Box A: Monetary policy and inflation in the second Elizabethan age

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2022 was a year to be remembered in the United Kingdom, as we emerged out of the pandemic but also experienced a mix of political and economic upheavals. Perhaps, though, it is the passing of Queen Elizabeth II that remains the most poignant. The United Kingdom that we know now is barely recognisable from the one that greeted Queen Elizabeth II when she came to the throne in 1952. The last seven decades have seen extraordinary changes socially, technologically, economically, and culturally.

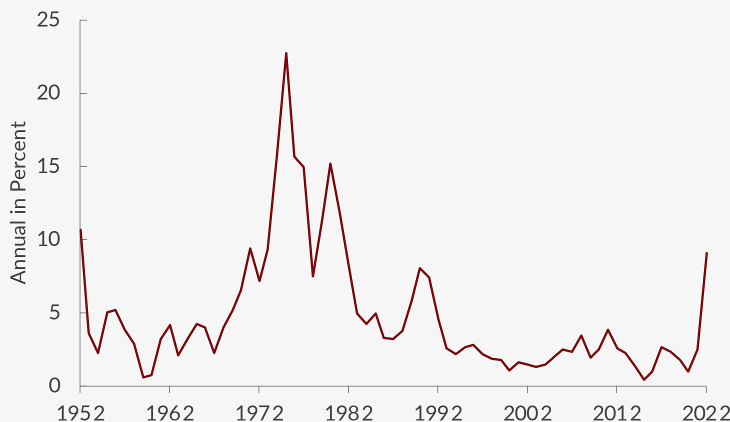
In this box, we look back on the evolution of inflation and monetary policy – whose evolution has clearly been related to the ups and downs of inflation – over this time. We start, however, by noting that there is a striking parallel between the start of the second Elizabethan era and now: high inflation and a cost-of-living crisis. Indeed, we can think of monetary policy over this period as being characterised by the search for a nominal anchor that would enable this high inflation to be banished once and for all. Unfortunately, as we reached the end of the second Elizabethan age it seemed as if the search had been in vain.

1950s and 1960s: Post World War II recovery

When Queen Elizabeth came to the throne in 1952, inflation was as high as it is now, hovering at around 10 per cent (Figure A1). High inflation in the early 1950s was attributed to the sky rocketing prices of commodities due to an inventory build-up in preparation for the Korean War while the economy was still recovering from the impact of World War II. In short, it appears that the problems of the 1950s are not so different to today. The end of the Korean war in 1953 ushered in a period of low inflation rates and stable commodity prices, which lasted up till the early 1970s.

In 1946, the Bank of England was nationalised. With large distortions between economic sectors due to World War II, the interest rate was seen as too blunt an instrument to direct scarce resources to where the government wanted. Moreover, low interest rates in the 1930s had not proved effective in lowering savings or stimulating investment (Patel, 2009) so directing credit was the preferred form of monetary control. The Bank was effectively a government department that played second fiddle to the Treasury (Capie et al., 1994).

Figure A1 Inflation Rate



Source: ONS and NiGEM.

Note: 2022 figure it that for October 2022.

In 1959, the Report of the Committee on the Working of the Monetary System (the Radcliffe Report) was published. Comprising mostly Keynesian economists, the writers of the Radcliffe Report assigned little weight to controlling domestic monetary aggregates, doubting the Bank of England's ability to do so and the effectiveness of the policy (Needham, 2014). Policymakers believed that the Phillips curve (an empirical inverse relationship

between the unemployment rate and inflation) provided them with a menu of policy choices (Haldane and Quah, 1999). Fiscal policy and quantitative credit controls were seen as the main means of controlling unemployment and therefore inflation. An important factor for interest rates, which grew in influence as capital controls weakened, was the need to keep sterling pegged to the US dollar under the Bretton Woods international monetary system. Effectively, the dollar peg limited the freedom of the UK government to manage domestic demand and had a central influence on monetary policy. In 1967, a burgeoning UK current account deficit forced a devaluation of sterling from $2.80 to the pound to $2.40 (Bennett, 2017).

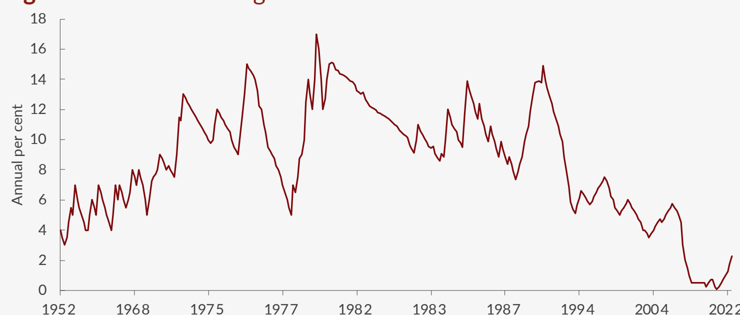
1970–80: The Great Inflation and Winter of Discontent

