

THE TREASURY AND THE NEW CAMBRIDGE SCHOOL IN THE 1970s

*John Maloney, University of Exeter**

Abstract: With the release of Treasury papers from the 1970s under the 30-year rule we have a much more complete picture of the dispute in the 1970s between the Treasury and the Cambridge Economic Policy Group, especially given the role of three Cambridge economists -- Nicholas Kaldor, Wynne Godley and Francis Cripps – as ministerial advisers at the time. The records show the Treasury and the CEPG eventually meeting near the middle regarding the latter's proposition of stable private-sector NAFA (Net Acquisition of Private Sector Assets) and its implications for demand management and the balance of payments. By contrast, the initial differences on counter-inflation policy and, above all, on import controls versus free trade were wider at the end of the decade than at the start of it.

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* Address for correspondence: Department of Economics, Exeter University Business

School, Streatham Court, Rennes Drive, Exeter EX4 4PU. Email: J.Maloney@ex.ac.uk

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1. Introduction

The 1970s and early 1980s saw the height of the Keynesian-monetarist controversy over economic policy. But for a while in the 1970s, Britain's Treasury, still conventionally Keynesian at all but the most junior levels, faced a challenge that was more immediate and less avoidable than anything coming from Milton Friedman and his followers. The 'natural rate of unemployment' doctrine might nullify any permanent effects from demand management, but it did not of itself exclude attempts to smooth out fluctuations around the natural rate, or even to use monetary policy to cushion the effect of temporary changes in the natural rate (in the unlikely event of their being identified). The New Cambridge School, by contrast, proclaimed short-term demand management as unsettling and unnecessary.

Whatever their differences from Friedman they shared his fundamental assumption that it was over-active government, not private sector instability, that needed reining back to give a stable macroeconomic background against which the economy would save, invest and grow.

The Treasury was sceptical of this message and, as will be seen, some of its denizens would have liked to ignore it. They could not. For a while, the *Times* articles of Wynne Godley, Francis Cripps, Nicholas Kaldor and Robert Neild eclipsed even the monetarist journalism of Samuel Brittan and Peter Jay in the public attention they commanded. When Labour returned to power in 1974, Kaldor and Godley were appointed special advisers to the Chancellor, Denis Healey, while Cripps became special adviser to Tony Benn, Industry Secretary and the Cabinet's most thoroughgoing advocate of import controls – basically a Cambridge cause, albeit one which exposed some divisions in the Cambridge school. The Parliamentary Committee on public expenditure summoned the Cambridge Economic Policy

Group and the Treasury and told them to start debating. At the end the committee persuaded the two sides to meet for a series of seminars. And all the while, Treasury officials had the worry that their Chancellor, exposed almost daily to Cambridge ideas, might convert.

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

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

2. Cambridge macroeconomics, 1972-4

2.1 The Cambridge expenditure equation

There had been agreement from the start as to what the essential new Cambridge message was. It was that the marginal propensity to invest out of income approximately equalled the marginal propensity to save. The private sector as a whole had a stable attitude to the net acquisition of financial assets (NAFA). With the personal and corporate sectors aggregated in this fashion, New Cambridge made a positive virtue of their failure to distinguish between consumption and investment. (Cripps and Godley, 1976, p.335) Private expenditure as a whole was a function of income and lagged income, the coefficients on these being expected to add up to unity and in fact very nearly doing so when estimated. Initially the expenditure equation was cast in real terms. In 1975, for example, it was taking the form:

$$PX_t = 0.533(Y - T)_t + 0.416(Y - T)_{t-1} + 0.899HP_t + 0.790BA_t + 0.962S_t$$

(Treasury, 1975, p.3)

PX = total private expenditure including fixed investment. Y-T = income after tax. HP = net increase in hire-purchase debt extended to the personal sector. BA = net increase in bank loans to the personal sector excluding loans for house purchases. S = stockbuilding.

But the initial policy impetus came from the simplest version of the 'stable NAFA' proposition.

If $NAFA \equiv S - I$, it follows that

$$\Delta S = \Delta I, \text{ or given that } I + G + X \equiv S + T + M$$

$$\Delta(G - T) = \Delta(M - X)$$

Changes in the current account will equal those in the budget deficit.

