Bank of England

“Muddling Through or Tunnelling Through?” UK monetary and fiscal exceptionalism during the Great Inflation

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Motivation of the paper

- History can be a useful guide to today's episode of high inflation.
- The UK experience of the 1960s and 70s was one of the worst of the advanced countries and understanding its complexities may be of value to today's policymakers.

UK experience in Great Inflation was different than the US experience

- Why was the UK experience so different ?
- Was fiscal policy as well as monetary policy the cause ?
- UK fiscal exceptionalism?

What ends periods of high but moderate inflation ?

- Does ending high inflation normally require fiscal consolidation ?
- How do old and new "fiscal theories of inflation" square with this ?
- Do inflation expectations depend on the combined monetary-fiscal regime ?

Fiscal policy and deficits appear to be at the heart of UK problems during the Great Inflation

Britain's difficulties in the 1970's arise from ill-designed policies based upon long and widely held misconceptions about how the economy works. The basic error committed has been to neglect to control the money supply while pursuing an unrealistically low unemployment target, primarily by fiscal means

David Laidler, American Economic Review 1976

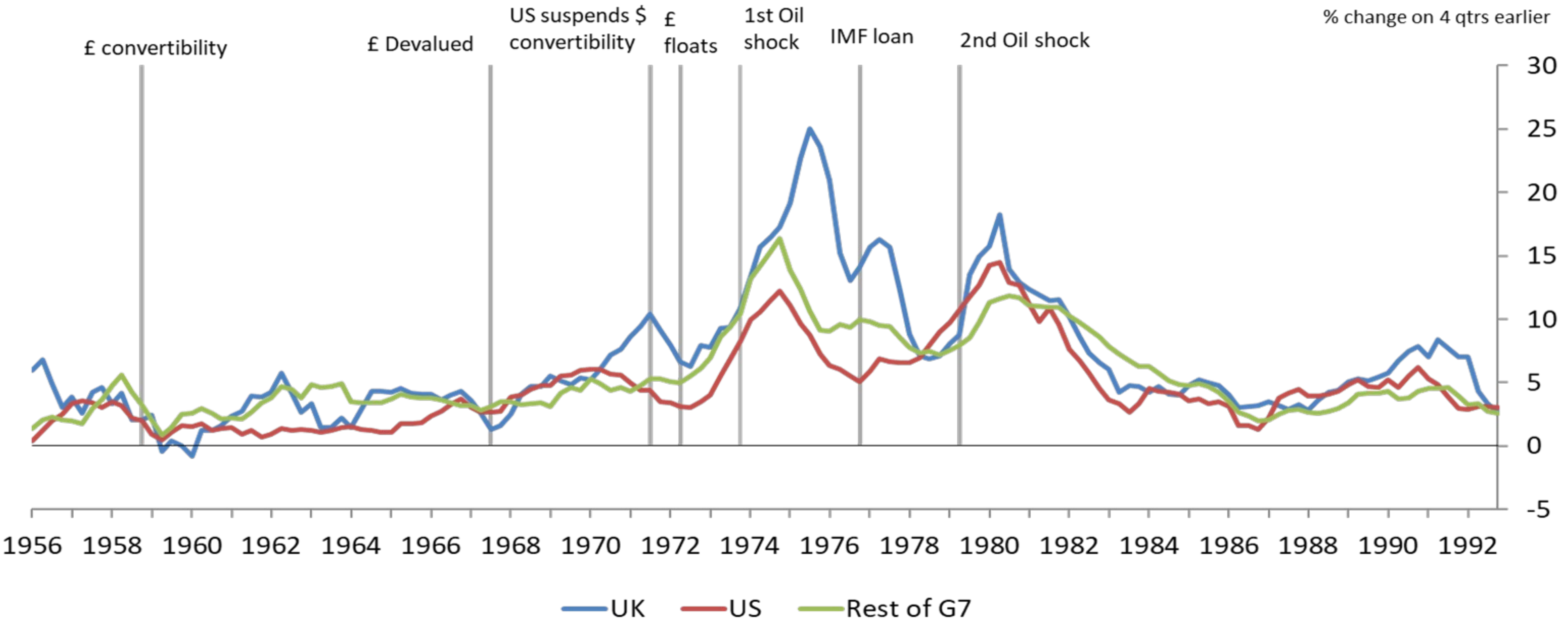
Whether the budget was in balance or had a surplus or deficit was a secondary consideration (indeed for some policy makers it was of virtually no importance).

