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CHARACTER ISSUES

364 Economists on Economic Policy

GEOFFREY WOOD*

[Abstract](#), [Keywords](#), [JEL Codes](#)

IN 1981, 25 YEARS AGO, THERE WAS A REVOLUTION IN BRITISH economic policy. Completely rejecting the conventional wisdom which had dominated the post-war years, the government then in office tightened fiscal policy in the depths of a recession and committed itself to using monetary policy to reduce and then control inflation. Three hundred and sixty four economists, mostly academic, but with five retired senior government advisers among them, then signed a letter to the *London Times*. It was very hostile to these economic policies, which were proposed by the first administration led by Mrs. Thatcher, who had taken office as Prime Minister in 1979.

Engagement in policy debate of a large number of “public intellectuals,” is not common in Britain. (364 signatories is perhaps the equivalent of 1500 signatories in an American context.) Policy benefits from open debate. More interventions would certainly be desirable. But whether intervention in the form of a letter with so many signatories is a good way of intervening is considered briefly in the concluding section of this paper.

* Department of Economics, Cass Business School, London, and Visiting Professorial Fellow in Commercial Law, University of London.

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The letter is reproduced here.

"We, who are all present or retired members of the economics staffs of British universities, are convinced that:

- a) there is no basis in economic theory or supporting evidence for the Government's belief that by deflating demand they will bring inflation permanently under control and thereby induce an automatic recovery in output and employment;
- b) present politics will deepen the depression, erode the industrial base of our economy and threaten its social and political stability;
- c) there are alternative policies; and
- d) the time has come to reject monetarist policies and consider urgently which alternative offers the best hope of sustained recovery."

1981: THE TIME OF THE LETTER

What prompted the letter? In 1981 the British economy was undoubtedly beset with problems. Sir Geoffrey Howe, then Britain's Chancellor of the Exchequer (that is, minister of finance), gave a public lecture just two months after the publication of the letter. When the lecture was republished in 2001, he added a postscript (Howe 2001). A quotation from that postscript sets the scene well. "The 'fight against inflation,' which had peaked at 22 percent [during 1980], was indeed of the highest importance" (53). That sentence describes perfectly the belief which

pervaded his 1981 budget. His original 1981 lecture well describes how policy participants in that year saw the situation:

The average rate of inflation under successive governments in the years to 1979 has marched remorselessly upwards: 3.5 percent, 4.5 percent, 9 percent, 15 per cent. Meanwhile, unemployment also rose: 300,000, half a million, three-quarters of a million, one and a quarter million. (Howe 2001, 43)

Then he went on to explain why his budget policy had been determined as it had:

All kinds of shocks can affect prices in the short run . . . but to control inflation on a permanent basis it is necessary to control the rate of monetary growth In short, if the underlying causes of inflation are not tackled a policy of price control can only check price rises for a short time. (Howe 2001, 44-45)

Next he cited evidence from other countries in support of his views, and remarked how previous British governments, Labour governments, had carried out policies that they could defend only if they shared his view on inflation. He also cited previous experience to illustrate that one could not control domestic monetary conditions without letting the exchange rate move as necessary for these monetary conditions to be achieved.

So far, he was close to what is nowadays conventional wisdom in Britain—at least among those who work on this area of policy—and were in 1981 close to the mainstream of U.S. economic opinion. We come next, however, to something which needs to be explained in its institutional context—what he called “Supporting Policies.” He wrote that “fiscal policy must be compatible with our monetary policy” (48). By “compatible” he covered a range of connections.