2.2 Cambridge advice

With inflation and unemployment both on the rise, Edward Heath's Conservative government, elected in June 1970, had followed only a mildly deflationary fiscal policy during its first year in office. But in January 1972 unemployment reached one million for the first time since 1940. The government's response was to panic. In March the Chancellor, Anthony Barber, brought in a budget whose declared aim was to raise real gdp by 10% between the first quarter of 1971 and the first quarter of 1973. 'I do not believe' he said, 'that a stimulus to demand of the order I propose will be inimical to the flight against inflation.' (Hansard, 21 March 1972, col 1353.) There was little opposition to the budget, the *Economist* even wondering if it had gone far enough.

Cambridge was an exception. Before the Barber boom had even properly got under way, the London and Cambridge Economic Bulletin (February 1972) had warned that simply reflating the economy to bring unemployment back down to half a million would produce an unsustainable trade deficit. (Coutts, 1977, p.91). In November 1972 the government, alarmed by the conjunction of world commodity price rises and their own boom, brought in a 90-day statutory wage and price freeze. This was succeeded by the "£1 plus 4%" rule in which they steered a compromise between a flat rate pay limit and one which preserved relativities. In July 1973 Neild, writing in *The Times*, explicitly related the unemployment / current account tradeoff to the NAFA concept. Given the size of the budget deficit, the boom in fixed investment and the upturn in stockbuilding, a tolerable balance of payments could be achieved only if vast corporate savings materialised. Profits, he calculated, would have to be 56% up on 1971 – something not only wildly unlikely to happen, but certain to wreck Heath's incomes policy if it did. (Neild, 1973, p.27.) Meanwhile Godley and Cripps (1973b, p.21) called for a reduction in consumption to reduce the trade deficit. Since any fall in take

home pay would end the incomes policy, that left only credit controls. Profits might not have risen fast enough to help the balance of payments, but they *had* risen fast enough to be another threat – via a ‘sense of unfairness’ – to the incomes policy. Corporation tax should be raised. Finally, Godley and Cripps called for import controls, though warning that unless they were ‘explained with extraordinary finesse, there could be bitter reactions’ from the U.S., GATT and the EEC.

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

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

the budget deficit and the current account, but this effect will be zero only if the government neutralises the tax revenues coming in through increased export sales.

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

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

But even with threshold payments stage 3 was too restrictive for the National Union of Mineworkers who called first an overtime ban and then an all out strike. Heath called an election to get a mandate to defend his policy and lost. On 7 March 1974, three days after Denis Healey's appointment as Chancellor, Godley, Kaldor and Neild attended a budget strategy meeting at the Treasury. Kaldor called for a 'more or less neutral budget' (Treasury, 1974a, p.3) but the main weight of argument came from the written submissions the economists sent in after the meeting. Godley wanted both 'a prolonged moratorium on living standards' and a slow adjustment of the current account deficit (now running at £4 billion a year after the OPEC price rise.) (T338/242, Godley to Healey, March [n.d.] 1974). The fact that even a slow adjustment ruled out any rise in living standards was a comment on the

extent of the problem. Kaldor reversed his advice at the meeting. There continued to be no strict economic case for deflation but

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

(T338/242 Kaldor to Healey, 9 March 1974, p.1)

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

One can hardly blame Kaldor for being so uncertain what to do given the situation Labour had inherited: wage inflation running at over 20% following the collapse of Heath's incomes policy, a projected current account deficit of £4 billion for 1974, and unemployment on the rise as forecasters differed only over the depth of the forthcoming recession. There was, however, opposition to all the Cambridge advice from Sir Kenneth Berrill, the government's Chief Economic Adviser. The Chancellor, he said, was getting advice on the basis of the New Cambridge proposition about NAFA and, although they had mercifully taken oil out of the equation and were basing their fiscal recommendations only on the non-oil deficit, Healey ought to know that in the short term 'the connection between the financial deficit of the public sector and the balance of payments is very weak.' (T338/242, K.Berrill to Healey, 'Outside Economic Advice', 12 March 1974.)