Douglas Wass, Permanent Secretary to the Treasury 1974-1982 writing in 2008

....the historical evidence provide(s) little reason for being optimistic about the efficacy of a plan for gradual monetary restraint which is simultaneously soft on the government deficit.

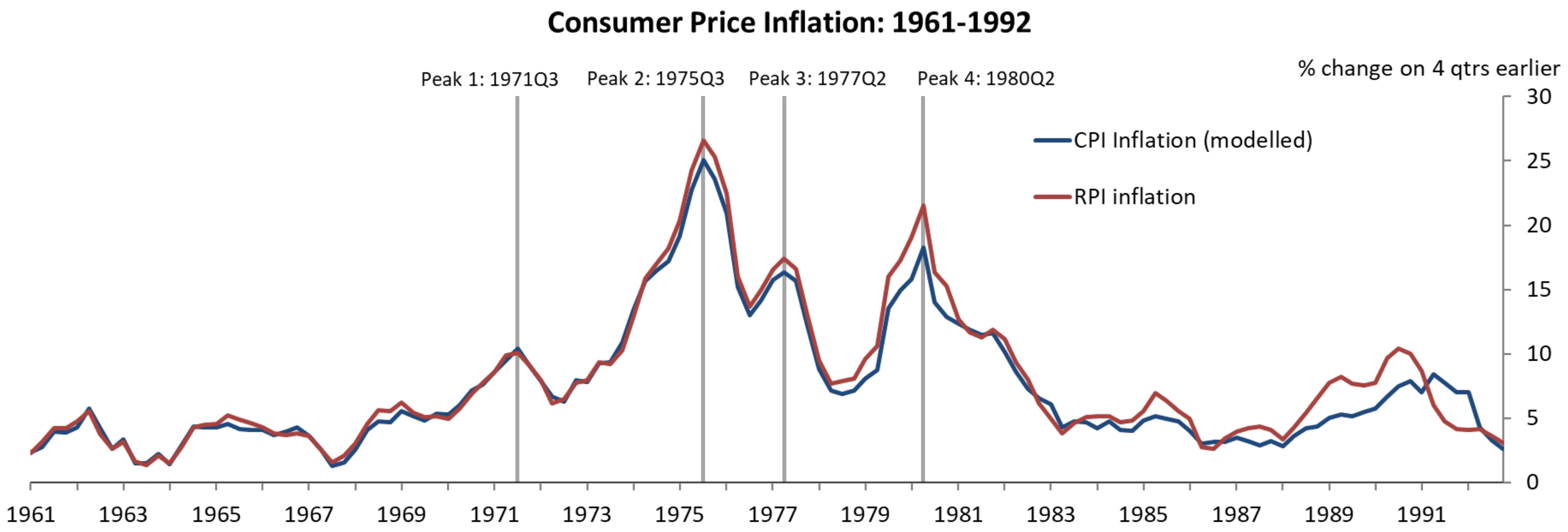
Thomas Sargent, *Stopping Moderate Inflations*, 1981

Great Inflation - the UK compared to US and other G7



- Similar experience following 2nd oil price increase and Volcker disinflation in early 1980s
- Four prominent peaks of double inflation during the 1970s/80s
- But why so different to US and other G7 in the1970s ?

Several "bursts" in UK inflation – Rollercoaster pattern



- Four prominent peaks of double digit inflation during the 1970s/80s
- Inflation picks up quickly, but also falls back quickly

Narrative Summary: Phases of UK Inflation

1. **1960s-1971** Inflation rises from 2% to 10%

- Domestic Go-stop polices, plus imported inflation from US under Bretton Woods ?
- Declining supply-side performance and wage explosion

2. **1971-1973: Another bout of Go-stop**

- Barber boom in fiscal policy, monetary policy passive
- Collapse of Bretton Woods (1971) removes BOP constraint, £ depreciates
- Competition and Credit Control: liberalization of banking (1971), money and credit explosion
- Secondary Banking Crisis, "Corset" scheme forces temporary "stop"

3. **Accommodation of supply shocks, 1973-1975**: inflation rises from 10% to 25%

- Unions and incomes policy, leads to real wage resistance: but real interest rates negative

