

UK monetary and fiscal policy since 2007: Could we have done better?

Terence Burns

Former Chief Economic Advisor and Permanent Secretary to HM Treasury,
United Kingdom



INSTITUTE OF
INTERNATIONAL
MONETARY RESEARCH

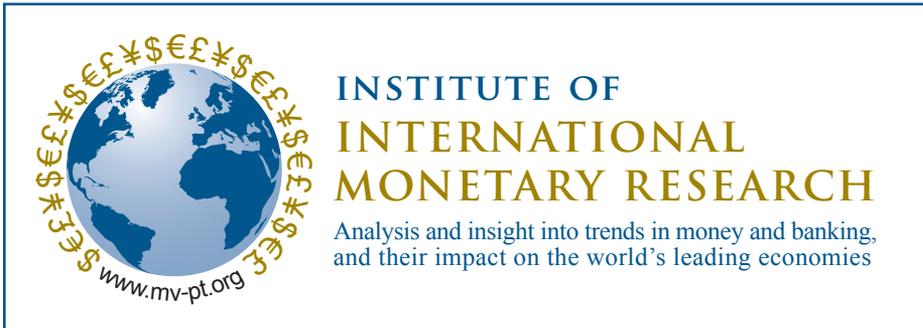
Analysis and insight into trends in money and banking,
and their impact on the world's leading economies

www.mv-pt.org



THE UNIVERSITY OF
BUCKINGHAM

This paper has not been previously published.



www.mv-pt.org

Please direct enquiries to enquiries@mv-pt.org

Charity registration number : 1155226

Registered charity address: University of Buckingham,
Hunter Street, Buckingham MK18 1EG

Correspondence

Email: lord.burns@me.com

Lord Burns delivered the IIMR's Public Lecture in London on 10
November 2025.

UK monetary and fiscal policy since 2007: Could we have done better?

Terence Burns

1 | INTRODUCTION

On many counts, UK economic performance has been disappointing since 2007. Average GDP growth has been 1 per cent compared with around 3 per cent in the previous 15 years. Debt interest has become a significant expenditure item. After years of low inflation, we have experienced a significant spike of inflation, with the rate exceeding 10 per cent in 2022 and remaining stubbornly above the target range even today. In the previous 15 years there were no significant inflation spikes.

I first became actively involved in economic forecasting at the London Business School in 1965. Over the past 60 years, I have observed significant changes to the monetary and fiscal policy framework. I would like to begin by setting out those changes and the main inflation episodes before trying to answer the question ‘could we have done better since 2007?’

2 | FOUR PHASES OF POLICY

For me, there have been four distinct policy phases in the UK over the past 60 years, which are shown in Figure 1. The first phase, ending in 1972, turned out to be ‘The breakdown of Bretton Woods’. Interest rates were rising but the rates for the leading economies were still bunched together. The second phase, from 1972 to the late 1970s demonstrated ‘Life without an inflation anchor’. Interest rates soared, were volatile and varied between countries. The third phase, from the late 1970s to the early 1990s could be characterised as ‘The search for a new monetary anchor’. This included monetary targets, the Medium Term Financial Strategy and a failed membership of the European exchange rate mechanism (or ERM). Interest rates remained high by today’s standards, but volatility was reduced and there were growing signs of rates in different countries coming closer together again. The final phase, from the early 1990s onwards is the age of ‘Inflation targets, in association with independent central banks’. Long-term interest rates fall steadily and were closely bunched together until 2020. I will say a little more about each of these phases in turn.

