9 The 1981 Budget: 'a Dunkirk, not an Alamein'

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Introduction

The 1981 Budget is principally remembered for the decision to raise taxes in the depths of the worst UK recession for a generation. By tightening fiscal policy in a slump, Margaret Thatcher's government flew in the face of the post-war Keynesian orthodoxy, famously incurring the wrath of the economics establishment. But, while the major public debates were over fiscal policy, an often neglected driver of the 1981 Budget was the need to restore monetary policy credibility. Like its Labour predecessor, the Conservative government had placed the fight against inflation at the heart of economic policy. Unlike its predecessor, it hoped to win the battle without resorting to an incomes policy.[1] In March 1980, in line with Milton Friedman's dictum that 'inflation is always and everywhere a monetary phenomenon', Sir Geoffrey Howe launched the Medium-Term Financial Strategy, laying out a four-year series of declining target ranges for the broad money supply (£M3), and explaining that 'control of the money supply will over a period of years reduce the rate of inflation'.[2]

In March 1981, with £M3 growth significantly above target and inflation still higher than when they had taken office, ministers recognised that the monetary leg of the MTFS was flawed.[3] This chapter explains why it

This chapter draws upon D. J. Needham, *UK monetary policy from devaluation to Thatcher, 1967–82* (Basingstoke, 2014), and I acknowledge the kind permission of Palgrave Macmillan in consenting to its inclusion here.

[1] There was, of course, no escaping the government's obligations towards determining incomes in the public sector.

[2] £M3 comprised currency in circulation with the public and the sterling deposits of UK residents. There was also a declining four-year 'projection' for the PSBR, intended to be 'consistent with achieving the planned reduction in the growth of money supply over the medium term with lower interest rates': *FSBR 1980–81*, 16, 19.

[3] The final RPI release before the 1979 election showed prices rising by 9.8 per cent in the year to March 1979. In March 1981 inflation stood at 12.6 per cent, having peaked at 21.9 per cent in May 1980.

was flawed. Sir Adam Ridley suggests elsewhere in this volume that budget making is like organising a naval convoy. Here I extend the analogy to policy making in general. Successful monetary policy implementation requires that all three members of the 'macroeconomic executive' – the government, the Treasury and the Bank of England – be travelling in the same direction, if not always at precisely the same speed.[4] In 1980–81 the government, the Treasury and the Bank were heading in broadly the same direction on fiscal policy. The same could not be said of monetary policy. With a brief history of monetary targeting in the United Kingdom, this chapter shows why the Bank and sections of the Treasury were sceptical about the monetary leg of the MTFS from the outset.

As Table 9.1 shows, monetary targets in various guises had been in place since the late 1960s. Some were published, others were known only to a handful of politicians and officials. Few conformed to any narrow monetarist definition of a 'target'. As Christopher Allsopp points out, 'Monetary targets may have many justifications other than those that arise conventionally from monetarist theories.'[5] Monetarists do *not* have a monopoly on monetary targets.[6] What matters is the level of commitment. What the authorities did as a consequence of monetary targets, unpublished or published, usually proved to be more important than what they said.

Experience of operating monetary targets in the 1970s had persuaded many senior Bank and Treasury officials that tight control over the broad money supply was impracticable in an open economy such as the United Kingdom. That is not to suggest that they were against monetary targets per se. The M3 target announced by Denis Healey in July 1976 was pressed upon him by the Bank of England's Governor, Gordon Richardson, with the support of his Keynesian Chief Economist, Christopher Dow. It was blessed by a sceptical Permanent Secretary to the Treasury, Sir Douglas Wass, for the beneficial impact it might have on market sentiment. Healey's money supply targets were designed for a specific set of circumstances in the 1970s. They were conceived partly to replace the financial discipline lost after the collapse of the Bretton Woods system of fixed exchange rates and partly as an adjunct to incomes

[4] The term 'macroeconomic executive' is from J. S. Fforde, 'Setting monetary objectives', in Bank of England, *The development and operation of monetary policy 1960–1983: a selection of material from the Quarterly Bulletin of the Bank of England* (Oxford, 1984), 65.

[5] C. J. Allsopp, 'Macroeconomic policy: design and performance', in M. J. Artis and D. P. Cobham (eds.), *Labour's economic policies, 1974–1979* (Manchester, 1991), 30.

[6] For an explanation of how a Keynesian could reconcile himself to monetary targets, see Hacche and Taylor, *Inside the Bank of England*, 61–2.

Table 9.1 *Unpublished and published DCE, M3 and £M3 objectives, 1968–79*

	Period	Objective	Outturn	Source
M3	1968	Below £1.2 billion	£986 million	1967 Letter of Intent
DCE	1969/70	Below £400 million	*minus* £541 million	1969 Letter of Intent
DCE	1970/71	Below £900 million	£1.4 billion	1970 Budget speech
M3	1971/72	3% per quarter	15% in 1971/72	1971 Budget speech
M3	1972/73	20%	27%	Unpublished
M3	1973/74	'Not more than 15%'	25%	Unpublished
M3	1974/75	Below nominal GDP	10% (vs 13% GDP)	November 1974 Budget
M3	1975/76	Below nominal GDP	9% (vs 26% GDP)	1975 Budget speech
M3	1976/77	Below nominal GDP	10% (vs 18% GDP)	1976 Budget speech
M3	1976/77	12%	10%	22 July 1976 Statement
£M3	1976/77	9–13%	8%	December 1976 mini-Budget
DCE	1976/77	£9 billion	£3.8 billion	1976 Letter of Intent
£M3	1977/78	9–13%	16%	1977 Budget speech
DCE	1977/78	£7.7 billion	£4.1 billion	1976 Letter of Intent
£M3	1978/79	8–12%	11%	1978 Budget speech
DCE	1978/79	£6 billion	£6.8 billion	1976 Letter of Intent

Sources: D. P. Cobham, *The making of monetary policy in the UK, 1975–2000* (Chichester, 2002), 50; *Bank of England Quarterly Bulletin*; ONS; Hansard; the National Archives.[7]

policy in the battle against inflation. They grew into a fiscal constraint on the spending ambitions of the Labour government. For reasons that are explained below, this pointed to targets for the broad money supply. But few doubted the fiscal convictions of the Thatcher government after 1979. The Bank's unease with the MTFS stemmed largely from the choice of

[7] There were also ceilings for bank lending and bank deposits (the 'corset') for much of the period. For the 1968 M3 target, see L. J. Callaghan, 'Letter of Intent', 28 November 1967, TNA, T326/730; and I. d. L. Radice, 'Working party no. 3: speaking notes for Sir D. Rickett', 28 November 1967, TNA, T326/730 (which specifies £1.2 billion). For the 1971/72 quarterly target, see HC Deb., 30 March 1971, vol. 814, col. 1374; and C. J. Riley, 'Monetary assumption', 1 October 1971, TNA, T338/68. For the 1972/73 unpublished 20 per cent target, see D. V. A. Allen, 'Monetary policy – post-Budget', 21 March 1972, TNA, T326/1562; A. M. Bailey, 'Monetary policy – post-budget, 23 March 1972, TNA, T326/1562; and F. Cassell, 'Monetary policy', 26 April 1972, TNA, T326/1562. For the 1973/74 unpublished 15 per cent target, see G. S. Downey, 'Monetary policy', 16 February 1973, TNA, T233/2505. For 1974/75, see HC Deb., 12 November 1974, vol. 881, c256; and J. B. Page, 'Monetary policy', 24 October 1974, BOE, 6A50/14. For 1975/76, see HC Deb., 15 April 1975, vol. 890, c279; and P. E. Middleton, 'Possible monetary policy objectives', 31 October 1975, TNA, T386/274. For the 1976/77 'below nominal GDP target', see HC Deb., 6 April 1976, vol. 909, c237. Samuel Brittan interpreted this to mean a 15 per cent M3 target: S. Brittan, 'Another gamble on incomes policy', *Financial Times*, 7 April 1976. The remaining targets are all a matter of public record.

monetary aggregate.[8] The econometric relationship between narrow money (M1) and nominal income had survived the monetary upheavals of the 1970s; the relationship between £M3 and inflation had not.[9] In 1980 Conservative ministers launched a medium-term strategy based not on econometric evidence but on the beneficial impact monetary targets might have on confidence and expectations. A strategy based on managing down inflationary expectations relied on the government actually hitting its targets. For this, they had chosen the wrong aggregate. In doing so, they subjected themselves, and the British economy, to a monetary policy roller-coaster ride.

A brief history of UK monetary targets

In the 1960s British monetary policy was guided by the findings of the 1959 Radcliffe Report. The report dismissed the importance of the monetary aggregates: '"The supply of money" – whatever that may be made to mean – is not by itself a reliable policy measure.'[10] With the demand for money assumed to be unstable, monetary policy was assigned a subordinate role to fiscal policy in managing aggregate demand: '[M]onetary measures can help, but that is all.'[11] Insofar as the UK authorities did look at money, it was within a framework that divided the broad money supply (M3) into its counterparts, principally bank lending to the private sector and the public sector borrowing requirement.[12] In an era of (generally) balanced budgets, this meant ceilings on bank lending to the private sector. The Radcliffe Report had warned that ceilings were inimical to an efficient banking system.[13] They froze lending at an arbitrary date, favoured established bank customers at the expense of newer businesses and inhibited competition between the banks. Nonetheless, ceilings remained in place for most of the 1960s. This is because, with

[8] Officials were also nervous about extending targets out over a four-year period.

[9] M1 comprised currency in circulation with the public and UK residents' sterling sight deposits with UK banks. In September 1977, despite 'a touching faith that improved econometric techniques would save the day', Bank officials finally admitted that 'there is no obvious simple, single equation, demand for M3 balances': Hotson, 'British monetary targets, 1976 to 1987', 6.

[10] *Radcliffe Committee*, Cmnd 827, para. 504. [11] Ibid., para. 514.

[12] The counterparts approach analysed the flow of funds between sectors such that ΔM3 = Δ currency + Δ reserves + bank lending to the private sector + bank holding of government securities – Δ non-bank liabilities: F. H. Capie, *The Bank of England: 1950s to 1979* (New York, 2010), 28. Batini and Nelson trace this approach to M. W. Holtrop's 1958 evidence to the Radcliffe Committee, based on his earlier IMF staff paper: Batini and Nelson, 'The UK's rocky road to stability', 31.

[13] *Radcliffe Committee*, Cmnd 827, para. 527.

sterling fixed under the Bretton Woods regime, attempts to run the economy at full employment led to a succession of balance of payments crises as demand increased imports and diverted exports back to the domestic market. With a chronic shortage of foreign currency reserves in the 1960s, balance of payments crises often meant recourse to the International Monetary Fund.

