESTER
OK, and it was done.

JOHN PLENDER
Sir Adam, could I turn to you and just focus a little bit on which you might call the 'Thatcher wobble'. Was there a point where you thought that this Budget might not go ahead from your perspective in the Treasury on the basis of her panicking about what might happen?

SIR ADAM RIDLEY
Well, let me take a slight step back on this question of how the decisions were made; and there are other points I'd like to make later. I think it's desperately important in this piece of history, now that the documents are coming out, and a number of us are still alive and coherent and can actually tell what we remember seeing of a unique moment. I think it's true of those of us on the platform if nothing else. It's important to avoid what I would call tabloid melodrama. This Budget was not a gladiatorial combat. It was not the Wimbledon men's semi-finals or whatever else. This was a very, very tricky and demanding set of circumstances in which there were

bound to be tensions and difficult decisions. But the most important point is the one that Nigel Lawson has already made. Geoffrey Howe, for his part, was always a very, very collegiate and considered decision-maker, and I must tell two anecdotes to explain a little bit about what that was like. Once, shortly after this desperate Budget, Douglas Wass stopped me in the corridor and he said, 'Adam, a rather delicate question, but can we get Geoffrey to take decisions more quickly? Can't he make up his mind more easily?' And I said 'Well, Douglas, honestly he does it in his own way and he does it very well. He cross questions everybody, he has the junior officials in the meetings who really have done the work, and he takes great trouble to ensure they're there. He gives all the Ministers and advisers and officials the chance to have their word heard, and he tries to carry everybody". 'Oh well', said Douglas, 'so be it', and off he went. A few years later, Malcolm Rifkind was in the Foreign Office and a Junior Minister to Geoffrey Howe as Foreign Secretary when a senior official came up to him and said: 'Malcolm, rather delicate question, but you will excuse me if I ask, can we get Geoffrey Howe to take decisions more quickly?' and the verbatim reply was more or less given, I believe. Now there's a very important point there. In a good Budget, you have a convoy of people, of experts, of advice from different quarters: from Customs, Inland Revenue, Bank of England, Treasury officials and special advisers, several very heavyweight. The process is like a convoy on the move. There are always some people who are getting a bit ahead, and others who are falling a bit behind. My metaphor means that, fundamentally, there were periods when you had to chivvy. But I don't think it was, in essence, a sort of great struggle, with the one exception. I didn't see this at first hand – but manifestly around February the thirteenth, fourteenth, fifteenth, the moment when Nigel said, 'She said I didn't want to be elected to put up taxes' – some kind of serious anxiety was in the PM's mind. Now, at that point, and previously, I had been talking pretty regularly, pretty frequently, often daily in fact, to John Hoskyns. We'd been exchanging thoughts, we were all of the same mind and pretty much of the same mind as most Treasury officials and Ministers too. I think that the Number Ten team really did believe she might not go for enough. There is evidence of that in the fact that they were prepared to draft a resignation letter. That's a matter of fact. But I had no evidence personally that she wasn't going to buy the policy in the end. And I see this hesitation as part of the rational process of policy making in extreme circumstances.

JOHN PLENDER
So, Peter, what is your take on that?

SIR PETER MIDDLETON
Well, interesting. I mean, from the bosom of the Treasury, I didn't really have any great interest in these internecine disputes that were going on at all. It was a very simple matter, as far as I was concerned, getting the tightest Budget we could. And the reason for that was that, since Denis Healey in 1975 and the IMF, despite what everybody says about depression in the Treasury, you know, a lot of us felt that there was a real chance of getting the economy on a track where we'd become a respected member of the international community – a bit like Greece now. Because, in 1976, our credit rating was zero, we couldn't raise money in any way which is why we went to the IMF. So, the election of the Conservative Government added a dimension to that. I think there are two things you had to do. One was you had to continue to establish your track record with the markets, and that was a track record of sustainably low inflation and a sustainable level of growth. That is what it was all about. But you couldn't afford to let up on the macro side of things, really for two reasons. One, in its own right, because we still had a

very high rate of inflation, which needed to be got down. And, secondly, because, if we lost that, we wouldn't have got the supply side reforms through. So, it was all part of a package. And if one was going to err on any side, given what we'd gone through in the previous twenty odd years, I personally was strongly in favour of overkill, if anything, but getting the fiscal position as right as we could. And I agree with the way Nigel put it. Public expenditure, we wanted to do first, but we had to get the PSBR right as well because that, whatever the economists said, in the eyes of the market, gave you a bit of latitude on monetary policy. And this was a sort of period of consensus really. I didn't come across anybody who didn't think the Budget ought to be tight.

LORD LAWSON
What within the ..

SIR PETER MIDDLETON
Within the Treasury.

LORD LAWSON
The Treasury, right.

JOHN PLENDER
Well, can I come back to you Lord Lawson, and ask you about perceptions at the time. I mean, this *FT* leader, his concluding line was 'This is the last chance for the strategy', presumably referring to the MTFS. Is that how it actually felt to you at the time that the Budget was being put together?

LORD LAWSON
I think it was crucial to the survival of the strategy and I think we all, all of us on the inside, recognised that. But I must say I was always optimistic that we would succeed. Maybe I was crazy, but I never ever thought that we couldn't carry it through. I did have to spend – Geoffrey asked me to and I gladly did – an inordinate amount of my time in the weeks and months following the Budget making speeches, selling it to groups usually of businessmen who were horrified by it. But there were others too. It required a great deal of explanation and I think that's necessary. I think that the public are entitled to an explanation. But when it is something which is so contrary to received wisdom – and the received wisdom was that of the 364 economists, that, at the height of a recession you must have an expansionary Budget. You don't have one which is 'contractionary'. Of course, it wasn't economically contractionary at all, but it was a tough Budget in that there was a fiscal contraction. Then you need even more explanation. So I spent an enormous amount of time making speeches, which is not what I felt my job as a Minister was mainly concerned with. My main concern was development of policy, but I had to make these speeches.

JOHN PLENDER
Could I just ask about the task of persuading your fellow Cabinet members because, at that time, of course, the high Tories were still in a very strong position.

LORD LAWSON
This is a very important point. You're absolutely right. The political dimension is crucial and you are absolutely right to bring it up, John. The 1981 Budget surprised everybody in the Cabinet, and horrified a number of them. And Margaret had to make some concessions – that there would be, in future, a full discussion in Cabinet once a year so that members of Cabinet can air their opinions and so on, how the forthcoming Budget should be, and other concessions of that kind. It didn't do them any good. But the wets felt that they got something out of that. What they didn't know was that this determined her in the forthcoming summer, the summer of 1981, to have a Cabinet reshuffle, and to purge it of the wets, and that was when she brought into the Cabinet Norman Tebbit, Cecil Parkinson, and me which changed the balance. And she either got rid of, or sidelined, the wets. And that made a huge difference. And that was crucial. And she recognised it as such. She had never been very happy with the Cabinet she'd inherited from Ted Heath, in many ways. What had happened was that Margaret, and a few of those who were likeminded – I was one and there were others – had effectively hijacked the Conservative Party. And there were many in the Conservative Party, many senior figures, former Cabinet Ministers and other Ministers under Ted, who didn't like being hijacked. Subsequently, the centre of gravity in the Party changed. But, initially, it was very difficult politically, and that reshuffle in 1981 following the revolt, following the 1981 Budget was a very important event, a very important point of change. It might not have gone that way. That was, actually, I think the biggest problem that she faced, and she did the right thing.

JOHN PLENDER
So, Tim could I – sorry, come in, Adam.

SIR ADAM RIDLEY
I just wanted to interject very quickly. It was partly brought out in Nigel's book that, interestingly, the criticism was often really attached to specific measures, rather than the totality of the strategy, and at no point did the critics come up with a coherent alternative proposal or philosophy. And that mirrors something else, which I think Patrick Minford was saying. There was a curious bankruptcy in the traditional intellectual world of any really alternative way of doing things. And I think that came out very clearly at the time. And so the same thing probably was an issue when, I think, at the very last minute before the Budget – I think Nigel will probably remember this too – Geoffrey sat down with a few of the colleagues and took them through the Budget and they accepted it.

JOHN PLENDER
So, Tim if you'd like to add to that, that would be great, but I think I probably ought to ask, for the record, what was the impact, if any, of the 364 economists letter in Whitehall?

SIR TIM LANKESTER
I can't speak for Whitehall. At Number Ten, the impact was zero. Mrs Thatcher's attitude was: 'Well, they would think this way, wouldn't they'. But you've got to remember that Margaret Thatcher was a paid up, convinced monetarist. She really didn't believe that Keynesian solutions could help. Indeed, she thought the opposite - that spending more money would result in more inflation, and would have no or no effect on activity. So I think she just parked the 364 aside.

Can I just comment briefly on what Nigel said? I think what he said, and what some of the books on the period don't quite capture, is the sense of gloom and near crisis at Number Ten in late 1980. Mrs Thatcher was very depressed about the whole situation. Inflation was still running at fifteen percent. The monetary aggregates seemed completely out of control, interest rates were at seventeen percent, sterling was nearly $2.40, and she was getting the message from industry, and from the Bank of England, that this was crucifying British industry. So she was looking for something new. And when the Treasury, with Walters' strong backing, came up with the idea of a restrictive budget - serious fiscal retrenchment which would allow a reduction in interest rates – she saw this as a lifeline. The MTFS was very important to her and, in keeping with the MTFS methodology, monetary policy and fiscal policy were joined at the hip, as far as she was concerned. The Budget was sold to her very much on the basis that if you do three or four billion pounds retrenchment, you can have a two percent fall in MLR. As it happened, MLR had to be increased later in the year for quite other reasons. But it was a fairly pivotal moment, and the politics was looking quite bad. I mean the so-called 'wets' in her Cabinet were coming and saying, 'Look, what the hell's going on. You've been trying monetarism for the last twenty months and it's a mess'.

LORD LAWSON
Yes, if I may comment on that because Tim is absolutely spot on. I mean, going back to what I was saying earlier, the whole terminology of the 'wets' came about because they were the majority of the Party at that time and this was a way of deriding them by some of us – not by me, but by those who wrote about it. And we were known as the 'dries' – a term which didn't really catch on but 'the wets' did and it's still valuable. What Tim is saying is tremendously important. There was never any attraction to the Keynesian route. That had been shown – or neo-Keynesian, whatever you like to call it – that had been shown to be a disaster and, indeed, Keynesianism is a beautiful theory, but there is absolutely no empirical evidence to support it whatever. And there's a lot of empirical evidence around in the years since the General Theory was published and none of it, in my judgment supports it, and none of us thought that it did. I mean, you could conceive of something which would be on such a large scale that it might have a Keynesian effect, but the scope would be so large that the consequences, ancillary consequences, would be absolutely unacceptable, so it is not possible. The problem was there was no confidence in the alternative. That was the depressing thing at the time. What, in fact, got Margaret through was, in my judgment, largely a fallacy. Many of us, I confess, believed in it to some extent at that time, but nobody believed in it more strongly than she did. And that is that there was some ineluctable rule, that the lower the budget deficit the lower the rate of interest. It was completely false – not completely false, but almost completely false, in the context of a global economy, and we hadn't really come to terms at that time with the consequences of the globalisation of economics, and it was a fallacy for other reasons.

SIR TIM LANKESTER
You wouldn't say that about the Greeks today, would you? I mean, the global economy affecting the Greeks, they have a budget deficit and they can't borrow.

LORD LAWSON
Well, because everybody expects them to default, yes.

SIR TIM LANKESTER
Yes, but I mean wasn't there an analogy there?

LORD LAWSON
No, I don't think people were talking about...

SIR TIM LANKESTER
Default. No.

LORD LAWSON
Default. We were in a pretty poor state, but I don't think anybody was talking about default.

SIR PETER MIDDLETON
By 1981, we were well away from default.

LORD LAWSON
Absolutely. No, as a matter of fact...

SIR TIM LANKESTER
It could have affected interest rates. It could have affected interest rates, short of default.

LORD LAWSON
No, this is actually quite an important point about the context of all this since you've got onto this territory, Tim. The surprising thing is that whereas the Labour Government that had preceded us was bedevilled by periodic gilt strikes, quite a lot of them, we, apart from one very short period, never had any problem with flogging the gilts necessary to finance the deficit.

JOHN PLENDER
And that, presumably, was partly because of the globalisation of capital flows …

LORD LAWSON
That's right. Absolutely. So we didn't have that problem which the Greeks have. We were nowhere near the Greek situation. But, as I say, she was stiffened by the idea that this would enable her to get interest rates down. And it didn't. I mean, they got them down and then they rose again. And, to some extent, I think Alan Walters argued this, although I've never quite understood how much he used that as advocacy.

SIR TIM LANKESTER
He did, absolutely.

LORD LAWSON
And how much he genuinely believed it. I don't know. How much he believed it, I don't know. But it was false and indeed the cuts in interest rates which had to be introduced had to be unwound, and they went up again. But that didn't mean the Budget was wrong. It was right.