Experience shows that it is virtually impossible to finance an excessive public sector deficit without adding to the money supply. Even were it possible, it could jeopardise success against inflation by adding to nominal incomes or precipitating a fall in the exchange rate. Excessive public borrowing could also, in some circumstances, increase the

transitional costs of reducing inflation. The high interest rates which might be necessary to finance an excessive PSBR [Public Sector Borrowing Requirement—the name by which the consolidated borrowing of the British government was at that time known] would bear most heavily on companies, leading to reductions in investment and stockbuilding. If this more than offset the direct effects on aggregate demand of the PSBR itself, there would be higher unemployment in the short run as well as a weakening of growth prospects in the long run. (Howe 2001, 48)

Intertwined here are several factors. The one which requires explanation at this point is his concern over financing deficits without money creation. It is well known that behind almost every very rapid inflation were large deficits leading to money creation (Capie 1986), but such problems have tended to emerge in much more extreme economic and political circumstances than Sir Geoffrey Howe was describing. The common problem up to 1981 had been that governments (which still instructed the Bank of England on interest rates) were often unwilling to vary interest rates sufficiently to sell debt to finance their expenditure. This reluctance led to monetary accommodation of government spending. Thus, while what concerned Sir Geoffrey Howe was not *necessarily* a problem in his circumstances, institutional practices made it likely that it would be.

That, then, describes the intellectual background to the policies he carried out. What were the actual policies, and what were their outcomes? In the 2001 postscript Howe wrote:

Targets for progressive reduction in the rate of monetary growth had been set, as required, for the second and third years of my Medium Term Financial Strategy.¹ Notwithstanding the depth of the recession we were experiencing, I had proposed substantial tax increases to reduce public sector borrowing to levels consistent with the lower monetary targets. All hell had broken loose. (Howe 2001, 53-54)

¹ That was the practice of announcing targets for money growth and public sector borrowing for several years ahead.

This “hell” included the above-mentioned letter with 364 signatories Sir Geoffrey continues, with understandable satisfaction:

Their timing (i.e. of the letter) could not have been more apt. The fall in national output came to an end in that very quarter. Over the next eight years, real GDP grew by an average of 3.2 per cent per annum...By the end of my last year in the Treasury (June 1983) all the measured monetary aggregates were for the first time ever within their target range and inflation was down to 5 per cent – lower than at any time since 1970. (Howe 2001, 54)

It is now almost time to turn to the criticisms expressed by the 364 signatories. But two matters remain.

First, I have mentioned that nowadays the views expressed in 1981 by Sir Geoffrey Howe are in the policy mainstream in Britain, and were in the United States back in 1981. But in Britain in 1981 the cost-push theory of inflation was common. Academic economic opinion by and large maintained that only incomes and prices policies could deal with inflation. According to some the Phillips curve provided a long-run trade-off. These views were certainly not held universally, however. For example, when I started my graduate studies (at the University of Essex, in 1967) the textbook we used in the introductory macroeconomics course was Martin J. Bailey’s *National Income and the Price Level*. The views of Sir Geoffrey Howe, with monetary policy changes being in the long-run neutral but having short-run real effects, can be found in that book. So, too, can much of the analysis of the short-run effects of fiscal policy that is implicit in Howe’s words quoted above. I disagreed with the views of the 364 at the time² and do today; but why their opinions on inflation remained so common in Britain is a puzzle to me still.³

² I was moved to write an article, “Can 364 Economists be wrong?”, which appeared in *Economic Affairs*. This article, along with the original letter, a list of its signatories, and additional commentary, is to be published by the Institute of Economic Affairs in March 2006 (Booth 2006).

³ What the views on inflation of academic economists are in Britain nowadays it is not really possible to say. Interest in and discussion of the subject have both fallen with the inflation rate. What discussion there is accepts a monetary view; but the discussion is primarily among central bankers charged with controlling inflation by use of monetary policy, and economic historians, who have in general always been sympathetic to monetary explanations.

Second, while what Sir Geoffrey Howe wrote is in no way misleading, it is a series of snapshots. It may be useful to have a table showing the performance of the British economy from 1973 to 1984.

Table 1: UK Economic Aggregates, 1973-1984

	GNP Growth % pa	Inflation % pa	Unemployment %
1973	7.3	9.18	1.9
1974	-1.7	15.98	1.9
1975	-1.1	24.11	2.9
1976	2.6	16.77	3.9
1977	2.6	15.89	4.1
1978	3.0	8.28	4.1
1979	2.6	13.35	3.8
1980	-2.3	18.07	4.8
1981	-1.6	11.59	7.6
1982	2.0	8.66	9.0
1983	3.2	4.61	9.9
1984	2.4	4.96	10.1

Sources and Definitions: Column 1. UK Accounts 'Blue Book,' 1985: Rates of change of GDP at constant factor cost. Column 2. Datastream: UK Retail Price Index, % pa. Column 3. Datastream: Claimant Count Measure of those registered for unemployment benefit.