Britain borrowed more from the IMF than any other country in the 1960s.[14] Initially, loans came with low conditionality.[15] The shift in emphasis came after loans to the new Labour government in November 1964 and May 1965. The Treasury explained:

> The Government's undertakings to the IMF as a result of the extensive use of the Fund's facilities during this period compelled the authorities to modify their approach to monetary policy... [W]hile policy continued to place great emphasis on controlling bank lending to the private sector, greater attention was paid to money supply and to domestic credit expansion.[16]

To secure another IMF loan after devaluation in November 1967, the Chancellor, James Callaghan, acknowledged 'the expectation at present that bank credit expansion will be sufficiently limited to ensure that the growth of the money supply will be less in 1968 than the present estimate for 1967'.[17] Accordingly, the banks were told to freeze aggregate lending at the mid-November 1967 level. This was the first time that a lending ceiling had been publicly linked to IMF assistance, because of the stigma attached to having policy imposed from outside.[18] The link was cemented in May 1969 when Callaghan's successor, Roy Jenkins, agreed to a published £400 million domestic credit expansion ceiling, comprised of an

[14] Britain drew upon IMF resources in 1948, 1956, 1961, 1964, 1965, 1968 and 1969 (and again in 1972, 1976 and 1977).

[15] In 1959 a Treasury official suggested that 'it would be repugnant to the dignity of a country of the UK's status' to have *any* conditions applied to IMF loans: 'Note to D. H. F. Rickett', 8 May 1959, TNA, T236/5740 [emphasis in original]. Increasing conditionality was also a result of the United Kingdom borrowing higher 'tranches' of its IMF quota. Borrowing from the first 'gold' tranche came with few strings attached. As members drew on successively higher credit tranches (each 25 per cent thick), however, they could expect increasingly harsh conditionality from the IMF.

[16] 'Control of credit in the private sector', T267/30, 3.

[17] In November 1967 the 'present estimate' for M3 growth in 1967 was £1.2 billion: Radice, 'Working party no. 3: speaking notes', T326/730; Callaghan, 'Letter of Intent', T326/730.

[18] The 1961 loan came after an 'IMF-friendly' statement by Selwyn Lloyd, the then Chancellor: B. M. Clift and J. D. Tomlinson, 'Negotiating credibility: Britain and the International Monetary Fund, 1956–1976', *Contemporary European History*, 17, 4 (November 2008), 552. In 1965 the IMF insisted that bank advances to the private sector over the next year be limited to 105 per cent of the April 1965 total: 'Control of credit in the private sector', T267/30, 5.

unpublished £250 million target and a £150 million margin of error, as a condition for a further loan.[19]

DCE was the IMF's preferred aggregate and adjusted the money supply for financing of the balance of payments from official reserves.[20] It rested on the assumption, shared with the monetarists, that the demand for money was both stable and predictable.[21] In order to test this assumption, the Bank set up the internal Money Supply Group in October 1968. Despite initial hostility towards the 'neo-quantity theorists', members found themselves agreeing with a number of core monetarist principles.[22] Disavowing the Radcliffe Report, they found that the velocity of circulation (and therefore the demand for money), was 'fairly stable' – a conclusion that was 'generally consistent with the quantity theory point of view as expounded by Friedman'.[23] The group's final report was published in 1970. It stated that, 'in the United Kingdom, movements in the money stock have preceded movements in money incomes' and that, 'in the absence of evidence to the contrary, a consistent lead is a prima facie indication of causation'.[24] Combined with the evidence that the demand for money could be controlled with interest rates, this was a powerful rejection of the Radcliffian approach. As the principal author of the Money Supply Group's final report, Charles Goodhart, pointed out:

> The main conclusions of this were that the chief intermediate objectives of monetary policy should be the rates of growth of the monetary aggregates, i.e. the money stock, in one or other of its various definitions, or DCE (and not particular components of these, such as bank lending to the private sector).[25]

The Money Supply Group's theoretical work underpinned the introduction of Competition and Credit Control by Ted Heath's government in 1971, recognised by Forrest Capie as 'the biggest change in monetary

[19] A. J. C. Edwards, 'Note for the record: domestic credit expansion and the central government borrowing requirement', 12 May 1969, TNA, T326/979; 'Control of credit in the private sector', T267/30, 22.

[20] The IMF's initial focus was on the central bank's balance sheet (i.e. the monetary base). After negotiation, officials persuaded the Fund that, in the United Kingdom's case, DCE should be predicated on the broad money supply.

[21] David Laidler refers to the stability of the demand for money as the sine qua non of monetarism: D. E. W. Laidler, *Monetarist perspectives* (Oxford, 1982), vii.

[22] In January 1969 Goodhart wrote that he 'was not sorry to see evidence unfavourable to the neo-quantity theorists': C. A. E. Goodhart, 'Visit to Mr A. O. Hughes of Nottingham University on 28th January' (covering note), 31 January 1969, London, BOE, 2A128/1.

[23] A. D. Crockett, 'The velocity of circulation of money', 2 April 1969, BOE, 2A128/2.

[24] Goodhart and Crockett, 'The importance of money', 176–7.

[25] Goodhart, *Monetary theory and practice*, 96.

policy since the Second World War'.[26] CCC swept away the panoply of lending controls in use throughout the 1960s and replaced them with the 'interest rate weapon' – more active use of Bank Rate to control the broad money supply. This was recognised at the time by politicians, officials, practitioners and academics alike. Commending the proposal to the Prime Minister, the Chancellor, Anthony Barber, wrote that 'the new system will operate on the money supply as a whole, putting more reliance on changes in interest rates'.[27] In February 1971, opening the first meeting to discuss the Bank's proposal, the Permanent Secretary to the Treasury, Sir Douglas Allen, declared: 'It should be assumed that it was still desired to have a numerical target for the monetary aggregates.'[28] Explaining the policy to his clients four months later, the influential City analyst Gordon Pepper, of W. Greenwell & Co., explained that 'the main emphasis will be placed on attempting to control the domestic money supply'.[29] The monetarist academic Brian Griffiths agreed: 'The intention of the new system is to move away from control of bank lending to control of one of "the broader money aggregates".'[30]

CCC was predicated upon more flexible use of Bank Rate. This produced the first unpublished M3 target, in March 1972.[31] In his 1972 Budget, Barber announced a 5 per cent real GDP growth target. The Bank's demand for money equations estimated that M3 would have to grow by 20 per cent simply to accommodate the fiscal stimulus announced in the Budget.[32] Less than 20 per cent and the government might not finance its 5 per cent GDP growth target; more than 20 per cent

[26] Capie, *The Bank of England*, 427.
[27] A. P. L. Barber, 'New approach to credit control', 6 May 1971, TNA, T338/40.
[28] D. A. Harding, 'Minutes of a meeting held on 18 February 1971 to discuss the Bank of England paper', 22 February 1971, TNA, T326/1261.
[29] G. T. Pepper, 'The gilt-edged market and the Bank of England's proposals', June 1971, 1, Churchill, THCR AS 3/17.
[30] B. Griffiths, 'Resource efficiency, monetary policy and the reform of the UK banking system', *Journal of Money, Credit and Banking*, 5, 1 (February 1973), 72.
[31] Susan Howson concludes that monetary targets 'could not be seriously adopted until the government had given up the commitment to a fixed exchange rate' in June 1972. An independent monetary policy is compatible with a fixed currency, however, if the foreign exchange reserves are sufficient. As Brian Tew and Peter Browning point out, the return to current account surplus in 1971 was an important factor in the timing of CCC. With less strain on the currency reserves, monetary policy could increasingly be directed towards the domestic economy. S. K. Howson, 'Money and monetary policy since 1945', in R. C. Floud and P. A. Johnson (eds.), *The Cambridge economic history of modern Britain,* vol. III, *Structural change and growth, 1939–2000* (Cambridge, 2004), 157; J. H. B. Tew, 'Monetary policy: part I', in F. T. Blackaby (ed.), *British economic policy, 1960–74* (Cambridge, 1978), 239; P. Browning, *The Treasury and economic policy, 1964–1985* (London, 1986), 276.
[32] F. Cassell, 'Monetary policy – post-Budget', 20 March 1972, TNA, T326/1562.

and there might be an additional, unwanted, monetary stimulus. This would run the risk of overheating the economy. But 20 per cent M3 growth was unprecedented. Heath had already shown his hostility towards the higher interest rates that would be required to rein in any excessive monetary growth, either by increasing the cost of bank lending, or by raising yields on new gilt-edged securities.[33] In an attempt to secure the interest rate flexibility demanded by CCC, the Bank and the Treasury turned the 20 per cent M3 forecast into a target:

> Numerical targets for money supply were not given in the Budget Speech. But the Chancellor has accepted our advice that for the present policy should be directed towards a target rate of growth of money supply of about 20% in the financial year 1972/73 – 20% being the growth which the Bank of England's demand-for-money equations suggest will be required, given the outlook for real output and prices, if there is to be no significant rise in interest rates from their present levels.[34]

What followed was one of the most intense periods of monetary chaos in recent British history. By the time the policy was de facto abandoned, in December 1973, M3 had grown by 72 per cent. Britain's highest ever inflation followed hard on the heels of Competition and Credit Control, apparently vindicating Friedman's assertion that excess monetary growth leads inevitably to higher prices after a lag. There also followed the worst banking crisis since the nineteenth century, and, despite its adroit handling of the 'Lifeboat' operation to rescue the stricken secondary banks after the property boom ended in 1973, the Bank's reputation suffered a serious blow.[35] Failure to control the money supply under Competition and Credit Control would shape the Bank's attitude to monetary policy for years to come.

There were a number of technical problems with the unpublished M3 target agreed in March 1972.[36] But the simple fact was, despite the econometric evidence that had suggested otherwise in 1970, it was just

[33] For a fuller explanation of Heath's reluctance to raise Bank Rate, see D. J. Needham, 'Britain's money supply experiment, 1971–73', Cambridge Working Paper in Social and Economic History no. 10 (2012), available online at www.econsoc.hist.cam.ac.uk/working_papers.html.

[34] Capie implies that the Treasury was trying to cap interest rates and M3 at the same time. They were not. They were trying to ensure that M3 growth above 20 per cent would trigger a higher Bank Rate. Capie, *The Bank of England*, 646; F. Cassell, 'Monetary policy', 26 April 1972, TNA, T326/1562.

[35] During the 'Heath–Barber boom' house prices more than doubled and commercial prices nearly trebled. See M. I. Reid, *The secondary banking crisis, 1973–75: its causes and course* (London, 1982); Capie, *The Bank of England*, 524–86; C. Gordon, *The Cedar story: the night the City was saved* (London, 1993).