In the general election of February 1974, Labour had campaigned with promises of a ‘Social Contract’ with the unions, whereby public spending increases and pro-union legislation on one side would be bartered for self-restraint on the other. Most of the Treasury was sceptical from the start -- including Healey, who recalled in 2008 that he realised the Contract was not going to work ‘the moment I became Chancellor and we used to have meetings with the unions ... I realised almost immediately that the unions were worse than a waste of time because you couldn’t totally ignore what they were saying.’ (Lord Healey, pers. comm., 9 April 2008). One implication of the Cambridge theories was that the Contract’s survival was extremely sensitive to the fiscal policy adopted – far more so than under orthodox Keynesian assumptions. On Cambridge assumptions, government spending cuts might actually assist the Contract’s survival. They would allow tax cuts without any net deterioration in the balance of payments, and tax cuts (indirect *or* direct) in New Cambridge’s view dented real wage resistance and thus tamed money wage claims. The Treasury was sceptical. In the first place they had to some extent signed up to the idea of the ‘social wage’ – the idea that workers and their unions took government spending into account when they decided how dissatisfied they were with their standard of living. (Castle, 1980, p.318) Lower public spending with lower taxes might therefore just increase the private wage at the expense of the social one. Secondly, most Treasury economists were sceptical of the real wage resistance theory, and particularly of its implication that faster growth would reduce the rate of inflation. Finally, since the Treasury saw the link between the PSBR and the current account as much weaker than New Cambridge did, the whole idea of public spending cuts being required prior to tax cuts was much more conditional on circumstances.

By the end of 1974 Healey had had prolonged and thorough exposure to New Cambridge views. But attempts to portray him as anything like a convert are unconvincing.

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

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

3. The Public Expenditure Committee

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

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

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

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

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

Having got the dignified rebukes out of the way, the Treasury settled down to its attack on Wynne Godley. The accusations were, first, that he had accused the Treasury model of treating investment as exogenous, when in fact it was his own model which lacked any theory of investment at all – an omission which eviscerated his contention that shocks to the economy did not usually originate in the private sector. (ibid., p.15.) He had represented fiscal policy as the only exogenous influence on the economy and yet held a theory of inflation where wages were exogenous. (ibid., pp.25-26). He had ignored evidence that the overseas sector was a major source of instability in the economy -- despite the fact that his own model, with its relatively high value for the multiplier, predicted this instability would be worse than the Treasury model did. (ibid., pp.29-30; Spencer and Mowl, 1974, p.2) As for the 'stable NAFA' proposition at the heart of New Cambridge, the aggregate figure did seem to lend it some credence, but concealed the instability of the corporate component. (T338/274, 'Draft from Honor Stamler'. 28 June 1974, p.4) It had, in any case, been fatally

weakened by Godley's recantation of the doctrine that the marginal propensity to spend was unity, which alone was enough to bring down 'what Kahn and Posner somewhat charitably described as "the elegant paradoxes of the New Cambridge School"'. (Treasury, 1974c, p.23)

In sum Godley had

... a highly aggregated relationship between disposable income and expenditure, that does not purport to describe behaviour directly or even say what behavioural patterns underlay it, and is not supported by empirical work on individual relationships. (ibid, p.20)

All these charges were levelled before Godley and Martin Fetherston had actually appeared before the Committee, and some of them bore little relation to what they went on to say. Fetherston denied that they had ever said the budget deficit was the only determinant of the current account. (House of Commons, 1974, p.5) Godley stressed the difficulty of forecasting what the budget deficit was going to be. There could always be 'new exogenous shocks ... exports can rise or fall a lot which is going to change the tax yield.' (ibid., p.7) They had always known that NAFA could vary substantially from year to year, and indeed accepted both David Laidler's point that any stability in NAFA might proceed from 'accommodating monetary policy', and that a lot of the time the respective changes in NAFA of the personal and the company sector had cancelled out, for reasons no one had explained. (ibid., p.9 & p.4)

But none of these concessions, Godley and Featherston argued, provided one iota of rehabilitation for the short-term discretionary fiscal policy to which the Treasury remained wedded. The Committee's report agreed with them: demand management over the last 20

years had been ‘extremely poor’, a view contested only by the Treasury and the Bank of England, ‘and they could hardly be expected to [agree].’ (House of Commons, 1974b, p.xix)

The report then collapsed:

We do not feel capable of making judgments on the efficacy of the Godley hypothesis and the performance of Mr Godley’s model relative to the behaviour of rival models (ibid., p.xvi)

The trouble was that that was exactly what they had set themselves up to do. Any sense of Schadenfreude felt by the Treasury would have intensified after they read ‘We are not experts and do not claim to be.’ (ibid., p.xxi) The main recommendations were, first, that people should not talk about inflation when they meant reflation and, second, that there should be Treasury / New Cambridge seminars though ‘the Treasury might not want to organise them.’ (ibid., p.xvii)