JOHN PLENDER
Sir Peter, could I turn to you, and could we talk a little bit more about the radicalism of the Budget in terms of some of the components. I'm thinking, for example, of cash limits, of the introduction of index linked gilts, which there'd been a long argument about – how dangerous it would be to index link, and so forth. I mean, for you, what were the really, apart from the overall architecture which we've talked about and the components, what were the things that, for you, were most radical and most interesting?

SIR PETER MIDDLETON
Well, the key thing was sticking to cash limits on public expenditure, without any question, in my view. It wasn't a Conservative venture, but they certainly gave it extra life. Once again, it was both getting a grip on expenditure and actually showing the rest of the world you were getting a grip on expenditure, and I think cash limits did that. Index linked stock was a bizarre episode and was one of the more extraordinary things I think we did. And it was one of the things where there was a real argument with the Bank of England. I mean, whether you introduced indexed stock, or not, is a question of whether you believe you're going to do better on inflation than the market thinks. I think, at that stage, we all did for the very good reason that we thought that the policy, if we stuck to it, which is back to the Budget, would acquire credibility. The problem with it was that the Bank thought that, as this was the only Government indexed stock, money would flow into the country, we'd over-finance the deficit, the exchange rate would go up, and there'd be terrible consequences from it. In fact, none of that happened. We didn't think it would. It was a modest success the index gilt and, you know, I wouldn't say it was the biggest thing in the Budget, by any manner of means. The biggest thing was establishing our position.

JOHN PLENDER
Sir Adam, do you want to talk a little bit about cash limits?

SIR ADAM RIDLEY
Well, first of all, to underline the importance of it, I think you can go a little bit further and say it was several things, really. It was, first of all, extending cash limits because, as Nigel said earlier, Leo Pliatzky introduced them in 1976, but they were relatively limited in their coverage. Lots of areas didn't fall within them. It was important to extend them more widely. But the second thing, therefore, was to couple that with something quite different, which was attacking the philosophy of volume planning. That was something that, I think, was a more fundamental philosophical shift in the longer run. And then there was another important reform at the same time, which is deep in the technicality of expenditure control: redefining the contingency reserve in a broader way.

Now all of this is very tedious stuff. But the cumulative impact of all this meant that both Ministers and officials had a much better grip potentially than they'd had previously. When you come to the history of these things, or when someone does, and if they look at what happened programme by programme, and blocks of activity, whether they were cash limited or not, I think they will find the impact of these changes was immensely important, as Peter said.

JOHN PLENDER
Sir Tim, for you, apart from the overall architecture, what were the things that were both radical and risky in this Budget? What were the things that you feared might go wrong?

SIR TIM LANKESTER
You're probably asking the wrong person because I was just the baggage carrier. On the other hand, I was a Treasury official so I had a few views...

AUDIENCE
A major piece of baggage.

SIR TIM LANKESTER
I suppose I had a bit of Keynesianism left in me and I was worried that there could be an excessively deflationary impact. I was probably the only person at Number Ten who was worried that we were trying to squeeze the bottle a bit too hard. But Mrs Thatcher wasn't interested in that argument. As I said, she was interested in the fact that taxes were going up too much, and the politics of that. I was worried about the politics too, because I could see the grand men of the – they were all men – of the Cabinet, not just Prior, but lots of others being very unhappy with this Budget and this all exploded on 23 July 1981 when there was the famous Cabinet Meeting when Hailsham declared something to the effect that this was worse than Herbert Hoover and Mrs Thatcher found herself in a serious minority. John Nott disappeared into the woodwork, John Biffen wasn't supportive and there was Geoffrey Howe and a couple of others who supported her and it was after that, as Nigel said, that she decided on the reshuffle. But that summer was pretty difficult, and remember, we didn't know that we were at the bottom of the recession. I mean, we know now that Q1 1981 was the bottom of the recession. We didn't know that until much later. So, through that summer it was pretty hairy stuff. And so the politics didn't look good for the Prime Minister, I would say.

JOHN PLENDER
How did you feel in July that year? Were you losing sleep?

SIR PETER MIDDLETON
No, it's not a thing I do. I find trouble keeping awake, but losing sleep is not the issue. I think all these decisions are a balance of risks, though the advocacy can be very strong at times. I don't think anybody thought this was a one-way bet and we were certain to be right. But I think if you put it in the context of where we come from, most people thought this was a risk that was well worth taking and that the 364 economists looked to us as though they were lost in some sort of time warp. It was desperately like a voice from the past. And so, I'd say, that had very little impact. But what certainly did cause one to worry was whether we got it right.

JOHN PLENDER
Yes. Sir Adam, that July Cabinet Meeting and the Hailsham remark about Herbert Hoover, did you think possibly that the game was lost at that point politically, or what was your feeling?

SIR ADAM RIDLEY
I was unnerved but I wasn't worried for some reason. I can't tell you why I had confidence. I thought that the policy was already working. Contrary to what some of my colleagues on the platform are saying, I think you could actually see from the CSO's leading indicators that the turn was happening, as Peter suggested, at the end of the first quarter. I had written a very unfortunate speech for Leon Brittan in, I think, April, in which I put in his mouth the immortal words 'As night follows day a recovery is on us ' or words to that effect. Leon was immediately shot at from every known quarter of the compass, but actually he was dead right. I felt, therefore, the recovery was going to take root and, therefore, economically, I was happy. I wasn't too worried about the way the Cabinet seemed to be thinking.

I go back to the point: no one had an alternative set of proposals to put forward. This is terribly important. Nigel was haranguing groups of businessmen and I, as the Chancellor's special adviser, with my colleagues, was replying to streams of letters from 'disgusteds' of everywhere you could think of, including the head of the CBI, and seeing large numbers of back benchers constantly. And time and time again, one said

'All right, so you don't like this and you don't like that. So what would you like Ministers to do'.

And they never came up with a coherent suggestion. They usually said things like, 'Well can't you raise all the money by gambling duty, dog licences or taxing fruit machines?' Literally, these were the sorts of things that people would suggest. But this was not an argument against the strategy.

JOHN PLENDER
Were you disappointed by the supply side implications of the Budget in the sense that, from a micro point of view, as we've discussed, there was a lot that was wrong with this Budget and, in a sense, the good things about Tory supply side policy took a long time to come through including the tax, a very architectural approach to taxation, that Nigel Lawson had, including the commitment to fiscal neutrality which is, again, radical and important?

SIR ADAM RIDLEY
Well, the debate running up to the Budget was characterised by a famous piece of analysis known, certainly to me, as the Burns-Middleton doctrine. The Burns-Middleton doctrine was picking out the fact that, if you took the three years after 1977, company profits fell by twenty five percent in national accounting terms; the usual old story, back to Andrew Glyn. Or, on the other side of the coin, if you looked at personal incomes, they were raised by fifteen percent – company profits down by twenty five, personal incomes up fifteen. Blindingly obvious, you had to do something. Now, even in this terribly stringent Budget, Ministers decided to make a raid on the banks which gave Nigel great pleasure, I seem to recall, and also the oil companies. But the Ministers did not go for the heartland of industrial profitability. They introduced a lot of other measures to help small business – bit of this, bit of that, bit of the other. And they managed to cut interest rates, so that there was a strong industry emphasis in the composition of the package, as part of a much longer programme of micro measures to which Nigel rightly referred. There was also a strong feeling that we had to try and do other things in the longer run

about things like National Insurance rates. The employer's National Insurance contribution was a sore thumb that had been causing trouble for years.

Let me stress this. There was a constant stream of micro measures all the time. It cannot be sufficiently emphasized. People tend to judge the Treasury's activities by whether they get the budget judgment right, and fiddle about with taxes. Well, this mass of other things going on – be it privatisation, be it other kinds of deregulation, and this had a cumulative impact. It was already well under way in 1981.

SIR PETER MIDDLETON

I think, if I might say so, that's absolutely right. I mean, no one thought the supply side was a matter for a Budget. This was a ten-year programme. And it was a whole succession of measures that actually gave the private sector a chance to stand on its own, basically. And I was saying at lunch, most people forget that when the Letter of Intent to the IMF was signed, it started off by saying the key points are economic strategy, the twin pillars, were the industrial strategy and the incomes policy. So there was a long way to go. And we couldn't have done it without keeping the macro framework in a counter inflationary direction.

LORD LAWSON

I've always maintained that there were two strands to the policy. There was the supply side policy, which has been discussed, and there was the macroeconomic, combating inflation and fiscal consolidation, which was partly a matter of supporting the combating of inflation and partly, to use the modern term, rebalancing the economy so you could have lower tax rates. There has been far too much relative attention paid to the macro, and not enough to the micro. And one of the reasons why I say that is, if you look around the world, you find that there are plenty of countries that have – not every country, not Greece, today – but there are plenty of countries that have been able to get a grip of their macro policy, which have been able to get a grip of inflation. The extent to which other countries have managed to make the supply side changes, because of the political difficulties, is very much less. That is, in a curious way, the tougher task, the harder task and it is of vital importance. Part of that is obviously a mixture of tax reform and tax reduction. Geoffrey did a great deal on the tax reform side. There was no opportunity for tax reduction because of the size of the deficit. But Geoffrey did a great deal in his first Budget which was critically important. But he then became interested in other things and so there was a lot, when I succeeded him as Chancellor, there was a lot to be done and I tried to set out the philosophy – philosophy's too grand a word, but the guidelines which in my opinion should determine tax policy including, as you say, neutrality as much as possible and we were able to make a great deal of progress. And I think that there is obviously more progress that can be made but many of the people like James Meade, I think, are a bit head in the clouds. There is more that can be done but, nevertheless, we did a great deal. If I may just go off-piste there's a reference to the indexed gilts incident and all that. If I may, because this is sort of a historical thing, advert to that. As Financial Secretary, I had delegated responsibility for all this and I decided that we should move on that front on very simple grounds really. Here we were, with our barrow in the market place, and if we said you can only buy apples, it might be difficult sometimes. If we said to the punters, you know you can buy apples but you can also buy oranges, maybe we would find it a little bit easier to sell our wares, in other words to finance the deficit by selling gilts. So I believed that we should have both products on our barrow and I decided to test the water very deliberately by introducing indexed national savings. The advantage of indexed national savings was that the Bank of England didn't come into it because national savings were entirely a Treasury responsibility and, in particular, my responsibility. So, we indexed national savings to test the water and they went perfectly well, nobody had a fit, so I decided that we should go further and have indexed gilts. Well, my goodness me, the Bank of England was appalled, absolutely appalled, first of all that anybody let alone – I'll come back to this, but it was a very real thing – that anybody as lowly as a Financial Secretary should be telling the Bank of England how they should fund, what sort of instruments they should use, what sort of gilts they should have. That was absolutely outrageous. But also, everybody knew that it was only disreputable Latin American countries which had indexation – no respectable country would. So I had terrible difficulty. Geoffrey was not difficult to persuade. Margaret initially had some sympathy with the Bank of England view, and there were those in the Treasury too, not just in the Bank of England, who, in addition to this feeling that it was disreputable, felt that, because we were the only people doing it, didn't like that. They only liked doing things in convoy. They don't like doing something that others, the people whose opinions they respect, are not doing. And some of them did feel that way, some in the Treasury – Ken Couzens, I think, was among them. Ken, I had a lot of time for. But, anyhow they thought that there would be a huge flood of money coming in to buy these instruments from abroad which would push sterling up even higher. Anyhow, we did it and it wasn't a dramatic thing, but I think it was a good thing to do and they still exist to this day. Howard Davies, who some of you may know, who was then an official working on that side of the Treasury said they should be called NIGELs standing for New Indexed Gilts Eligible Liabilities. But I was far too modest to adopt that suggestion.

JOHN PLENDER
Could I just ask one...

LORD LAWSON
Yes, Andrew wants to say something.

LORD TURNBULL
Didn't you restrict the first tranche to gross funds?

LORD LAWSON
Yes, there was a problem with taxation. There was a problem with taxation. You're absolutely right Andrew, so I restricted the first tranche to gross funds which didn't pay tax.

JOHN PLENDER
Right. One last question for me before we turn to our commentators. Perhaps I could ask you, Sir Peter, one of the criticism that was made of the Budget in that *FT* leader was that, in essence, the great monetary debate, as between monetary base and money supply targetry was essentially unresolved. How much damage did that do in terms of credibility? Did it matter that much?

SIR PETER MIDDLETON
Do you mean leaving it unresolved?

JOHN PLENDER
Yes.

SIR PETER MIDDLETON
I don't think it mattered at all. I mean, once you went beyond the narrow confines of the academic world, nobody had got the least idea what the difference was between monetary base, M1, M2, M3. I think the important thing is that you were pursuing some sort of monetary policy, alongside your fiscal policy, and whether it was right or wrong. The importance of that was that certainly the international markets were completely convinced that this has got something to do with inflation. It wasn't just happening here, it was happening in the United States as well. So, the important thing was a commitment to follow monetary restraint, if you've got high rates of inflation, not which aggregate it was.