[36] See Needham, *UK monetary policy*, for a detailed discussion of the technical problems associated with CCC.

not possible to exercise tight control over the broad money supply in the United Kingdom, especially when the power to set interest rates lay in the hands of a politician such as Ted Heath who was more committed to a high-profile GDP growth target than to an unpublished M3 target. Heath was concerned that higher interest rates would be construed as a return to the 'stop-go' policies of the 1960s.[37] He was also worried that higher debt servicing and mortgage costs would derail the delicate negotiations with the employers and unions over incomes policies, then seen as the natural solution to cost-push inflation. As the President of the Confederation of British Industry pointed out in 1972, 'The recently announced further increase in bank base rates to 7% will damage the prospects of agreement on a package to contain inflation.'[38] Clearly, the CBI had not been bitten by the monetarist bug.

After M3 growth of 27 per cent in 1972/73, the Bank was told to find a way of controlling the money supply that did not rely on higher interest rates.[39] The result was the supplementary special deposits scheme (the 'corset'), which penalised banks that grew their interest-bearing liabilities (deposits) above published thresholds, themselves derived from unpublished M3 targets.[40] The Bank explained: 'The prime objective of this device is, quite simply, to contain the growth of M3. A second objective is to avoid producing any perceptible further upthrust to the general level of interest rates.'[41]

Different institutions drew different conclusions from the failure of CCC. In 1975 Goodhart admitted:

> The monetarist edifice rests largely on the stability, and predictability, of the demand-for-money function. Econometric study of the data in the 1960s had suggested that in the UK we, too, could build parts of our monetary policy on this basis. Subsequent experience has revealed weakness in this foundation.[42]

That same year he formulated Goodhart's law: 'Any observed statistical regularity will tend to collapse once pressure is placed on it for control purposes.' This was not abstract theorising; it was a reflection on the painful experience of failing to control M3 under Competition and Credit Control.

The Bank concluded that M3 was a 'decidedly defective' measure and began a long campaign to shift the emphasis to M1, which continued to

37 'R. T. Armstrong to A. M. Bailey', 16 June 1972, TNA, T326/1563.
38 G. S. Downey, 'Bank base rates and the CBI', 24 July 1972, TNA, T326/1564.
39 'A. P. L. Barber to G. W. H. Richardson', 15 November 1973, TNA, T233/2508.
40 Capie, *The Bank of England*, 521.
41 A. L. Coleby, 'Controlling growth in M3', 29 November 1973, BOE, 6A50/12.
42 Goodhart, *Monetary theory and practice*, 113.

enjoy a more robust econometric relationship with nominal GDP.[43] The Treasury had always been sceptical of the Bank’s ability to control the money supply, and fell back on its traditional remedy for cost-push inflation: incomes policy. Just as officials were retreating from M3, however, Conservative ministers were becoming increasingly enthusiastic targeters. The Financial Secretary, Terence Higgins, responded to Allen’s recommendation of a 15 per cent target ahead of the 1973 Budget by arguing that ‘we are aiming too low and should go for 13% rather than 15% as a target growth of money supply (M3)’.[44] The Minister of State, John Nott, was persuaded against publishing the target only because it would look too high compared to the Europeans, who had recently agreed to limit money supply growth to 6 per cent, albeit on a narrower measure than M3.[45]

The Conservatives were out of office by March 1974. The monetary objective of the new Labour Chancellor, Denis Healey, was to keep M3 growth at or below nominal GDP growth.[46] With the economy moribund in the post-oil-shock recession, and inflation high, this was easily achieved. In July 1975, however, with inflation above 25 per cent, Healey launched a new incomes policy. Wage increases would be limited to £6 per week.[47] It was hoped that this would reduce inflation to below 10 per cent by the autumn of 1976. But, perversely, by hitting its inflation target the government would almost certainly breach its monetary objective: 10 per cent inflation implied nominal GDP growth of 13 per cent, versus forecast M3 growth of 15.4 per cent.[48] This created a conundrum: bank lending to the private sector would have to increase for economic recovery to take hold; consistent with the counterparts approach, this would require an offsetting PSBR reduction to ensure compliance with the objective of keeping M3 growth below nominal GDP growth. Healey had endured a torrid time getting less than £1 billion of cuts through Cabinet ahead of his 1975 Budget, so there was little chance of reducing

[43] Goodhart had argued as early as February 1971 that the structural changes brought by CCC ‘make the case for concentrating on M1’: C. A. E. Goodhart, ‘A new approach to credit control: some quantitative implications’, 25 February 1971, 3A8/11; J. B. Page, ‘Monetary policy’, April 1973, BOE, 6A50/8.

[44] C. W. Kelly, ‘Monetary policy’, 19 February 1973, TNA T233/2505.

[45] D. Haig, ‘Monetary policy’, 22 January 1973, TNA, T233/2505.

[46] J. B. Page, ‘Monetary policy’, 24 October 1974, BOE, 6A50/13.

[47] £6 equated to about 12 per cent for average wage earners. Incomes were frozen for those earning more than £8,500 per annum: *The attack on inflation*, Cmnd 6151 (London, 1975).

[48] Home Finance Division, ‘Counter-inflation policy: monetary policy’, 27 June 1975, TNA, T233/2831; G. E. A. Kentfield, ‘Money supply: a look ahead’, 7 July 1975, BOE, EID4/200.

the PSBR with further spending cuts.[49] In July 1975 officials were charged with 'restricting the growth of M3 other than by cutting the PSBR'.[50] The eventual solution, despite the traumas of CCC, was another M3 target. Bank Director Kit McMahon explained:

> If we can establish internally, with the Treasury, the principle of keeping the growth in money supply down and taking any necessary measures to that end, we will in due course get an extra lever on the Chancellor to attack public expenditure itself… [I]f we could get a public statement of a target for the growth of money supply, we should have a tighter rope round the Chancellor's neck.[51]

The M3 target imposed on Healey in July 1976 was born of the need to keep monetary policy consistent with incomes policy in the fight against inflation. Because of the counterparts approach, it grew to become a restraint on the spending ambitions of the Labour government – fiscal policy via the monetary policy back door. There was also the need to calm the gilt market, which was increasingly concerned about money supply growth in the crisis year of 1976. As Wass remarked, 'Notwithstanding the pain a target could inflict on us later on, the confidence-raising value in the package could make all the difference between success and failure. Since we cannot afford failure we must have a target.'[52]

But, unlike the unpublished M3 target agreed with his Conservative predecessor in March 1972, there was no econometric evidence underpinning Healey's published target in July 1976. As Anthony Hotson points out, 'Britain's monetary regime was not built on the back of a stable equation or model of money, but on a conceit intended to shackle the state's spending bureaucracies.'[53] As Goodhart explained at the time:

> The statistical basis for monetarism – a stable relationship between the monetary aggregates and nominal incomes – which has always been weaker in the UK than in the USA for example, has recently largely collapsed. A time when the authorities have moved towards quantitative monetary targets…is perhaps not the best time to make a big splash about the breakdown of these relationships.[54]

January 1977 was not the time to 'make a big splash' about the lack of econometric evidence linking the broad money supply to nominal incomes because, alongside a two-year programme of DCE and PSBR ceilings agreed with the IMF in return for yet another loan, the Labour

[49] D. W. G. Wass, *Decline to fall: the making of British macro-economic policy and the 1976 IMF crisis* (Oxford, 2008), 100–1.
[50] Kentfield, 'Money supply: a look ahead', EID4/200.
[51] C. W. McMahon, 'Monetary policy', 26 September 1975, BOE, EID4/200.
[52] Wass, *Decline to fall*, 212. [53] Hotson, 'British monetary targets, 1976 to 1987', 3.
[54] C. A. E. Goodhart, 'Provisional bulletin article on special deposits and supplementary special deposits', 31 January 1977, BOE, 6A50/20.

government had just announced a new 9 to 13 per cent target range for £M3 growth in 1976/77. For the next two years the government would be under the surveillance of both the IMF and the financial markets. Partly because of this, 1977 saw a rapid return of confidence, allowing Healey to boast that he was one of the few post-war Chancellors to preside over a growing economy, falling inflation, falling unemployment and a balance of payments surplus.[55]

Conservative monetary policy in opposition

The principal architect of the Medium-Term Financial Strategy, Nigel Lawson, points out that, in contrast to the detailed consideration of fiscal policy, an 'error, in hindsight, was to do so little work in Opposition on the conduct of monetary policy'.[56] This is a startling admission from a minister in a government that placed monetary policy at the heart of its agenda. After cautiously concluding in favour of published M3 targets in June 1976, a month before Healey revealed his 12 per cent target, the Conservatives announced in their October 1976 policy document, *The right approach to the economy*, that 'it would now be right to announce clear targets for monetary expansion as one of the objectives of economic management'.[57]

By Lawson's account, there was little further consideration of monetary policy while the Conservatives remained in opposition.[58] Detailed work on the MTFS had to wait not only until the Conservatives were back in power but until Howe's first Budget was out of the way, in June 1979.[59] In the meantime, although there were several meetings between Conservatives and senior Bank officials, they rarely touched upon the technicalities of monetary policy.[60] Lawson admits: 'We. . .assumed too readily that the task was essentially one of applying with conviction the approach that a reluctant Labour government had had forced upon it by

[55] Healey, *The time of my life*, 400–1. [56] Lawson, *The view from No. 11*, 17.

[57] 'Economic Reconstruction Group: minutes of meeting', 24 June 1976, Churchill, RDLY 2/1/2/1; Howe *et al.*, *The right approach to the economy*, 24.

[58] Ridley points out that this also reflected doctrinal differences between the Conservatives' various monetarist advisers. Christopher Johnson compares these to the disputes between Swift's Lilliputian 'Little-Endians' and 'Big-Endians' over which end of a boiled egg should be cracked open. C. Johnson, *The economy under Mrs Thatcher, 1979–1990* (London, 1991), 40; Lawson, *The view from No. 11*, 17–18; conversation with Sir Adam Ridley, 9 July 2013.

[59] Lawson, *The view from No. 11*, 17.