The quantitative control of lending resulted in disintermediation of the banks (Capie et al., 1994). In response, 1971 saw the introduction of Competition and Credit Control (Goodhart, 2014) which replaced guidance on bank lending and encouraged competition between the previously cartelized banks. The Bank aimed to control the evolution of credit through interest rates, open market operations, and movements in reserve ratios, including calls for Special Deposits. However, monetary growth accelerated to 72 per cent, with the policy abandoned in December 1973 (Needham, 2014). The United States suspended the convertibility of the dollar into gold in August 1971, effectively cutting the external anchor for price stability that many countries had relied upon and ending the Bretton Woods system (Bordo, 2017). The large rise in inflation began in 1973 when OPEC raised the price of a barrel of oil in retaliation for the West's support for Israel in the Yom Kippur War. After this shock, Britain's inflation rate rose to over 20 per cent, peaking at 25 per cent in 1975 (Figure A1), triggering a rampant wage-price spiral which fuelled inflation. The government resorted to incomes policies rather than monetary restrictions to try to contain it. But this led to the 'Winter of Discontent' in 1978/79 when both private and public-sector workers went on strike for higher wages to keep up with the high cost of living, with powerful unions backing them.

1980s: The Thatcher Era

The experience of high inflation in the 1970s, and Britain's humiliating resort to an IMF programme in 1976, led to deep dissatisfaction with previous macro-economic management and the formal adoption of monetary aggregate targets. Rising inflation expectations meant that the Phillips curve broke down and the belief took hold that monetary policy's main role was to control inflation. The second oil shock in 1979 stimulated a still greater concentration on inflation as the object of monetary policy. With the advent of the 'Monetarist-inspired' Thatcher government in 1979, monetary aggregate control ascended to a more prominent role under the Medium-Term Financial Strategy (MTFS). The Monetarists interpreted the inflation of the 1970s as having been caused by earlier monetary growth, and the MTFS reflected this by stressing the importance of controlling the monetary aggregates. More generally, the MTFS represented a paradigm change in the monetary approach, encompassing changes in which instruments were used and how they were used, as well as in policy priorities (Hall, 1993). There was a distrust of discretionary policy and a desire to move to a more rules-based framework, encapsulated in monetary targeting. However, monetary targeting proved problematic due to the instability of the demand for money..

Figure A2 Bank of England's Bank Rate



Source: Bank of England.

The Thatcher government unleashed a series of interest rates hike and public spending cuts. At that time, the interest rate (which was still set by ministers) rose to 17 per cent in November from 12 per cent in April, in a bid to control inflation (Figure A2). The soaring interest rate meant higher borrowing costs which pushed the United Kingdom into recession, causing unemployment to rise beyond 3 million for the first time since the 1930s, while inflation remained high and monetary growth remained rapid. Eventually, the policies did bring down inflation from its peak of 20 per cent in 1980 to less than 10 per cent 2 years later, before stabilising to around 4 per cent in 1987 (Figure A1). However, after that experience money supply targets took a back seat, with interest rates cut to address the recession despite still-rapid monetary growth.

In 1987, the exchange rate assumed a more prominent role, as the authorities tried to avoid a strengthening in sterling stifling the recovery. Exchange rate targeting became the keystone of monetary policy, echoing Bretton Woods, when the United Kingdom entered the European Exchange Rate Mechanism (ERM) in 1990. With fiscal policy in the newly unified Germany being expansionary as the economy absorbed East Germany, the Bundesbank (Buba) instituted a restrictive monetary policy. Less robust UK activity than Germany and the sensitivity of the UK mortgage market to short-term interest rates meant that the United Kingdom could hardly have picked a worse time to join the ERM. Rates that were apt for Germany were too high for the United Kingdom, and on 'Black Wednesday', 16 September 1992, the United Kingdom had to withdraw ignominiously from the exchange rate mechanism (Eichengreen, 2022).

1990s – 2000s: Inflation targeting and Bank of England independence

Monetary policy needed a new nominal anchor, so the United Kingdom switched to inflation targeting, which had been implemented successfully in New Zealand. In 1997, the new Labour government, to boost its credibility and to combat perceptions that in the 1960s and 1970s its policies had resulted in excess inflation, gave the Bank of England operational independence over monetary policy, setting it a 2.5 per cent target for inflation as measured by the retail price index excluding mortgage interest payments (RPIX); the target has since been replaced with one of 2 per cent for consumer price index (CPI) inflation. The inflation rate remained relatively low from 1993 onwards. It hovered around an average of 2 per cent into the early 2000s, though rose to about 4 per cent ahead of the Great Recession.

2008 – now: The zero lower bound bites

For much of the period since the Great Financial Crisis of 2008, monetary policy attempted to get the economy back to full employment. With Advanced Economies beset for years by too low inflation, monetary policy has been mostly aimed at stimulating growth, which remained consistent with the inflation target due to global disinflationary pressures. Central banks came to believe in a flat Phillips curve and exploited that by pushing economies to historically very low unemployment rates. Central bank balance sheets became the tool of preference once interest rates had bottomed near zero, with a massive expansion by the Bank of England, including a doubling of the Bank's holding of gilts in response to Covid-19. While external price shocks due to Covid-19 and the Ukraine-Russia war provided the spark to set inflation going, ex-Bank of England Governor Lord Mervyn King and others blame excessively lax monetary policy for the UK returning to double-digit inflation (Elliott 2021; Horan, 2022). Thus, as in the past, a crisis over UK inflation sets the stage for a reassessment of the institutional and operational arrangements of monetary policy, an examination of how economists and officials think about the causes of inflation, and a rethinking of the importance of the Phillips curve. As the country settles down under its new King, we shall see where this reassessment takes us.

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