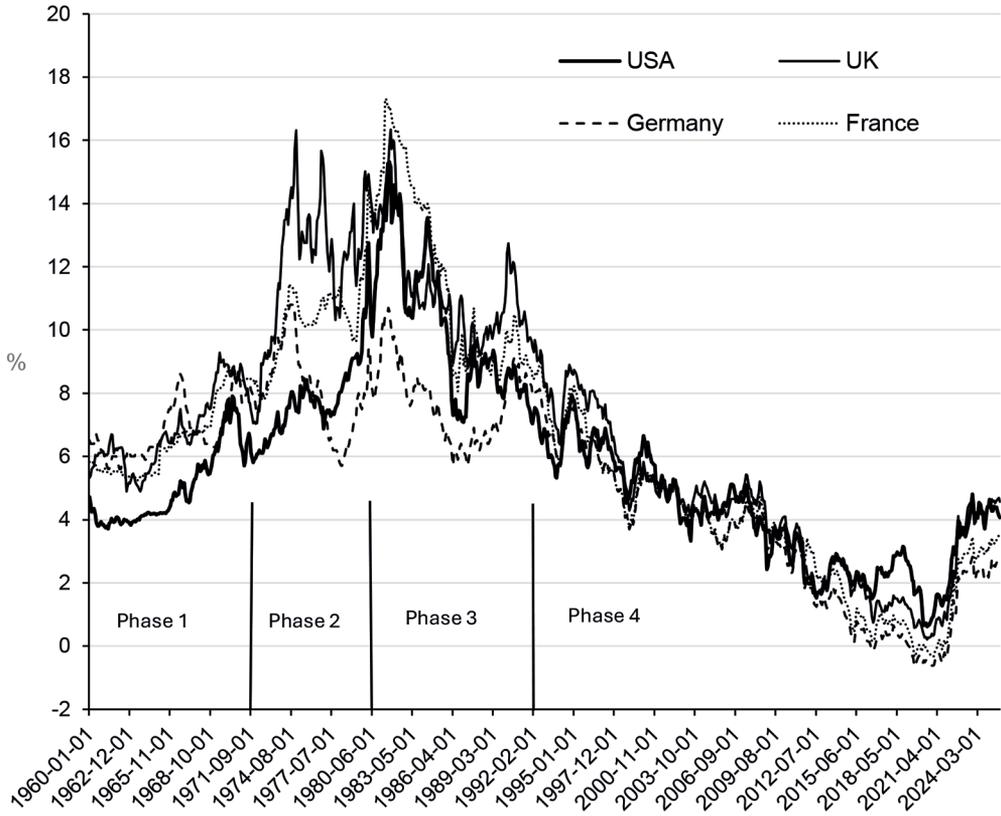


FIGURE 1 Long-term bond yields in four major nations: ten-year constant maturity percentage yield, 1960–2024. *Source:* Federal Reserve Bank of St. Louis FRED database.

2.1 | Phase 1: The breakdown of Bretton Woods

The first period covers my early years in model building and forecasting at the London Business School. These turned out to be the final years of the Bretton Woods system, which had provided the post-war inflation anchor. It did this by bringing about interest rate and fiscal policy changes when faced with an emerging balance of payments problem. For most of the post-war period this worked well. The 1967 sterling devaluation was the first sign of impatience with the constraints of this system. It was followed by the French devaluation of 1969 and effectively came to an end with the suspension of convertibility of the US dollar to gold in 1971. The inflationary impact of the 1967 devaluation was underestimated and by the middle of 1971 UK inflation was close to 10 per cent.

PHASE 1 The breakdown of Bretton Woods.	
1967	Devaluation of pound by 14.3%
1969	Devaluation of French franc
1971	US end of gold convertability
1971	UK inflation touches 10.5%

Source: Author.

2.2 | Phase 2: Monetary and fiscal policy without an inflation anchor

The end of Bretton Woods effectively left the UK, along with other countries, operating economic policy without an inflation anchor. Competition and Credit Control was introduced in September 1971, under which the Bank of England sought to control money supply indirectly through open market operations rather than through lending ceilings. Fiscal policy was still seen as the main instrument for balancing demand and supply potential, and was aggressively expansionary during the early 1970s. Inflation control centred on attempts at prices and incomes policies, but they did little more than postpone inflationary pressures. The worldwide loosening of monetary policy in the early 1970s soon sparked a worldwide commodity price boom, a rapid growth of money supply and a house price boom. In the autumn of 1973, the Arab–Israeli war broke out, followed by an oil price crisis.

By 1975 many countries were experiencing high inflation, but the UK's experience was significantly worse than others. Furthermore, by this time the level of government borrowing had become a major issue. In the following year the UK government called upon the IMF for help

and the search began for a replacement inflation anchor. Control over domestic credit expansion was the centrepiece of the IMF programme to deal with the UK's problems. In turn this required substantial public expenditure cuts and the emphasis of fiscal policy shifted to supporting monetary policy. These events raised significant questions about the conduct of policy and the forecasting models. It was during this period of re-evaluation that I first met Tim Congdon, and we started to debate issues of monetary and fiscal policy. It was also when I started to work with Alan Budd in trying to build on the experiences of this period for our research work and the structure of the London Business School model. This drew us towards the proposal for a medium-term financial plan for monetary and fiscal policy aimed at bringing down the rate of inflation and restoring the weakness of public finances.