[60] Howe reported to Sir Keith Joseph that 'I sat next to [Bank Director] McMahon at lunch and, to me at least, he took a slightly different line to the effect that the Bank and Treasury did know more than you imply about the technicalities': 'R. E. G. Howe to K. S. Joseph', 2 July 1976, Churchill, THCR 2/1/1/30 [underlining by M. H. Thatcher in original];

the International Monetary Fund.'[61] Nonetheless, glimpses of a medium-term monetary strategy do emerge from the period of opposition. As Sir Alan Budd explains in this volume, much of the intellectual foundation for the MTFS came from the work done at the London Business School after the imposition of the IMF package in December 1976.[62]

Before the 'winter of discontent' most Conservative policy makers assumed, like their Labour counterparts, that incomes policy rather than monetary policy would be the principal weapon against inflation. Therefore, a great deal of attention was paid by both parties to the German system of *Konzertierte Aktion* ('concerted action'), whereby management and the unions combined with a group of 'wise men' to arrive at, inter alia, an acceptable annual wage norm.[63] Howe saw such 'realistic bargaining' as a viable alternative to free collective bargaining and the dirigisme of statutory incomes policies.[64] But 'concerted action' perished alongside Callaghan's wage policy in the winter of 1978–79. Monetary policy would be forced to bear a far greater share of the anti-inflationary burden than had ever been intended.

A respray of Labour's monetary regime[65]

In May 1979 the Conservatives inherited an economy recovering smartly from the 'winter of discontent'. GDP grew by 4.25 per cent in the second quarter, and, while inflation was rising, at just below 10 per cent it was a long way off the 1975 peak.[66] Fiscal policy making in opposition had

A. N. Ridley, 'Meeting with the Bank of England 18th October 1977', 20 October 1977, Churchill, TCHR 2/12/2/3; R. K. Middlemas, *Power, competition and the state*, vol. III, *The end of the post-war era: Britain since 1974* (Basingstoke, 1990), 216.

61 Lawson, *The view from No. 11*, 18.

62 See also ibid., 69. Howe refers to a March 1978 speech setting out a medium-term strategy that he delivered as a riposte to speeches by the Governor and the Permanent Secretary: Howe, *Conflict of loyalty*, 109. An earlier medium-term plan was laid out in 'Programme for economic stability', *The Times*, 20 September 1976.

63 Thatcher responded to Howe's proposal by suggesting that successful wage bargaining in Germany had little to do with 'concerted action' and everything to do with 'the German character'. As she explained, '[T]his German talking shop works because it consists of Germans': S. Zweig, 'Die Konzertiete Aktion', 1977, Churchill, THCR 2/1/1/31 [annotation by M. H. Thatcher]; 'R. E. G. Howe to M. H. Thatcher', 26 May 1977, Churchill, THCR 2/1/1/31 [annotation by M. H. Thatcher].

64 Despite Thatcher's initial hostility, 'concerted action' made it as far as the 1979 Conservative election manifesto.

65 Hotson, 'British monetary targets, 1976 to 1987', 19.

66 Inflation bottomed out at 7.4 per cent in June 1978. Some of the rapid GDP growth in 1979 Q2 was consumer spending brought forward in anticipation of the VAT rise in the Budget. This may not have been obvious to ministers and forecasters in the summer of 1979. The 1979 Q2 GDP figures were not released until September and initially showed a 3 per cent rise over the quarter: 'GDP up after winter', *Guardian*, 22 September 1979; ONS.

focused on identifying public expenditure cuts sufficient to finance the desired income tax cuts.[67] In the buoyant economic conditions of mid-1978, it had appeared that modest cuts, combined with the proceeds of a growing economy, would be sufficient.[68] As declining growth and a rising public sector wage bill increased the PSBR during the winter of 1978–79, however, it became clear that income tax cuts would have to be financed by indirect tax rises. This formed the basis for Howe's first Budget, in June 1979, when he reduced the basic rate of income tax from 33 to 30 per cent, and the highest rate from 83 to 60 per cent, while raising VAT to 15 per cent.[69] Howe regards this as his most popular Budget.[70] Yet this was the Budget that precipitated the deepest recession in Britain since the 1920s. Treasury economists estimated that the 'revenue-neutral' tax switch alone would shrink the economy by 1.7 per cent, wiping out the pre-Budget estimate of 1.5 per cent growth in 1979/80.[71] Chancellors traditionally included a passage in their Budget speeches estimating the net effect of the measures on growth. This was dropped in 1979.[72] Officials were told that ministers doubted the reliability of the forecasts and that, given the apparently critical state of the economy, there was no realistic alternative to benchmark the Budget against.[73] The 1979 *FSBR* did publish a growth forecast for the coming year of minus 1 per cent. The only indication that this might be policy-induced was on page 4: 'In the short term the reduction in public expenditure is likely to reduce economic activity

[67] Lawson, *The view from No. 11*, 17.

[68] D. J. Needham, 'Fentiman Road: drawing the Conservative fiscal policy threads together in 1978' (June 2011), available at www.academia.edu/2431227/Fentiman_Road_drawing_the_Conservative_fiscal_policy_threads_together_in_1978, MTFW 114053.

[69] Prior to the 1979 Budget the standard rate of VAT was 8 per cent, with a 12.5 per cent rate applied to petrol and certain luxury goods.

[70] Howe, *Conflict of interest*, 121–36.

[71] Ministers appear to have overlooked the different behavioural consequences of direct and indirect tax changes. In the short term, individuals tend to react to a decrease (increase) in net income (after a direct tax change) by drawing down (adding to) savings to maintain existing levels of consumption. By contrast, an indirect tax rise increases the cost of existing consumption, causing individuals to substitute tax-exempt goods for the (now more expensive) taxed goods, thus narrowing the indirect tax base. The increase in the general price level after an indirect tax rise also discounts the stock of real wealth. Since individuals tend to want to hold their real wealth fairly constant, they react to higher prices with increased saving. This further reduces the overall level of consumption, with additional negative consequences for overall output. J. B. Unwin, 'Preparations for the Budget', 10 May 1979, TNA, T366/456.

[72] Thatcher was advised that 'certain aspects of this forecast, notably unemployment, the exchange rate, interest rates and the economic effects of the Budget, are not being quoted publicly': H. P. Evans, 'Post-Budget forecast: the economic outlook to end 1980', 14 June 1979, TNA, PREM 19/25.

[73] [?], 'Points for brief B4: effects of Budget', June 1979, TNA, T414/37.

slightly. This is probably also true of the net effect of reducing direct and raising indirect taxes.'[74]

The 1979 Budget was also notable for lowering the £M3 target range inherited from Labour to 7 to 11 per cent. Howe had flagged his intention of operating a tighter monetary policy when he first met the Bank Governor on 9 May.[75] This was despite the cautious advice he received on his first day in the job from both the Treasury and the Bank. The initial briefing from his own officials warned that 'no one has succeeded in establishing a relationship between M3 [sic] and money incomes which has proved stable during the 1970s'.[76] The Chancellor was also advised 'to bear in mind that there is no close relationship between £M3 and the PSBR' and that exporters were concerned about the consequences of tighter monetary policy on an already strong pound.[77] The Bank's advice was similarly cautious:

> Proper control of the money supply is unlikely to become a simple matter... [W]ith a combination of correct judgement and good fortune, the authorities are able to steer a course that allows the money supply to grow within its permitted range without this being accompanied by unforeseen, unwelcome, or unacceptable behaviour of either the rate of exchange or the rate of interest.[78]

Nonetheless, ministers were keen to provide the markets with 'a declaration of intent' that the new government was more serious about monetary policy than its predecessor.[79] Despite the latest figures showing £M3 accelerating out of Healey's 8 to 12 per cent target range, Howe decided to lower the target to 7 to 11 per cent.[80] Contained within his announcement was an early indication that a more pragmatic form of 'monetarism' would trump 'believing monetarism'.[81] Ministers were not prepared to take responsibility for the rapid growth of the money supply during the two months of the financial year that had fallen under Healey's stewardship. The target would apply only for the ten months from the date of Howe's first Budget. If ministers really believed that the way to reduce inflation was to reduce the

74 *FSBR 1979–80* (London, 1979), 4.
75 A. M. W. Battishill, 'Domestic and overseas monetary policy', 10 May 1979, TNA, T386/524.
76 Home Finance Group, 'Monetary targets and control', May 1979, TNA, T388/93.
77 Central Unit, 'Budget', 26 April 1979, TNA, T388/92; EFI Division, 'The exchange rate', 25 April 1979, TNA, T388/92.
78 Bank of England, 'Problems of monetary control', 30 April 1979, TNA, T386/524.
79 N. Lawson, 'Monetary policy', May 1979, TNA, T386/524.
80 In the six months to April 1979 £M3 grew by an annualised 12.8 per cent: 'R. E. G. Howe to Prime Minister', 10 May 1979, TNA, T386/524.
81 For a distinction between the various types of monetarist, see G. T. Pepper and M. J. Oliver, *Monetarism under Thatcher: lessons for the future* (Cheltenham, 2001).

rate of growth of the money supply, then it should not have mattered whether £M3 had grown under a Labour or a Conservative government.[82]

After growing modestly during the first three months of the new target period, the money supply burst out of its new range in October 1979.[83] The gilt market reacted in typical fashion, and called a buyers' strike. At a crisis meeting on 14 November, Richardson told the Prime Minister that the Bank would need to sell £500 million gilts within the week simply to get monetary policy back on track.[84] In order to do this, interest rates were raised three percentage points to the highest nominal level in British history, before or since: 17 per cent. To further placate the markets, Howe extended the £M3 target for another four months to October 1980.[85]

The Medium-Term Financial Strategy

The November 1979 monetary mini-Budget delayed the introduction of the MTFS, which Lawson had been working on since the election. As the Prime Minister's Private Secretary, Tim Lankester, remarked, 'There is no point in having *a medium-term financial plan* when the Markets are dubious about our ability to stay within the existing target.'[86] The prospect of smoothing out the short-term monetary difficulties was integral to the MTFS, however. Lawson reformulated his plan in early 1980. As Howe explained to Mrs Thatcher, there was

[82] Thatcher was already exhibiting a Heath-like distaste for higher interest rates, arguing that a two percentage point rise in MLR on Budget day would affect the Conservative vote in the forthcoming European elections. Commenting on this episode, Charles Moore writes: 'Mrs Thatcher was perfecting a technique she was often to deploy – permitting a decision, but distancing herself from it.' Moore, *Margaret Thatcher*, 463; 'T. P. Lankester to A. M. W. Battishill', 11 June 1979, TNA, PREM 19/33.

[83] Bank lending to the private sector hit a new record. Bank lending to the public sector was also higher as VAT payments and telephone bills were delayed by strikes. The Treasury accountant had failed to anticipate either of these, so the Bank had not scheduled significant offsetting gilt sales, which, after redemptions, were negative during the month. J. M. Bridgeman, 'Gilt edged market: tap stock', 6 September 1979, TNA, T386/526.

[84] 'T. P. Lankester to M. Hall', 14 November 1979, TNA, T386/525.