Table 1 shows for 1973 to 1979 the GDP slowdown followed by acceleration, and the reverse pattern taken by inflation. It can also be seen that through 1984 unemployment remained high, (although it did subsequently fall). The phenomenon of income recovering from recession while employment fails to do so even with a substantial lag is not unique to Britain. It is, for example, a problem that Finland still faces after its 1992 recession. Whether the policies of the 364 might have achieved a faster fall in unemployment is considered briefly below.

THE VIEWS OF THE 364

The letter's four paragraphs of comments are best reviewed in the order they appear.

- (a) "There is no basis in economic theory or supporting evidence that by deflating demand they [i.e. the government] will bring inflation permanently under control and thereby induce an automatic recovery in output and employment."

This paragraph requires perhaps decoding rather than just reading. What is meant by "deflating demand"? Certainly reading the Budget at the time, and looking at the Geoffrey Howe quotations provided here does not suggest that the Thatcher government intended to reduce demand permanently so that the price level would fall without limit. Nor did they aim for a temporary squeeze, followed by return to excess monetary expansion. What the Thatcher government plainly intended was monetary control so as first to reduce inflation and then keep it at a tolerable level. As it turned out, the weight they placed on money supply measures to guide to monetary policy turned out to be perhaps greater than the measures could bear. Long-established relationships between money growth and future inflation suddenly seemed not as reliable as they had been—indeed, this is implied by Sir Geoffrey Howe's quoted remark that money growth was within its target ranges "for the first time ever," at the same time that inflation had fallen more or less as planned. But the government did pursue monetary stringency and inflation did fall. In recent years the Bank of England has had sole responsibility for controlling inflation, and has done so. Monetary policy is the only policy the Bank can implement. This observation alone suggests that monetary policy is what matters for inflation. But if anyone wished to look further, they could look at the numerous studies of the long run relationship between money and prices.

What about the claim that the 364 attribute to the policy makers, that deflating demand will control inflation "thereby inducing an automatic recovery in output and prices"? The criticism is puzzling. Unless continual monetary shocks are administered to an economy, eventually money will become a "veil," with real economic performance determined by numerous other factors. Once the rate of change of prices has stabilised, output and unemployment would tend to revert to their long-run level, whatever that

was.⁴ There is neither theory nor evidence to suggest that stopping inflation depresses demand forever.

So, to summarise, if point (a) is decoded as meaning that stopping inflation requires permanent recession, there is, in the words of the letter, “no basis in economic theory or supporting evidence” for the proposition.

(b) “Present policies will deepen the depression, erode the industrial base of our economy and threaten its social and political stability.”

The assertion certainly does not look too good in retrospect. Indeed, one might argue that the policies restored social and political stability. The years of high inflation had been years of accelerating wage claims, and attempts to resist these in the public sector had led to increasing economic and social disruption. These culminated in the winter before Mrs. Thatcher’s 1979 election victory. In that winter, which became known as the “Winter of Discontent,” bodies were left unburied.

What about the “industrial base”? Here, too, there is lack of clarity. Did the signatories mean manufacturing industry? That has on average been falling as a share of Britain’s output since the 19th century. If the production of services qualifies for membership of the “industrial base,” then it should be noted that service industries are thriving. But of course, most important of all, output per head has been rising.

(c) “There are alternative policies.”

To that elliptical statement, one is tempted to respond, “no doubt,” and leave it there. But one can go a little further. High wage claims and high wage settlements characterised Britain’s years of high inflation. Wage claims remaining high despite falling inflation might have been a factor in the employment-recovery lag. But what policy could deal with this? Controls over incomes, perhaps supplemented if only for political reasons by controls over prices, might appear to be a possibility; but a recent study in the *Scottish Journal of Political Economy* (Capie and Wood 2002) found that such controls in the UK had a systematic effect on prices only in wartime, when they were supplemented by a complex rationing system.