JOHN PLENDER
OK, well, at that point I wonder if our organisers could turn up the lights a bit so I can see who's here – that's great. And could I now invite any of our commentators to come in. I can see Sir Samuel at the back there. Would you like to kick off?

SIR SAMUEL BRITTAN
I think it was all a lot simpler than is implied today. It's a pity that Geoffrey Howe is not here because whenever people, many of my colleagues, have asked Geoffrey Howe what was the rationale for that Budget, he was always afraid that he could not sell enough gilts and that that would be disastrous, of course. Now jump forward about thirty years, and George Osborne around about the end of his time as Shadow Chancellor and the beginning of his time as Chancellor also thought that he might not be able to sell enough gilts. I always thought that these fears were economically illiterate, but given the reputation of economics today, it's not such a damning thing to say as it might have been. But the impetus was a fear of not being able to sell gilts. Although I supported the Budget in a way – I'll come back to that in a moment – the thing that influenced the sort of people who were interested in economic policy, but not economists, was the fear of not being able to sell enough gilts. I seem to remember the *Financial Times* arguing that you take the barrow out and you see what they will fetch, and that was that. Now there's one other thing that tends to happen. Just before many Budgets the Treasury estimate of the borrowing requirement tends to go up and then somebody – I won't mention his name – would take aside a couple of journalists – I'm afraid I wasn't in the market for this – and explain how the fiscal outlook had deteriorated. And this attracted the same sort of people who were afraid of not being able to sell gilts, it put them into the restrictionist camp. And when the Budget was out of the way – it wasn't only 1981, there were lots of other years as well – the fiscal estimates were revised in another direction. All the rest of it was commentary. That, I think, was the basis of it. Can I say a bit about my own position?

JOHN PLENDER
Succinctly.

SIR SAMUEL BRITTAN
OK. I was not enamoured of the Budget and would have advocated the kind of strategy which Norman Lamont and Kenneth Clarke carried out, of a gradualist reduction of the budget deficit.

But then I saw a letter from the 364 economists which seemed to be absolutely unreconstructed dinosaurs and I didn't want to associate myself with them. So I gave the Budget more of a showing than I would have done without the 364.

JOHN PLENDER
OK, shall we have one or two other comments before we bring the panel back in? Who else would like to have a word?

LORD LAWSON
Well, while there's a pause, may I just comment on one of the things that Samuel said? The need to sell gilts was certainly a preoccupation of the Bank of England and, to some extent, we have to accept that. That was the thinking, as I said, behind the introduction of index-linked gilts. But, all I can say is that I was very close to Geoffrey Howe at the time and, as we've said, Geoffrey had a very collegiate way of budget making. So I was present at every single one of his meetings. And, from my own recollection and experience, the need to sell gilts was not the primary motivation for the Budget at all.

SIR PETER MIDDLETON
Wasn't a Treasury thing at all.

LORD LAWSON
No, no. It certainly wasn't.

JOHN PLENDER
OK, well, perhaps I should call on our commentators individually to see if they would like to talk.

SIR IAN BYATT
As a commentator, I've got one point to make. I think it's quite a big point, actually, but I can make it quite briefly. I complained earlier this morning that the macro policy of the 1970s was inimical to supply side, to good supply side, policies. I wouldn't regard the industrial strategy and the incomes policy as good supply side policies. But the 1981 Budget, which I had personally very little to do with, if anything, was something that set the scene for better supply side policies which could then be market oriented policies; that was extremely helpful in terms of the kind of work I was doing.

JOHN PLENDER
Would Sir Alan Bailey like to have a word?

SIR ALAN BAILEY
Thank you. I was in the CPRS at the time, so looking at the longer term (and we were abolished shortly afterwards). So my only take, I think, on the 1981 Budget – I was more involved with some subsequent ones – was about cash limits, and that point has been made, so I won't press that. I do remember the debate within the public expenditure side of the Treasury as to whether we could go all the way to cash planning for the three years term that, as Nigel Lawson has said, was then being aimed at, or whether we should go for cost terms, which was a sort of

intermediate arrangement which I won't expand. But it would have made a difference. And there was a 'peasant's revolt', as it was called, within the Treasury (which shows how open the discussions were) where the statisticians and some of the economists, junior economists, said we ought, if we're going to do it at all, to go all the way to cash planning, and we did and it seems to have survived more or less. Indeed, it's got probably more robust since then. With the inflation as high as it was, it looked a pretty tall order, but it was obviously a move in the right direction and I'm not defending volume planning, though I think I would defend the five years term. The five years was originated by the Plowden Committee who'd been looking at the way defence was being badly planned and over-spent (as is familiar, much more recently), and at least five years for that kind of long-term operation has a case to be made, at least. And it was an effort and a step in the direction of controlling an uncontrollable budget. But no, the only thing I think I did want to say about the 1981 Budget was that it strikes me, having, as I say, been completely detached on the sidelines, how big arguments get set up in the Budget discussions between fairly small proportionate differences, between the three billion and the four billion and economics is a kind of analogue decision, which gets put into binary terms, much debated. And I think that has a more recent implication for where we are now which we shall come on to later.

JOHN PLENDER
Would Bryan Rigby like to have a word? Is he here?

AUDIENCE
He's at Lord Croham's funeral I think.

JOHN PLENDER
I see. And is Sir Nicholas Monck here?

SIR NICHOLAS MONCK
I am here.

JOHN PLENDER
Good, would you like a word?

SIR NICHOLAS MONCK
Not particularly.

JOHN PLENDER
OK. Lord Turnbull?

LORD TURNBULL
A lot of the argument was about the Budget's effect on GDP. If you read the footnote in Nigel's book, it tells us that in 1981 GDP increased by 1.8 percent more than the previous year. Probably from Q1/81 to Q1/82 it was slightly more. I suspect that this Budget's major importance wasn't what it did to GDP, after all, the interest rate cut didn't survive. And, normally when we think of fiscal tightening, as you know, there's quite a long lag. I think the impact was really a much more general one about expectations, rather than the purely mechanical effect which Jim Shepherd's model would have created. In Brian Reading's original

briefing paper he compares this to 2011. Of course, Sam has mentioned 1993 which completes a quartet of rebalancing Budgets – 1976, 1981, 1993, 2011. And, I suspect, what will happen in all of them is that the feared retrenchment of fiscal tightening will not be as great as expected. Now, I think in Brian's paper he referred to a tightening of 3.5 percent. I don't think that can be the right figure, whether you're comparing a tightening from 1980 to 1981 or from 1981 in terms of what it would otherwise have been and what it turned out to be. I think this is more like 1.5 to 2 percent. The other missing thing is that, when we discuss all these measures these days, the central concept is the cyclically adjusted deficit. Now you, Nigel, were absolutely passionately against this. I think you thought it was a way of introducing all sorts of alibis and rather dangerous. Somewhere, I remember a bit of the Treasury I was working for produced the Treasury Bulletin and you said 'No you can't, I don't want you to write about the cyclically adjusted deficit. The only deficit that matters is the one that you have to finance', which was the actual PSBR. And yet, I think if we'd had that concept and were able to use it sensibly it would have been very helpful to making the right judgment. And, of course, what was wrong, and was wrong even as recently as 2010, is this question of the alibi. If you make the judgements about how the cyclically adjustments are made, and you've got no one to second guess it, you can abuse it. But thanks to Steve that will never happen again.

LORD LAWSON
Now then, can I just comment on ..

JOHN PLENDER
Brian? Can I just put a rider question on that, Brian Reading?

BRIAN READING
The term expansionary fiscal contraction has now come in. Was 1981 a real expansionary fiscal expansion, because that follows on directly from your question?

LORD LAWSON
Well I'll answer that but I'd like to say something going back to that time. Now, I don't believe in this expansionary fiscal contraction argument. What I do believe is that you don't get contractionary fiscal contraction. The fact that neo-Keynesianism is nonsense doesn't mean to say that the opposite of neo-Keynesianism is right. The economy is huge. There are so many other forces at work that the idea that you just sit at the controls and you change the fiscal balance and the whole economy turns, you know, that's not how economies work. It is a very minor matter and therefore you use the Budget for totally other things, not to have an expansionary contraction or the reverse. Two quick things. One particularly, one thing I think is important, Andrew is the first person today so far as I'm aware to talk about expectations. And expectations are absolutely crucial in economic policy making. And one of the things that we were trying to do was to shift expectations which had been working in a malign way for so long, particularly inflationary expectations, but not just that. And you needed to do something radical to change expectations. And that was tremendously important. And Andrew is quite right to fasten on that. And that is so much more important than the minutiae.

JOHN PLENDER
Stephen Nickell, would you like...?

PROF. STEVE NICKELL
Yes ... my words may be recorded for posterity. I'm here for a special reason. I signed the letter. Did anyone else in this room sign the letter? I thought not. I'm wheeled out as the man who signed the letter, despite the fact that I'm not the most important person who signed the letter. If you go about two hundred yards from here, you'll find the Governor of the Bank of England, a well known signatory of the letter. In fact you'll find another member of the Monetary Policy Committee, namely Martin Weale was also a signatory of the letter so we signatories don't necessarily disappear into the back waters. Indeed I was, Richard Layard and I were, asked by the Treasury, only about three years later, to do work on trying to understand why unemployment wouldn't go down and so I've got to defend the signatories of the letter. Now I'm not a dinosaur, an unreconstructed Keynesian, in fact I'm just a straightforward, natural-rate man. I believe that in the sort of environment that we had in the late 1970s, early 1980s, there's only one way of getting inflation down, you had to have lots of unemployment. That's all there is to it. And the question then becomes a matter of calibration. How much unemployment do you need? How much of a recession do you need to get inflation down? And it was my view at the time that, by early 1981, the macroeconomic policy was too tight in the sense that there was plenty of unemployment already there, quite enough to get inflation down and so we didn't need any more. So, I signed the letter because it contained one good sentence that was that present policies would deepen the depression. I strongly believe that to be true. So I overcame my distaste at the ridiculous, theoretical analysis of the first sentence of the letter which is obviously absurd and can only have been written in Cambridge at that time. And that was incidentally the reason why there were only about ten people signed the letter in LSE. Nearly everybody else in LSE just couldn't. You know that first sentence was just so appalling that they couldn't face it. But I held my nose. Because I thought I had to stand up and be counted.

SIR TIM LANKESTER
Can you read it to us?

PROF. STEVE NICKELL
The first sentence? '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 and output in employment'. You see, that's just complete rubbish because, obviously, to get inflation under control you had to deflate demand. It's just that I felt they over-egged the pudding. So, and if you look at what actually happened of course, unemployment continued to rise for some time and, by the calculations of most people, the level of unemployment relative to the natural rate rose after the Budget and the output gap was actually wider after the Budget. I've just found that out actually. I've got this wonderful Treasury little green book on the public finances, has a thing on the output gap, and the output gap was actually bigger after the 1981 Budget. And that's what counts, you see. That's what worsening a depression means. It means the output gap widening. It doesn't mean negative growth because the fact that growth recovered after the 1981 Budget and became positive is neither here nor there. The important point is whether growth goes above trend. And it took quite a long time for that to happen. So that was basically the reason why I signed the letter and I'd still like to justify it. Now, there is one other fact which is absolutely fascinating. In the period from, I don't know, 1972 to 1992, there's a constant battle against inflation.

Policies came and went, we had incomes policy, Medium Term Financial Strategy, this and that, we joined the Exchange Rate Mechanism, and so on, and there is this rather interesting set of statistics. At the beginning of when the new Government came to power, so June 1979, inflation in British was 10.6 percent, unemployment was 5.3 percent and the rate of interest was 14 percent. After eleven years of blood, sweat and toil, we come to September 1990. Inflation was 10.4 percent, unemployment was 5.4 percent and the rate of interest was 15 percent. We were back exactly where we started. And of course we had to bring down inflation all over again, which we did. Thank you.

JOHN PLENDER
Do you want to make a quick response?

LORD LAWSON
Yes. To say that we were back just where we started is a travesty, and you know it. But I'd just like to make one comment on this interesting defence from a signatory of the letter, and, as he points out, there are other eminent signatories of the letter still around, that you were mistaken, but anybody can be mistaken. But what struck me, what struck me most, was that Steve Nickell said, the fact that the economy – we've been told, incidentally, by the signatories of the letter independently, outside that letter to *The Times* which was short, time and time again, that what we were condemning the British economy to, and I remember the phrase very well, was a self-perpetuating downward spiral. That was what they all said. And Steve Nickell says that the fact that the economy had been in decline during the period up to the Budget, and started to expand at the time of the Budget, and went on expanding for several years, was neither here nor there. I can assure him that in the practical, real world, and indeed in political terms, it was very much here and there. And it completely discredited the letter. The timing was fortunate, I agree. The timing of the letter couldn't have been better from the Government's point of view. OK, unemployment took more time to come down. That's obvious. Not least because there had been so much over-manning in the British economy that it took time for the economy to get down to reasonable manning levels. But, anyhow, whatever the reason, the thing is that that was a turning point, and it was a turning point in more ways than one.