[85] Howe also announced that consultations would commence on moves towards a system of monetary base control. The monetary base (M0) comprises notes, coin and bankers' balances at the Bank of England. As a backward-looking, demand-determined aggregate, M0 has no causative effect on nominal GDP. The Bank privately rejected MBC after extensive analysis in 1977, and then publicly in 1979; see P. E. Stevenson, 'Monetary base, bankers' balances and movements in money: some results', 11 October 1977, BOE, 6A50/23; and Foot, Goodhart and Hotson, 'Monetary base control'.

[86] 'T. P. Lankester to Prime Minister', 9 November 1979, TNA, PREM 19/34 [emphasis in original].

a good deal of force in the argument that by displaying a credible strategy for the medium term we shall be better able in the Budget to ride out the immediate problems of high monetary growth and interest rates, which, whatever course we follow, are still likely to take some time to control.[87]

Despite substantial gilt sales in January 1980, £M3 was still outside the 7 to 11 per cent target range at the time of the Budget.[88] Lawson's proposal offered a way of terming the current monetary difficulties out over a four-year period. It also offered the tantalising prospect of 'jam tomorrow' in the form of tax cuts just ahead of the next election:

Although the situation in the next two years is still likely to be extremely tight, the prospect thereafter – as we feel the full benefit of higher North Sea oil revenue – is a good deal easier and offers the prospect of substantial fiscal relaxation.[89]

The proposal contained no empirical evidence that control of the broad money supply was either a necessary or sufficient condition for lower inflation. As Lawson admitted, it rested on 'the beneficial effects on confidence (and hence expectations)'.[90] But, as his Cabinet colleague Sir Ian Gilmour points out, '[r]egrettably, trade unionists were not well versed in monetarist doctrine and had no such expectations, rational or otherwise'.[91]

The lack of robust econometric evidence had worried Goodhart when he was sent a similar proposal by the newly appointed Treasury Chief Economic Adviser, Terry Burns, and his London Business School colleague, Alan Budd. Drawing on his practical experience with monetary targets, Goodhart drafted a letter to Budd:

What really gets to me is the implicit self-confidence that you, Alan Budd, have now identified a stable demand-for-money function, on which future policy can firmly be based. After all our experience in recent years, can you seriously claim that 'your calculations' – undemonstrated – are a sound basis for official policy. Frankly I feel that the process of picking numbers in this way for serious policy recommendations is breath-taking in its irresponsibility.[92]

Four months later the Governor was equally annoyed to discover that Lawson's proposal had gone to the Prime Minister before being discussed

[87] R. E. G. Howe, 'Medium Term Financial Strategy', 20 February 1980, TNA, PREM 19/177.
[88] Annualised £M3 growth during the target period was 12.1 per cent: C. J. Riley, 'Recent developments', 7 February 1980, TNA, T386/527.
[89] Howe, 'Medium Term Financial Strategy', PREM 19/177.
[90] N. Lawson, 'A medium term financial plan', 24 September 1979, TNA, T386/525.
[91] I. H. J. L. Gilmour, *Dancing with dogma: Britain under Thatcherism* (London, 1992), 22.
[92] 'C. A. E. Goodhart to A. P. Budd', 24 October 1979, BOE, 6A50/31. The letter was never sent, and, after a conciliatory lunch, the article was toned down for publication.

with Bank officials. He told Howe that the Bank had 'serious reservations about the credibility of the sort of document produced and the wisdom of publishing it'.[93] He believed that the strategy was 'undesirably dogmatic, mechanical and rigid', and reiterated that there was no clear relationship between changes in the money stock and the price level.[94] Richardson addressed his concerns directly to Thatcher: 'Monetary policy had to be defensible. It was hard enough to set a monetary target for one year ahead: it was much harder for a four year period.'[95] The Prime Minister replied simply that 'she and the Chancellor were convinced that it would be right to publish the medium-term targets on the lines of the draft; she hoped that the Governor would be able to live with this'.[96]

The Bank was not the only part of the official machine with misgivings. The head of the Central Policy Review Staff, Sir Kenneth Berrill, warned that, by 'deliberately hooking itself on a programme for M3 [sic] which it intends to stick to come what may', the government could be in for 'a very bloody battle indeed with interest rates, exchange rate, reduced investment, bankruptcies, at unknown levels'.[97] The Cabinet Secretary, Sir Robert Armstrong, agreed. Publishing the target ranges four years ahead allowed 'nothing for the unforeseen, or for slippage', and would 'make life even more difficult than it is in any case bound to be'.[98] More significant was opposition from within the Treasury ministerial team itself. On 4 March the Chief Secretary, John Biffen, told the Prime Minister that demand for the strategy came from 'journalists, academics and commentators rather than from those in the commercial world'.[99] Belying his own monetarist reputation, Biffen doubted whether there was any mechanistic relationship between the PSBR, the monetary aggregates and inflation. He finished with pointed criticism of his colleague, Nigel Lawson: 'Our monetary policy is still at the stage of apprenticeship. The Financial Secretary, on the other hand, will suggest a certainty about pace and direction that we do not possess, either technically or politically.'[100]

After guiding the proposal through Cabinet, Howe published the MTFS alongside his March 1980 Budget.[101] He also announced that

[93] A. J. Wiggins, 'Note of a meeting held in the Chancellor of the Exchequer's room, HM Treasury at 9.30 am on Friday, 22nd February 1980', 25 February 1980, TNA, T386/528.
[94] A. J. Wiggins, 'Note of a meeting in the Chancellor of the Exchequer's room, HM Treasury on Monday, 3 March at 10.15 am', 5 March 1980, TNA, T386/528.
[95] 'T. P. Lankester to A. J. Wiggins', 10 March 1980, TNA, T386/529. [96] Ibid.
[97] K. E. Berrill, 'Medium Term Financial Strategy', 25 February 1980, TNA, PREM 19/177.
[98] R. T. Armstrong, 'Medium Term Financial Strategy', 26 February 1980, TNA, PREM 19/177.
[99] W. J. Biffen, 'Medium Term Financial Strategy', 4 March 1980, TNA, PREM 19/177.
[100] Ibid. [101] *FSBR 1980–81*.

the 'corset', back in place since 1978, would be discarded for the final time in June 1980. The 'corset''s designers were fully aware that its application had only a cosmetic effect on the £M3 statistics. Quantitative limits simply pushed lending out to the overseas branches of the clearing banks, the wholesale markets and the commercial bill market. Until Howe abolished exchange controls in October 1979, however, there was a limit to how much lending a UK bank could divert to, for instance, its Paris branch. After October 1979 there was no such constraint.[102] Nonetheless, the Bank estimated that £M3 would rise by about 3 per cent when the 'corset' was finally discarded.[103] Howe left open the question of whether the target for 1980/81 would include this 'reintermediation'.[104] Once again, critics were left asking just how strong ministerial monetarist credentials were when they were prepared to write off another 3 per cent of £M3 growth.

Further questions were asked four months later when, despite the latest figures showing the money supply moving out of the target range, Minimum Lending Rate was cut by one percentage point to 16 per cent.[105] The Governor pressed for the cut because 'pressure on the corporate sector caused by high interest rates and the high exchange rate had become too great and needed to be moderated'.[106] The British economy was enduring its worst recession for sixty years. This was partly because of the high price of oil.[107] It was partly because of the 1979 Budget, which shrank the economy with its switch from direct to indirect tax and public expenditure cuts. But it was mainly because of a misconceived monetary policy that, whatever the £M3 figures indicated, was imposing an unprecedented squeeze on British business. The strong pound would soon make Britain a net importer of manufactured goods for the first time

[102] The abolition of exchange controls also effectively ruled out monetary base control. As Goodhart commented in July 1979, any attempt to limit bank lending by squeezing the monetary base in the absence of capital controls would produce offshore disintermediation 'with a vengeance': C. A. E. Goodhart, 'Some notes on Middleton's "negotiable base asset scheme"', 10 July 1979, BOE, C40/1444.

[103] P. E. Middleton, 'The monetary prospect', 7 November 1979, BOE, C40/1448.

[104] HC Deb., 26 March 1980, vol. 981, cc1442–6.

[105] Annualised £M3 growth in the current target period was 11.2 per cent: 'T. P. Lankester to A. J. Wiggins', 3 July 1980, TNA, PREM 19/178. Minimum Lending Rate replaced Bank Rate in October 1972 and tied the Bank's discount rate to Treasury bill rates then prevailing in the market, by taking the rate at the previous weekly tender, adding fifty basis points (one basis point is a hundredth of a percentage point) and then rounding up to the nearest twenty-five basis points.

[106] Ibid.

[107] We cannot simply blame the oil shock. The upper turning point in the United Kingdom's cycle came in May 1979. The US economy (and the rest of the OECD) continued to grow through 1979, briefly contracted in the second quarter of 1980 and entered recession in the final quarter of 1981 as Britain, an oil exporter, was *exiting* its much deeper recession.

since before the Industrial Revolution.[108] Gross domestic product fell by 5.9 per cent in the 1979–80 recession.[109] Manufacturing output shrank by 15 per cent.[110] Manufacturing investment shrank by 26 per cent, and unemployment reached levels not seen since the 1930s.[111]

Despite the risks to the credibility of the MTFS, the Prime Minister and Chancellor agreed to the interest rate cut. As the Governor pointed out, 'The money supply figures on their own would scarcely justify a reduction.'[112] Four months into the MTFS, and the Treasury was engaging in intellectual acrobatics to convince ministers that the strategy was on course: 'The one point reduction in MLR in July was therefore a calculated risk; it was not justified by the monetary situation to date but by the prospects of slower money growth in the future.'[113] But, as Andrew Britton points out, the July 1980 MLR cut meant that 'the retreat from monetarism had begun'.[114]

The authorities narrowly avoided a rout with the publication of the next month's banking figures. £M3 grew by 5 per cent in July. Even adjusting for reintermediation, annualised £M3 growth was 16 per cent, versus the 7 to 11 per cent target range.[115] By focusing media attention on the post-'corset' distortions, the authorities just managed to sail through. But no amount of press briefing could hide the fact that the strategy was off course when £M3 grew by a further 2.9 per cent over the next month. Annualised growth was now 17 per cent, even after adjustments. Lawson concluded that 'our existing techniques of monetary control have failed'.[116] Thatcher reached a similar conclusion after meeting the Swiss economist Karl Brunner while holidaying on Lake Zug. Glossing over the fact that the Swiss had recently suspended their own monetary target, Brunner assured Thatcher that the Bank of England could easily control the UK money supply within a 2 per cent band simply by adopting Swiss techniques.[117] The immediate outcome

108 In January 1981 sterling was 20 per cent higher against a trade-weighted basket of currencies than when the Conservatives took office in May 1979.

109 G. Chamberlin, 'Output and expenditure in the last three UK recessions', *Economic and Labour Market Review*, 4, 8 (August 2010), 52.