4. Development of the Cambridge model

But the Treasury did eventually organise them, and the seminars got under way in the summer of 1975. The Cambridge expenditure equation was now undergoing an important change: it had been recast, and would shortly be re-estimated, in money not real terms. As its creators pointed out, this would have been the logical thing to do all along: lagged income, like everything else, should be deflated by the *current* price level, not a lagged one, in order to find out its effect on current spending. But the improvement excited little applause from the Treasury. Patricia Brown pointed out that you would simply have a new set of problems if, as was likely, ‘different components of expenditure were differentially sensitive to

inflation.’ (Treasury, 1975, p.7). Nor could she agree with Godley’s proposition that the Cambridge formula left less of a role for short-term forecasting. On the contrary, she said, the shortness of the lag in the Cambridge picture required that more effort be put into short-term forecasting, while the centrality of bank lending and hire-purchase expenditure called for some ‘sophisticated flow-of-funds forecasting’ which the Treasury currently lacked and needed to develop. (ibid., p.31)

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

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

Treasury criticisms, together with those made by J.A.Bispham (1975) in the National Institute Economic Review were answered by Cripps, Fetherston and Godley in their article ‘What is Left of New Cambridge?’ This appeared in the Cambridge Economic Policy Review, March 1976. The article first took up the charge that the Cambridge income-

expenditure equation had ‘insufficient theoretical underpinning to be convincing.’ (Cripps, Fetherston and Godley, 1976, p.47). Cripps et. al. conceded something to this charge in their statement that aggregate NAFA ‘comprises so many separate elements that it cannot be thought of en bloc in behavioural terms: therefore much empirical work on component relationships needs to be done.’ (ibid., p.47n.) They did, however, reiterate the point that unless the marginal propensity to invest were set equal to the marginal propensity to save, then a step change in the flow of income would lead to an unending change in the stocks of financial assets held by persons and companies. ‘It is precisely this implication, built into most conventional forecasting models, to which we object.’ (ibid., p.47)

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

Finally there was the allegation that ‘the experience of the period since 1972 has been such as to destroy the equation originally put forward.’ Again, said the article, the issue was whether destroying the equation, if indeed it had been destroyed, did anything to rehabilitate fine tuning. As Bispham said, the equation’s errors were down to unpredictable changes in stocks. But these were most likely due to the unprecedented level of, and variability in, inflation that the economy had suffered since 1973. Recasting the Cambridge equation in nominal terms would link stockbuilding to inflation. In fact this had now been done, and the prediction errors for 1973 and 1974 were very much less. The key table is reproduced here:

Prediction errors (total private expenditure: £ million at current prices)

	Original equation (real variables) estimated 1954-72	Revised equation (nominal variables) estimated 1954-72	Revised equation (nominal variables) estimated 1954-74
1973	-2242	-1262	60
1974	-7086	-3131	-1015
1975	n.a.	-230	-34

(Cripps, Fetherston and Godley, 1976, p.47)

The main Treasury reaction to the article came from Andrew Britton, in a paper which limited itself to alleging that the proposition that ex post changes in the current account would match those in the PSBR ‘holds only as a very rough approximation indeed according to the Treasury model at least.’ Extraordinarily, even this was too much for Honor Stamler, who told Britton ‘I believe it is a mistake to sneer at the New Cambridge propositions.’ Posner meanwhile told Britton he was looking increasingly New Cambridge himself. Britton had pointed out that, although particular changes in government spending and taxation produced very different effects on the PSBR and the balance of payments, when you added up the effects of these changes, the PSBR and current account effects were almost identical. When he called this ‘fortuitous’, Posner asked him if he was sure about this. ‘I am not the only one, I am sure, who has been struck by the very New Cambridge nature of the [Treasury] model simulations in the medium term.’ (1)

Indeed the Treasury (at least as represented by Britton) was in danger of becoming more new Cambridge than new Cambridge, who had sounded a further retreat in their 1976

Economic Policy Review. This brushed off the contention that the whole Cambridge picture had collapsed when the public sector and current account deficits had moved so sharply in opposite directions. This outcome, the *Review* explained, ‘was entirely due to short-term influences’ (abnormally high private saving, heavy de-stocking and the impact effect of an improvement in the terms of trade.) (CEPG, 1976, p.8) Yet these were just the things that had initially been proclaimed *not* to get in the way of a stable NAFA and hence a stable ex post relationship between the two deficits.

In July 1976 Kaldor returned to the theme that NAFA was currently abnormally high and that its reversion to a more usual value would worsen the tradeoff between the PSBR and the current account, which meant the former needed to be cut sharply and immediately. His pessimistic view on the balance of payments, he said, ‘has not been shaken by the fact that I have been consistently wrong in prophesying balance-of-payments doom ever since the budget of Autumn 1974.’ The intervening period, Kaldor said, had been one of recession in which ‘“New Cambridge” does not hold.’ Pessimistic animal spirits had broken the link between savings and investment.