PHASE 2 Life without an inflation anchor.	
1971	Introduction of Competition and Credit Control
1972	Commodity prices and UK house prices surge
1973	OPEC oil embargo
1975	Inflation hits 25%
1976	UK signs IMF Letter of Intent

Source: Author.

2.3 | Phase 3: The search for a new monetary anchor

The third phase runs from the late 1970s to the end of 1992 and was dominated by the search for an alternative inflation anchor and supporting fiscal policy. For almost all this period I was in HM Treasury. Monetary targets were introduced in the late 1970s and were toughened in the early 1980s. However, the attempt to implement strict monetary targets proved challenging for the UK's new government. Broad measures of money supply continued to grow rapidly, but other indicators suggested that policy was very tight.

At the same time, the Medium-Term Financial Strategy (MTFS) was introduced in the Budget of 1980 and continued through the years of the Conservative governments right up to 1997. Its aim was to establish a sustainable and supportive path for fiscal policy that supported monetary policy, while preventing interest rates from bearing too much of the anti-inflation burden. The tough 1981 Budget was designed to put this into practice. There were also changes to the public expenditure control system with a move to cash budgeting rather than the real terms control that had been used for most of the post-war years.

Throughout the 1980s, exchange rate volatility posed problems. For the UK this was partly due to the emergence of significant North Sea oil production and exports, but the main factor was the huge variation in exchange rates between the US, Germany and the UK. This generated increased international interest in managed exchange rates and greater interest rate coordination. The Plaza agreement and the Louvre Accord of the mid-1980s were important events at the time. This volatility of exchange rates also stimulated the interest of Chancellor of the Exchequer Nigel Lawson in joining the ERM as an inflation anchor. Despite the success in bringing down inflation in the mid-1980s, higher inflation emerged again along with a further oil price hike in 1989, which combined to take consumer price inflation back to over 8 per cent. In the autumn of 1990, the UK joined the ERM but rising German interest rates put further pressure on UK rates at a time when UK domestic conditions pointed to lower interest rates. This led to ‘Black Wednesday’ (16 September 1992) when we left the ERM.

PHASE 3 The Search for a nominal anchor.	
1979	M3 target set
1980	Abolition of the ‘corset’
1980	Introduction of the Medium-Term Financial Strategy
1981	1981 Budget: Fiscal contraction
1985	Plaza Accord to coordinate intervention to weaken the dollar
1987	Louvre Accord to stabilise currencies after dollar depreciation
1989	Inflation back above 8%
1990	UK joins ERM
1992	UK leaves the ERM

Source: Author.

2.4 | Phase 4: Inflation targeting and an independent central bank

This marked the beginning of the fourth phase of my story. I was Permanent Secretary of the Treasury for the period until mid-1998 and was Chair of Santander UK between 2004 and 2015. Within weeks of leaving the ERM, Chancellor Norman Lamont established the inflation target regime, along with a degree of semi-independence for the Bank of England. The Bank was required to publish its own *Inflation Report*, free of the hands of Treasury subeditors.

A regime of monthly monetary meetings between the Chancellor and Governor of the Bank was instituted instead of the existing practice of ad hoc meetings. At a later point Chancellor Ken Clarke took the decision to publish the minutes of these monthly meetings. We had examined

the case for an inflation target in the early 1990 before joining the ERM. However, there were credibility challenges in setting a specific numerical target for inflation given the level of inflation at that point.

From the outset there were also concerns that the long lags in the effectiveness of interest rate changes would put too much emphasis on the forecasts of inflation. There were also worries that it would lead to too much weight being given to cost pressures, and too little weight given to monetary and financial flows. However, this arrangement settled down well with the famous ‘Ken and Eddie’¹ show. In 1997, following the election of a new Labour government, Chancellor Gordon Brown legislated to give a new Monetary Policy Committee of the Bank of England operational independence to meet the target range for inflation set by the Chancellor.

