Stayin' alive amid the shocks

__Warwick Lightfoot__ looks back at what caused stagflation in the 1970s and examines whether that period of economic setbacks has any lessons for UK policy in the 2020s

The 1970s are associated with flared trousers, inflation and the breakdown of the post-war Keynesian welfare consensus. Confidence that economic and social problems were tractable gave way to stagflation. Steady economic growth that had doubled living standards in a generation, financing higher public spending, greater private consumption and progress on an egalitarian agenda, came to an abrupt halt.

Expectations of economic growth and rising living standards were not the only casualties. Advanced economies were also shocked out of the post-war belief that governments could ensure full employment. Until the 1970s, economists had thought that governments could trade a certain rate of inflation for a certain level of unemployment and that the so-called Phillips Curve – which posited an inverse relationship between inflation and unemployment – was stable. Instead, at the same time as inflation grew so did unemployment.

Why the cycle didn't turn

If economists in the 1970s thought that the problems would subside as the economic cycle turned, they were to be disappointed. Structural challenges in advanced economies – in particular, increasing evidence of de-industrialisation – could no longer be ignored. High, erratic and unexpected inflation played havoc with savings, investment returns and company balance sheets.

The country where those structural challenges were starkest was the UK. It was not an accident that the term 'stagflation' was coined by a British Chancellor of the Exchequer, Iain Macleod, in the mid-1960s and taken up by *The Economist* in 1970.

In many respects, the UK economy was a sort of model of the post-war economic and social consensus. This is not surprising, given that Lord Keynes was an economic adviser at the Treasury and framed much post-war policy, such as the 1944 Employment White Paper, which set out "the maintenance of a high and stable level of employment" as a "primary aim and responsibility" of the post-war government.

The economic approach taken to achieve this was based around Keynesian macroeconomic demand management. *The Economist* described it as 'Butskellism' (named after two former Chancellors – Rab Butler, a prominent Conservative politician, and Hugh Gaitskell, a leading Labour one). It was pursued by both Labour and Conservative governments and could be summarised by a few propositions. These were: uncontested trade union power; a mixed economy with a large, nationalised industry sector that controlled basic industries, such as utilities; and the use of fiscal rather than monetary policy to fine-tune demand to maximise growth and employment.

> *There was an assumption that modern business managers were motivated neither by incentives nor profits*

It assumed a level of cooperation and self-restraint across society that proved to be optimistic. In particular, the 1944 Employment White Paper noted: "It will be essential that employers and workers should exercise moderation in wages matters."

The adoption of the stylised economic policy framework was initially buttressed by several widely shared political beliefs. The first was that unemployment could never be allowed to rise above 1m without unacceptable social and political distress and that policy makers had the tools to ensure that did not happen. The second was a commitment to a more egalitarian society, with a complex progressive income tax schedule, and an investment income surcharge on income from savings over and above the top marginal tax rate. There was also an assumption that modern technocratic business managers were motivated neither by incentives nor profits.

Then, between 1970 and 1975, UK inflation was transformed from the creeping increases of the 1950s and 1960s to a rocketing more than 25%. But the real shock was that the economy was suffering from both inflation and unemployment – and that Keynesian demand management could not get it back to growth and full employment.

The 1976 Public Expenditure White Paper, presented to Parliament by the Labour Chancellor Denis Healey, which proposed cuts in public spending as unemployment rose and

demand fell, was a seminal event. It analysed the constraints on policy that arise when public spending reaches a point where tax thresholds are so low in relation to average earnings that people were "being drawn into tax at income levels…below social security benefit levels". The White Paper noted that taxing the rich wouldn't fill the gap. It said: "If no taxpayer were left with more than £5,000 per annum after tax, this would increase the yield by only about 6 per cent."

How did we get there?

In the 1960s, internationally advanced economies suffered from three successive shocks that destabilised their domestic policies. The first was a synchronised international economic boom that set off a commodities supercycle, worsening their terms of trade at the same time as import costs rose. The second was the domination of international labour markets by recently radicalised trade union movements.

In May 1968, far-left student protests in Paris led to a nationwide French shutdown, including general strikes and the dissolution of parliament. In the UK, the trade unions thwarted the proposals of the Labour government's *In Place of Strife* White Paper in 1969 and opposed the Industrial Relations Act of 1971. In the US, there were widespread demonstrations against the Vietnam war, and urban distress. There was an international atmosphere of political, trade union and student direct action.

When governments tried to control inflation through direct controls on incomes they were opposed. Trade union wage negotiators started to focus on them, and they broke down. But at the same time, the prices that companies could charge were tightly controlled. The upshot was calamitous for the corporate sector in the UK: wages went up while costs were not passed on in prices, resulting in collapsing profits.

This was vividly analysed by a provocative book, *British Capitalism, Workers and the Profits Squeeze* by two Marxist economists, Andrew Glyn and Bob Sutcliffe, in 1972. The interesting thing is that the book was written before the full effects of inflation in the mid-1970s. Inflation caused huge problems for companies because of the accounting treatment of stocks in company balance sheets, which exposed them to taxes on purely paper profits generated by inflation.

Bretton Woods

The third shock was the collapse of the Bretton Woods fixed parity foreign exchange regime in 1971. US President Richard Nixon ended the convertibility of the dollar into gold because high US inflation meant confidence in the dollar had been falling. Once the 44 other economies in the agreement did not have to maintain an exchange rate target against the dollar, their balance of payments with the US was no longer a constraint on growth. It also freed economies such as Germany, Japan and Switzerland from accommodating US inflation with their domestic monetary policies. Some countries used this new-found international discretion to stabilise their domestic price levels, others to expand output, some to borrow and some to allow devaluation to take the strain.