But we cannot count on this as a lasting factor. I am convinced, therefore, that sooner or later I shall be proved right; and if this is the case, we would be taking unnecessary risks by delaying action until these are justified by the expansion of home demand. (T364/17 Kaldor to Wass, 1 July 1976, p.3))

But cutting the PSBR, Kaldor continued, was not enough in itself, there also needed to be direct action on the balance of payments with import deposits (more on this later.)

The CEPG's 1977 review divorced the two deficits further, concluding on this basis that fiscal policy since 1974 had been 'about right' but 'largely by mistake.' In particular the Labour government's deficits between 1974 and 1976

... now look to have been appropriate, mainly because the rise in personal savings and large-scale destocking provided an unexpectedly large deflationary impulse which the budget deficits served to offset (CEPG, 1977, p.5)

It is hard to translate this as anything but 'it's lucky they didn't listen to us.'

5. The real wage resistance theory of inflation

But if New Cambridge's fiscal recommendations had lost their sharp edge, other theories had been developed which led to increasingly radical criticism of what the Treasury was doing. Some of the New Cambridge policy proposals stemmed from their distinctive view of inflation. Successive Policy Reviews stated their position unambiguously: deflation made inflation worse. (CEPG, 1975, p.13, 1976, p.2; 1977, p.6; see Cripps (1977) for the most comprehensive argument.) This is because price inflation follows wage inflation, which is driven by the gap between workers' actual and target real wages. So far as 'counter-inflationary' fiscal and monetary policy damages productivity, the real wage is held down and money wage inflation gets worse.

This 'real wage resistance' theory of inflation had come to enjoy some support in the Treasury too, though the official who said it was now 'the Treasury orthodoxy' was exaggerating (2). What distinguished New Cambridge from anyone in the Treasury was their assumption that any wage increase would be passed on in prices, irrespective of the state of

demand. This stemmed from their Normal Price Hypothesis, which said that prices were formed on the basis of costs regardless of the state of the business cycle (Godley and Nordhaus, 1972) And it was why Healey's Cambridge advisers regarded Heath's threshold payments (see above, p.7) with even greater horror than the Treasury did. But, as Kaldor told Healey, the threshold payments were there and could not be abolished or watered down without terrible union resistance. So the best thing would be that 'threshold payments should be met by the Exchequer, and not by the individual employer.' (T338/242 Kaldor to Healey, 9 March 1974, p.2) Kaldor then said that, as long as the threshold payments lasted, the Price Commission 'would have to be instructed' not to allow threshold-induced wage increases to be passed on as prices. (Treasury, 1974b, pp.2-3) Healey said 'he would wish to reflect on this' (ibid.p.3); Patricia Brown sent him 'a dampener' on the idea (ibid, p.3, note in margin) – justifiably, given that even the existing Price Code, whereby firms could pass on up to half the wage increases they were paying, would by the autumn produce the worst corporate liquidity crisis for 40 years and bring a swathe of industry to near-bankruptcy. Kaldor's hope that his proposal would force firms to find productivity gains – with the bonus that workers could be 'released' from the service sector into manufacturing (ibid, p.3) – sounds distinctly utopian in the light of what actually happened.

And by the end of 1974 further ground was opening up between Cambridge and the Treasury on inflation. The former were sticking by the real wage resistance theory more emphatically than ever: the latter, mostly, had swung round to the view that unemployment was not a cause of inflation but, if no other remedy could be found, would have to be used as a cure. In the words of Sir Bryan Hopkin, recently appointed Chief Economic Adviser:

To check inflation by operating on demand is of course a barbarous and

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

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

6. Import controls

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

Treasury officials expected import controls to be on a Labour government's agenda, at least for possible consideration. On 1 March 1974, the day after the general election, and before Heath had even resigned, they judged direct action on imports 'attractive', insofar as

bringing imports down by tighter macroeconomic policy involved taxes rising ‘perhaps four times the import saving sought.’ (PREM 16/707, ‘Note by officials’, 1 March 1974, p.1)

But the note went on to turn import controls down for the usual reasons (they would distort resource allocation, probably involve leaving the EEC, and provoke a tidal wave of imports in the inevitable period between announcement and implementation.) Healey, the new Chancellor, wanted to keep the option open, but not to do any preparatory work on it, which would ‘increase the risk of leak.’ (3)

