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Introduction and Overview

No one invented central banking. The earliest central banks emerged from commercial banks. Any central bank that was a central bank from its inception was modelled on one of these ancestors. The Bank of England, founded in 1694, evolved as a central bank in the course of the nineteenth century. By the last third of that century it was carrying out the key functions of monetary policy (exchange-rate management in those days) and financial stability (lender of last resort). Most histories of central banks, perhaps because their births were so relatively recent, begin from their date of establishment. The Bank, however, has had a long history as a central bank, a longer one still as a bank of monopoly issue, and an even longer one as a banker to the government. All that history has been covered in volumes prior to this one, which starts with the 1950s and takes the Bank's history to 1979. The period thus covered was very mixed. At the outset, financial stability was taken for granted; it was always there without anyone apparently having to do anything to maintain it. And monetary policy was downplayed in importance. But monetary policy conducted by neglect failed, and financial stability was lost. A major rethink then took place. There were many forces at work in this process. Some perspective on these and on the world more widely will help to place the Bank in the context of its time.

Some Overview

Modern economic growth, the sustained rise in the rate of economic growth, began in the eighteenth century in Britain and northwestern Europe and accelerated and spread further afield in the nineteenth century. The first half of the twentieth century was a period of turmoil – of war, inadequate adjustment, economic depression, and war and adjustment again. Then growth rates accelerated in the second half of the twentieth century to the point where no previous era had known anything comparable in the levels of and rate of expansion in material well-being. By some measures, the world economy was as integrated in the 1890s as in the 1990s, but at the end of the nineteenth century, there was an emerging reaction against globalisation, and nationalism, together with its economic manifestation, protectionism, began to spread.[1] Indeed, much of this carries the blame for the collapse into war and depression that followed.

The developing world economy of the late nineteenth century came to an abrupt halt with the outbreak of war in 1914.[2] Trade, capital flows, migration, and the international monetary system all were seriously disrupted. The war was not without its economic advantages in terms of technological advances, and there were clear improvements in the fields of management and production. But the costs – even looking beyond the human suffering and loss of life – were enormous. All manner of problems were born, most of which were not to be resolved properly in the decade after the war. Some of them played a part in the coming of the depression that was so devastating for much of the world at the beginning of the 1930s. Apart from the disruption to trading patterns, huge war debts accumulated, and reparation payments were imposed on Germany. Hyperinflation and exchange-rate misalignment contributed to the distortions. The Great Depression that followed from 1929 to 1932 and beyond so severely damaged growth around the world that recovery was not achieved until the end of the 1930s.

Given this background, it is perhaps not surprising that following the Second World War there were very low expectations for growth in the world economy even on the assumption that there would be a relatively smooth political transition. In fact, a dominant theme was the likelihood of secular stagnation. Some fears went back to Hansen's belief that there would be an end to both rapid population increase and rapid capital-intensive technological change.[3] These fears increased in the later war years when it was believed that inevitably there would be high unemployment for some time after the war as millions of servicemen were demobilised and millions of other defence workers were put out of work. However, all this turned out to be yet another bad forecast by demographers and economists.[4] A legacy of the two world wars and the interwar depression was the view that governments could do better than markets. Indeed, the idea that markets failed

1 Bordo and Flandreau (2003).
2 Whether or not this was the end of globalisation is debatable, see James (2002).
3 Hansen (1938).
4 Fogel (2005).

became widespread, and the obvious response at the time was that governments intervened in or, more commonly, substituted for the market.

Throughout the Second World War, discussions were held among the Allies (although most often that meant between the United States and the United Kingdom) on the shape of the world economy after the war. The principal objectives were to escape from the problems and the solutions of the 1930s – trade protection, currency devaluation, self-sufficiency, and so on. Out of this came the International Monetary Fund (IMF) and the General Agreement on Tariffs and Trade (GATT), which laid the basis for a stable international monetary system and led to the increasing freeing of restrictions on trade. On the domestic front, however, there were retrograde steps as the interpretation of the 1930s that markets had failed and governments had to replace them resulted in the application of controls and nationalisation. However, the most immediate threat in the 1940s was the communist one. The rapid recovery of Western Europe was seen as one means of containing that threat, and the Marshall plan was at the centre of that effort.