4. **IMF Crisis, 1976-1977**: high inflation and currency crash

- Fiscal reforms and moral suasion on wages (social contract)
- Inflation rebounds consequent upon sterling collapse

5. **1978-1985**: Second OPEC shock, Winter of Discontent and reform

- Tighter monetary policy: Medium Term Financial Strategy, fiscal policy plays a key part
- Thatcher breaks public sector unions

Key Takeaways

- Interaction of monetary, financial and fiscal policy had important implications for inflation expectations, financial market prices and wage determination in labour market

- Large fiscal and current account deficits and double-digit inflation suggest major policy failures
  - Fiscal policy was the key instrument used to manage aggregate demand before 1976
  - The BoE was not independent and it was fiscal policy as much as monetary policy that appears important in both the run-up and ending the Great Inflation through three major consolidations in 1976, 1981 and 1993/4
  - Large unexpected budget deficits arose out of subsidizing energy price increases, large public sector wage settlements and government spending plans set in volume terms
  - In part these were funded by the banking system, increasing broad money growth
  - Financial markets believed unsustainable deficits and faster money growth would increase inflation leading to the IMF crisis 1976

- Evidence fiscal policy was more active and monetary policy more passive than they are today

- Resonant with modern fiscal theories of inflation such as Sargent and Wallace Unpleasant Monetarist Arithmetic (1981) and FTPL (Leeper (1991), Cochrane (2022)

Key hypotheses for the UK similar to US story

- **Bad policy**
- Poorly-timed “Go-stop” policies continue into 1970s – **Old Keynesian critique**
- Monetary neglect – money supply growth – **Monetarist critique**
- Monetary and fiscal policy over-accommodate cost push shocks – **New Keynesian critique**
    - over-optimistic on potential supply
    - government reluctant to raise interest rates in response to shocks, Taylor principle violated
- Poorly-designed prices and incomes policies were de-stabilizing – **“Cost push” critique**

- **Bad luck**
- Declining UK supply-side and tradable performance
- Collapse of Bretton Woods, UK loses its nominal anchor
- Commodity price shocks
- Wage push shocks – unionization/rising NAIRU/real wage resistance

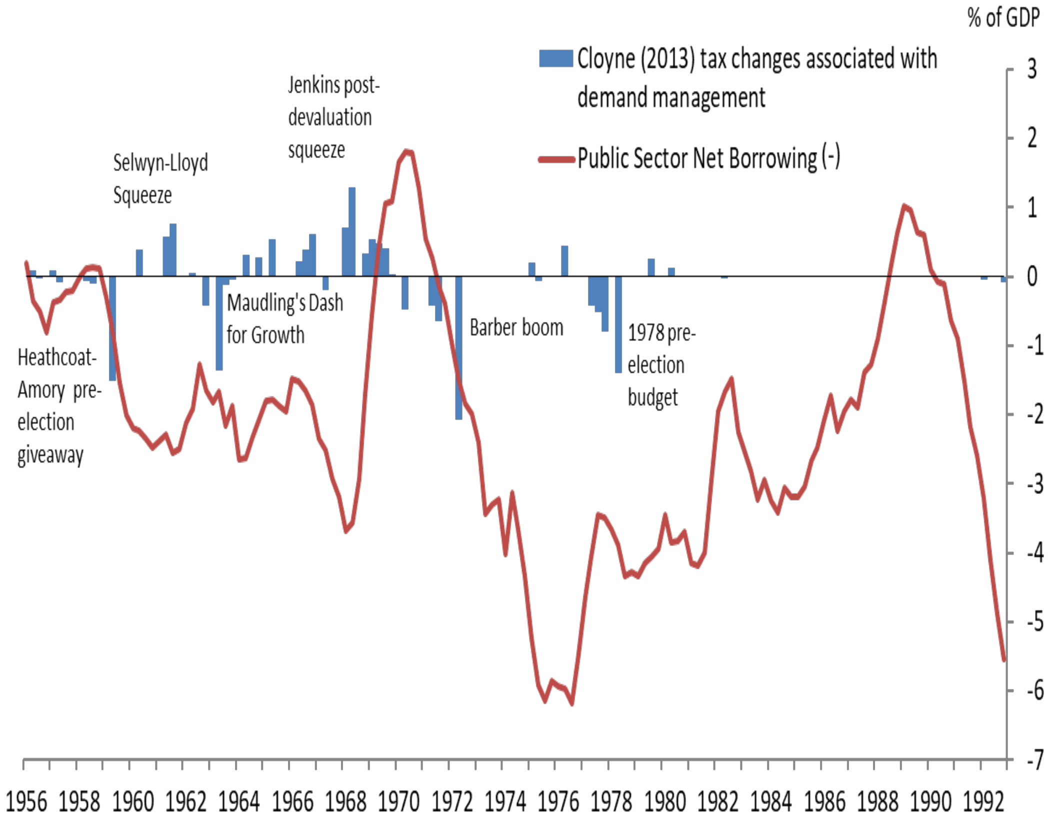
Bad policy - Theoretical and empirical underpinnings of Go-Stop