JOHN PLENDER
Adam?

SIR ADAM RIDLEY
Could I just comment on the very important, misleading picture conveyed by the RPI statistic in the second quarter of 1979? If you study what had been happening under the previous Government, the first thing is that nationalised industry prices had been held back for a long time as part of the great prices and incomes policy. I can't remember quite how much they were below what they ought to have been, but there was a massive backlog that had to be made up. And one of the short term consequences was that Ministers faced a very large deficit. And if you were going to release them, you had to ask over what period you did it. But there was, if you like, a price increase dammed up there.

That was not all. For political reasons, again to do with prices and incomes policy, many of the specifics, non ad valorem indirect taxes, had not been indexed, I think for two years. This was in a period of quite high inflation, so you had another massive price increase dammed up there. The third part of the picture, which of course is quite interesting analytically, is what you say about the oil price? We had the Ayatollah rampaging around and the Shah, I can't remember where he'd got to. Was he in Panama, or somewhere in New York? Oil prices were clearly set to rise, and they didn't stop rising for another eighteen months. And as far as I remember they doubled again between about April 1979 and December 1980. Therefore, it's extremely misleading to imply that the inflationary position that Ministers were confronted with is adequately embraced by a published ten percent inflation rate at election time.

JOHN PLENDER
Right. Time is getting a little short. Sir Alan Budd, I don't know if you'd like to make a comment?

SIR ALAN BUDD
Well, I've been so much outshone here by Steve. I was going to talk a bit about the letter and so on. I'm reluctant to do that. My involvement in this was twofold. One, just before the Budget, though I'll come back to Nigel Lawson's view of this sort of thing, it does so happen that the Economic Outlook of the London Business School published an article saying, entitled 'Bringing the medium term fiscal strategy back on course', in which we did advocate a further fiscal tightening in that Budget. But, as I say, Nigel very frequently reminds us that academics have no influence on anything at all. I wasn't asked to sign the letter. I certainly wouldn't have done. Though one thing I did get was a nice remark from Ferdy Mount who wrote about it in *The Spectator* the following week, so that was a nice thing to happen. Another thing that happened at the London Business School was that, in 1981, a very dark time, we did actually forecast a recovery in 1982. We were the first to do so. The main basis for this recovery was, in fact, the stock cycle. Stocks were falling and falling and falling and if stocks stopped falling, of course, that's an impetus. The result of that even outclassed a remark from Ferdy Mount and I experienced the peak of my media career, which was to appear on the Jimmy Young Show early one morning, and I was very impressed to find how much about the economy Jimmy Young actually knew in that interview. But that's all by the by and one shouldn't even refer to it at all. There is one point I'd like to make, not to do with this but made by more than one of the commentators, which was the point about the role of cash limits, of course, started by Denis Healey, but very much sustained and continued under the Conservative administration, and this is not so much about cash limits as a way of controlling public spending, though it was, and I think it was Samuel Brittan who used to call this funny money. This was controlling public spending and funny money. But it was symbolic. It was symbolic of a separation, complete separation between cash figures and real figures. And I can speak of this because I was the chief forecaster in the Treasury in the 1970s and we did something called producing the NIF which is the National Income Forecast which was entirely a real phenomenon. It was all about real growth and real everything else and we stopped it and it then went off a very peculiar journey via the Central Statistical Office, as it was at that time, which forecast company profits and it went off to the balance of payments people. Eventually it came back as a current price forecast, with a forecast of the money supply. There used then to be a meeting at the end of all this which always went as follows. We were all gathered round one table and the Chief Economic Adviser, Donald MacDougall again, would ask the following question. He would say 'Well Alan, in the light of all this, would you like to change your forecast?' At this point it had been pointed out to

us for example that the money supply was going to grow by twenty percent. And the way to deal with this was to pause for a few seconds for thought, and then say 'No I don't think so. Thank you very much Donald' and that was the end of the discussion. As I say it was not so much to do, only with controlling public expenditure, but to do with the very peculiar way in which the Treasury thought about the economy. Again, someone referred to a question that Bryan Hopkin was asked. I remember at an OECD meeting someone asking me what was the size of the budget deficit in cash terms. And of course I didn't know the answer, nor could I understand why on earth I'd been asked the question.

JOHN PLENDER
Right, Charles Goodhart, do you want a last word?

PROF. CHARLES GOODHART
A couple of slight comments. First, I think the panel has given the impression that Ministers and Treasury and all were pulling completely together and I think this is an exaggeration. I've never known a Budget which, I think, was so politically dominated. Remember, Alan was saying that the Treasury was very Keynesian in the 1970s and remained so really until 1979, and I think the Treasury was as divided as the Bank was. And Ministers actually had to introduce a whole series of personnel changes. And the Treasury, I don't think, was a unified institution because, I think, the 1981 Budget was, in a sense, imposed on them with the support of those in the Treasury who believed in it. And I remember Christopher Dow who was our resident Keynesian at the Bank, coming back from time to time and saying that x or y or z was totally depressed by what was going on. And, I think, that it's only fair to indicate the official Treasury and members of the official Treasury were not as unified as I think the panel was actually indicating. Nor, of course, was the Bank ever unified. No large institution actually ever is. And Nigel was saying that the Bank was opposing indexed gilts. I know a lot of people in the Bank who saw the advantages of indexed gilts. One of the reasons why there were a number of doubts was you will remember that Steve Nickell was talking earlier about how awful it was that we had indexed wage. Well, we were desperately trying to get away from indexed wages and some of us, including me, at the Bank were worried that indexed gilts were a form of indexing the returns to capital, where we were trying to get away from indexed wages. And if you were going to index the return to capital, why would the trade unionists not say, well, let's index wages as well. Now, it never happened. And why it has been the case that you can have indexed gilts and indexed returns to capital and this has not led to a recall from Labour to have indexed wages, I've never quite actually understood. Maybe Nigel can put me, as a poor benighted academic, right in the real practical world.

JOHN PLENDER
OK, well look, we are now into the tea period, but will you excuse me if I actually just ask the panel to make a last sort of succinct statement in turn. Perhaps starting with you, Lord Lawson?

LORD LAWSON
Well, we're running short of time so I'll be very brief. The answer to Charles Goodhart is that, quite right, there was a superficial connection between indexed wages and indexed gilts and it was an argument which I had to tackle head on and I tackled it head on. And no harm was done by introducing indexed gilts. So the results justified the policy. And on the question also that

Charles raised about differences within the Treasury, the official Treasury, of course there were differences within the official Treasury. For example Douglas Wass was wholly opposed and there were others.

SIR PETER MIDDLETON
I don't think that's true.

LORD LAWSON
I think he was very largely opposed, Peter. Anyhow, I'll come to you in a moment. Alan reminds us of the peasants revolt. That was a very important part of what happened and it showed that there were those slightly lower down, the so called peasants, who were on the right lines and they had to stop what their seniors wanted to do. That was a great victory, and you deserve enormous credit for it. And, of course, it was one of the important reasons that led to the appointment of Peter here as Permanent Secretary, because he was perhaps the most prominent Treasury official who fully supported what the Government was doing. He supported it on economic grounds, not on political grounds. Entirely on economic grounds. I've no idea what his politics are and I've always been suspicious of them. But it did lead to changes. And, I remember, I think it was Leo Pliatzky, it may have been some other official, who in the early years said a terrible thing has happened to economic policy making under this Government. It's the Ministers who are designing policy. And that was true.

JOHN PLENDER
Right, well, with that can I turn to you, Peter?

SIR PETER MIDDLETON
Yes, I don't think I've got really anything much to add. Douglas Wass keeps getting an appearance in his absence at the meeting. I think, on this issue, the Budget, my recollection is he wasn't opposed. I don't think he was – do you Adam?

SIR ADAM RIDLEY
I don't think he was either.

SIR PETER MIDDLETON
No. No.

LORD LAWSON
But the one thing Treasury officials have always been keen on and bless them, it's very important, is that they have always been keen on the control of public expenditure, the firm control of public expenditure. And some politicians are not so keen. And when they had a Government that was keen on it, that was an immediate rapport. They may have differed on other things but on the control of public expenditure, we were absolutely at one. And that is very important and it's perhaps the most important single role that the official Treasury can fulfil. It's very basic but it's fundamental.

JOHN PLENDER
Adam, last word?

SIR ADAM RIDLEY
There's a very interesting question that Charles raises about what was the degree of dissent and debate in economic policy making circles, in the 1970s. I would say it actually began to get out of hand in the late 1960s when a certain Samuel Brittan came along and gave an extraordinary lecture to the Treasury's Economic Section during which he drew a slightly shaky line, a vertical Phillips curve, and started telling us about the importance of NAIRU and Mr Friedman, or Professor Friedman. And from that moment onwards you begin to hear the ground creaking a bit. The degree of controversy was probably intensified by the time of the Budget, but I don't see this as anything very special or out of the ordinary. I think it was part of a healthy debate as people came to terms with the collapse of the old verities and stumbled around trying to work out what the new ones should be.

JOHN PLENDER
Good, well, could I thank our panel on your behalf, some extraordinary and fascinating insights. Could you join me please in expressing your appreciation.

The 1981 Budget – Facts & Fallacies

Session Three: Lessons for today.

PETER ALLEN
Welcome back, ladies and gentleman, for the final session. Thank you for staying with us for the whole day. Once again, we have a short video link to get you in the mood and perhaps you might like to try to identify which headlines we've invented and which ones are real. Thank you very much.

VT

HUGH PYM
Gosh, it's normally the BBC that gets accused of being excessively gloomy. We do try and look on the bright side but that's Lombard Street's contribution. I think they all look reasonably plausible, some a lot more so than others. Anyway, I'd like to thank Lombard Street very much for giving me this opportunity to be here. It's been a fascinating day for me. I'll just run through the house rules very quickly once again. This is not on Chatham House rules. Anything that you say will be recorded and may be used in evidence against you so please sign a consent form if you do speak and it will go into the archive. And when I call for contributions from the floor, if you don't mind introducing yourself, that would be very useful. Now, following John Plender's introduction, I thought I'd better admit to what I was doing in 1981. And the answer is, I was approaching my finals in Politics, Philosophy and Economics at the same College, actually, which had been graced by Lord Lawson and Peter Jay before. My academic achievements were considerably inferior to those two, I have to admit. But I'm afraid the March Budget rather passed me by at the time and may have done to all economics students at that moment. History obviously becomes a lot more sharp in its meaning after the event. Maybe the excise duty on a pint of beer concerned us in the common room but, beyond that, I don't have any great knowledge of it. My main memories of 1981, apart from some of the clips shown earlier, were of the Ashes triumph later that year by an England cricket team coming back from the depths of despair to record an amazing victory. A rather good DVD was brought out this year recalling Botham's Ashes in 1981. I think we now need a DVD of the 1981 Budget based on some of the very interesting contributions that we've had today. I was also taught by Andrew Glyn, sadly no longer with us, and I remember him teaching me classical economic thought – Marx, Ricardo, and Adam Smith. And he was very nice about it, very insightful. He used to sell *Socialist Worker* on a Saturday morning when he wasn't doing tutorials. I remember him writing to my tutor at my college saying about me, 'I think he's read all the works. I'm not sure he totally understands them' and I'm not sure I do now necessarily. But, some of the lessons from those economic thinkers have proved extremely useful. I think just a couple of observations about 1981 and today. I suppose one of the key similarities which we'll try and tease out of our panel is that we've had a Chancellor announcing fiscal contraction, sharp fiscal contraction, in the teeth of either a recession or very sharply slowed down economic growth. Now, clearly, there are different circumstances. There was recession in 1981. There wasn't by the time the Conservatives took office but obviously growth is considerably slower now and we are arguably in the teeth of a major slowdown. The major differences clearly are in terms of the nature of the

recession – that we didn't have a banking crisis in the lead up to 1981, although we did in the early 1970s, the secondary banking crisis, and the scale of the banking crisis in 2008 has obviously cast a long shadow over any Chancellor, in terms of impaired growth and balance sheets needing to be reconstructed and clearly household indebtedness is a major factor this time round which wasn't the case in the late 1970s. And one of the other key areas I think I'd like to try to bring out which has struck me is the interaction of fiscal policy and monetary policy, the interaction of the Treasury and the Bank of England. And to hear some of the stories about Ministers and the Bank of England, robust discussions and chocolate cake being served and all that sort of thing in 1981, and now looking at the interaction of fiscal policy and monetary policy and the Bank of England, now independent, and making its own decisions about interest rates obviously, but with George Osborne and the Conservatives coming into a coalition Government making clear that they would want to see a tight fiscal policy combined with a loose monetary policy. And to what extent that has happened, and to what extent monetary policy can continue to take up the slack now in the face of continued issues over low inflation longer term and possible deflation, And to what extent politicians are putting pressure on the Bank of England to embark on another round of quantitative easing and looser monetary policy. Anyway, those are just some thoughts from me. Two of the panel need no introduction because they've made very interesting contributions so far – Lord Lawson on my far left, Sir Alan Budd on my far right. Jamie Dannhauser here from Lombard Street Research is on my right. On my immediate left Charles Dumas of Lombard Street as well who tells me that in 1981 he wrote a paper on the need for fiscal contraction in about February 1981 when he was working for JP Morgan, but he's not necessarily sure it was implemented for the right reasons by the Chancellor, but more on that in a minute. But I'd like to call on Jamie Dannhauser first. Jamie, what do you think are the key lessons from 1981 for today?