⁴ Multiple real equilibria are possible in theory, but this possibility can not affect the conduct of monetary policy, for one could not know in advance of being there where these equilibria were, or how monetary policy could move an economy from one to another.

It is also worth reflecting whether, without the fiscal squeeze, there would have been a faster recovery in output and employment. This is a possibility; but there are reasons to doubt it. Britain had at that time a floating exchange rate, which at the least diminishes the effect of fiscal policy.⁵ Second, the recovery in output was already rapid, and, as remarked above, Britain is not the only economy to have experienced what is sometimes called a jobless recovery. Last, and perhaps most important, in view of the reluctance to vary interest rates so as fully to cover government deficits by debt sales, a laxer fiscal policy might indeed, as Sir Geoffrey Howe feared, have undermined monetary policy.

(d) “The time has come to reject monetarist policies and consider urgently which alternative offers the best hope of sustained economic recovery.”

The trouble with that statement is, of course, that monetarist policies were, and are, based on sound theory and evidence, if at least one regards monetarist policies as the use of monetary policy to control inflation. It is hard to see how the signatories of the letter could think otherwise; monetarism, whatever its theoretical novelty to the letter’s signatories, was not new to them in practice. The UK had ample experience in the use of monetary policy. It just happened to be monetary policy of excessive ease. The most notable had been the monetary promiscuity of the last Conservative government to precede Mrs. Thatcher’s 1979 administration. That government, led by Edward Heath and with Anthony Barber as Chancellor of the Exchequer, had pursued a very easy monetary policy and thus given Britain its greatest peacetime inflation since the reign of Henry the Eighth.

⁵ This diminution is consequence of the interaction of interest rate and exchange rate movements that is explicated in the well known Mundell-Fleming framework. That effect is of course aside from the other qualifications to the effectiveness of fiscal policy, which hold regardless of the exchange rate regime.

CONCLUDING REFLECTIONS

Was there behind the letter a belief that inflation did not matter? It is undeniable that the effects of inflation on growth rates of output, when inflation is below about 10 percent per year, are in the short run not easy to measure. They do, however, seem to accumulate over time (Barro 1996). It is also undeniable that higher inflation does not buy us a higher level of output forever.

Further, people seem to dislike inflation. Economic theorists may say that they are foolish so to do; but it is not clear that economic theorists are entitled to tell people what their tastes ought to be.

Why, then was the letter written, and written so vaguely? The second part is easier to answer; the vaguer a statement is, the harder it is to object to. The desire for a large number of signatures may have led to a vague document. If that is the case, then perhaps such letters are not a good way of getting academics involved in policy debate. A large number of signatories reduces the individual cost of being wrong, so people may think less carefully about what they are doing, or be more susceptible to peer pressure. In addition, the vagueness necessary to get so many signatories does little for the credibility of academic economists as contributors to policy debate.

Why was the letter written at all? It is clear that there could be, within the standard analytical framework that plainly was behind the budget, dispute over whether the time was appropriate for a fiscal contraction, and if so, how big the contraction should be. But the letter went much wider in its criticisms. To repeat, I find it puzzling why the signatories held the views they did. At the time I thought the letter's assertions wrong, and I still think them wrong. In that I rest not on what has happened since the letter appeared—although by and large that supports my view—but on the preceding centuries of economic theorising and economic history.

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ABOUT THE AUTHOR

Geoffrey Wood is Professor of Economics at Cass Business School, London, and Visiting Professorial Fellow in Commercial Law at the University of London. In the past he has worked in the Bank of England and in the US Federal Reserve System. He has acted as an adviser to the New Zealand Treasury. He has published twelve books and over a hundred professional papers in the fields of banking, monetary policy, and regulation. Recently he has written extensively on monetary history, primarily of the UK. For the Institute of Economic Affairs he has written several monographs, and he contributes regularly to the Institute's journal *Economic Affairs*. His original article on the 364 economists, which is to be reprinted by the IEA in March 2006, first appeared *Economic Affairs* in 1981.