There are seldom any clean breaks in history, and 1950 is not one either. However, much of the postwar adjustment had taken place by then, although no sooner had it than the Korean War broke out. Nevertheless, it was from this juncture that much of the world began to embark on a period of most striking economic progress. The world economy grew at a remarkable pace across the second half of the twentieth century, although there were interruptions along the way. The period from 1950 to 1970 is increasingly referred to as a 'golden age', with many Organisation for Economic Co-operation and Development (OECD) countries experiencing dramatic improvements in their economic fortunes. Of course, the 'world economy' was a much smaller one in 1950 in several respects. There were fewer countries and a very much smaller total population. The Soviet Union and its satellites in Eastern Europe largely excluded themselves from the rest of the world economy, and Communist China too was essentially closed.

Between 1950 and the end of the century, the world's population more than doubled from 2.5 billion to almost 6 billion. Africa and Latin America tripled in size, whereas Western Europe grew by less than a third. The growth of income, though, was vastly greater. World gross domestic product (GDP; in 1990 dollars) grew from $5.3 billion to over $33.7 billion. Growth was fastest of all in Asia, where it rose by a factor of 12. In Western Europe it grew fivefold. Even Africa grew fivefold.[5] The greatest period of growth

5 Maddison (2006).

was that from 1950 to the beginnings of the 1970s. Real GDP per capita in Europe grew at 3.8 per cent per annum in these years, more than twice as fast as any comparable previous period and more than twice as fast as the following 20 years. Economic growth in Japan was even faster. Explanations for such performance range over many factors. US aid was important in the early stages of recovery in Europe, although that varied greatly across countries. In the case of Japan and some others, there was undoubtedly technological catch-up. The improving international environment of freer trade played its part, as did the desperate need to restore capital equipment and raise consumption following a long period of neglect.

World trade grew even faster than output. World exports (in 1990 dollars) grew from $0.295 billion in 1950 to almost $6 billion by the end of the century, that is, by a factor of 20. In the golden age, German exports were growing at an annual rate of over 12 per cent, America's by over 6 per cent, and Japan's by more than 15 per cent. For the world as a whole, the figure was 8 per cent. All these rates slowed in the following quarter-century to 4.4, 6.0, 5.3, and 5.1 per cent, respectively, but that was from a higher base and still represented considerable growth.[6]

The explosion in capital flows came later. They were constrained under the Bretton Woods arrangements, but they were growing in the 1960s, and when they were completely freed, they grew rapidly, reaching their greatest rates in the 1990s. It is not easy to be precise about the scale of capital flows – distinguishing net and gross is just one problem – but there can be little argument that it was huge. One indicator is that foreign-exchange trading in the 1970s was of the order of $10 to $20 billion. By the mid-1990s, it was around $1,260 billion – close to 100 times greater.

In the Western world, there were two important political developments for the world economy. One was the end of empires, and the other was the formation of the European Economic Community (EEC) that would in time become the European Union (EU). A principal feature of the postwar world was the retreat from empire. European countries that had colonised the world in the late nineteenth century came under pressure to return sovereignty to what had been colonies. In some cases, some former dependencies simply declared independence. Since the war had been fought in terms of freedom and democracy, this was both to be expected and not seriously resisted. Some of the transfers were successful, and others less so. The British experience was on the whole successful, although there were many setbacks in the process. By 1965, all British colonies in Africa were independent

[6] OECD, *Annual Report*, 2003.

except Southern Rhodesia. Countries that gained their independence did not blossom immediately, for they were often not well equipped to direct their own affairs; in fact, they almost invariably regressed. The Colonial powers had not prepared the way for the transference of power – indeed, in many cases could not, given the pressing demands that were being made. Although suitable legal systems frequently were in place, education was not advanced, and there often was disagreement among the different domestic political parties, disagreement that too often ended in civil war, with the inevitable human and economic costs.

The second important feature was the emergence of the beginnings of the EU. Almost as soon as the war was over, schemes were devised and implemented to bring the countries of Europe together. This was motivated partly by politics and partly by economics. There was the desire on the part of some to offer competition to the United States and Soviet Union, who otherwise looked like they would be dominating the world. On the economic front, there were schemes for co-operation and the integration of some industries (e.g., coal and steel). In 1957, the Treaty of Rome created the EEC or Common Market. This marked the beginning of the process that would lead to ever greater co-operation and integration. A scheme for monetary union also was launched and was finally achieved for most of the EU in 2002 with the introduction of the euro. Many saw this as essentially politically motivated, for a monetary union really requires a fiscal union to support it, and that, in turn, requires increased centralisation of political power.