There the matter largely rested until Healey called a meeting on the subject in December 1974. Discussion centred on the prospects for getting away with controls without provoking retaliation or too much international hostility. A few days later Healey commissioned a Treasury paper on import restraints. Its author, Mary Hedley-Miller, pointedly contrasted ‘the attraction’ with ‘arguments against’ (and said the latter were conclusive before she even spelt them out.) Simultaneously Kaldor was agreeing with Hopkin that ‘if we can do without import restrictions this would be much better.’ His preferred policy towards the balance of payments was now a dual exchange rate system, with a more competitive pound for exporters and importers of manufactures. (This would be achieved by crediting the former and debiting the latter with an amount of sterling equal to the difference between the two rates of exchange.) However Kaldor also spelt out the circumstances in which this would not be enough, and import quotas required: ‘What if the whole of British industry is threatened with collapse?.. what *else* could we do?’ As for retaliation ‘I do not see what the Germans could reasonably do if we cut off unnecessary imports like motor-cars, television sets and many other things ... over a longer period we must bring our trade with other manufacturing exporters into a state of balance.’ (4)

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

(Wass, 2008, pp.96-7)

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

devaluation arguments, adding that by now the pound had in any case fallen enough to rule out price factors as the cause of poor export performance. The trouble, rather, was that 'we are not capable of producing up-to-date products with the design and quality required.' With further depreciation not a useful option, the balance of payments would remain the barrier to full employment until industry was modernised. But this in itself would require 'large imports of machinery of a kind that we are not at present able to produce at home.' All the more reason, therefore, to restrict inessential imports to make room for the essential ones. (5)

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

Except for the last bit, Hopkin's diagnosis and prescription could have come straight from Mrs Thatcher. This did not stop Kaldor agreeing with much of it, but he thought Hopkin's reforms needed a 'favourable economic environment' where firms thought investment worthwhile and workers could be confident that less overmanning and restrictive

practices did not simply mean more unemployment. For this reason import restrictions ‘may be needed not as a “last resort”, but as a precondition for a programme of reform.’ (T338/345, Kaldor to Wass, ‘Economic Strategy’, 22 September 1975). On this manifesto Hopkin wrote ‘No further action (in case go on for ever!’).

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

(6)

Meanwhile Kaldor was getting into another debate with the Treasury, this time about the efficacy of devaluation. When Kaldor presented many pages of country-by-country statistical tables and picked out numerous countries which had devalued and done themselves no good, A.J.C.Edwards of the Treasury weighed in, insisting that multiple regression must be used -- as in the Treasury model, which showed devaluation to be effective. Kaldor retorted that the Treasury model had been used to do something very different and much less useful -- namely to derive price elasticities on the basis of time-series evidence for the UK alone. His was an international cross-section study which showed there were long-term differences between countries’ export performance which exchange rate changes did nothing to address. In any case, time series analyses like that of the Treasury were exceptionally sensitive to the data and assumptions used – the CEPG had performed the same exercise and reached an opposite conclusion. Hopkin intervened to pour cold water on both time-series

and cross-section studies of the exchange rate effect but gave judgement against Kaldor, whose work was

extremely crude and over-simplified. It takes no account of lags; none of the effects of divergent experience of different countries, in regard to levels of activity; and none of the structural differences of national behaviour in the face of trade opportunities.

Treasury studies showed this last factor (measured by elasticity of exports with respect to world trade) was especially important. This, said Hopkin, might seem like a victory for Kaldor, but ‘for a country like the UK, facing various adverse structural factors which are difficult to influence, it is an important consideration that changing competitiveness is one of the few ways of influencing trade flows.’ (7)

It sounds like a draw, which is maybe why both sides moved on at this point. At a meeting of the Policy Co-ordinating Committee in February, ‘all’ (Kaldor was there) wanted the exchange rate to fall, though divisions emerged over the size of the fall, and on how, indeed if, it could be managed. At the Ministerial Economic Strategy Committee in March, Shore proposed a reflationary policy to bring down unemployment, damage to the current account being contained by controls which would hold imports of consumer goods and some semi-manufactures at their 1975 level until 1980. Foreign critics would be told that *any* solution to Britain’s problems would involve holding down imports one way or another. (8)