110 A. J. C. Britton, *Macroeconomic policy in Britain, 1974–87* (Cambridge, 1991), 49. From its 1979 Q2 peak to its 1982 Q4 trough, manufacturing output fell by 17.6 per cent: Chamberlin, 'Output and expenditure', 54.

111 *Economic trends annual supplement* (London, 1994), 185.

112 'T. P. Lankester to A. J. Wiggins', 3 July 1980, TNA, PREM 19/178.

113 HMT, 'Money supply, interest rates, the PSBR and the exchange rate', 6 October 1980, TNA, T386/545.

114 Britton, *Macroeconomic policy*, 53.

115 P. E. Middleton, 'Monetary policy', 29 August 1980, TNA, T386/543.

116 N. Lawson, 'Monetary policy', 1 September 1980, TNA, T386/544.

117 'K. Brunner to M. H. Thatcher', 10 September 1980, TNA, PREM 19/178.

was a series of bad-tempered meetings with senior Bank officials, followed by two MBC seminars at which the participants would re-rehearse the arguments about the merits of monetary base control.[118] The more important outcome was the transformation of the MTFS into what Sir Samuel Brittan calls the 'Medium-Term Fiscal Strategy'.[119]

The 'Medium-Term Fiscal Strategy'

In his 1980 conference speech, the Director General of the CBI, Sir Terence Beckett, launched an outspoken attack on the government:

> You had better face the brutal fact that the Conservative Party is a rather narrow alliance. How many of them in Parliament or the Cabinet have actually run a business? This matters. They don't all understand you. They think they do, but they don't. They are even *suspicious* of you – many of you – what is worse they don't take you *seriously*. I would not advocate what I am going to say were the cause not noble – we have got to take the gloves off and have a bare knuckle fight because we have got to have an effective and prosperous industry.[120]

On 20 October 1980, after the bellwether Imperial Chemical Industries had warned that it was poised to announce its worst trading results since 1930, the Prime Minister (a former chemist) asked Wass to 'explore ways of mitigating the adverse conditions in which British industry is operating, so that good and viable companies like ICI should not be driven to the wall'.[121] Wass offered a range of options, including lower interest rates, capital controls and a pay freeze. The fiscal options were limited because, despite the autumn forecasts showing that the PBSR outturn for 1980/81 was likely to overshoot the implied MTFS objective by nearly £3 billion (equivalent to 1¼ per cent of GDP), the Cabinet had, the day beforehand, reneged on a July commitment to find a further £2 billion of spending cuts.[122]

The government's response to the distress being felt by British business revealed its new ordering of priorities. With the PSBR overshooting

118 'Summary record of a meeting held at 10 Downing Street at 1800 hours on 3 September 1980', 3 September 1980, Churchill, PREM 19/178; 'T. P. Lankester to A. J. Wiggins', 9 September 1980, TNA, PREM 19/178; 'Monetary control seminar: Church House, 29 September 1980: record of the discussion', TNA, T388/129; T. P. Lankester, 'Note of a meeting between the Prime Minister and foreign participants in a seminar on monetary base control: 1430 hours 30 September at 10 Downing Street', TNA, T388/129.
119 S. Brittan, *The role and limits of government: essays in political economy* (London, 1983), 248.
120 T. N. Beckett, 'Director-General's national conference speech 1980', 11 November 1980, TNA, PREM 19/490 [emphasis in original].
121 D. W. G. Wass, 'Policy options', 5 November 1980, TNA, T386/534.
122 Howe, *Conflict of loyalty*, 189.

its MTFS ceiling, tax cuts for business were ruled out. But £M3 was also overshooting its target range. Nevertheless, Howe plumped for the second of Wass's options: a 'modest' cut in MLR from 16 to 14 per cent. This would reduce the cost of debt servicing and help exports by weakening the pound, 15 per cent higher on a trade-weighted index since the Conservatives took office. But it would require careful explanation. There was simply no way of justifying a two percentage point cut in MLR within the current MTFS framework. So, in the Governor's words, the monetary target was taken 'out of action' until the Budget.[123]

Fiscally, all the Chancellor could do was target the two sectors that were performing well. The 1979 income tax cuts and continuing high wage settlements had produced a large shift of wealth to the personal sector. Howe partially reversed this with a one percentage point hike in employees' National Insurance contributions. The high oil price in the wake of the Iranian revolution meant that the oil industry was generating large profits, so the Chancellor also announced a supplementary petroleum duty. But, since neither of these measures would take effect until 1981, there would be little impact on the PSBR in the current year, then estimated at £11.5 billion (5¼ per cent of GDP) versus the £8.5 billion (3¾ per cent of GDP) forecast in the Budget.[124] It was now clear, however, that the fiscal leg of the MTFS was taking priority over the monetary leg. The government was relieving itself of what Colin Thain calls its 'naïve monetarist baggage'.[125] A more pragmatic approach was required. The money supply had overshot, the PSBR had overshot, the economy was in a policy-induced recession and unemployment was about to break through 2 million. As Britton points out, 'At this stage "the new beginning" introduced by the Conservative government seemed an almost unmitigated failure.'[126]

The 1981 Budget

The origins of the 1981 Budget lay in attempts to mitigate the difficulties companies such as ICI were experiencing as a result of the deliberate

[123] To retain some credibility, the MLR cut was followed by the announcement of three further monetary measures: the phasing out of the reserve asset ratio, a greater role for the market in determining MLR and a new role for the cash ratio observed by the banks. A. J. Wiggins, 'Note of a meeting held at 11 Downing Street on Thursday, 20 November, 1980 at 9.00 am', 20 November 1980, TNA, T386/547.

[124] HC Deb., 26 March 1980, vol. 981, cc1446–9.

[125] C. Thain, 'The education of the Treasury: the Medium-Term Financial Strategy 1980–84', *Public Administration*, 63, 3 (autumn 1985), 283.

[126] Britton, *Macroeconomic policy*, 54.

squeeze on profits, operated through a misconceived monetary policy. Early budget planning focused on ameliorating the situation by transferring resources from the personal sector to the corporate sector. Given the political difficulties of raising income tax rates so soon after the 1979 Budget, this would likely involve only partial indexation of the personal allowances and higher indirect taxes. As William Keegan points out, given Lawson's close involvement with the Rooker–Wise amendment, which had codified indexation in 1977, this 'might have embarrassed a lesser man'.[127] Lawson himself recalls that he 'had no hesitation in supporting this course of action' since indexation, while a presumption, was not automatic.[128]

Potential measures to help companies included the abolition of the employers' National Insurance surcharge (the CBI's preferred option), reduced corporation tax, a reduction of heavy fuel oil duty and relief from local rates. As the Budget approached, however, successive forecasts showed the PSBR significantly overshooting the MTFS-implied £7.4 billion ceiling for 1981/82. Even allowing for the £2 billion of tax rises announced in the November Statement, the winter forecast generated a PSBR estimate of £10.2 billion (4.1 per cent of GDP) for the year ahead – a figure Howe revealed to a gathering of ministers and advisers at Chequers on 17 January 1981.[129] Thatcher was 'not amused'.[130] Any extra revenue coming from the personal sector would now have to go towards reducing the PSBR rather than alleviating corporate distress if the MTFS were to retain any credibility. As Sir Tim Lankester shows in this volume, barring some horse-trading between No. 10 and the Treasury over the exact size of the tax hike, the fiscal lines of the 1981 Budget were set.

The monetary policy lines had been laid down by the decision to reduce interest rates the previous July, and then again in November, despite above-target monetary growth. The decision to further loosen monetary policy was given traction by a report from the Swiss economist Jürg Niehans into the causes of sterling appreciation.[131] Alfred Sherman of the Centre for Policy Studies had commissioned the report by Alan Walters' former Johns Hopkins University colleague in October 1980. On 7 January 1981 Niehans reported his findings to a group of officials and policy advisers. Flatly contradicting the Treasury view that the pound was strong because of North Sea oil, he concluded that the root cause was monetary. £M3 may have been growing well above target, but M0 had

[127] Keegan, *Mrs Thatcher's economic experiment*, 169.
[128] Lawson, *The view from No. 11*, 95.
[129] H. P. Evans, 'Summary of short-term forecasts', 12 February 1981, TNA, T388/197.
[130] Howe, *Conflict of loyalty*, 202.
[131] Niehans, *The appreciation of sterling*, WTRS 1/4.

been *shrinking* in real terms since the middle of 1979. Claiming a link between M0 and the exchange rate, Niehans recommended that interest rates be cut immediately and M0 allowed to expand by 5 to 6 per cent. This, according to Niehans, would allow sterling to fall from $2.40 to a more comfortable $2.15.

Walters, newly arrived as Mrs Thatcher's economic adviser, wrote in his diary that the No. 10 advisers greeted the news that the government had inflicted unnecessary damage on the economy by following the wrong monetary aggregate as a 'bombshell'.[132] The Prime Minister's reaction fell some way short of her 1979 manifesto pledge for 'more open and informed discussion of the Government's economic objectives': 'Told MT about JN's seminar and his findings. MT very defensive: NO ONE must know about it – especially Bank of England. Why? Frightened of calls for relaxation or sops to the wets. Am rapidly learning the political game – never admit to an error.'[133] Walters' colleague in the No. 10 Policy Unit, John Hoskyns, elaborates: 'Niehans' advice was not politically welcome. Despite the diplomatic language in which it was couched, it advocated actions that could be seen as a public admission that the Government had done the economy a great deal of damage by mistake.'[134]

The report bolstered the Prime Minister's view that the principal aim of the forthcoming Budget was to relieve corporate distress by continuing to lower interest rates, without appearing to execute the U-turn that she had so publicly ruled out at the Conservative Party conference the previous October. She hoped to achieve this by lowering the PSBR. This rested on the belief that the lower the deficit, the lower the interest rate. Lawson now admits that this belief is 'largely a fallacy'.[135] He goes on, however: 'Many of us, I confess, believed in it to some extent at that time, but nobody believed in it more strongly than she did.'[136] The intention had always been to attack wage inflation by using tight monetary policy to bear down on company profits. Confirmation that the additional misery heaped upon British business by the high exchange rate was *not* an inevitable consequence of North Sea oil, however, meant that a monetary problem (the strong pound) could now be met with a monetary solution (lower interest rates), albeit via a fiscal route (higher taxes). This would have the added advantage of reducing the corporate debt-servicing burden, since each

[132] A. A. Walters, 'Diary entry', 7 January 1981, Churchill, WTRS 3/1/1.
[133] *1979 Conservative Party general election manifesto* (London, 1979); Walters, 'Diary entry', WTRS 3/1/1 [emphasis in original].
[134] Hoskyns, *Just in time*, 279.
[135] Needham, Oliver and Riley, 'The 1981 Budget: facts and fallacies', 33. [136] Ibid.

percentage point off MLR would reduce the company sector's interest payments by £270 to 300 million.[137]

Niehans may have reinforced the view in No. 10 that monetary policy needed to be further loosened. Lawson claims that, as far as the Treasury was concerned, the report was 'inconsequential'.[138] Certainly, the initial reaction was sceptical, with Middleton branding it 'theology'.[139] Despite Thatcher's prohibition, officials enlisted Bank support to challenge its findings. Goodhart has described the report as 'one of the most important unpublished papers of our times'.[140] This is not to say that he agreed with it. He dismissed its claim to have found causation running from the monetary base to the exchange rate.[141] Similar work by Bank officials had failed to establish any such link, and, given their long campaign against monetary base control, they were reluctant to accept that M0 had much to contribute to exchange rate management.[142] Nonetheless, while they disagreed with Niehans' method, they agreed with his conclusions. Interest rates had to be lowered before more British businesses were unnecessarily bankrupted.

