

UK FISCAL EXCEPTIONALISM AND THE GREAT INFLATION

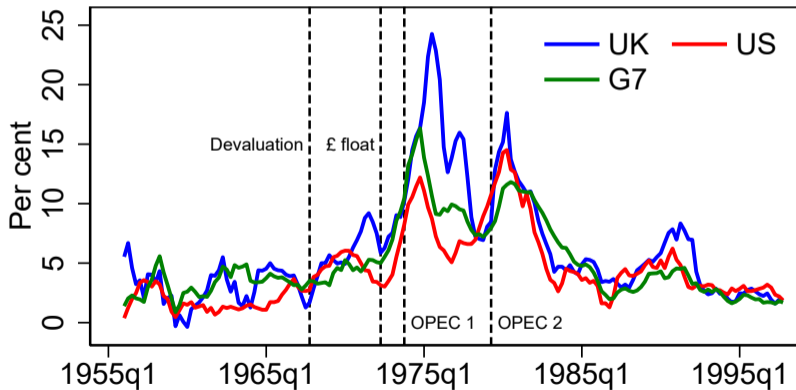
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Hoover Institution: Independence, Structure, and Risks Ahead for Central Banks

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Section I: Motivation

- History can be a useful guide to understanding the drivers of inflation today
- UK experience amongst the worst of the advanced economies during the Great Inflation



Summary

- UK story different from US, where the consensus view focusses on errors by Martin and Burns, corrected by Volcker
- Novel argument that UK exceptionalism was largely due to a fiscal regime switch
 - Departure from longstanding approach to fiscal policy – the Treasury View
 - Bank of England not independent (from 1946)
 - The end of the inflation was associated with a return to fiscal orthodoxy
 - This resonates with modern theories of fiscal inflation

Fiscal foundations of UK's Great Inflation

- For most of British history there was a strong commitment to using fiscal policy to stabilise the public finances (the Treasury View)
- Oliver Bush, Ryland Thomas and I show that after WWII this policy was abandoned
- Post-WWII regime resembled one of 'fiscal dominance', with active fiscal policy and passive monetary policy (Leeper, 1991)
- Fiscal shocks were financed in part by unexpected inflation
- Theory tells us that under this regime tighter monetary policy may have *worsened* the inflation problem (Sims, 2016, 'Stepping on a Rake')

Relevance for today

- Demonstrates the importance of the fiscal regime for the inflation-generating process
- Has resonance with recent post-pandemic inflation
- When fiscal policy isn't used to stabilise debt, inflation can be the mechanism by which fiscal imbalances are resolved, ...
- ... monetary policy may lose control of inflation ...
- ... and government bond and other markets may become stressed, with adverse consequences for the rest of the financial system
- But a nominal anchor can still act to restrain fiscal policy

Section II: Fiscal financing regimes

- A set of arrangements and institutions accompanied by a set of expectations which determine how fiscal shocks are financed
- Financing fiscal shocks (Cochrane, 2022):

$$\underbrace{-\Delta E_{t+1} S_{t+1}}_{\text{expansionary fiscal shock}} = \underbrace{\sum_{j=1}^{\infty} \rho^j \Delta E_{t+1} S_{t+1+j}}_{\text{future surpluses}} + \underbrace{\sum_{j=0}^{\infty} \omega^j \Delta E_{t+1} \pi_{t+1+j}}_{\text{inflation}} \\ + \underbrace{\sum_{j=0}^{\infty} \rho^j \Delta E_{t+1} g_{t+1+j}}_{\text{growth}} - \underbrace{\sum_{j=1}^{\infty} (\rho^j - \omega^j) \Delta E_{t+1} r_{t+1+j}}_{\text{real interest rates / repression}}$$

Identifying fiscal financing regimes

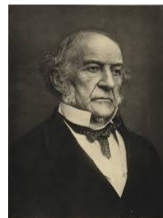
- Narrative approach to identifying regimes: what did policymakers *say*?
 - We rely heavily on Budget speeches
 - Main vehicle for tax policy announcements and for Chancellors to explain underlying objectives
 - Consistent run of speeches since second half of eighteenth century
- Supplemented in Bordo, Bush and Thomas (2025) with empirical evidence on fiscal and inflation outcomes (similar to Berndt, Lustig and Yeltekin, 2012)
- Evidence shows that expansionary fiscal shocks were financed by higher inflation during 1960s-70s and by higher primary surpluses in Gold Standard era (up to 1914)