For almost all the period since 1993, I regard this regime as a success. Until 2022 inflation was close to target even though the challenges for the authorities were very different pre- and post-financial crisis. Credibility increased as it became clear that interest rate decisions were being taken in relation to the target and there was no conflict in the messages that were coming from monetary indicators and other forecasts. In addition, world conditions were helpful, with very little in the way of shocks to world prices or inflation in other countries to disrupt matters. In part this was helped by the rise of China putting downward pressure on the price of manufactures. The major changes to fiscal policy came with the introduction of fiscal rules in 1997 and the establishment of the Office for Budget Responsibility in 2010.

PHASE 4 Inflation targeting, with independent central banks.	
1992	Announcement of inflation targeting
1994	Decision to publish minutes of meetings with Governor
1997	Bank of England operational independence for interest rates
1997	UK’s first formal fiscal rules
2010	Charter for Budget Responsibility

Source: Author.

3 | FOUR INFLATION PHASES AND THREE FISCAL CORRECTIONS

Next, I would like to make some observations about four clearly defined inflation episodes over this period – that is, periods when inflation went clearly above 5 per cent for several quarters – and the significant fiscal correction that followed in three of the episodes. Figure 2 has more detail. I have also included US inflation in the chart to demonstrate the similarity in the overall shape and timing of the episodes. The first is the 1973 to 1975 episode; the second is between 1979 and 1981; the third is at the end of the 1980s; and the fourth was the recent 2022–23 episode. Distinguishing between the first and second episodes is not easy as, apart from an 18-month spell in 1978–79, inflation was in double figures from autumn 1973 until spring 1982.

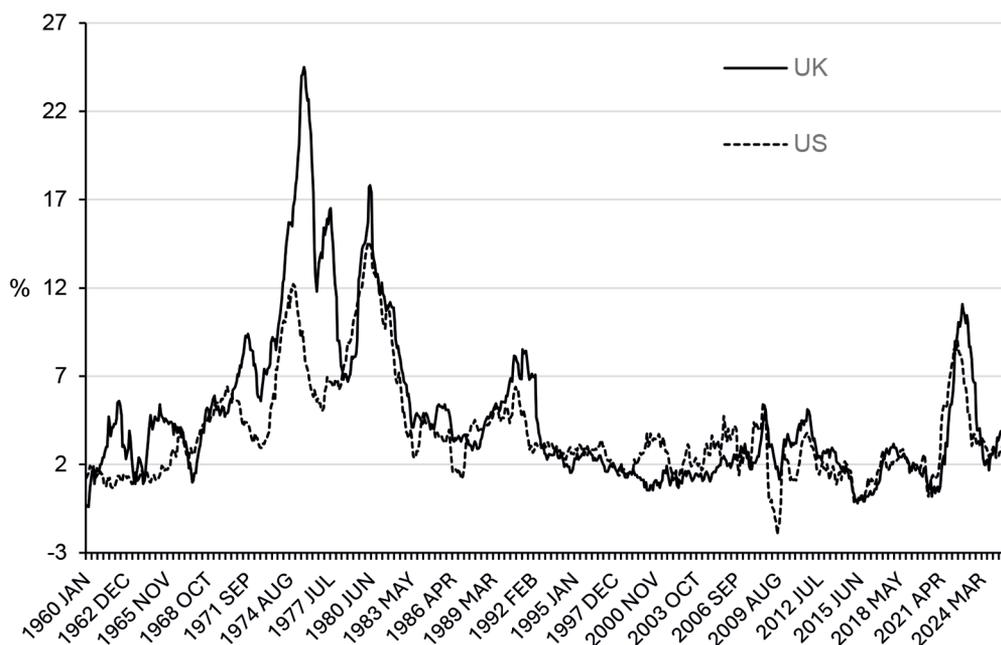


FIGURE 2 Consumer inflation in the US and the UK, from 1960. *Note:* Monthly data, with annual percentage changes in consumer prices indices. *Source:* Bank for International Settlements.

These episodes have several features in common as well as some differences (see Table 1). All four of the inflation spikes were preceded by, or coincided with, strong growth of the quantity of money, broadly defined. On three occasions, financial deregulation played a part in money supply growth. Specifically, the Competition and Credit Control measures were important from September 1971, while the ending of foreign exchange controls and the scrapping of ‘the corset’ mattered in 1979–80, and the Big Bang and associated reforms influenced events from 1986.²

The most recent inflation spike was also preceded by an acceleration in money growth, but on this occasion it was driven by an expansion of banks' claims on the public sector (mostly in the form of their cash reserves at the Bank of England), a consequence of Quantitative Easing, not by more bank lending to the private sector.³ In a modern banking system this is as close as it gets to 'printing money'.