The end of the golden age came with the accelerating inflation of the late 1960s. There are several explanations for the inflation (to which I will return later), but it was in part a consequence of the financing of the Vietnam War and of large US government expenditures on the 'Great Society'. The pegged exchange-rate regime then transmitted the inflation around the system. The Vietnam War was an unpopular war and had to be financed by money creation rather than by taxing and borrowing. The resulting inflation was becoming clear towards the end of the 1960s and led inevitably to the breakdown of the international monetary system at the beginning of the 1970s. The world at that point moved to an entirely fiat monetary system for the first time in history, ensuring that inflation would persist for much longer – in fact, until people tired of it, and governments were obliged to take action to curb it.

Inflation was one of the striking features of the world economy in the second half of the twentieth century. Remarkably, most market economies in this period underwent at least one inflationary experience of more than

25 per cent per annum. The principal exceptions were West Germany and Switzerland. Many had inflation of more than 100 per cent that lasted for some years. In the 'transition' economies, the experience was far worse. Most of them had inflation of more than 400 per cent at some point in their transition. All of this had a damaging impact on economic performance. Thus the great achievements that were made might have been even greater.

Further, at the end of the golden age, there was a downturn in many economies, but there was a good deal of misinterpretation of the reasons for the downturn and confusion over how recovery might be effected. The response to the recession at the beginning of the 1970s generally was to turn to expansionary policies of a Keynesian kind. Under floating exchange-rate regimes, expansionary monetary policies could be used, it was believed, to boost incomes. Of course, as some leading economists had been pointing out for some time, these policies would produce inflation in the long run without any benefit to output. And inflation is what followed.

At least two contributory factors were involved. One was trade union power. It was widely believed that powerful unions were pushing up wages and producing 'cost-push' inflation. It is clearer now, although it could be seen then, that weak governments were giving in to union pressure and printing the money required to settle large wage demands. The second factor was oil price rises brought about by the Organisation of Petroleum Exporting Countries (OPEC) cartel. The first of these shocks came in 1973–74; the second, in 1978. Again, the price of one item rising does not produce, let alone cause, inflation, even if that item is a large one in the economy. What happened, and arguably with some justification in order to ease adjustment, was that governments again printed money to accommodate the increase in prices. These monetary expansions certainly contributed to the increasing inflation, in several OECD countries reaching annual rates of around 20 per cent.

However, the real economy did not improve. Instead, it languished in the doldrums, and the term 'stagflation' – stagnant output with inflation – began to be used. This was the point at which, at least in some countries, there was growing realisation and acceptance of the fact that there needed to be supply-side corrections. The real economy had become over-regulated and taxed and lacked the appropriate incentives to produce at its most efficient. Thus it was that in the recession in Britain at the end of the 1970s, policies were adopted that looked, to many, to be tightening rather than expansionary and widely condemned as such. In fact, however, they signalled the beginning of supply-side changes that would help to arrest the relative decline of the British economy.

The last 20 years or so of the twentieth century might be labelled the 'triumph of the market'. It was then that there was increasing recognition that while there might have been less than ideal market outcomes, there also were less than ideal government outcomes. In its crudest form, this could be seen from casual inspection of the two great competing systems – those of the centrally planned economies and those of the market or, more accurately, mixed economies. Even within these mixed economies, however, it was becoming clear that less intervention produced better results. Thus it was that around the world all kinds of markets were being deregulated, labour markets freed, barriers to trade reduced, capital markets liberalised, and so on. The growing divergence between the economic performance of the market economies and the centrally planned economies undoubtedly contributed to the demise of the latter.

The British Economy

The period covered by this study was one of mixed fortunes for the British economy (Table 1.1). For most of the period, there was better performance than there had been for a long time, although in the 1970s there was the worst experience with high inflation and sluggish growth. Despite of the good performance, though, there was a developing awareness that others were doing better, and the perception of decline began to take over. This notion of decline, as well as a growing desire for faster growth, became one of the principal features of the period. The other striking feature is high, accelerating, and volatile inflation.