JAMIE DANNHAUSER
I think before I answer that I've got to confess I am probably the biggest fraud in the room because I wasn't alive in 1981, and I barely even remember the policy mistakes of the early 1990s. So, my memory of macroeconomics really starts in the mid-1990s. But, I think for me the main lesson of 1981 is more why today is different than why it's similar to 1981. From the macro side, I think there are three key things. First of all, Britain had lost all monetary credibility by the time of the Budget so we had very high inflation expectations. At the same time we had very high real interest rates and, accompanying oil and high real interest rates, we obviously had a very high real exchange rate. So there was very considerable scope for monetary offset in the face of fiscal consolidation. For me that is the lesson, not just of what Britain is undertaking today, but what is happening across the developed world. Can monetary policy offset the consolidation that is taking place? Obviously, alongside that, we have the issue of what does the global environment look like. I would suggest the 1980s that Britain faced was a very different environment to the world that we face over the next five to ten years. And then, obviously, we had the issue that Brian Reading alluded to at the start of the day about the state of balance sheets in the UK. There's no doubt that the ability of monetary policy to gain traction is dependent on the state of balance sheets, so I think coming back to Hugh's point about these interactions, I think this whole part of this debate of whether we are re-enacting 1981 here is really about can the Bank, can the fall in the currency, do enough to offset the fiscal contraction? I think I'm unsure about that and I'm pretty sure everyone else is as well. I'm not convinced the evidence is clear on that in any particular way and I think we'll find out going through. But one

point I'll make before I hand across is the issue of the counterfactual. I find it astonishing how the debate continues in this country and abroad without discussing what would have happened had the fiscal policy not been put in place. And, for me, the difference in Britain today versus Britain in 1981 is that Britain faces public finances in far worse shape than they were in 1980-81. The structural deficit was seven percent of potential output at the end of last year. It was about one percent on the OECD's numbers thirty years ago. Net Government debt is about twice as high, roughly, as it was thirty years ago. Britain has far worse public finances than, say, Spain. And so my question, the thing that I'm trying to get straight in my head, is what was the counterfactual for Britain, had the March 2010 Budget been the basis for fiscal plans going forward. I know the Bank of England is particularly keen on the idea that there's a cliff edge and nobody's really sure how close to the cliff edge we're getting. But it's absolutely essential that we put other countries between us and that cliff edge. And I think Sir Peter Middleton earlier talked about the balance of risk and I think this is something also that's hugely important. If you're a policy maker you've got to not just think about what the most likely outcome is, but where do the risks lie. And, I think, had I been sitting there setting policy last summer just after the election I would have come to the judgment there was significant risk for the UK if we didn't put in place a very large fiscal contraction. Now, I have huge question marks about whether the Government will achieve that contraction, but I think it was important that a statement of intent was laid down eighteen months ago and, as far as I'm concerned, the next stage of the process is what does the Government do from here. And I'll ask one of my colleagues on the panel to take it from there.

HUGH PYM
Can I just quickly ask, Jamie, do you think there's a lesson from 1981 in terms of the contraction being, the policy being, introduced and growth, if you like, picking up as a direct result of that? Did it help private sector activity and growth?

JAMIE DANNHAUSER
Yes, I think unfortunately the macroeconomics - well, there's this. There's dogmatic adherence either to Keynesianism or monetarism or some other 'ism', whatever it might be. For me, the lesson of all the evidence on fiscal behaviour is that fiscal contractions do depress demand relative to where it would be subject to the fact the central bank responds. Interest rates tend to be lower, inflation credibility improves, the currency often adjusts. So the question for me is, are there the offsets here? And I think that is something that we're really struggling to get a grip on, the Bank of England is surprised by how little traction monetary policy is gaining at the moment. And there's a big question mark given the debt overhanging the West about whether monetary policy will be significant. And I'm not convinced that anyone really has an answer to that yet.

HUGH PYM
Sir Alan, any observations on lessons which are relevant today?

SIR ALAN BUDD
Well, only unhelpful ones, because I do find this quite extraordinarily difficult. I think at the moment, to a very large extent, we are facing unique conditions, at least in my lifetime, which is a lot longer than Jamie's. The policies of 1958 actually caused me to go on the dole queue, so I've been thinking about economic policy for a very long time. And I can find very few parallels

today with 1981, and Brian Reading's extremely helpful background material supports that conclusion. I'll talk a bit about the state of economic thought, since this has come up at various times, and then come on to what is happening. One of the points about what was happening in 1980 was a very bitter battle about the conduct of economic policy and the letter of the 364 was an example of one side responding to what was happening. And after that happened, there was very much a move towards a consensus in policy making. A very important contribution to it, of course, was Nigel Lawson's Mais Lecture on the assignment question, about what macro economic policy should be used for and what microeconomic policy should be used for. That is now widely agreed but was not before. We use microeconomic policy to improve the performance of the supply side wherever possible. We rely on market mechanisms to allocate resources. This is all part of the consensus. It certainly was not so before round about 1980. So, on the micro side, a very wide area of agreement. On the macro side, again, the recognition is that the way to control inflation, via managing demand in the short term, should largely be the responsibility of monetary policy and we have an independent central bank to do this. And the concerns of fiscal policy should be to allow the automatic stabilisers to operate but, largely, to have a view on the sustainability of the public finances. Now, that's a remarkable degree of agreement about how economies work and what you ought to do to keep them moving along. And, of course, to start with it had these wonderful results known as the Great Moderation. It was even given a name, the Great Moderation. And, to me, the Great Moderation was the triumph of the moderate economists. It was the moderate economists who produced the Great Moderation so it's particularly baffling for the likes of me who are so pleased by this consensus to find ourselves in the position we do and, as the Lombard Street headlines showed, how can it be that, after all this, and a sensible conduct of policies, we're back in such an appalling position, and so much worse in so many ways than 1981. And, of course, it is largely because the problems have arisen elsewhere, and particularly they continue, of course, to run along in the Eurozone. So what one can learn from 1981 on how one responds to the type of shock we've had, through the banking sector, and the appalling external position, is very, very difficult. And what can we cling to? This comes a bit to Jamie's point. I have observed or been involved in three processes of fiscal consolidation. There was the 1976-77 experience imposed on the Labour Government by needing to borrow from the IMF. There was the 1981 consolidation which we've been talking about all day. And I was closely involved in the post-1992 consolidation because I was Chief Economic Adviser to the Treasury at the time. And in each of these cases, and Andrew Turnbull also alluded to this, the pessimists were wrong and the optimists were right, that despite fiscal consolidation and tightening of fiscal policy, economies recovered and grew. All right, as Steve Nickell has pointed out, the output gap continued to grow after 1981. But, nevertheless, the economy did start to recover. So, three times we've had fiscal consolidations and the results of this have rapidly been beneficial. So, do we draw the same conclusion this time? Now, last time I sat at this table at one of these discussions to discuss the crisis which continues I said then that I thought, yes, that this was another example where the right thing to do was to have the fiscal consolidation for the sorts of reasons that Jamie's talking about. What, however, I do not know, and I honestly do not think anybody knows, is how rapidly this process should continue. After all, there is bipartisan agreement about the need for fiscal consolidation. What there happens to be disagreement about at the moment, though it's actually quite small, is the speed at which this happens. And I do not see that our experience, these previous experiences, really tell us the answer to that question. Sorry, you want me to stop?

HUGH PYM
No, I was going to pick up on one of your points which is the globalisation argument, where we are now, compared to the early 1980s. You know, ninety percent of gilts were sold in the UK back in the early 1980s. Now it's roughly sixty percent.

SIR ALAN BUDD
Yes.

HUGH PYM
It is a very different set of policy challenges to any Government.

SIR ALAN BUDD
It is. And that's part of it. And that's why, of course, credibility, fiscal credibility, is extremely important because we're selling these things into a world market. So I sit here hoping to hear from the young, actually, because I'm far too old now ever to learn anything new at all. But I will listen to the young. And I feel I've run out of solutions to these problems so I want to hear what we should be doing now.

HUGH PYM
Well I'll bring in the two young gentlemen on my left.

CHARLES DUMAS
Nigel is younger than I am.

HUGH PYM
Actually, Charles, would you quickly like to go first? I've rather dropped you in it. You said you'd written a paper in early 1981 calling for precisely what happened, but you think Nigel Lawson and Geoffrey Howe did the right thing for the wrong reasons?

CHARLES DUMAS
Yes, that's true. I believe in the expansionary contraction policy and I certainly disagree with Nigel Lawson to the effect that fiscal policy doesn't have any great significance. In fact, of course, as we know, he was a great supply side Chancellor and one of the best things that came out of the whole 1980s thing was this succession of good supply side changes. And, more generally, the cutback in the size of the Government sector vis-à-vis the total. And, in defence of poor old Keynes, who's come in for a bit of stick recently in a number of quarters, Keynes took the view that any total tax take of over twenty five percent would be very bad for the economy. So people who think that Keynes stands for tax and spend, as with so many people, have not read Keynes. So, where do we stand? Well, of course, people who are good supply side Chancellors sometimes have not been regarded as the best demand side Chancellors and this is true of Anthony Barber, for example, who has been excoriated today for irresponsible policy but he had very good tax reforms. And I think that we have to look at the demand side effect. And it's very clear that even if interest rates were raised later on in 1981, they were substantially lowered and that sterling, which had soared to an amazing level of about five deutschmarks and was pushing towards three dollars by the time of this 1981 Budget, fell back a long way and the exchange rate

was a hugely important factor, creating the sort of expansionary counter current to the fiscal restrictiveness. So, we're looking at today what are the lessons from this. Well, the lessons, I would say, are firstly, that the Friedmanite side is a lot less important, secondly, that the Keynesian side is regrettably more important and, thirdly, that a name which has not yet been mentioned, of course, at this episode which is Schumpeter, let's say, or the Austrians in a more general sense, are radically important in the overall situation. So what does that mean? Well, first of all, of course, it's true that conditions were not rosy in the rest of the world in 1981, but there was some expansion in the United States, even if, in the subsequent year, there was a downswing. The world at large was in an expansive, relatively expansive phase and, more importantly, the exchange rate effect was very important and we also had high interest rates which, over the course of the next several years, came down. And nominal interest rates, as Brian pointed out first thing today, are a vitally important aspect of the restrictive effect of inflation on an economy, other things being equal. So, are we going to get that? Well, no we're not because interest rates are already zero for the practical purposes. So we have now a world in which the United States next year is deflating its budget. I regret to say this, Lord Lawson, in structural budget terms, the policy measures being taken in relation to the budget, amount to about two and a half percent of GDP between this year and next. And in Britain, we know all about the contraction here. It's about half to three quarters of a percent of GDP in core Euroland and very substantially more in already deflating and recessionary Club Med. The Chinese have been given a dose of inflation by the Americans for having the cheek to clamp their currency onto the dollar and in trying to achieve a permanent undervaluation are getting inflation as a result, so they're now also deflating their economy. So the world at large is deflating and so the external conditions could be hardly less favourable and interest rates, of course, cannot be lowered. So, Jamie has mentioned to me that monetary policy still has potential force. If, for example, the Fed went out and bought a trillion dollars worth of houses and demolished them, then you would get some stimulus. And I agree with that. But I'd be strongly opposed to the policy nonetheless. The basic point here, of course, is the reason why there's a very large Government deficit. It's because for the most part in the deficit countries, at least, there was much too much private sector borrowing in the run up to 2007-8. And that, in itself, was the counterpart of an excessive savings rate in, most conspicuously, China but also Japan, Germany, the countries around Germany, and all the rest of it so that turned. For those of you who don't know this, the world savings rate in 2007 was the highest on record by a very large margin. So, there was not a deficiency of saving in the world at large. It was a distribution problem – the famous imbalances. So, one of the results of this, of course, was too much debt and too-high asset prices, which I'll allude to in a moment. Anyway, the upshot of it is that, because the Chinese and the Germans refuse, in the case of the Chinese, to move the exchange rate, in the case of the Germans, to adopt a stimulative policy, it follows that the only way we've managed to achieve any kind of recovery at all is by the deficit policies which are now judged to be something we can't continue with, and I agree with that judgment. So, it follows that there are no Friedmanite ways out, expanding the money supply or anything like that on any kind of scale to offset this scale of fiscal deflation that's being imposed on the world. And, I'm sorry to say, that I think we just have to go through the wringer because otherwise we cannot isolate the cause of the problem which is, in the current context, excessive inflation all over again. The world savings rate projected by the IMF for this year is exactly equal to that of 2007, which is an all-time high, and what they're projecting for next and subsequent years in their rosy scenario is a move into new stratospheric highs for the world savings rate based, presumably, upon Chinese capital spending, currently forty nine percent of GDP going into more than half GDP. It's a ludicrous forecast. So it isn't going to happen and the investment will not be there and so the savings will, of course, not be there because the income will not be there. And the reason the income will not be there is because the savings rate is projected to increase because of a reduction of dis-saving by Governments next year, and the year after, and so on and so forth around the world and the result is going to be a drastic downswing. Now, fortunately, the Chinese inflation has achieved for the Americans what they need, which is to free up effectively their real exchange rate. They've managed to devalue through the mechanism of the back door of Chinese inflation and the Euro has gone up. And so, China will be in serious trouble when all this happens. And the Americans, being now cheap, will get a larger share of their own market so they'll have import substitution, as well as exports. And out of it will emerge, out of the ashes, I think, what I'm calling in my latest book the 'American Phoenix'. The British, I'm glad to say, have some possibility of tagging along somewhat slowly in the footsteps of this because we have an exchange rate. The lessons about the supply side that we've heard obviously apply much more dramatically now to Club Med than they apply to Britain but, to the extent that we can actually bring down the huge increase in the public sector take, most of which was spent on extra public sector wages over the last five to ten years, and get the overall size of Government down, and take some supply side movements and luckily have, from what is already a mostly cheap exchange rate, probably a substantial further cheapening, then I think we will get some sort of growth. But it's going to be a grim process and, as I say, a Schumpeterian process because basically we have to destroy some of the excess wealth that has been created.