Healey vigorously opposed Shore’s scheme and the Committee rejected it. But the Treasury’s March Medium-Term Economic Assessment was far more sombre than anything so far. It predicted that bringing unemployment down to 3% by 1980 would involve a current

account deficit of £10 billion. This led to another interdepartmental inquiry, this time to look at ‘a medium term protectionist strategy’, not temporary tide-over expedients. The inquiry stayed close to the macroeconomics, avoiding, in particular, getting into the argument over whether British industry would wilt under the featherbedding or re-equip itself behind the wind-break. They found the Shore scheme could produce a fall in unemployment of about 200,000 by 1980. However they worried what would happen after 1980 (assuming the scheme was taken off by then), and ruled the idea out on the usual grounds of the international repercussions. (9)

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

Or was it? The surprising thing is that Kaldor did not sound any kind of inflationary alarm, still less (given his continued adherence to the Cambridge theory) warn of what might happen to wage demands via the real income effect. But the further fall in the pound in the autumn of 1976 (it touched \$1.57 in October and was widely predicted to go below \$1.50) had Kaldor worrying about imminent hyperinflation, not least through the channel of falling real wages (Thirlwall, 1987, p.253.) In the meantime, he fired off to Healey a succession of increasingly desperate remedies for the dire state of current account /unemployment tradeoff -- remedies which, he hoped, might also avoid an IMF loan and the consequent end of all possibility of import restrictions. Kaldor proposed a £1 billion cut in public spending, a 5%

payroll tax, a car tax surcharge, a marginal employment subsidy, further controls on capital exports and an import deposit scheme whereby those importing manufactures would place 200% of their value at the Bank of England for 12 months. The Treasury made the £1 billion cut, briefly considered a much smaller import deposit scheme and ignored the other proposals. Kaldor had by now had enough, and in August 1976 he resigned from the Treasury. (ibid., pp.252-4)

Kaldor was right about real wages, if not about consequent hyperinflation. Thanks to the combination of the falling pound and Labour's £6-a-week limit on pay increases (introduced in July 1975), real wages fell faster in 1976-7 than at any time since 1945, Healey actually boasting to the Cabinet that by the late summer of 1977 they would be down by 7%. Some of his colleagues, to put it mildly, saw this figure less positively. Tony Benn used it in his argument for a much bigger scheme than Shore's involving a 30% tariff on all imports of manufactures. Healey repeatedly warned Benn that his policies would require as much deflation as any of the alternatives if they were to work, invoking the Cambridge School's authority for this. (Presumably he meant that a given improvement in the current account, however achieved, required a given cut in the PSBR to make it work.) The final time he did so was under the shadow of the IMF negotiations, as officials worked on contingency plans 'on a possible scheme of import restraints' in the event of breakdown. In a meeting in October it was even suggested (probably by Healey, though the remark is unattributed) that Benn's 'Alternative Economic Strategy' would involve *more* deflation than any other option. (10) It is hard to see how anyone arrived at this conclusion, and surprising that the record does not show Benn challenging it.

7. IMF crisis and after

As the government approached and then survived the IMF crisis of December 1976, the imports issue became the sole focus of the Treasury's disagreement with the CEPG. This is understandable. But the other disagreements between the two institutions had in any case waned. Away from the question of protection, the Cambridge macroeconomic position had shrunk to little more than an embargo on fine tuning, and even this was watered down by their revisionist contention that in the short run NAFA was both variable and sometimes unpredictable. The Treasury was meeting the CEPG at least half way, as it retreated from active short-term demand management. One reason was that the 'natural rate of unemployment' doctrine had become uncontentious to many of the younger economists. In December 1975 the 'Steering Group on the Development of the [Forecasting] Model' had actually voted on whether the long-run Phillips curve was vertical and decided by a majority that it was. (11) It is thus hard to support Mosley's (1984) characterisation of the Cambridge School as a 'Trojan horse' for monetarism. Mosley claims that Cambridge's leftish political orientation made its hands-off message more palatable to the Labour government than doctrines associated with Enoch Powell and Sir Keith Joseph. But by 1976 Cambridge was barely more 'hands-off' than the Treasury itself. The two institutions had met in the middle. And, while Treasury papers for the period show some intellectual resistance to any challenge to Keynesianism – how else, indeed, could they do the 'normal science' expected of them? – it seems likely that it was professional rather than ideological baggage that officials were loath to shed, even supposing that they found Cambridge more ideologically sympathetic than Chicago in the first place.