Although the British economy was the first to experience modern economic growth, it has never been at a high rate. Even in the course of the industrial revolution in the second half of the eighteenth century, the economy grew at close to 1 per cent per annum.[7] It was not until the middle years of the nineteenth century that it reached annual rates of growth of close to 3 per cent. Data deficiencies preclude any precision in these figures. For the years after the middle of the nineteenth century, there are better data, although they are still far from ideal. The picture from that point on, however, is of a fairly steady decline in the rate of growth such that by the closing years of the century and the opening decade of the twentieth century, the rate was around 1 per cent per annum. Thereafter, it picked up, and in the 1920s and 1930s, the trend rate was again over 2 per cent, only for that to be interrupted by war in the 1940s. In the 1950s and 1960s, though, it was

[7] Crafts and Harley (1992).

Table 1.1. *UK macroeconomic variables, 1955–80 (%)*

Year	GDP growth (2002 prices)	GDP growth (1980 prices)	Inflation	Unemployment	Unemployment (contemporary)	Money growth (M3)	Bank Rate	
							High	Low
1955	3.1	3.4	4.5	1.2	1.1	0.4	4.5	3.5
1956	1.0	1.6	4.9	1.3	1.2	−1.0	5.5	4.5
1957	1.7	2.0	3.7	1.6	1.4	2.2	7.0	5.0
1958	0.4	0.3	3.0	2.2	2.1	2.9	7.0	4.0
1959	4.4	4.0	0.6	2.3	2.2	4.1	4.0	4.0
1960	5.5	4.6	1.0	1.7	1.6	3.6	6.0	4.0
1961	2.5	3.3	3.4	1.6	1.5	3.2	7.0	6.0
1962	1.2	1.1	4.3	2.1	2.0	2.2	6.0	4.5
1963	5.1	4.2	2.0	2.6	2.5	4.1	4.5	4.0
1964	5.6	5.2	3.3	1.7	1.6	0.04	7.0	4.0
1965	2.3	2.3	4.8	1.5	1.4	11.9	7.0	6.0
1966	2.0	1.9	3.9	1.5	1.5	4.8	6.0	7.0
1967	2.5	2.8	2.5	2.3	2.4	4.0	8.0	5.5
1968	4.2	4.2	4.7	2.5	2.4	6.2	8.0	7.0
1969	2.1	1.3	5.4	2.5	2.4	2.1	8.0	7.0
1970	2.3	2.2	6.4	2.6	2.6	15.8	8.0	7.0
1971	2.0	2.7	9.4	3.4	3.6	11.7	7.0	5.0
1972	3.6	2.3	7.1	3.8	3.8	23.9	9.0	5.0
1973	7.1	7.9	9.2	2.7	2.7	26.9	13.0	7.5
1974	−1.3	−1.1	16.0	2.6	2.6	18.3	13.0	11.5
1975	−0.6	−0.7	24.2	4.0	4.2	9.5	11.5	9.8
1976	2.7	3.9	16.5	5.5	5.7	10.5	15.0	9.0
1977	2.4	1.0	15.8	5.8	6.2	9.4	12.3	5.0
1978	3.3	3.6	8.3	5.7	6.1	14.5	12.5	6.5
1979	2.7	2.1	13.4	5.3	5.8	11.6	17.0	12.0
1980	−2.1	−2.1	18.0	6.8	7.4	15.9	17.0	14.0

Source: GDP growth (2002 prices) calculated from *Economic Trends Annual Supplement* 2005; GDP growth (1980 prices) calculated from *Economic Trends Annual Supplement* 1985; inflation, Office of National Statistics (ONS); unemployment, Mitchell (1988); unemployment contemporary, monthly average from *Monthly Statistical Digest* (unemployment rate defined as the number registered as unemployed as expressed as a percentage of the estimated total number of employees); M3 calculated from Capie and Webber (1985); Bank Rate and MLR taken from *Bank of England Quarterly Bulletin.*

again between 2 and 3 per cent. Thus the picture from around the middle of the nineteenth century to about 1970 was a U-shaped one, with rates close to 3 per cent at the beginning, then falling fairly steadily to around 1 per cent in the middle, and then climbing to between 2 and 3 per cent at the end. Then it stalled in the 1970s so that, for instance, the level in 1976 was only about 5 per cent above that of 1972.[8]