- **Post war-consensus on maintaining 'full' employment given the experience of the Great Depression – fiscal stabilization policy**
  - Fear of unemployment and labor power in both political parties. Unions to cooperate
  - Called Butskellism after Chancellor R.A. Butler (Tory), Hugh Gaitskell (Labour)
    - Phillips curve tradeoff
- **Developed into a more dynamic theory of how to achieve faster growth**
  - Verdoorn's Law/Kaldor – faster growth in manufacturing increased productivity through economies of scale
  - Harrod's theory of growth suggested running the economy "hot" to achieve high investment ratio

- **Misguided belief fiscal policy and demand stimulus could achieve faster growth**
- Monetary policy downgraded based on Radcliffe report (1959): Direct controls on credit, liquidity controls rather than interest rate policy. Monetary policy to accommodate fiscal, BoE follows policies similar to US. 'Even Keel,' to keep interest rates low to fund gilts. Worked through discount window and commercial banks.

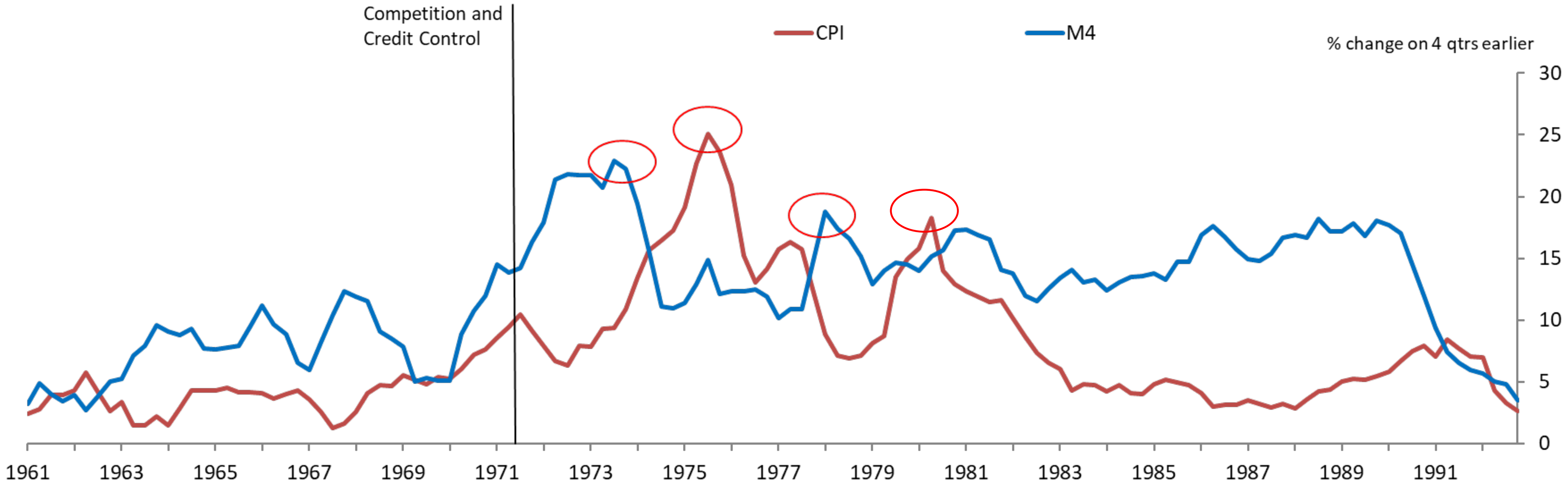
- **Before 1971:** Bretton Woods constraint would mean most of these attempts led to BOP deficit and "stop" phase in policy to maintain peg
- **After 1971:** future attempts to boost growth would lead to depreciation and inflation