History of economic thought

- Fiscal orthodoxy developed during 18th and 19th centuries – became known as the Treasury View
- Deficits rose in wartime, but strong commitment to running primary surpluses in peacetime to stabilise debt
- Barro (1979) called this strategy ‘tax smoothing’



Walpole



Gladstone

Narrative evidence on fiscal objectives before WWII

- Treasury View: debt rose in wartime but debt stabilisation / repayment always the primary peacetime fiscal objective
- Sinking funds / terminable annuities used almost continuously
- Gladstone (1862):

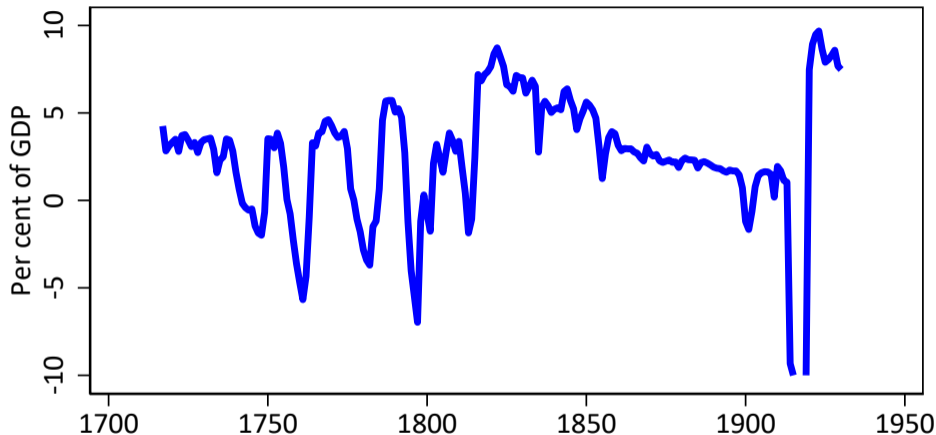
In years of war ... you do not think of the balance of your revenue and expenditure, but you get what revenue you can, and make large loans to meet the exigencies of the public service.

- Gladstone (1859):

I think we are all nearly agreed on this, that in time of peace nothing but a dire necessity should induce us to borrow.

- Sheer scale of WWI meant fiscal inflation was inevitable, as perhaps was the failure of the attempt to go back to gold at the pre-war parity

Primary balance to income ratio



- After each war, the primary surplus plateaued at a higher level → suggests wars were paid for with higher primary surpluses

Move away from the Treasury View

- BoE nationalised in 1946 and Treasury took control of macroeconomic policy
- Keynes and his followers succeeded in arguing for new fiscal policy objective (demand management)
- By mid-1950s, the traditional, debt stabilisation, objective was abandoned – post-WWII Chancellor Dalton (1954):

We may now free ourselves from the old and narrow conception of balancing the budget, no matter over what period, and move towards the new and wider conception of the budget balancing the whole economy.

- Treasury View gradually readopted in 1980s and 90s
- Different story from the US (Federal Reserve, Burns, Volcker)



Keynes and Morgenthau

Narrative evidence on Great Inflation-era fiscal objectives

- New role for fiscal policy: Keynesian demand management
- Debt stabilisation objective disappeared (probably as early as the mid 1950s), as did the sinking fund
- Fiscal policy still partially disciplined by Bretton Woods and, later, monetary targets
- No nominal anchor between 1972 and 1976
- Barber (1972):

It has been traditional to give, in the Budget Speech itself, some description of the Government's financial accounts, both past and prospective. But as all the figures are set out in the greatest possible detail in the Financial Statement and Budget Report, I think that hon. Members will agree that I can this year spare the House an oral summary.

The fiscal regime change was noticed and linked with inflation

- *The Times*, 20th February 1976:

[The balanced budget] orthodoxy... now seem[s] to have been forgotten. Taxation decisions are not taken with a view to keeping the budget deficit under control but only with a view to their supposed effects on demand.