HUGH PYM
I'd like to come back to global imbalances a bit later on. But, Lord Lawson, have you got any comment on Charles's earlier points, or thoughts on similarities between now and 1981?

LORD LAWSON
Yes, let me say a few things about how the similarities and differences strike me. Although I have some insight into the 1981 Budget, having been deeply involved in it, my views on what is happening now are no better informed, probably less well informed, than those of everybody else in this room. Before I do, however, let me say this. Somebody mentioned 1981 cricket. I remember that very well. Some years ago, I gave a little speech at one of those wonderful dinners at Lords in that great room there and the theory I advanced was that there was a correlation between the fortunes of the Conservative Party and the fortunes of England cricket. I have no idea why that should be so, but it has remained, to a remarkable extent, true. And I have rather more confidence in that relationship than I have in most of the other relationships that we've been talking about today.

AUDIENCE
Inaudible

LORD LAWSON
Exactly, that's right. No, it all works. The similarities and differences – well the world is certainly very different. I don't take as negative a view as Charles Dumas. I mean, it is true that for, different reasons, the United States is in a worse position than it was then. This is the global context. As is Europe because of the Eurozone fiasco, which must go down as the most

irresponsible economic policy initiative, the creation of the Eurozone, of the last fifty years at least. So, Europe is in a worse position. However, China, although it has its problems, China is still going ahead pretty well and a major force in the world economy, which it wasn't in 1981, and there are a number of other developing countries which are in a similar position. So, although the world picture as a whole is probably slightly worse, there are some encouraging things about the world, notably the great growth and success of some of the developing countries since they moved from socialism to a kind of market economy. Incidentally, I agree with Charles, I have great confidence in the fundamental strength and resilience of the American economy. It is going through a very bad patch, but I believe that it's far from finished and going to recover, whether it's a phoenix or not is another matter. But anyhow, that's the world picture, which is different. The picture in this country is obviously different. The banking disaster was not unique to this country, but was particularly bad in this country, and it matters particularly in this country because of the importance of the banking sector to our economy as a whole – the banking disaster is a different phenomenon. There was nothing like that in 1981. And, also, the fiscal picture is even worse than it was in 1981. However, pretty well everything else is better. The condition of British industry, we've talked about the supply side, and so on. The condition of British industry is hugely better. The danger of trade union mayhem – and I'll come back to that – or fear of trade union mayhem, is considerably less than it was then. The inflationary problem, although inflation is never dead, the inflationary problem is hugely less acute than it was then. This huge gloom and defeatism, which was so difficult, is not present today. And I think that although people are glum, expectations are nothing like as disastrously negative as they were then. So, in some ways, it's certainly different. In some ways it's slightly worse. In other ways, more fundamental ways, I think, it is very much less bad than it was then. Incidentally, one thing – I noticed the briefing stuff we were given saying that how much bigger this fiscal retrenchment – mind you, it needs to be – the fiscal public expenditure cuts I'm talking about, public expenditure retrenchment, how much greater it is than what we did in the 1980s. I have to say that comparing plans with out-turns is not a very clever thing to do. Because, in the real world, there is always attrition. And you never have the degree of public expenditure retrenchment and consolidation which you plan to have. There are always reasons why you don't. You fall short. And the question is not whether there will be any attrition in the present Government's plans, it's a question of how great that attrition will be. I hope it will be only small, but there will certainly be some. To what extent has the 1981 experience that we were talking about earlier had a bearing on what is being done now? I think it's had an enormous bearing. You have to remember that when we did what we did in 1981 it had never within living memory been done before. And the assumption was that it was politically impossible, that the trade unions had an irrefragable right of veto over whatever you did and that it was not just the coal strike, which was very much in people's minds, and how Ted Heath and the democratically elected Government had allegedly been overturned by industrial action, but also we had the steel strike, and various other strikes, which rocked the Government to its foundations. That has all changed. I think that I'd be surprised if the present Government or the present Chancellor has not been encouraged by the experience of the past, encouraged by the fact that the 1981 Budget, which was the first time this sort of fiscal consolidation had been attempted, worked, or at least appeared to work and it was certainly politically sustainable and all the policies that we introduced were politically sustainable. I agree that a lot more needs to be done on the supply side. We did a great deal but some of that has been undone and there's a great deal more to be done. But, I think that the experience of the 1981 Budget and the fact that the 364 were proved completely wrong and all our critics were proved completely wrong – if Steve Nickell doesn't mind my saying that – and that we did move ahead successfully, and the fact that we could withstand the sort of strikes we're going to have over the coming year over public sector pensions by the trade unions or whatever, I don't know what it is. It's going to be bloody awful. But now nobody thinks that the Government can't withstand it. And that's an important lesson of what happened in the early 1980s and that is I think good news for the future. Finally let me say why I dissent from Charles Dumas's view that there is a clear link between the fiscal deficit, the budget deficit and what is happening to the real economy, whether it's growing or whether it's not growing. The fact is – and he kind of rehabilitated Keynes and I would like to join in this rehabilitation of Keynes in a limited way because, as some of you may have guessed, I'm not a complete out and out Keynesian. But...

HUGH PYM
We would never have guessed.

LORD LAWSON
.. the chapter which doesn't really belong to the General Theory, right at the end, 'Some notes on the trade cycle' I think it's called, where he seeks to analyse the cycle. He does it very interestingly in terms of what might be called confidence. He more or less says, at the heart of the cycle, there is the matter of businessmen's intentions to invest. And sometimes businessmen are very confident and they will go ahead and invest a lot because they think they'll get a return. Sometimes they lack confidence and so you get this credit cycle which produces a cycle in the economy as a whole. Of course, what he didn't live to see was a huge increase in consumer credit, because in those days it didn't exist. Then credit was basically a business concept. So you now have a much greater credit cycle. Nobody can say when businessmen's animal spirits are going to change. Nobody can say when households are going to decide that they've accumulated too much debt and they ought to retrench, or when they think they can move ahead. And you see the huge numbers that are produced by changes in the savings ratio which far dwarf any changes in the Government's finances. And so for the Government, with its fiscal policy, to outweigh the fluctuations in confidence would require measures on such a scale that they'd be completely unthinkable and the markets would completely take fright either way. So, what you have to do in economic policy is for the medium term where you can do sensible things and that is why a medium term policy is essential. A short-term cyclical policy is a complete nonsense. And then in the short term what you need to do is to maintain confidence and you can help that by supply side measures, you can help that by having a steady policy which you persist with. It is confidence that matters and you do your best to create a climate of confidence. And that is why all this talk of Plan B would do far more harm than good because it would be the Government running scared, and if the Government is scared then everybody is going to be scared. And the consequences of that are going to be unhelpful. So that is my perspective as a very old man.

HUGH PYM
Not at all, not at all. Just quickly, before we move on, Sir Alan, Jamie, do you have any view on the global position – either imbalances and what can we do in the face of these huge imbalances or the Eurozone? I'm conflating two questions really.

SIR ALAN BUDD
Mervyn King made a speech about the global imbalances some time ago and actually said these problems cannot be solved unilaterally. That is not their nature. And, therefore, we must set up some arrangements under which we try to move towards a solution to these problems. I'm not normally a supporter of coordination in economic policies but this seemed to me to be very true, and very relevant, and it seems unfortunate that really nothing has come of that. But I suppose it's all because people have got so much more concerned with the immediate crisis.

HUGH PYM
Jamie do you share Charles's views on the Euro?

JAMIE DANNHAUSER
I sort of have to if I work for Lombard Street I think.

HUGH PYM
It's an unfair question isn't it?

JAMIE DANNHAUSER
Europhiles are not accepted.

HUGH PYM
You can tell me off the record.

JAMIE DANNHAUSER
The only thing I would add to the global imbalance story is that the debate is frequently couched in terms of the exchange rate manipulation. I think that's clearly been a part and maybe we'll come onto it in a bit. But I think there are far deeper structural imbalances to do with demographics in Germany, China, Japan, to do with capital controls and capital, whether it's to do with private property rules in China, land rights, any number of things. I think it is important in this global imbalance debate, which Mervyn King has been a loud advocate of, that we think beyond the exchange rate manipulation to the much broader problem, which is that we have huge distortions in the way the world produces things and until we get that sorted out and there is some coordinated adjustment, the world's going to struggle to grow.

LORD LAWSON
It is much more fundamental than that. The global imbalances are perfectly natural and one of the least of our problems. I gave a lecture, which was subsequently published, the inaugural Adam Smith lecture at Cambridge, which I called 'Five Myths and a Menace'. The menace was protection and all bets are off if the world descends into protection, but absent that, most of the other things are myths. And one of them is that there is a great problem of global imbalances. But the thing is much more fundamental than this. All history shows that when you have economic development you first of all have a huge improvement in output. You subsequently, after a gap, will have people learning how to consume, because you don't have a consumer culture in the primitive cultures, so you have a lag between the production really getting going – this happened in Japan and it is now happening in China, but it's always happened in history. And then the growth of the consumer culture occurs, and then people start spending. And also,

the growth of a welfare state. That follows. And the welfare state has a huge impact on how much savings and spending there is. There's a great difference if people feel that the only way they can look after their futures is if they save themselves. And if they think there's a welfare state which will enable them to get by without saving. Whether it's a good thing or bad thing, it's a huge change. So you initially get, when you have a new significant country coming up onto the block and becoming really successful in terms of economic development, you will find that it will have a large current account surplus. And Charles is right, I think was it Charles, or was it Jamie, the exchange rate is actually only a small part of that, and even if you got to purchasing power parity exchange rates you would still have this surplus at this stage of China's developments, so you have to live with it. And it is nothing to do with whether you're rich or poor. The analogy I draw is between the North of England and the South of England. It may not be true now, but it was true in my time. The reason why the Halifax Building Society came to be by far the biggest mortgage provider in this country was that it was based in Yorkshire. And the people in the North of England are savers. They have a savers culture, or did in those days. The people in the feckless South are borrowers and spenders. And so what the Halifax Building Society was doing was getting the savings from the North and channelling to the South. So there was huge imbalance between the North and the South. And that is an analogy, it's not a perfect analogy, but I think it is a telling analogy between what is happening in the world today between China and the United States.

HUGH PYM
And presumably in Blaby, your former constituency, it was half way in between, so a bit of both.

LORD LAWSON
Oh well, Blaby was the very centre, very heart, of England and that was why it was a great constituency to represent because I was unaffected by all these special pleadings of one side or the other.

CHARLES DUMAS
This is a slightly prelapsarian view about how the world works I'm afraid, Lord Lawson.

LORD LAWSON
But true.

CHARLES DUMAS
Sadly not, no. I mean it was true until 2007. The South, which in this case we'll define as being the United States, Britain, Club Med, and so on and so forth, willingly took on the debts necessary to absorb the surpluses of these countries.

HUGH PYM
I might have to terminate this discussion, maybe continue it a bit later. Sorry, Charles.

CHARLES DUMAS
OK. All right.

HUGH PYM
Jamie wanted to have a quick word on it.

JAMIE DANNHAUSER
I was just going to raise the point that, let's look at India. India runs a big current account deficit. I don't know the data for Brazil, but I have a feeling that's also a current account deficit economy. And also if we're in a world now where the West can no longer borrow and spend, the imbalances do become a problem and that, to me, is the fundamental issue here. It's all well and good in a world where there is no constraint on borrowing, but in a world where there is, those imbalances are essential to understanding how the world moves from here.