TABLE 1 Events surrounding the four major inflation peaks, 1975–2022.

Event	1975	1980	1990	2022
Money supply growth	✓	✓	✓	✓
Banking deregulation	✓	✓	✓	
Quantitative easing				✓
Fiscal loosening	✓		✓	✓
Oil prices and supply problems	✓	✓	✓	✓
Recessions followed	✓	✓	✓	
Fiscal corrections followed	✓	✓	✓	

Source: Author.

Fiscal conditions also played a part. Two of the inflation episodes were preceded by active fiscal loosening. Budgets were expansionary in 1972–73 and 1987–88, while the 1979–80 inflation spike was exaggerated by a major switch between direct and indirect taxation. The 2022 inflation episode was preceded by *both* a substantial increase in government borrowing *and* a large build-up of personal sector savings because of the support to protect people from Covid combined with the absence of opportunities for personal expenditure. To complete the picture, there was also a major increase in borrowing in 2009–10 because of recession and the need to support the banking system. Whilst inflation did increase at that time, it did not go much beyond 5 per cent.

All four inflation bursts were made more severe by international oil price increases associated with political and military conflict. Furthermore, in 2022 and 2023 there were additional international shortages because of the interruption to supply lines following Covid lockdowns. Generally, the international price shocks came after the beginning of a build-up of inflation. These characteristics of the inflation episodes were common to most of the advanced industrial countries, although the UK was either at the top or close to the top of the inflation league table. Much commentary underestimates the similarities between the patterns of inflation across countries. The first three inflation spikes were followed by recession, in 1974, 1980, and 1991 (see Figure 3). The Great Financial Crisis also brought a recession, but the inflation spike was modest. In the case of the 2022 episode, the recession preceded the inflation spike.

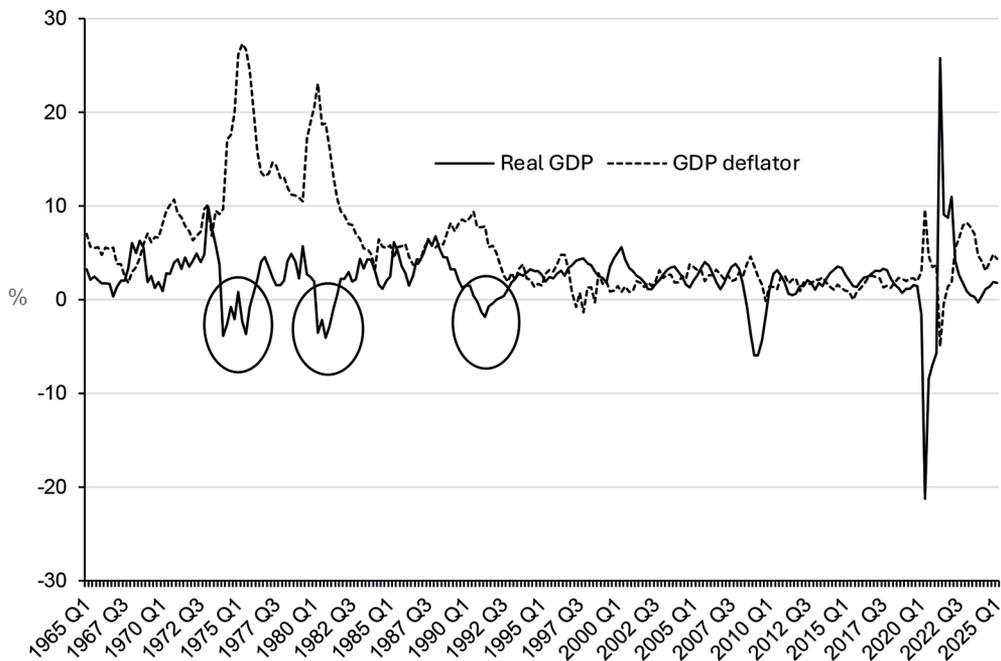


FIGURE 3 Real GDP and the GDP deflator over 60 years (percentage change on year earlier). *Note:* The three oval shapes correspond to periods of falling – on two occasions sharply falling – inflation, as shown by the line for the GDP deflator. The line for real GDP shows that all three such periods coincided with falls in output, that is, with recessions. The apparently dramatic events of real GDP in 2020 and 2021 are to be explained by the official lockdowns which accompanied the Covid pandemic. *Source:* Office for National Statistics.