Britain enjoyed rates of growth in the 1950s and 1960s that were better than they had been perhaps since the middle of the nineteenth century. If not quite a 'golden age', it seemed highly satisfactory in the 1950s. When the period 1950–73 is taken as a whole, GDP per capita in the United Kingdom grew at 2.4 per cent per annum. This rate dropped to 1.5 per cent per annum for the remainder of the 1970s (1973–79). Viewed from an international perspective, however, the picture looked less rosy, and indeed, by the end of the 1950s, it was evident that other European countries in particular were performing considerably better. For example, for the period 1950–73, the annual rate of growth per capita for a 12-country OECD median was 3.4 per cent, substantially higher than the British. And although that dropped in the period 1973–79, it was still 2 per cent and again considerably better than the British.[9]

Additional output can usually be produced with more inputs, so a better measure of performance is productivity, and labour productivity is one guide. The figures for Britain for 1950–73 are 2.5 per cent per annum as opposed to the 12-country median of 3.6 per cent; then the British figure fell to 1.3 per cent for the remainder of the 1970s, whereas the OECD average was 2.2 per cent.[10] Nevertheless, over the whole period, British output (GDP) per hour worked almost doubled. It is true that these figures did turn around over the next decade, and the British were marginally higher than the OECD for both output growth and labour productivity in the period 1979–88. From the 1950s onward, growth had become a policy objective, something to which most governments explicitly committed themselves. By the 1970s, growth had moved firmly to centre stage and dominated policy making. A range of policies was pursued, often misguidedly, as the drive for growth took precedence over all else.

These growth rates, of course, are the trend rates. As ever, the actual path of output growth was cyclical. For long periods in British economic history, the cycles were of roughly similar length – around seven to nine years from

[8] Matthews, Feinstein, and Odling-Smee (1982).
[9] Bean and Crafts (1986, p. 133).
[10] Ibid.

one peak to the next peak or from trough to trough. In the period up to the Second World War, the downturn in the cycle usually resulted in actual falls in output. After the war, actual falls disappeared, but nevertheless there were still cycles, although they had become growth cycles. The cycle became shorter too, and it was argued that it was more subject to political forces.

There has been much written on the dating of cycles, and several variants are available depending on the definition being used and the techniques employed to identify the cycle. According to one, though, our period began in 1958 with a trough followed by a sharp boom that peaked in 1960.[11] Then it was down to a trough in the winter of 1962–64 and a peak again in 1964. This short period cycle continued with another trough in 1967, followed by a peak in 1969 and a trough again in 1972. Another peak is given as 1973, and that is followed by a trough in 1975. The period then ends with a peak in 1979, following the longest and slowest recovery in the whole period.

There were fears at the time that the cycle was becoming more pronounced. And indeed in the mid-1970s there was a return to actual falls in output. There was a great deal of gloom at that time and some good reason for it. Falls in output had not been seen since the 1930s, and there were many comparisons made with that earlier experience. In the depression of the 1930s, output had fallen in total over a period of three years (1929–32) by 5.6 per cent. In the 1970s, there was negative growth in 1974, 0.6 per cent in 1975, and then a jump back in 1976 of 2.7 per cent.[12] The big difference between the two periods was in prices. In each of the three years of recession in the 1930s, prices fell by 5.7, 6.1, and 3.2 per cent, whereas in the 1970s, prices rose by 16.0, 24.2, and 16.5 per cent (see Table 1.1). Thus, as output was falling, prices were soaring, and that was the completely new experience that earned the name 'stagflation'.

The economy reached another peak in 1979 and then began a downturn that produced another deep recession. It was time then to resurrect the Kondratieff cycle, the notion that modern industrial economies move through long cycles as well as short cycles of around 50 years – 25 years of growth followed by 25 years of slowdown. The fact that timing seemed so precise, a peak in 1979 just as there had been a peak in 1929 and a trough in 1982 just as there had been a trough in 1932, encouraged a great burst of research activity and the revival of the idea of long cycles.

Aside from that cyclical experience, from the early 1950s, there was a growing awareness of the superior trend performance on the continent.

11 Britton (1986).
12 Capie and Collins (1983); *Statistical Abstract*.