Bad policy: Go-stop cycle from 1950s and 1960s continues into 1970s with Heath U-turn and Barber Boom of 1972-73



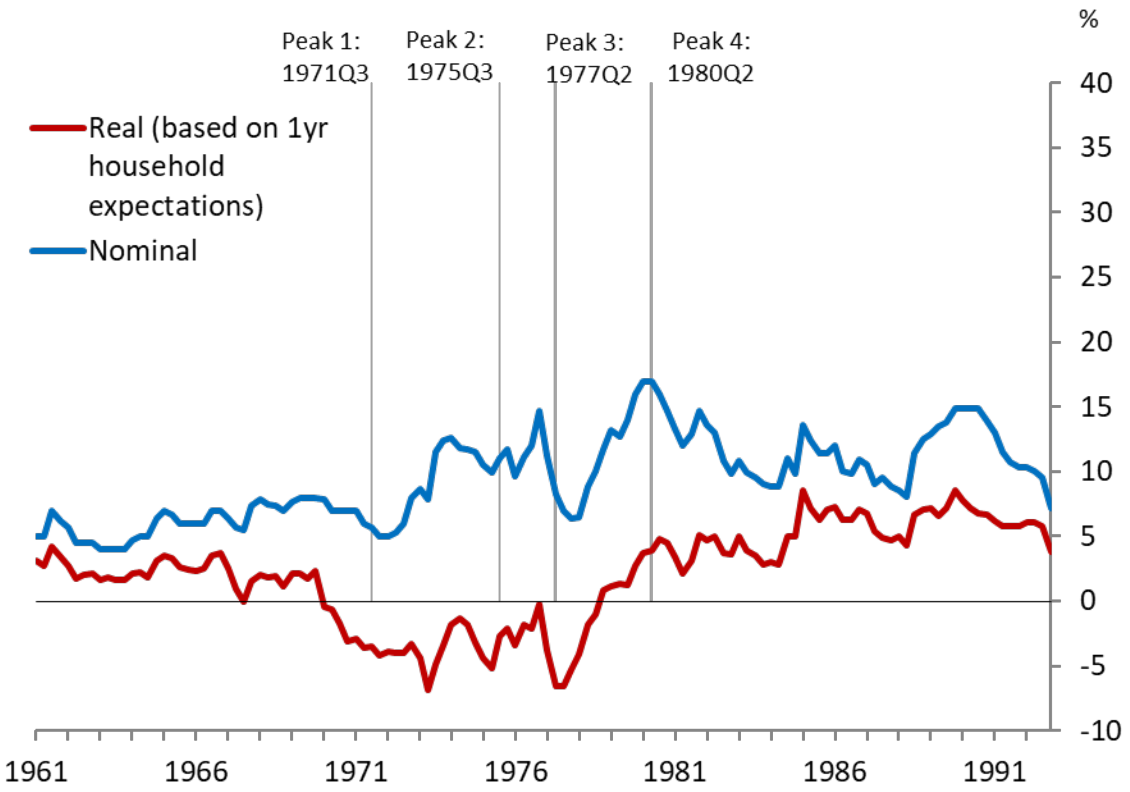
- Heath government U-turns on its restrictive policies
- Barber Boom: tax cuts and expansion of public sector borrowing to lift GDP 10% over two years
- *"I do not believe that the stimulus to demand I propose will be inimical to the fight against inflation."*
- Real GDP growth peaks at 7% in 1973
- Ended with real estate boom bust