Significant fiscal corrections followed the first three inflation episodes; in the mid-1970s after the agreement with the IMF; in the early 1980s, in the form of the 1981 Budget plus some generous help from North Sea Oil; and finally in the early and mid-1990s after leaving the ERM. Each were directed at seeking to ease the pressure from interest rates and to stabilise national debt levels. By contrast, there has been no major fiscal correction following either the financial crisis or the Covid crisis. I will come to this later.

4 | LESSONS

For me, there are many lessons from these different policy regimes and inflation episodes.

1. The first and most important lesson is the need to maintain a credible inflation target. The period in the 1970s without such an anchor was very damaging in both economic and social terms, which took some time to correct.
2. The money supply is an important indicator and should have an important role in informing policy decisions to meet the inflation target. Repeatedly, mistakes were made by ignoring these messages - even if there were false alarms at times.
3. Lags in the operation of monetary policy are difficult to handle and mean that often the policy response is too slow. Furthermore, different signals come from different indicators. This is a challenging fact of life. The lesson for me is that, when signs of inflation do appear, action should be quick and decisive.
4. Fiscal policy should support monetary policy. Normally, this means pulling in the same direction and avoiding making the task of setting monetary policy more difficult.
5. The biggest challenges for the operation of fiscal policy are variations in the growth of output (and hence the tax base), and the difficulty of measuring trend output as they have a profound impact on both taxation and public spending.
6. When fiscal corrections are needed, they should be decisive, as was the case in 1976, 1981 and 1993. On those occasions action was taken both in respect of reductions to public expenditure and increases in taxation.
7. Changes to financial regulation have played an important role in monetary behaviour through their impact on bank lending. In standard textbooks changes in bank regulation do not quite qualify as instruments of monetary policy, but changes in it can have a considerable impact and need closer attention.
8. Sharp movements in exchange rates can complicate monetary assessments and give different messages at different times. Again, they cannot be ignored but nor can they be relied upon as a single indicator.
9. Forecasting errors are inevitable. Margins for error to deal with those errors and surprises need to be built into the policy framework.
10. Finally, the sharpest falls in inflation happened to occur when policy was tighter than intended. This happened in both 1980 and 1992. The first was because of misleading signals from money supply figures and the second from a requirement to remain within the ERM limits on exchange rate movement.

5 | COULD WE HAVE DONE BETTER SINCE 2007?

Applying these ideas, I now propose to look in turn at three policy areas and ask if we could have done better. First, I will first question how far the financial crisis and banking regulation have contributed to the slower rate of growth over the past 18 years or so. I will then look at the operation of monetary policy, including the emergence of QE as a policy instrument and question why it took so long to identify the emerging inflation in 2022. Finally, I will question why the national debt ratio has reached such a high level and whether there has been too much delay in addressing the fiscal deficits that arose from the two crises.

However, embarking on these questions, I would like to return to the scale of the slowdown of growth we have seen since 2007. Since 2007 the G7 growth rate has been less than half what it was in the period between 1992 and 2007. The figures are in Table 2. There are special factors between countries, for example Brexit in the case of the UK. But the similarities are more striking and interesting to me than the differences.

Country	2007–2024	1992–2007
France	0.9	2.2
Germany	0.8	1.5
Italy	0.0	1.5
Japan	0.3	1.1
Spain	0.8	3.2
UK	1.1	3.1
US	1.9	3.2

Note: Annualised percentage change between the years specified.

Source: OECD.

Therefore, in discussing the issues I have mentioned we have to keep in mind that most of them have been issues common to the other major advanced countries. I suggest that any attempt to explain the slowdown in growth must look beyond specific issues in individual countries. Of course, apart from monetary and fiscal policies, many other factors need to be considered. These include the strength of industrial competition from China and other SE Asian countries. Just as Japan became a major competitor in the 1970s and 1980s, so we have witnessed the impact of the export-led growth of China. These are issues I cannot go into today.