HUGH PYM
Do you mind if we move on from global imbalances just for the moment – maybe come back to it. But I'd like to bring in David Smith, Economics Editor of *The Sunday Times* to lead off our comments from the floor. David tells me that in 1981 he interviewed Geoffrey Howe a couple of times when he was Chancellor. David was working on *Financial Weekly*.

DAVID SMITH
Thank you very much indeed. It's very difficult to know what is left to say after today. We've had some fascinating insights, I think. One thing that I would mention, perhaps contrasting what's been happening recently with 1981 was, and I don't think it's been mentioned all day, that the biggest single measure in the 1981 Budget was the freezing of personal allowances at a time of high inflation. And that was, I suppose, in some ways a stealth tax. It was less obvious than raising rates and, in some ways, less damaging than some of the tax changes we've seen recently including national insurance, VAT, the fifty percent tax rate, and so on, and easier to reverse over time. So, I think, over the subsequent years there was over-indexation of personal allowances to, if you like, give that tax increase back. So that's a contrast with what's been happening recently. The contrasts are easier to think of than the similarities. The other one, of course, is timing and the 1981 Budget was incredibly bold and brave in its timing. Some years ago I did a league table of best post war Chancellors, and I gave Geoffrey Howe the top slot. Of course, Lord Lawson wasn't far behind and I may have to redo the table in the light of a certain change in Gordon Brown's reputation. But the fact was, to do it in 1981, to do it at the time when, as has been said, the recovery was very uncertain, was incredibly bold, incredibly brave and the equivalent today or in recent years would have been doing a similar tough Budget in 2009 when we didn't know whether there was going to be a recovery at all and, of course, the fiscal response to the recession, to the financial crisis, was somewhat different. There was a temporary fiscal stimulus, followed by a subsequent tightening. That tightening started at the beginning of 2010 and, of course, has been continued by this Government. I think the other thing as has been said, and Alan has said this, and Lord Turnbull said it earlier, that every recovery we've had has been accompanied by some kind of fiscal tightening. The difference is the speed at which it is done. And so the spirit of 1981, I think, still applies there. And, based on nothing at all but hunch, I think we may well look back to this period when the ONS has done all its revisions, when we properly see what's been happening, what the strength of the recovery is as perhaps not much different from those previous tightening cycles. You know, global conditions are different but, in some ways, it was Britain against the world in 1981. There's been an element of that this time – that Britain's fiscal position clearly needed attention in May

2010. The ratings agencies had said that the AAA rating was under serious threat although they were waiting to see what happened after the election. We have a very similar fiscal position, or had a very similar fiscal position, to the United States, which just had a downgrade. Overall the fiscal position of the UK is worse than the aggregate fiscal position of the Eurozone. So, something needed to be done. I don't think we had the luxury of doing nothing. And, as I say, my hunch, and it can be no more than that, is that in a few years time, and it may take several ONS blue books before we know it, we'll look back to this being the right thing to do at the time. The recovery may, in the future, some time perhaps in the distant future, look a lot better than it does now.

HUGH PYM
An optimistic note there from David. Thanks very much. I think Sir Samuel Brittan wanted to come in again?

SIR SAMUEL BRITTAN
Excuse me coming in so early but I will have to go in a few minutes for purely personal reasons, not because I'm afraid of what people will say in rebuttal. Now, first of all, a point on which I agree with Lord Lawson is that it's absurd to lecture the Chinese to consume more and save less. Some of these lectures are also directed against Germany, a country of which I have much more knowledge than I have of China. I grew up among German speaking people and there used to be a lady who would take a long bus ride to save about a farthing on a bunch of vegetables. So lecturing people to spend more, or for that matter, to spend less, is futile. That's a point of agreement. Now I come to a point of disagreement with nearly everybody. My own interest, unashamedly, is in output and employment and I'm a Keynesian in that sense. Now, I did not press any opposition to the 1981 Budget because, it seemed to me, that the main cause of unemployment in the 1970s and 1980s was union monopoly. And, until that had been broken, it was no use pumping a lot of nominal demand into the economy. And I think today is completely different. Despite whatever may happen this winter, the unions are hardly a menace at all. The place of the unions has been taken up by the banks. And, if there's any structural force behind either UK or world unemployment, it is the banks. And the great important technical difference between now and 1981 was that it's hardly possible to offset a tight fiscal policy with expansionary monetary policy. It's only the policy-determined interest rate, at rock bottom throughout the world. I don't know if quantitative easing will or will not work. If it does work it works through enriching the bloody banks even more, which is not, I think, an optimal policy. We are facing a situation of demand deficiency in this country, and worldwide, and the hopeful thing is that it is not accompanied by a raging inflation which creates the well-known policy dilemma. I think the most sophisticated approach would be for the Treasury to borrow pound notes from the Bank of England and drop them from a helicopter, but I don't think the electorate is sophisticated enough to follow this. But the budget balance is not the balance of a whelk stall and if only we could get rid of the idea of a balanced budget we would all be better off for the foreseeable future.

HUGH PYM
Thanks very much, Sir Samuel. Is this a good time to talk about quantitative easing and what the next yank on the monetary policy lever will be, well it's pretty clear what it's going to be, but how effective it might be. Sir Alan?

SIR ALAN BUDD
Well, the only evidence I have on this is the evidence provided in the latest Bank of England Quarterly Bulletin in which they do establish, in a way that impresses me, that the counterfactual is that, without quantitative easing, GDP would have been one to one and a half percent or so lower than it turned out to be, so I find that fairly convincing evidence, that in those circumstances quantitative easing was effective.

HUGH PYM
I mean second time round, if it is launched, would you amend it at all? Do you go along with some of the arguments we've heard from Adam Posen, and others, about varying the asset purchases?

SIR ALAN BUDD
Is Charles Goodhart still here? I think maybe he's gone. I was talking to him about this yesterday and this also refers to something that Samuel Brittan just said. One of the present conditions is this enormous gap between the policy rate, which is close to zero, and the rate at which banks are lending to the general public, including businesses, and those businesses who need credit. You know, the large businesses don't need credit, they just need animal spirits, as Nigel has said. And one of the reasons for this is the banks themselves are facing very, very high market rates for borrowing and they're facing very, very high market rates for borrowing because people think they can go bust. And so it's not just greed from the point of view of the banks. It is the market conditions in which they are operating. So it would be highly desirable if the rates at which people are effectively borrowing could be brought closer to these extraordinarily low policy rates which the Bank of England is currently establishing and I don't know the solution to that. I'm not enough of an expert at intricacies of the banking system. But if there's a way of closing, reducing, that gap, that would be highly desirable.

HUGH PYM
Jamie, do you think monetary policy can continue to perform an offsetting role or is it that we're near the end of the road?

JAMIE DANNHAUSER
Well, my own view – it's a shame Tim Congdon were not here because I can imagine he'd have a lot to say on this as well, but my own view is that there is plenty more that central banks can do. A lot of it would be politically unpalatable and would certainly border on quasi-fiscal, quasi-monetary policy. But if we're talking about Governments doing things and printing money to do it, there's plenty more Governments can do. And I agree with Sir Alan on the point about trying to close the gap between the policy rate and the effective lending rate to the private sector because this is a clearly something the Bank is very concerned about and something that is really hindering the adjustment. I mean, if we're going to go down the route of saying we're going to have tight fiscal policy, we need easy money and the argument that real policy rates are negative is a completely meaningless one because effective monetary conditions are still pretty tight as evidenced by the fact the money and credit has been basically flat in the developed world now for three years on average. So my own view is that there are other things central banks can do. I'm not very convinced, for instance, that Operation Twist Part Two in the US is going to do

very much. It might, at the margin, bring down the long end of the curve but, frankly, given the state of balance sheets throughout the western world, is that really going to do very much, pulling our rates down another few basis points? And I never thought I'd say this, but I am beginning to have some sympathy with Mr Posen's argument, which is that maybe the Governments in the West do need to think along more radical lines and come up with some more radical policies about how to intervene in the banking sector, not in terms of ownership but obviously QE was ultimately designed to get round problems in the banking system. And what they've done so far really hasn't done very much.

HUGH PYM
But, for now, on the fiscal side, Lord Lawson said earlier no Plan B, Do you agree with that, press on with Plan A, and let monetary policy try and take up some strain?

JAMIE DANNHAUSER
Yes, I think the broad brush of macro policy in the UK is right. I'd like to think there is a Plan B even if they don't tell it to the public. And I think the Government has to move with events. And the simple fact is Britain faces some very significant external risks and if those external risks materialise there's not point in the Government simply ignoring them and ploughing ahead with Plan A in the face of either a Eurozone crisis or a very stagnant world economy. So I hope that they react to the significant external head winds if they arise, but my view is you stick to Plan A and you adjust as and when those risks hit the economy.

HUGH PYM
Now did anyone else want to come in from the floor? A gentleman over there. If you could just identify yourself.

DOUG JONES, AUDIENCE
My name's Doug Jones. I want to ask about fiscal policy and what is Plan A? Is Plan A continuing with the existing policy, even in the face of downward revisions to growth, and the probability that we're going to overshoot in terms of the deficits? Or should the Government have another round of adjustment to stay on track with its previous forecasts? So, basically, should the Government be allowing the fiscal stabilisers to work from the current starting point, or should it be looking to have another round of tightening to offset those fiscal stabilisers?

HUGH PYM
Lord Lawson?

LORD LAWSON
Well, I would say the first of those. I would say that the Government will stick to the policies as already set out and I don't believe, actually, that the fiscal stabilisers stabilise. It's a convenient term. But it is not very accurate. But I do think Plan A is sticking to the public expenditure plans as set out in the Budget. That's what I mean by Plan A. If I may come back very briefly to the question of the imbalances. The imbalances, I think, will come down naturally through the economic evolution that I have tried to explain. But they are not going to come down dramatically any time soon and we have to accept that. And we should not waste our time, as

Samuel Brittan said, trying to get the Chinese to behave totally differently. We have to live in a world where these imbalances exist.

HUGH PYM
Charles, did you want to come in on fiscal policy and what you do if you don't get your tax revenues and growth undershoots?

CHARLES DUMAS
Yes, I think we have to accept that. I don't believe any of the panaceas. I certainly wouldn't want to try to pretend to change Chinese or German behaviour but we, on the other hand perhaps, should allow for the fact that those people exist and are doing what they're doing which is saving a huge amount as a result of which the world savings rate is an all time high. So what's happened is that we had a huge build up of asset prices and debt and it seems to me slightly perverse to say that in an era of deleverage we should be encouraging banks to lend more money. I find that extraordinary. It's perfectly clear that the last thing we need is more of the Bernanke Put, if you like, which has encouraged this very high level of asset prices and excessive level of borrowing. So we have to take that down. At the same time, we have to reduce the Government borrowing but the results are frankly deflationary. The only way out is Sam Brittan's implicit alternative which is a sort of national investment bank which takes in fifty year money at nought percent real yield which, of course, is now available to the British Government and lends it out directly without the intervention of huge bank margins to a bunch of people. Now, that might create some very wise investments, but I don't tend to favour platonic guardians. And so, I think we just have to go through the wringer. I mean, the reality is we shouldn't be encouraging banks to lend. We know how to get our debt under control. Asset prices are too high relative to the level of income that will support them as a result of this excess saving. And until the savers have their wealth destroyed, we will not be in a position to have a new expansion. And I completely disagree with Lord Lawson's idea that in any kind of acceptable time scale the Chinese are going to spend a lot of money. And, as for the Germans, they're getting a little bit richer, but not much, and they're saving more and more all the time. So I think this sort of vision of a benign soft landing as I said is prelapsarian.

LORD LAWSON
I did actually say that there's not going to be, the imbalances are not going to go away any time soon.

HUGH PYM
You did. You did.

LORD LAWSON
On the banking thing, if I may, I think Alan put his finger on it. I disagree with Charles that bank lending is too much. I think that there is an extraordinary divergence, I cannot remember a time when there have been two nations in the economy as different as there are today. Those corporations that can access the capital markets directly have absolutely no difficulty in financing themselves at very good rates on whatever scale they wish to do. Whereas those, the small and medium sized enterprises who are dependent on bank finance, are finding it extremely difficult to get finance at all, and if they do get it they have to pay very high rates. I cannot

remember a time when there's been such a huge divergence. I think it is a problem for the small and medium sized enterprises. And I think this has a bearing on the Vickers debate – I don't say it's the main reason for supporting the Vickers proposals or some kind of Glass Steagall, which I do support very strongly, and I have been supporting it for years now. But I do think there is a problem now when you don't have large banks whose sole raison d'être, whose sole business, is lending to small and medium sized enterprises. And I cannot understand why the Government, which effectively owns the Royal Bank of Scotland, doesn't do something about it. The previous Government put quite a competent investment banker in Stephen Hester to run the Royal Bank of Scotland, even though the Royal Bank of Scotland, the bulk of it, is straightforward, what we used to call joint stock banking. The investment bank is quite small. But obviously in present conditions it is sensible for, if you are running a universal bank or whatever it's called, it is sensible to focus your attention on investment banking because that's ..