- *The Times* leader, 7th June 1978:

HIGH P.S.B.R.=HIGH M3=INFLATION

- In practice, over half of the fiscal deficits during the Great Inflation were funded by the banking system

Narrative evidence on fiscal objectives after the mid-1980s

- Move towards explicit borrowing and then debt targets/rules
- Lawson (1988):

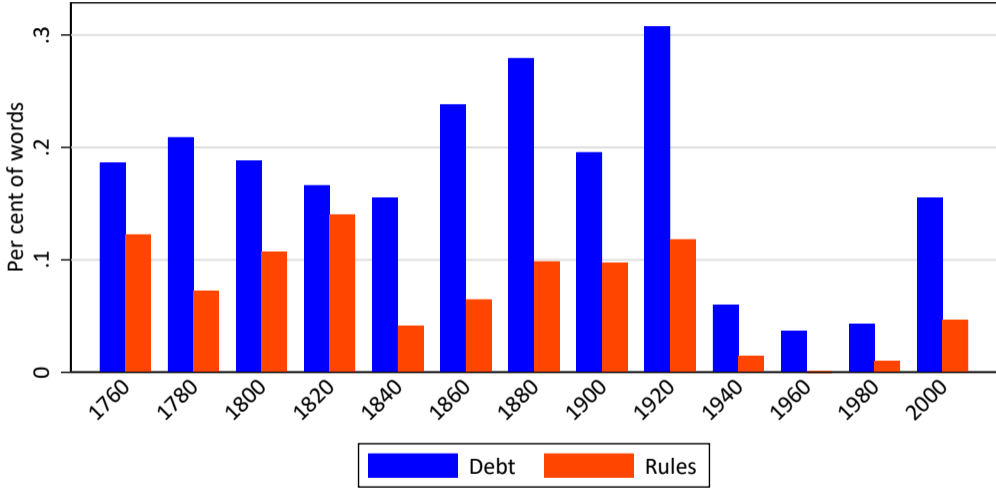
A balanced budget is a valuable discipline for the medium term. It represents security for the present and an investment for the future. Having achieved it, I intend to stick to it. In other words, henceforth a zero PSBR will be the norm. This provides a clear and simple rule, with a good historical pedigree.

In the very nature of things, there are bound to be fluctuations on either side from year to year.

- Brown (1997):

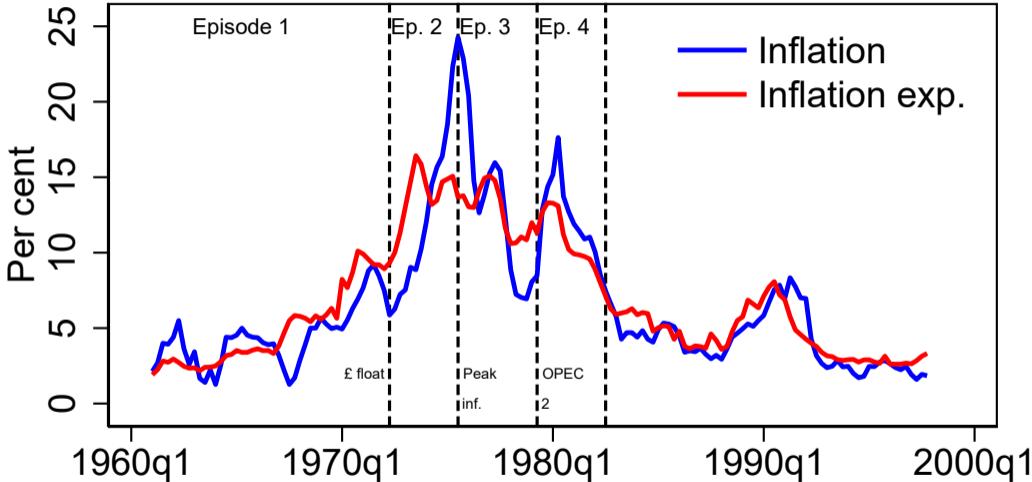
My second rule is that, as a proportion of national income, public debt will be held at a prudent and stable level over the economic cycle.