I am fully aware of the danger of hindsight. I know only too well that reviewing possible mistakes is not the same as making decisions in real time. However, during a weekend conference last winter in Hay-on-Wye, organised by the Library of Mistakes, I was reminded that discussing

possible mistakes is a good framework for thinking about issues. And at my age I have made my fair share of mistakes. As I am making comments about banking regulation, I should declare that I am a shareholder in Santander and some of my comments reflect the time I spent with the bank.

5.1 | The financial crisis and banking regulation

My first question is whether the financial crisis and banking regulation have contributed to the slower rate of growth over the past 18 years or so.

I am not equipped to get into the details of the reason for the financial crisis, but it is now widely recognised that it was the consequence of regulatory failure across the major countries, particularly in the US. Two red flags were ignored for too long. One was the extent of non-banks engaging in risky financial activities, such as credit default swaps, while holding insufficient capital against them. A second was the reliance on wholesale funding by banks, combined with an over-concentration of risk in loans to commercial property and related assets. Once the US problems came to light there was a severe liquidity crunch for UK banks which coincided with fears of non-performing loans.

I was a member of the Board of Santander Group during this period. Fortunately, Santander was not caught in this crisis, in part because the Spanish regulator did require capital to be held against credit default swaps. This destroyed the profitability of this activity, and as a result Spanish banks were not involved with them.

However, following the crisis I fear we have suffered the opposite problem with regulation. To ensure such a crisis would not be repeated, the regulators initiated a sharp increase in the amount of capital banks were required to hold. In many countries, banks moved from being allowed to hold insufficient bank capital to being required to hold excessive amounts. In turn this had a significant impact on the risk-weighted assets banks could hold. Again, I saw this at first hand and the impact it had. Basically, bank lending was constrained, particularly to small and medium-size businesses.

The scale of the change is captured by a subsequent report by the Financial Services Authority in December 2011, entitled *The Failure of the Royal Bank of Scotland*. The report noted that – if the Basel III definitions of capital had been in place before the crisis – RBS would have only recorded an end-2007 common equity tier 1 ratio of around 2 per cent (FSA, 2011, p. 22). This compares to an absolute minimum during normal times, under the post-crisis standards, of 4.5 per cent, and a higher level of 9.5 per cent for the largest systemically important banks.

I am persuaded of the importance of macro-prudential policy. A great deal of progress has indeed been made in embedding this in the approach to banking supervision. However, my view is that two mistakes were made: the pre-crisis capital requirements were often much too low, while the increases required since the crisis have been excessive.

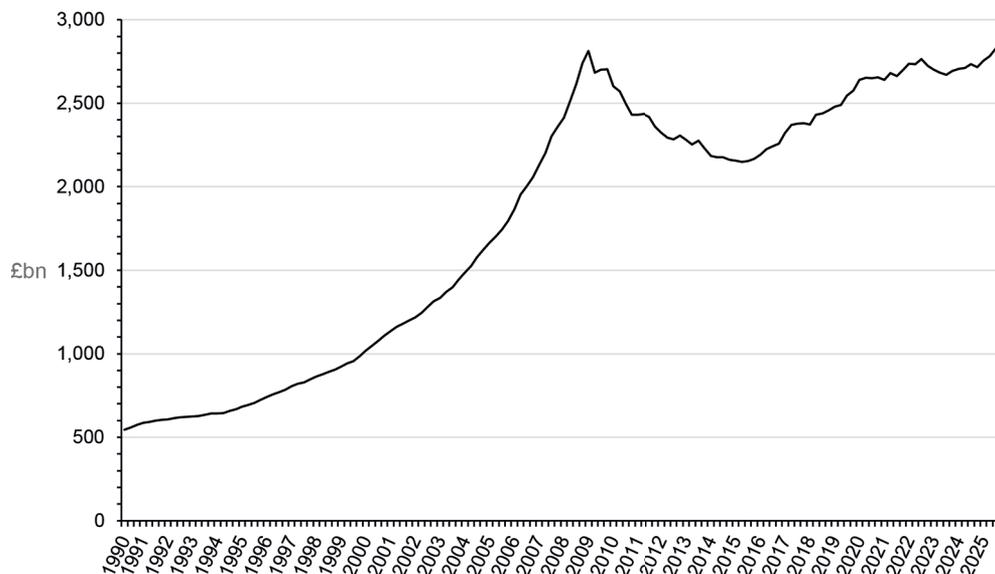


FIGURE 4 Bank lending to the private sector in the UK, 1990–2025 (£bn). *Note:* Data are quarterly and seasonally adjusted. *Source:* Bank of England.