Given its difficult experience with the money supply since the early 1970s, the Bank had been hostile to the monetary leg of the MTFS from the outset. By early 1981 even MTFS cheerleaders within the Treasury were reluctantly coming round to the Bank's long-held views about the limited merits of £M3 targets. In their ongoing search for a stable demand for money function, Treasury economists had recently formulated an equation that showed financial wealth to be the main driver of money balances.[143] Since individuals like to keep their proportion of money to financial assets fairly steady, it was not surprising that, in a year of rapidly rising money incomes (up 18 per cent in 1980/81), the

[137] S. J. Davies, 'Effect of interest rate change on ICC's finances', 24 February 1981, TNA, T386/552; J. R. Lomax, 'Effect of cut in MLR on companies', 25 February 1981, TNA, T386/552.

[138] Needham, Oliver and Riley, 'The 1981 Budget: facts and fallacies', 27.

[139] Upon being told that the strong pound was a consequence of monetary policy rather than North Sea oil, Hoskyns reports that 'Peter's face was a study': Hoskyns, *Just in time*, 256; P. E. Middleton, 'Study by Niehans', 3 February 1981, TNA, T388/200.

[140] Ibid. The paper was published as Niehans, *The appreciation of sterling: causes, effects, policies*.

[141] 'C. A. E. Goodhart to J. R. Lomax', 25 February 1981, TNA, T388/189.

[142] G. Hacche, 'The appreciation of sterling in relation to monetary developments: further equations using M1 and base money', 20 February 1981, TNA, T388/189.

[143] Indeed, Treasury economists concluded that income 'has no role to play'. Elsewhere, Britton suggested that the relationship between £M3 and financial assets was 'new and controversial': A. J. C. Britton, 'The money supply target in retrospect', 13 January 1981, TNA, T388/187; Bennett, 'Direct forecast of the money supply', January 1981, TNA, T388/186.

money supply should have grown by a similar amount. Monetarist orthodoxy stated that this large rise in £M3 would inevitably lead to higher inflation, after the usual time lag. If the personal sector had merely been restoring its real money balances to an equilibrium level, however, then the extra money would *not* lead to an inflationary increase in spending on goods and services. This was the view of the Treasury minister, Lord Cockfield, who argued that 'the growth in the money supply has no implications for the future: its potential for future trouble was exhausted even before it was created'.[144] The extra money was simply an ex post facto validation of increased personal wealth. This was a sizeable blow to the monetarist theory underpinning the MTFS.

The monetarist case was further undermined by the findings of a thoroughgoing Treasury study, which concluded that inflation was *not* simply a monetary phenomenon.[145] As Andrew Britton, then at the Treasury, pointed out, 'The simple account of inflation in terms of monetary growth two years previously, which received a lot of public attention in the mid-seventies, has not stood up well to closer inspection, or to the test of time.'[146] World prices, the exchange rate, indirect taxes, and incomes policies had all made significant contributions to RPI growth.[147] This is what the Conservative Treasury team had assumed in 1975 before the monetarists' Jacobin revolution.[148]

Even Peter Middleton, the Treasury official most associated with the MTFS, was losing his faith:

> The events of the last year or two have called in question the status of £M3 as 'the' money supply. It is difficult to control, either by existing methods or by MBC; its

[144] F. A. Cockfield, 'The money supply and inflation', 21 January 1981, TNA, T386/549.

[145] HMT, 'Report of money supply and inflation research group', 9 December 1980, TNA, T388/195.

[146] A. J. C. Britton, 'Conditionality and money supply targets', 16 January 1981, TNA, T388/187. As former Bank Director William Allen points out: 'The events of 1971–75 appear to have been unique: there is no other episode in UK monetary history in the last century in which broad money gives so accurate a prediction of future inflation.' W. A. Allen, 'Recent developments in monetary control in the United Kingdom', in L. H. Meyer (ed.), *Improving money stock control: problems, solutions, and consequences* (Boston, MA, 1983), 104.

[147] Britton, 'Conditionality and money supply targets', T388/187.

[148] In June 1975 Adam Ridley advised Howe's Economic Reconstruction Group: 'Money, like other commodities, is subject to the laws of supply and demand. It follows directly therefore that a Government cannot have exclusive and total control over the money stock and its deployment.' He went on, '[Inflation] is not determined uniquely by any <u>single</u> one of the unions and monopoly power, expectations, excess demand, militancy, wages, the money supply or the Government. To focus on one factor to the exclusion of the others is to indulge in a dispute which is at best semantically confusing and at worst deliberately misleading.' A. N. Ridley, 'Institutional considerations', 26 June 1975, Churchill, RDLY 2/1/2/2 [emphasis in original].

economic significance is not as clear-cut as it once seemed, and it does not provide a clear guide to short term interest rates.[149]

There was nothing in this statement that the Bank could not have told him nearly a decade beforehand. It made a mockery of Lawson's reference to 'those variables – notably the quantity of money – which are and must be within the power of Governments to control'.[150] It also chimed with the findings of a report by the majority-Conservative Treasury and Civil Service Committee, which concluded, a fortnight before the 1981 Budget, that there was no evidence of causality running from £M3 growth to inflation.[151] The report was particularly scathing of the view that monetary targets could reduce inflation by working on expectations, and called for a more pragmatic approach that relied less on any single monetary aggregate. By this stage, even the Conservative Research Department had given up: 'The fact is that the MTFS, as set out in last year's Red Book, is a shambles whether one takes M3 [sic], Government spending, PSBR, or growth rates, and the publication of precise monetary targets has made political life more difficult than would otherwise have been the case.'[152]

The need to retain political credibility militated against abandoning £M3 targets straightaway. But, with the MTFS target set at 6 to 10 per cent for 1981/82, there was simply no way the eight percentage point overshoot in 1980/81 could be clawed back without plunging the economy even further into recession. The Chancellor would have to point to other factors to explain why he was doing nothing about the overshoot. But, as Middleton explained, '[t]he more successfully we justify that overshoot, the more our *unconditional* commitment to future targets and the precise MTFS path is weakened'.[153] Ministers and officials considered making the £M3 target conditional upon an exchange rate objective.[154] They considered giving £M3 and M1 equal billing. They even considered the Bank's long-preferred option of switching to an M1 target. Unable to reach a consensus, and with the imminent arrival of a new M2 aggregate holding out the prospect of a better alternative, the Treasury

149 P. E. Middleton, 'The money supply target', 29 January 1981, TNA, T386/549.
150 Lawson, *The view from No. 11*, 69.
151 Third report from the Treasury and Civil Service Committee: *Monetary Policy* (London, 1981).
152 C. Mockler, 'Monetary policy', 5 February 1981, Oxford, Bodleian Library, Conservative Party Archive, CRD 4/4/11.
153 Middleton, 'The money supply target', T386/549 [emphasis in original].
154 A. J. Wiggins, 'Note of a meeting held in the Chancellor of the Exchequer's room, on Tuesday, 3 February, 1981 at 3.00 pm', 4 February 1981, TNA, PREM 19/438.

settled on a fudge.[155] In his 1981 Budget, Howe restated the annualised MTFS target range of 6 to 10 per cent £M3 growth over the fourteen months to April 1982, while admitting that he would also monitor the behaviour of M1 and two wider measures of private sector liquidity, PSL1 and PSL2.[156] In the course of his speech, he also mentioned the exchange rate, inflation and house prices as influences over monetary policy, while skating over the question of the previous year’s overshoot by simply stating, without precise commitment, that ‘it may be desirable to recover some of the past year’s high monetary growth in the form of lower growth over the medium term’.[157]

All this would seem to belie the claims of those involved that monetary policy was of secondary importance in planning the 1981 Budget.[158] This is because, despite a series of complicated tactical decisions, No. 10, the Treasury and the Bank were all agreed that monetary policy had to be loosened. The only question was by how much. Anticipating a cut ahead of the Budget, the markets had taken wholesale rates below MLR, creating the room for a one percentage point cut in early February. The Governor and the Chancellor were keen.[159] So too was the Prime Minister, who expressed her clear wish ‘to give industry a boost’.[160] The decision to wait for the Budget was ultimately about salvaging political credibility. As Lawson pointed out to Howe: ‘In political terms the announcement of an MLR cut promises to be the one bull point of your Budget speech, when it ought to be possible to present it in an appropriate monetary and fiscal context. To put in your finger and pull out that plum now would leave the Budget cake very unappetising indeed.’[161] Lawson was referring to the ‘unappetising’ decision, discussed above, to reverse some of the 1979 income tax cuts by (at that stage) only partially indexing personal allowances, and further raising indirect taxes. As Tim Lankester shows, the exchanges between No. 10 and the Treasury over the next fortnight

155 M2 comprised M1 plus UK private sector sterling time deposits with UK deposit banks.

156 PSL1 comprised M1 plus private sector time deposits with a maturity of up to two years, private sector holdings of sterling certificates of deposit, and private sector holdings of monetary instruments (bank bills, Treasury bills, local authority deposits and certificates of tax deposit). PSL2 comprised PSL1 plus private sector holdings of building society deposits (excluding term shares and SAYE), plus National Savings (excluding saving certificates, SAYE and other long-term deposits), minus building society holdings of money market instruments and bank deposits. Hotson, ‘British monetary targets, 1976 to 1987’, 30; *FSBR 1981–82*, 16.