Crude summary of the narrative evidence



Mentions of 'debt' and fiscal rules and their predecessors

Section III: Inflation episodes



Existing accounts

- Focus on bad policy and bad luck
- Bad policy
 - Go-stop policy
 - Monetary policy neglect – Taylor principle not observed (Nelson, 2003; Nelson and Nikolov, 2004)
 - Incomes policies (Miller, 1976) – belief in cost push inflation → fiscal policy used to secure union agreement over wage moderation
- Bad luck
 - Falling trend TFP growth
 - Rising NAIRU
 - Hit to terms of trade → commodity price increases accommodated by fiscal policy
- Our account: high inflation was the product of the interaction of bad policy and bad luck with the fiscal financing regime

Episode 1: 1960 to 1971

- Initial rise in inflation and inflation expectations
- 'Go-stop' (bad policy)
 - Expansionary policies to maintain full employment and raise economic growth (e.g. 1963 Maudling Budget), under the influence of academics such as Harrod and Kaldor...
 - ...eventually reversed by Bretton Woods commitments...
 - ...although Wilson government ultimately failed to prevent devaluation in 1967
- By the late 1960s, the NAIRU started to rise (bad luck)

Episode 2: 1972 to 1975

- Nominal anchor lost (Nixon shock in 1971 and sterling float in 1972) (bad luck)
- 1972 Barber 'go-for-growth' Budget (bad policy)
 - Real (nominal) GDP growth peaked at 10% (20%) in early 1973
 - Accompanied by growth of up to 30% in broad money and 40% in credit, both also fueled by CCC deregulation
 - Significant fiscal and current account deficits by 1973
- Two weeks before first oil shock, incomes policy agreed which built in automatic wage response to price increases (bad policy and bad luck)
- Wage explosion followed (earnings growth peaked at over 30% in 1975)
- Healey hesitated to tighten fiscal policy in 74-75 given expectation of North Sea revenues and rising unemployment (bad policy)
- Produced the perfect storm leading to 25% inflation in 1975

Episode 3: 1975 to 1977

- Currency crash in 1976 leads to IMF rescue
- IMF package agreed on the basis of monetary targets and fiscal conditions
- Callaghan's rejection of Keynesian consensus:
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.
- Euphoric market reaction
- But backsliding in 1977 and 1978: expansionary fiscal policy and monetary target overshoot (bad policy)

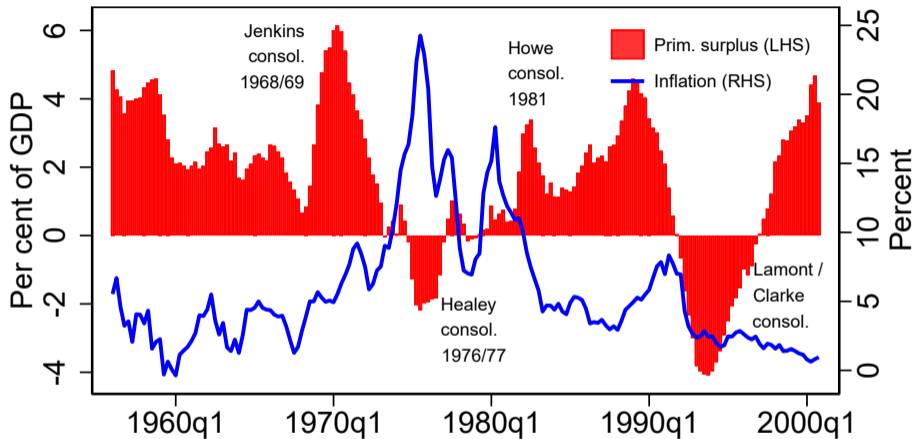
Episode 4: 1978 to 1982

- Second OPEC shock (**bad luck**)
- Winter of Discontent: massive labour unrest
- Incoming Thatcher government adopts the Medium-Term Financial Strategy
 - Stronger commitment to get inflation down
 - New focus on the medium term
 - Based on monetary targeting
 - Coupled with desire to rebalance away from public sector borrowing and thereby crowd in private investment
 - 1981 Budget: significant fiscal tightening despite downturn



Uncollected rubbish in
Leicester Square

Fiscal credibility rebuilt by early 1990s



- Unlike in mid-1970s, early 1990s deficits not associated with high inflation → suggests confidence that they would be paid for with future surpluses

Conclusions

- Post-WWII UK provides a clear case study of fiscal inflation
- Made possible by a fiscal financing regime switch combined with some bad luck and bad policy
- Inflation was only brought under control with the rediscovery of the Treasury View and renewed reliance on monetary policy
- Resonates with post-pandemic inflation