CHARLES DUMAS
Why?

LORD LAWSON
.. where you can make the money. That's where you get the bonuses. Absolutely. That's where the big bonuses come from. And if you don't recognise that, you're not living in the real world.

CHARLES DUMAS
They're all making losses.

LORD LAWSON
They're collecting huge bonuses and they're not all making losses. And so I think it'd be sensible to split up the Royal Bank of Scotland and to have at least one substantial bank which can only make money from retail lending if you include retail lending to the small and medium sized businesses.

HUGH PYM
Patrick Minford.

PROF. PATRICK MINFORD
I think we're exchangeable. I'd like to say that, it seems to me, there is a lesson from the earlier part of the day, which is that if you're in a situation like 1981 the natural assumption, which was made by the 364 economists, is that there's a demand efficiency of large scale and that, therefore, fiscal policy should be activist. And, of course, what the 1981 experience showed us was that actually the fiscal policy had very little effect on the business cycle. In fact, as was pointed out, the business cycle was already turning up at the time and what the Budget did was to have no multiplier effect on the economy but it did have an enormous effect on resetting the monetary confidence of the environment that the MTFS would go ahead. And, of course, the same was true about monetary policy. What we've discovered over the years is that monetary policy has very little real effect on the economy, except very temporarily. What it has an enormous impact on is inflation. And that's why the Bank of England Act says that the Bank of England should only look at inflation and shouldn't be seduced into thinking its role is to have endless packages to boost growth. And I think another thing, when people talk about demand

efficiency, another thing we've learnt from bitter experience over the years, is that these measures of excess capacity are mostly illusory. I mean, now we're going through a period when the Office of Budget Responsibility is revising these numbers down. Indeed, if you go back to the 1973 crisis in the world economy there were huge estimates of excess capacity made for the US in the 1970s oil crisis and they were mostly massively revised away. And the reason for this is when you have these shifts, and crises, or interruptions in the economy there's usually a huge mismatch in the capacity and large parts of it aren't viable and others parts that are actually in quite high use. So, I think the lesson of the 1980s, the early 1980s, has been that in fact we should be very suspicious of the remark that the economy is constantly requiring a demand boost. And now, coming to today, what do we see? The world economy grew five percent, five point one percent last year. Clearly, the 2008 period, early 2009, was very nasty and that was the height of the crisis and the banking system collapsed. But once we're going into 2010, the world economy grew five point one percent which is pretty much the fastest it's ever grown. In this year, the IMF, which is trying to alarm us all again, is expecting a growth rate of four percent. The truth is that what's happened is there's been a change in the structure of growth in the world economy. It's mainly happening in the East and the West is very slow. Now, there may well be very good reasons for this in terms of productivity growth in the East which is people moving between sectors, low productivity sectors to high productivity sectors, whereas in the West maybe productivity growth is being disrupted by very high raw material prices and it's very hard to get productivity growth. Look at productivity growth in the UK. It's actually now negative. And so there's a very good productivity growth reason for what's going on. And so I'm very worried that central banks now think they can manufacture growth with more and more extravagant schemes for boosting this and that and QE or Operation Twist now in the States and the Fed seem to think it's got another Operation Twist that'll come along if that doesn't work. We should be very suspicious, I think, on the basis of the evidence of the '80s, or in particular the episode this morning and I think we should be a bit more hard-nosed about all this. I mean, why do we think that these multipliers will be anything other than trivial? Why do we think that destabilising fiscal sustainability is going to be a good thing to do? If it's going to have no effect because the economy is essentially on a trajectory which we don't, perhaps, fully understand from a supply side – essentially the lesson, I think, of 1980 is the problems of the British economy were not demand, they were supply. And they needed addressing. And what was getting in the way was a debauched monetary policy and a debauched fiscal policy. And when that debauch was brought to an end that was a very necessary condition for then addressing supply side issues. That, it seems to me, comes out of the macro experience and the data and therefore today we now, because we're very uncomfortable with one percent growth, think it must be a demand side phenomenon. But, actually, if you look at the world economy, as I say, there's world inflation. China has six percent inflation. India has ten percent inflation. Now the world has an inflationary problem which is why those countries slowed themselves down. And there's a little bit of a slowdown in the world economy because the world had inflation. I think we should bear these lessons in mind and not just run once again to the printing presses in various forms or indeed to the reversal of fiscal sustainability in the West.

HUGH PYM
So look at the supply side as the policy objective?

PROF. PATRICK MINFORD
Yes, but also recognise that sometimes you can't do a lot about it in the short term and you may just have to, as Charles has said, grin and bear it through an unpleasant episode and just not think you can do anything about it. We always assume we can do something about it by stimulating something or other but maybe one of the lessons of the past is that you can't do that.

HUGH PYM
Adam Ridley?

SIR ADAM RIDLEY
Could I just offer one other area to think about if one's looking at the key parts of the supply side? If you sit inside a biggish bank today and look at what is happening, you're not very surprised by the pursuit of very, very cautious conservative with a small 'c' policies. Let me just itemise a little of what hits you day in, day out. We've got Basel coming in, quite a substantial increase in capital ... and tougher attitudes to different classes of assets and risk weighting. There's an astonishing pressure on companies to maintain something which is paradoxically called minimum levels of liquidity. Never mind whether that is conceptually mad, which it is. The reality is that you suddenly find yourself being asked, maybe in the case of a big investment bank, that many billions of dollars or pounds or whatever, be held in a sterile way in the highest quality assets which are by definition immobile, except when you're given permission to release them. When? Who knows?

You've got some very interesting accounting moves coming in. The 'mark-to-market' pressure is analytically absurd in some cases but, be it absurd or not, it's on the whole combined with the anxieties of the accountants for greater provisions. And then, in this country, you've got the impact of Vickers which, whether it's right or wrong, is certainly not going to increase the ease with which a bank can run. Obviously all the old games of cross subsidy get less easy. Finally, there's something that no one has mentioned in the current context, which is what might happen if there is a rather shambolic set of developments in the European monetary framework - not necessarily complete, total collapse. What begins to happen? You then get another round of provisions.

Under these circumstances I find it quite perturbing if we don't talk about this aspect of the supply side at all in asking about how to get economies growing. Otherwise, you're just back into a world in which anything which smacks of risk or enterprise is likely to be very difficult to lend on and interest rates are going to rise and rise and rise.

HUGH PYM
Thanks very much, Sir Adam. Could I bring in Sir Tim Lankester quickly and then we might move towards our concluding thoughts?

SIR TIM LANKESTER
David Smith and, earlier, Andrew Turnbull suggested that this fiscal retrenchment, as in the past, could well be followed by recovery. But, if you look at the page 16 of the briefing and look at the household financial balances it seems to me there is quite a difference. In the past, household expenditure lifted the economy. But, right now, household balances are still very weak,

household debt is very high. And it looks to me as if households are still going to be trying to rebuild their balances and reduce their debt over the next two or three years. So, in these circumstances, I would be a lot less optimistic.

HUGH PYM
Thank you very much. Well I think we're fairly close to concluding. I think Lord Lawson's got to make a fairly quick exit so I'm afraid we ought to move to concluding remarks now from the panel. Lord Lawson?

LORD LAWSON
I don't want to cause the whole session to terminate early but I do have to go in a minute or two and I apologise for that. Just two remarks. One on the general outlook and the other on the banks. I think Adam has put his finger on something. I think that whereas we do need, I believe, to move very quickly, as quickly as we possibly can on the structural separation for reasons that Vickers set out, I believe we should go slow on the capital requirements. I think that the amount of capital that the banks are being forced to hold, I think that is necessary, but over a period it is not, we should go slow on that whilst going quickly on as I say the structural changes which I believe are required. And structural changes will take time to bed down anyway, so you need to make a start very early on. On the general thing there was in this country, and in many other countries, this country perhaps one of the worse cases, but not the only bad case, there was a huge excess of borrowing, particularly consumer borrowing. And, therefore, households have to rebuild their balance sheets. It's not just companies that have to rebuild their balance sheets. Households do. And the price of this inflated growth that we had for many years is that we're now going to have, I don't know whether it'll be seven, but after the seven fat years you're going to have to have the seven lean years. And I think we have to, our political leaders ought to make clear that this is the price that has to be paid. And there's no quick fix. And anything you try and do to stop that will do more harm than good. That doesn't mean to say you stop trying to improve the supply side of the economy. You should all the time be focusing on that. But in fact we are going to go through many years. I think if we can avoid protectionism it is not going to be a depression or a slump but we are going to have to go through several years of, maybe zero growth, but certainly very small growth and we just have to live with that. There is no getting away from it because, if you do try and get away from it, you will pile up problems which you will bitterly regret.

HUGH PYM
Thanks very much for that, Lord Lawson. Charles Dumas, seven lean years or more than seven lean years?

CHARLES DUMAS
Yes, well, I mean, we need to have a recovery and we need to save more and that means that the demand side of it has to either be capital spending or balance of payments and I don't see it being capital spending so it's got to be the balance of payments. And we're right next to Europe with fifty percent of our exports there and they're in a mess and probably going to be more of a mess next year than they are now. So I think we just have to accept the fact that we're just going to have very slow growth, as Lord Lawson has said, for the time being and hope, I suppose will be the best phrase, that the exchange rate goes down and that we can hopefully achieve some

import substitution and also some very high profitability in the manufacturing and export sectors generally so that it will induce a wave of capital spending in the sectors of the economy which have a lot to offer. But there is absolutely no question that the very substantial increase of disposable income and consumer spending vis-à-vis GDP in the years until the crisis will have to be, to a large extent, reversed. And so, even if one takes a moderately optimistic view about the prospects for growth, we're still talking about feel-bad growth at the best.

HUGH PYM
Sir Alan, any observations particularly in the light of the comments about the banking sector and the risks in the Eurozone?

SIR ALAN BUDD
I do feel I'm none the wiser at the end of this extremely interesting discussion in its own right but I still don't know how relevant the 1981 experience is to today. I continue to think that the differences are more important than the similarities, so I can't conclude that the right thing to do now is what happened in 1981 nor do I find it at all easy to know where the economy will go from now on, again, but this is all because economists live by trying to learn from previous experience and I don't think we have the previous experience that tells us, can guide us in these circumstances. I'd only make one point really to Patrick Minford which is that I listened very carefully to what he was saying about what the monetary policy committee might or might not be doing. It seems to me that the monetary policy committee is required to do exactly the sort of things that he hopes it will do. It has to assess precisely how much spare capacity there is in the economy, including the possibility that there isn't any and to the extent that they manage demand, they only do this because they think that's the way of controlling inflation in the medium term. They're not demand managers, *per se*.

CHARLES DUMAS
They should be tightening in that case because...

SIR ALAN BUDD
Well, that may or may not be the case. But it's not because they're trying to do the wrong thing. They're trying to assess, as best they can, what they need to do given their very clear remit.

HUGH PYM
Jamie?

JAMIE DANNHAUSER
Well, I would just conclude with, I think there is an experience we need to learn from and that's Japan. This is bringing together Adam's point and Patrick Minford's point which is the level of output in Britain is somewhere of the order of ten to fifteen percent below where it might have been had the crisis not come along. Now, we can take the view that that's all supply damage and we can assume it away, we can have the crisis, we can do nothing about it. We all accept that the UK needs some kind of supply side adjustment, rebalancing, call it what you will. But, to me, one of the great lessons of Japan is not to get into the defeatist attitude that there's nothing that monetary policy can do. If we want to get the rebalancing process to take place I think there is an important role for the central bank to play and in particular QE is often couched as a demand

management tool. But to the extent it helps deal with problems in the banking system it also has a supply component. It's totally reasonable to say that some SMEs are struggling to produce things because credit is unavailable. So it's not obvious to me that QE is solely about demand. I can see many monetary tools, if you want to call them that, that have a supply consequence and could aid the process. And, for me, the great worry about the next few years, not just in Britain, in the Eurozone as well, is that Japan sneaks up on us because we don't do enough and we get into this defeatist attitude. Adam Posen made a speech a few months ago where he made a nice point about 'We didn't wake up after Lehman's and our left arm had been chopped off and our leg was missing'. The point being that economies don't just lose supply capacity, it erodes away over time and I think that to me is an important lesson of Japan which, it worries me, we're not really learning.

HUGH PYM

Good. Well, thank you very much everybody. Thank you very much to the panel – Sir Alan Budd, Jamie Dannhauser, Charles Dumas and in his absence Lord Lawson. Fascinating session to conclude the day. Thank you very much indeed.

The last inflation number published before the May 1979 General Election showed the RPI rising by 9.8% in the year to March. The April figure of 10.1% was published a week after the Election.

[2] See A.J. Glyn and R.B. Sutcliffe, *British capitalism, workers and the profit squeeze*, (Harmondsworth, 1972)

[3] Britain drew from the IMF on ten separate occasions before December 1976. France and Italy also drew from the IMF before December 1976.