> *The idea was that the two 'locomotive economies' would pull other advanced economies out of the crisis*

The UK was an outlier. The Heath-Barber boom explicitly went for growth and used a return to prices and income policy in 1972 to control inflation. The pay policy broke down. Its complicated rules and its clauses relating to an escalation in prices set off a dramatic wage-price spiral between1974 and 1975. This process of 'gearing up' was described by John Flemming in a book, *Inflation*, written while he was an adviser at the Bank of England, published in 1976. It was a sign of the stagflationary times. In 1978, his colleague at Nuffield College, Maurice Fitzgerald Scott, published *Can We Get Back to Full Employment?*

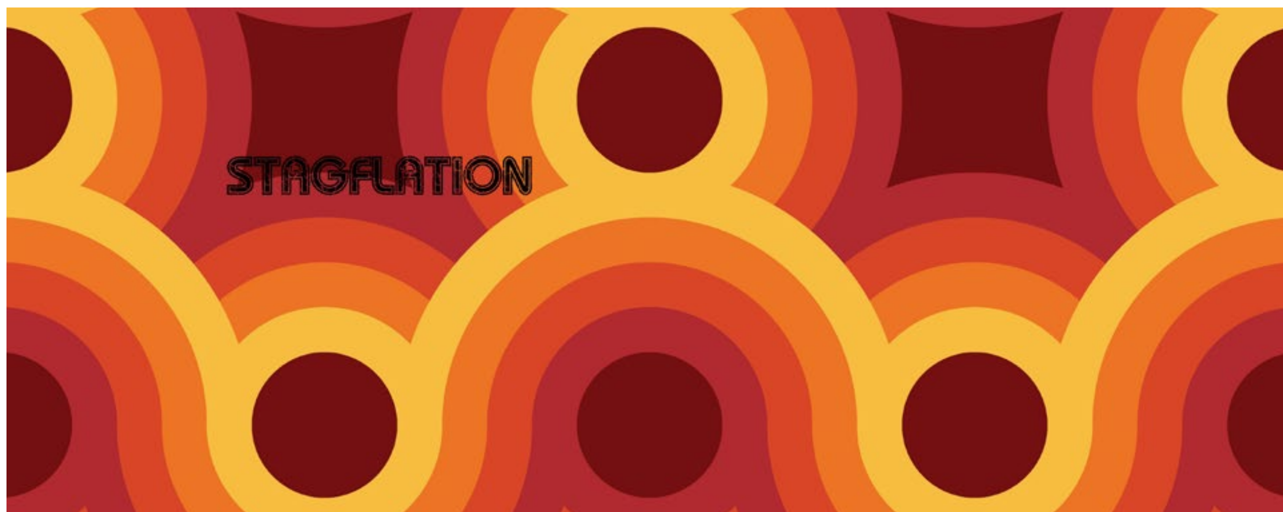
The oil shock

The first three shocks were hard, but policy makers were to find that worse was to come. As a result of the Arab-Israeli war in 1973, the oil price quadrupled. This was both a huge relative price increase that pushed up inflation and a major brake on demand and output that was going to slow long-term growth.

Some economies struggled more than others. Those that tried to avoid hits to living standards and simply hoped to use conventional Keynesian economic tools to maintain output, growth and employment suffered more inflation and economic crisis. The principal major economies in this camp were Italy, the UK, France and the US. West Germany and Japan navigated the oil shock and the new domestic monetary discretion created by the ending of Bretton Woods more successfully.

The stalled G7 locomotive

At the initiative of President Giscard d'Estaing of France, international leaders met at the Château de Rambouillet in 1976. The purpose of this summit was to get the big



'locomotive economies' – West Germany and Japan – to reflate and pull the other advanced economies out of the crisis. The 'locomotive theory' was that countries with strong current accounts should increase deficit spending so that their higher imports, and the consequent multiplier effects, would revive the global economy. Despite an eventual West German fiscal stimulus of around 1% of GDP, the initiative never really got off the ground.

What did stand out in the later 1970s was the lower-than-average inflation delivered by one central bank that had adopted monetary targets – the Bundesbank in West Germany. In the 1960s, West German inflation had been slightly higher than inflation in the US. In the 1970s, this position was significantly reversed.

> *Economies cannot avoid lower living standards when their terms of trade move against them*

The Nixon, Ford and Carter administrations used wage and price controls and public campaigns, such as Gerald Ford's Whip Inflation Now initiative in 1974, to contain inflation. They had little success. By the middle of the 1970s, US inflation was more than 12%.

After the appointment of Paul Volcker as Chair of the Federal Reserve Board in October 1979, the US central bank set targets for both the money supply and a supply of non-borrowed reserves to the banking system. Inflation fell from more than 14% to under 4% three years later. But there was a cost to this process of monetary disinflation: a sharp fall in output and a rise in unemployment.

The lessons for the 2020s

There are lessons from the 1970s that should inform contemporary policy makers. The synchronised commodity price cycle did not just happen. It was the result of loose international monetary conditions led by the Federal Reserve. Controls on prices and wages do not work. They damage relative price signals and the functioning of labour and product markets. Economies cannot avoid lower living standards when their terms of trade move against them. Measures can be taken to address the distribution of the pain, but the hit cannot be avoided.

A necessary disinflation will not be accomplished without accepting tighter monetary conditions as central to the process. Disinflation requires real and nominal interest rates to rise, and it involves short-term losses of output and employment that cannot be avoided by clever fine-tuning. In the 1970s, the Bundesbank showed that national policy makers are not powerless. Realistic monetary policy can reduce the pass-through of international price pressures.

There is one important and helpful difference between now and the 1970s: a flexible labour market. The cost of an uncomfortable policy adjustment should now be lower in the UK than when the labour market was the Achilles' heel of the economy. ■

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