157 HC Deb., 10 March 1981, vol. 1000, c762.

158 Howe, *Conflict of loyalty*, 205; Lawson, *The view from No. 11*, 88.

159 A. J. Wiggins, ‘Monetary affairs’, 12 February 1981, TNA, T386/550.

160 T. P. Lankester, ‘Note for the record’, 13 February 1981, TNA, T386/550.

161 N. Lawson, ‘Minimum lending rate’, 11 February 1981, TNA, T386/550.

concerning the finer details made only a marginal difference to the final package. And any lingering suggestions that the 1981 Budget was 'Made in Downing Street' at the eleventh hour are dismissed by the text of a collective letter of resignation, drafted by the three No. 10 Policy Unit advisers, Walters, Hoskyns and David Wolfson, when they saw the final package:

> We believe the time has now come for your No. 10 advisers to disband and leave Whitehall. The opportunity to turn the UK economy round, presented by the May 1979 mandate has passed… We have had 3 misjudged budgets in a row with no consultation with the colleagues. Even AW has been kept out because he was being 'awkward'. Treasury officials know it's a disaster but, in contrast, they daren't say so.[162]

As Lawson points out, paternity claims over the 1981 Budget arise from the subsequent eight years of economic growth.[163] The mood of the time was very different. It is summed up by the then head of the No. 10 Policy Unit, John Hoskyns: 'For me, and I think for the other Number Ten advisers, the Budget was never some great battle honour to be celebrated in song and legend. We saw it as a Dunkirk, not an Alamein; a narrow escape, the closest we had come to an early end of the Thatcher experiment.'[164]

Conclusions

In the introduction, it was suggested that successful policy implementation requires that all the members of the 'macroeconomic executive' be travelling like ships in a convoy; in the same direction if not always at precisely the same speed. It also requires that each ship's crew have a clear idea of the destination. This was not the case during the two least successful periods of monetary policy in post-war Britain. In 1971 the Bank mis-sold Competition and Credit Control to the Heath government on its supposed competitive merits. In 1980 the Thatcher government bounced the Bank into the Medium-Term Financial Strategy without adequate consultation. The result, in both cases, was above-target money supply growth. In 1972–73 this was followed by higher inflation. In 1980–81 it was not.

Another contrast between these two periods of rapid monetary growth is that, in 1971, the Bank believed it had firm econometric evidence to show that the demand for broad money in the United Kingdom was

162 'A. A. Walters, D. Wolfson and J. L. A. H. Hoskyns to Prime Minister', 3 March 1981, Churchill, WTRS 1/1.
163 Lawson, *The view from No. 11*, 88.
164 Hoskyns, *Just in time*, 283.

stable, predictable and controllable, and that (for the most part) causality ran from M3 to nominal incomes. After CCC, officials knew, once again, that none of this was true. Elsewhere in this volume, Anthony Hotson explains why the Bank’s narrow money equations also broke down in the early 1980s. In 1979, though, the Bank believed it had identified a tolerably robust relationship between M1 growth and nominal income. Why, then, was the MTFS not predicated on M1 targets? The answer lies in the institutional structure that prevailed. The credit counterparts approach suggested that the broad money supply could be influenced by fiscal policy (the PSBR), bank lending to the private sector, and the external accounts. By contrast, controlling M1 is principally about more frequent interest rate changes. This would have meant more interest-rate-setting powers for the Bank – something the politicians and the Treasury were not prepared to countenance until after the ERM debacle in 1992. As the Treasury’s Michael Bridgeman noted in 1977, the Bank was ‘pursuing a dream of being given a monetary target and independent authority to achieve it, and against this background M1 had definite advantages for them’.[165] Conservative ministers’ mistrust of the Bank prevented them from choosing monetary targets they might have been able to hit.[166]

Failure to engage with the Bank on the MTFS produced a policy with two fundamental flaws in 1980. First, despite the failures of Competition and Credit Control, more active monetary policy had re-emerged as an adjunct to incomes policy in 1975. After the ‘winter of discontent’ the broad money supply target had to fill the role it had previously shared with a wage norm between 1975 and 1979. As we have seen, it was not up to the job. A policy based on credibility and managing expectations relied on the government actually hitting its targets, and, as the Bank, the Chief Secretary, the Permanent Secretary, the Cabinet Secretary and the CPRS warned in 1980, this was not likely to happen with £M3.

Second, if minsters had engaged with the Bank, they would have known that the primary purpose of the M3 target imposed on Healey in July 1976 was fiscal rather than monetary. It was ‘a tighter rope round the Chancellor’s neck’ on public expenditure. This also went to the heart of the Bank’s objections to monetary base control. As Goodhart pointed out in July 1979, quite apart from the lack of econometric evidence linking M0 growth to nominal incomes,

165 K. V. Watts, ‘Note of a meeting held in Sir Douglas Wass’ room at 3.15 pm on Wednesday, 9 November’, 10 November 1977, TNA, T386/269.

166 Thatcher referred to Richardson as ‘that fool who runs the Bank of England’, while Lawson makes the extraordinary suggestion that the Bank ‘had never at that time taken monetary policy very seriously or. . .thought deeply about it’. Moore, *Margaret Thatcher*, 462; Lawson, *The view from No. 11*, 17, 83.

> The ability to control the growth of the quota regulated monetary aggregate [M0] would relax the present monetary discipline on the authorities, allowing them to run higher PSBRs and keep MLR down, 'secure' in the knowledge that quota restraint was keeping £M3 on track. It could encourage a considerable degree of comfortable self-deception among the authorities.[167]

Money supply targets in the late 1970s were primarily about restraining the spending ambitions of the Labour government. Before the emergence of the Social Democratic Party and victory in the Falklands, this was an issue that might have re-emerged after the 1983 general election. But few doubted the Thatcher government's desire to reduce the PSBR. There was little need to influence fiscal policy by the monetary policy back door. By failing to engage with the Bank, Conservative ministers selected the wrong target. This had profound consequences for British economic performance in the early 1980s.

We must consider the possibility that minsters were perfectly aware that there was no robust relationship between £M3 growth and inflation, and that money supply targets were simply 'cover' for tough deflationary action.[168] After all, this was the approach taken by Paul Volcker at the Federal Reserve. In 1978 Volcker saw 'no need to accept as complete, or even adequate, a simple causal explanation running from monetary behavior to price behavior'.[169] But he was quite prepared to use monetary targets as cover for a deflationary squeeze. Lawson commented privately in the 1970s that 'the conditions for monetarism in Britain do not exist'. When asked what they were, he replied: 'Water cannon.'[170] Cockfield was certainly under no illusions about the monetary transmission mechanism: 'Control of the money [supply] operates through the simple but brutal means of butchering company profits. Ultimately insolvency and unemployment teach employers and workers alike that they need to behave reasonably and sensibly.'[171]

Nonetheless, subsequent comments by ministers, officials and advisers show that we should take their public statements about monetarism at the time at face value. Looking back on the MTFS, Lawson quotes Robert

167 Goodhart, 'Some notes on Middleton's "negotiable base asset scheme"', C40/1444.
168 Wass commented in November 1980 that 'nor can it be argued that business conditions as they have evolved this year are very much worse than we expected when we set the current targets and formulated the MTFS': Wass, 'Policy options', T386/534.
169 P. A. Volcker, 'The role of monetary targets in an age of inflation', *Journal of Monetary Economics*, 4, 2 (April 1978), 330.
170 Quoted by R. K. Middlemas, 'Margaret Thatcher, 1979–1990', in V. B. Bogdanor (ed.), *From new Jerusalem to new Labour: British prime ministers from Attlee to Blair* (Basingstoke, 2010), 151.
171 Cockfield, 'The money supply and inflation', T386/549.

Burns: 'The best laid schemes o' mice an' men/Gang aft a-gley.'[172] Middleton has commented that 'having a target and missing it turned out to be quite a good policy. It allowed for flexibility.'[173] And Hoskyns writes that 'the excessive monetary squeeze of 1979–81 [was] an embarrassing error and. . .the Government's most difficult and unpopular action in its first term, the 1981 Budget, [was] designed to correct it'.[174] As Christopher Collins explains in this volume, the fiscal tightening of the 1981 Budget helped to provide 'cover' for the unwinding of the monetarist experiment.

In October 1980 Thatcher declared 'the lady's not for turning'. Five months later, having already taken the money supply target 'out of action', her Chancellor executed a brisk U-turn on monetary policy. By this stage it was clear that monetary policy was being driven at least as much by the exchange rate as by the money supply. In June 1981 Lawson sent Howe a note extolling the virtues of British membership of the European Monetary System, the policy that would reach its full expression with Britain's ill-fated membership of the Exchange Rate Mechanism after 1990.[175] In his March 1982 Budget, Howe formalised the shift away from £M3 targets by introducing targets for M1 and PSL2. He also raised the remaining £M3 target by three percentage points, again with no attempt to claw back the 3.7 percentage point overshoot in 1981/82. This enabled the Conservative government, in 1983, finally to hit one of its (revised) £M3 targets. At Thatcher's suggestion, signed charts were produced to commemorate the event.[176] The Bank's Chief Economist, Christopher Dow, assumed that this was a joke.[177] It was not.

After the 1983 general election, Howe was succeeded as Chancellor by Lawson, who, after briefly suspending his broad money target in October 1985, published his final – 11 to 15 per cent – £M3 target range in March 1986.[178] But, as Christopher Johnson remarks,

> In March 1986 £M3 was dragged out of its coffin for a last death-ride. Unlike El Cid, riding dead in the saddle at the head of his troops to his final victory, it impressed nobody.[179]

[172] Lawson, *The view from No. 11*, 72.
[173] Quoted by P. F. C. Stephens, *Politics and the pound: the Tories, the economy and Europe* (London, 1997), 34.
[174] Hoskyns, *Just in time*, 391. [175] Lawson, *The view from No. 11*, 111.
[176] Howe, *Conflict of loyalty*, 282.
[177] Hacche and Taylor, *Inside the Bank of England*, 216.
[178] The M1 and PSL2 targets were replaced by M0 in 1984.
[179] Johnson, *The economy under Mrs Thatcher*, 55.

Within a year Lawson was shadowing the deutschmark, the policy that presaged Britain's brief and unhappy membership of the ERM.[180] In 1988 Middleton wrote: 'Monetary policy. . .has assumed the role for which it is best suited: the achievement of whatever goals are set for nominal demand.'[181] The authors of the Radcliffe Report would have recognised this twin focus on the exchange rate and demand management. Monetary policy had come full circle. It was almost as if the monetarist 'revolution' had never happened.

[180] 'Monitoring ranges' for M0 and M4 remained in place until 1997 but were relatively unimportant to the conduct of monetary policy.

[181] Middleton succeeded Wass as Permanent Secretary in 1983: P. E. Middleton, 'Economic policy formation in the Treasury in the post-war period', *National Institute Economic Review*, 127, 1 (February 1989), 50.