But certainly there was a huge contrast between the Treasury's tone in 1974, when any engagement with the NCS appeared to be seen as a form of intellectual slumming, and 1976

when a mild glancing criticism of the CEPG could have the critic rebuked for ‘sneering.’ Because the focus of this article has been on Cambridge and the Treasury, it has dealt rather briefly with non-Treasury ministers. In particular much more could be said about Tony Benn’s campaign for import controls. Given that (as both men confirm) Benn’s views can be taken as a reliable indicator of those of Francis Cripps, the division between the CEPG and Kaldor can only widen. (12) In the end Britain managed without import restrictions – had to, as part of the price of the IMF loan – and 1977 and 1978 saw falling inflation and a halving of the PSBR. But unemployment fell only slightly, staying above 1 ¼ million, and the Cambridge message continued to be that current policies could not get past the balance-of-payments constraint on full employment and the only solution was protection by means of import controls. (CEPG, 1977, p.10) And the recession of the early 1980s was just around the corner. Then, as manufacturing output shrank by one-sixth in a single year, and unemployment passed two and a half million on its way to its eventual peak of more than three, the Left’s Alternative Economic Strategy – a macroeconomic if not always a microeconomic descendant of the CEPG – emerged as the most coherent of the alternatives to the policies of Margaret Thatcher.

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NOTES

1 T378/9 A.J.C.Britton, "The Public Sector Borrowing Requirement", 11 June 1976, p.9; Stamler to Britton, 15 June 1976; Britton, 'The PSBR – revised', 29 June 1976; Posner to Britton, 29 June 1976

2 T338/198, 'The Medium Term Economic Outlook', 31 May 1974, p.10. CAB134/3744, Official Committee on Economic Policy, 1st meeting 29 March 1974 p.2 and 2nd meeting 19 July 1974 pp.1-4; T338/219 A.P.Budd, 'Why unemployment does not cure inflation,' 24 June 1974, p.2

3 PREM 16/707 Healey to Peter Shore, 25 March 1974. Shore had circulated the officials' note to the Cabinet, though it was anything but an endorsement of his own position.

4 T338/345, M.Hedley-Miller, 'Import Restraints', 9 January 1975. T338/302 Kaldor to Hopkin, 'Resources and Wages', 9 January 1975, pp.2-3. T277/3053 Kaldor, 'A Dual Exchange Rate System', 24 January 1975

5 T277/3055 Bryan Hopkin, 'Methods of Balance of Payments Adjustment', 20 May 1975, appendix by H.H.Liesner, p.13f.; N.Kaldor and W.Godley, 'Methods of Balance of Payments Adjustment', 21 May 1975, pp.1-2. T277/3057 N.Kaldor, 'Methods of Balance of Payments Adjustment', 23 July 1975, p.2 & p.6

6 T364/19 Davies to Healey, 'The Conjuncture', 27 October 1975, p.2. CAB129/185, Healey and Shore 'Selective Import Controls', 4 November 1975. Controls were put on textiles from Spain and Portugal, and television sets and tubes from the Far East; the government sought voluntary restraint on footwear imports from Eastern Europe.

7 T364/9 Edwards to Kaldor, 8 January 1976; Kaldor to Edwards, 'Devaluation and the Trade Balance', 13 January 1976; Kaldor to Robert Sheldon, 'Devaluation and the Trade

Balance’, 16 January 1976; Hopkin to Chancellor’s Principal Private Secretary, ‘Devaluation and the Trade Balance’, 11 February 1976, pp.3-4

8 T277/3175 minutes of Treasury Policy Co-Ordinating Committee Meeting, 18 February 1976, pp.2-3. CAB134/4048, Ministerial Committee for Economic Strategy, 17 March 1976

9 CAB134/4025 Healey, memo. to Ministerial Committee for Economic Strategy, 3 June 1976, p.1. T389/23 Airey to Wass, ‘Import Restraints’, 14 May 1976, pp.20-21, 32-33

10 CAB129/193, Healey memo. to Cabinet, ‘Incomes Policy, Living Standards and Public Expenditure’, 30 November 1976, p.2; CAB1344/4025, minutes of Ministerial Committee for Economic Strategy meeting, 15 June 1976, pp.5-6; PREM16/792 Benn, ‘The Chancellor’s New Proposals’, 21 July 1976; CAB134/4025 minutes of Ministerial Committee for Economic Strategy meeting, 2 August 1976, p.4; CAB134/4026 Healey, ‘Economic Policy: The Next Steps’, 21 September 1976, p.8; CAB134/4025 minutes of Ministerial Committee for Economic Strategy meeting, 20 October 1976, p.3

11 T389/2 Minutes of the Steering Group on the Development of the Model, 18 and 19 December 1975

12 Tony Benn, pers. comm., 12 December 2007; Francis Cripps, pers. comm., 13 October 2008