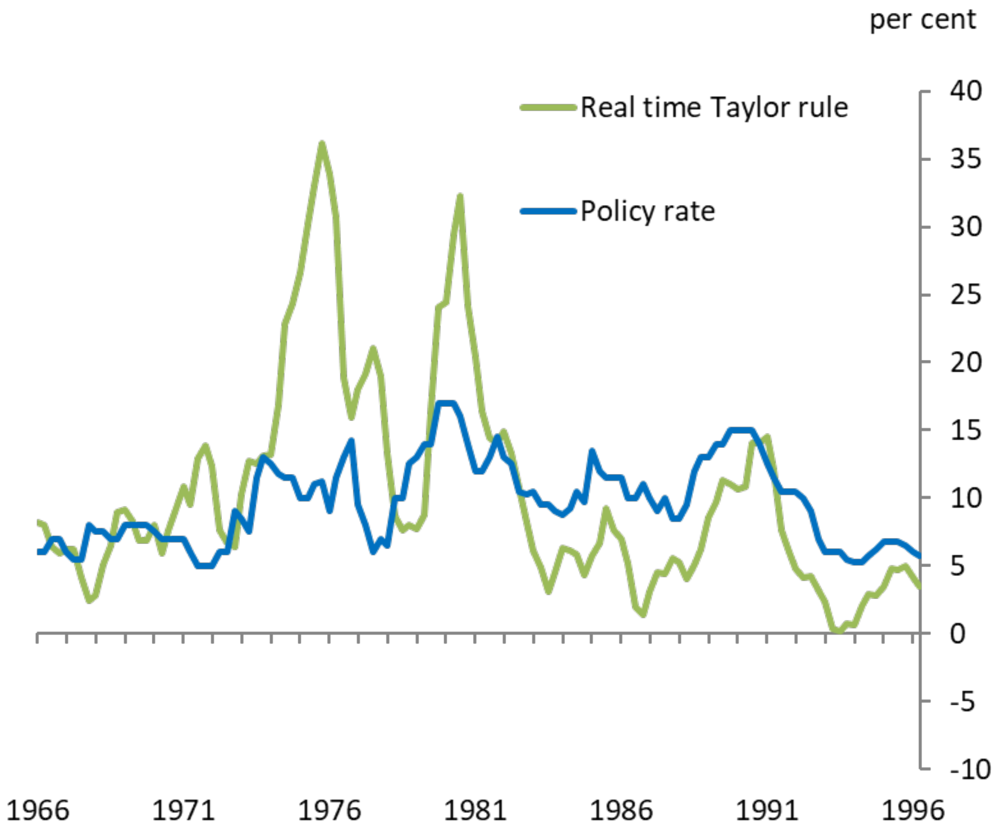
Bad policy– Money and credit growth neglected



- Competition and Credit Control (CCC) in 1971 led to boom in money and credit, no Bretton Woods constraint
- 1970s: money growth peaks two years ahead of inflation peaks, BoE negative real rates below Taylor Rule
- 1981 BOE removes corset, Increased intermediation. BoE maintains high policy rate as inflation recedes

Bad policy – real interest rates negative and well below Taylor-rule prescription based on real time data

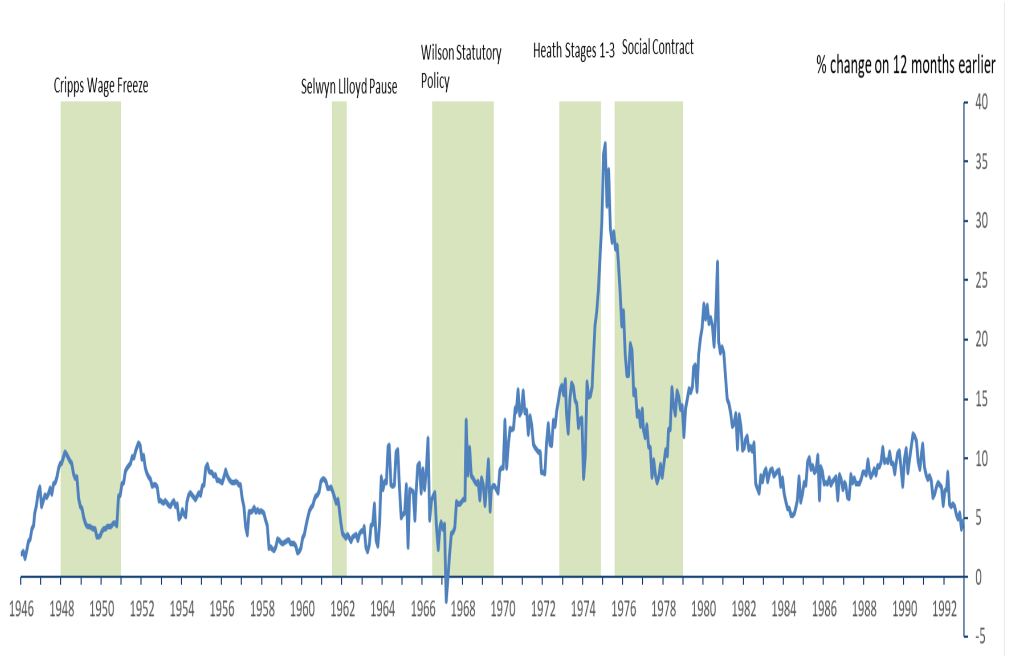




Based on Nelson and Nikolov (2001)

