20 The UK Government’s Financial Strategy

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20.1 INTRODUCTION

For much of the period since the Second World War, United Kingdom governments were influenced by the economics that followed from Keynes’s General Theory. Monetary and fiscal policies were used with the intention of controlling the level of aggregate demand to achieve an employment rate that governments considered close to ‘full employment’. Although apparently successful at first, this strategy increasingly came under question as it became associated with a steady acceleration of inflation after 1961. Table 20.1 shows that the growth of money GDP (GDP expressed in current prices) increased from an average of 7 per cent per annum in the economic cycle from 1961 to 1965 to almost 18 per cent in the cycle from 1973 to 1979. Extra output accounted for almost half the increase in money GDP from 1961 to 1965, but by 1973–79 real output growth accounted for less than one-tenth of the increase.

<table>
<thead>
<tr>
<th>Average annual percentage change</th>
<th>Money GDP (%)</th>
<th>Output (compromise GDP) (%)</th>
<th>GDP (MP) deflator (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1961–65</td>
<td>7.0</td>
<td>3.5</td>
<td>3.6</td>
</tr>
<tr>
<td>1965–69</td>
<td>6.9</td>
<td>2.6</td>
<td>4.3</td>
</tr>
<tr>
<td>1969–73</td>
<td>11.8</td>
<td>3.3</td>
<td>8.0</td>
</tr>
<tr>
<td>1973–79</td>
<td>17.8</td>
<td>1.3</td>
<td>16.0</td>
</tr>
</tbody>
</table>


The Medium Term Financial Strategy (MTFS) was introduced in 1980 with the objective of reversing these trends.

Macro policy has been directed explicitly to reducing inflation. This follows from the view that macroeconomic policy is the key determinant of
inflation – by contrast with the explanation that it is generated primarily by exogenous forces; for example commodity price shocks, bad harvests or the outcome of a bargaining struggle over incomes.

Similarly, macro policy has been directed less explicitly at economic activity and employment in the short run, not because of a downgrading of these objectives, but because of doubts about the efficacy of policy to stabilise real fluctuations without increasing inflationary pressures. The reduced emphasis on short-term demand management follows from the expectation that the pursuit of a steady nominal macroeconomic framework, avoiding excessive fluctuations in money GDP growth, will deliver steady growth at a rate determined by supply performance. The view is that the longer-term growth of the economy will be promoted by greater micro-efficiency and improved supply performance.

20.2 THE CHARACTERISTICS OF THE MEDIUM TERM FINANCIAL STRATEGY

The essentials of the MTFS have been present since it was first published. These can be summarised as follows:

(a) that macroeconomic policy should be conducted with a medium-term perspective;
(b) that there should be a nominal framework within which the growth of money GDP is gradually reduced and the division of that growth between real output growth and inflation improved;
(c) that the path for money GDP growth should be delivered by monitoring and responding to the evolution of monetary conditions. Initially this was formulated in terms of a target for broad money but quite soon other monetary aggregates and the exchange rate came to play a more dominant role;
(d) that fiscal policy should support monetary policy. Until 1987, when the PSBR had been reduced to 1 per cent of GDP, each version of the MTFS included projections showing a declining medium-term path for the PSBR;
(e) and finally a recognition that macroeconomic policy could only play a part. The underlying growth of the economy and the speed at which it adjusted to shocks would be dictated by success in improving supply performance.

In this chapter I discuss each of these issues: how policy has been conducted in practice, and how it has adapted to changing circumstances and experience.