Bad policy: Prices and Incomes policies added to inflation volatility

Earnings growth and incomes policies 1946-1992

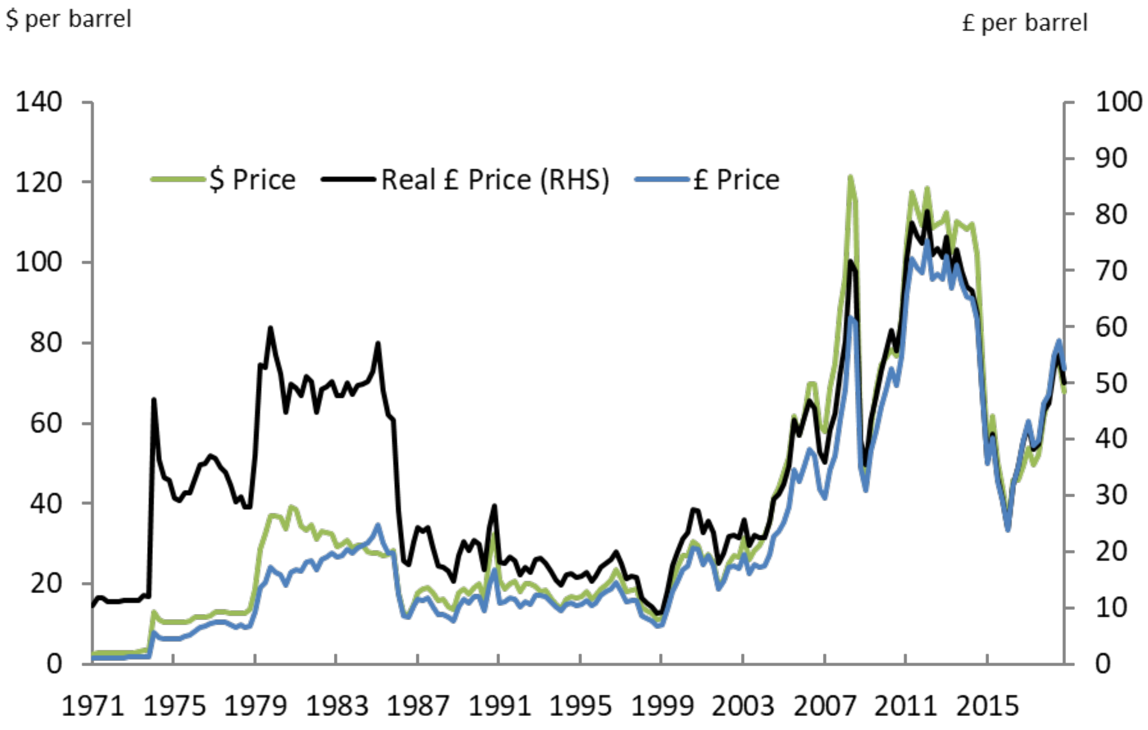


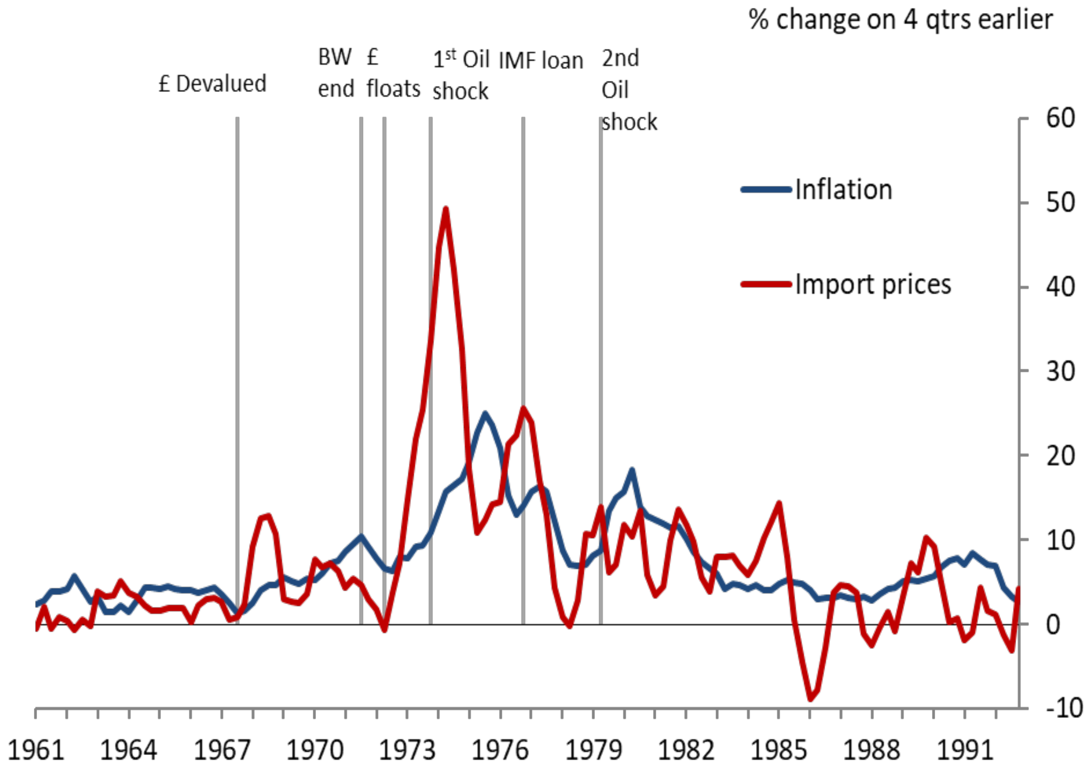
- Income policies put in place sporadically
- Their impacts are temporary and then fail
- Productivity declines and contributes to higher unit labor costs and inflation
- Spikes in wages lead to bursts in inflation
- Consistent with notion of Cost push inflation

Bad luck: Incomes policies were response to Cost Push pressure from labour market

1. Donovan Report (1968) revealed weaknesses in the UK's bargaining framework but attempted government trade union reforms in late 1960s and early 1970s fail
2. Go stop policies lead to excess demand and rising inflation. Becomes expected as unions push to preserve their real wages
3. Declining TFP growth and rising NAIRU as sources of wage resistance
4. Incomes policies break down, triggering catch up wage inflation
5. Dominant Public Sector Unions achieve generous settlements, e.g. coal miners in 1972
6. Partial spillover into private sector as unions stage wild cat strikes to catch up
7. Drives up deficits
8. Monetary policy largely accommodates

Bad luck: Commodity and import price increases





- Largely accommodated by fiscal and monetary policy

How the Great Inflation Ended—1976?

Jim Callaghan *"We used to think that you could spend your way out of a recession and increase employment by cutting taxes and boosting government spending. I tell you in all candour that that option no longer exists"*

- **Rejection of Keynesian consensus**
- **Fiscal policy no longer to be used for demand-management**
- **Monetary targets introduced**
- **Nominal limits introduced on public spending which had previously been set in real terms**

How the Great Inflation Ended -1981?

Geoffrey Howe's 1981 budget

- **Thatcher Government Medium Term Financial Strategy (MTFS)**
  - Monetary gradualism through declining targets for broad money growth (and reduced public sector borrowing)
  - **But monetary targets were exceeded**
- **Geoffrey Howe tightens fiscal policy in the midst of 1981 recession to bring MTFS back on track**
- **Thatcher clamps down on the unions**

Muddling through, tunneling through or both ?

Muddling through narrative

- Authorities were feeling their way towards a new nominal anchor following the demise of Bretton Woods
- Had an eclectic and changing mix of targets and instruments in the face of difficult structural issues on the supply side and large shocks to commodity prices
- General distrust/neglect of monetary theory
- As a result, many missteps and costly mistakes before stumbling on inflation targeting affect ejection from the ERM, allowing inflation to fall to low levels in the early 1990s

Tunnelling through narrative

- The causes of the UK economy’s problems became better understood by authorities and the longer term vision of what was necessary to become a low inflation economy with sustainable growth became clearer.
  - Authorities (and some union leaders) accepted that by the mid-1970s the inflationary nettle had to be grasped.
  - Understood the need for monetary discipline but also a fiscal regime where public sector deficits would be controlled.
  - Reforms on the supply-side of the economy to make the UK product and labour markets more competitive.
- Required tough intellectual battles and difficult periods of adjustment in 1974-6 and 1980s to make that transition