Figure 4 shows the level of the stock of bank lending to the private sector. This shows the slump in bank lending to the private sector from the summer of 2009 through to summer 2016. Today it has just – but only just – returned to the level of spring 2009. I find it difficult to avoid the conclusion that the financial crisis and the regulatory response have had a severe impact on the economies of the major industrial countries. They have contributed to low growth, low inflation and low interest rates.

I am not suggesting that banking regulation is the whole story. Past evidence suggests that banking crises tend to lead to a slower recovery than from other recessions. Factors include the disappearance of banks, the impact of bad debts and the squeeze on the margins of banks from falling interest rates. All reduce the amount of capital available to support lending, as well as being a shock to confidence and investment.

5.2 | Monetary Policy and the emergence of Quantitative Easing

Next, I will look at the operation of monetary policy since 2007, including two issues:

- the emergence of Quantitative Easing as an important policy instrument, and
- the question why it took so long to identify the emerging inflation in 2022.

I don't want to point the finger at the policies of individual countries, because there was a remarkable similarity in the policies followed. But I do ask myself whether the success in meeting the inflation target over so many years led to complacency, with an undue level of confidence among central banks in their ability to respond to inflationary pressures. As Mervyn King (2022) pointed out in giving this lecture series in 2021, policymakers may have given too much weight to the effectiveness of the inflation target in reducing inflation expectations.⁴ They did not give sufficient weight to financial and money supply indicators.

Note the similarity of UK and US policy rates over the period since the onset of the financial crisis and the very long period of almost zero interest rates (Figure 5). The combination of sustained low interest rates and low inflation may also have tempted central banks into a regime of so-called 'forward guidance'. Given the margin of error around forecasts and the frequency of unexpected events, I am no fan of forward guidance. For me, the strength of the inflation target lies in central banks being seen to act in response to deviations from it. Simply asserting that the inflation target exists and will be met is not sufficient to anchor inflation expectations.

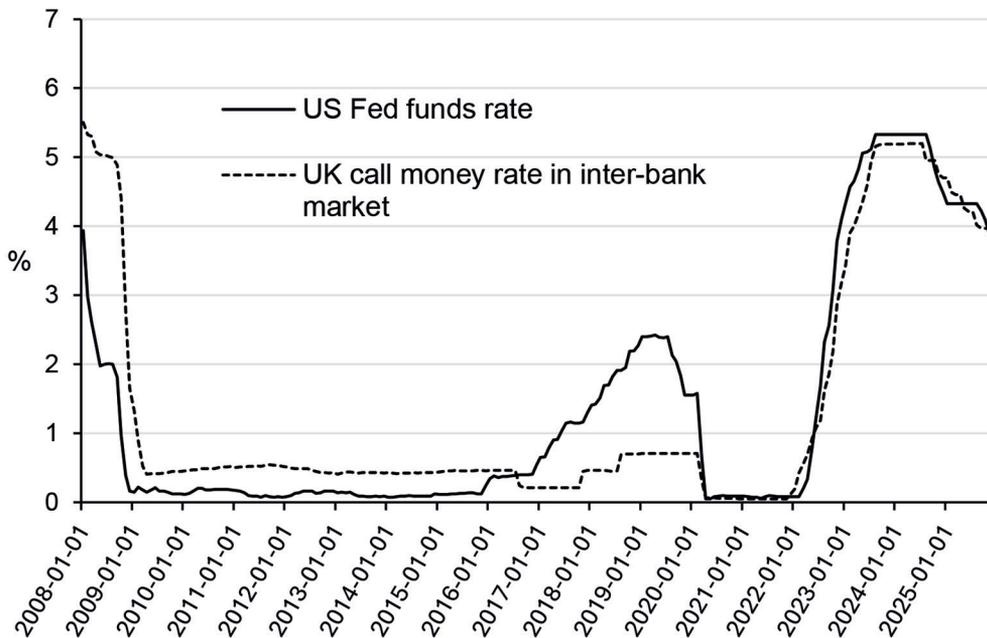


FIGURE 5 US and UK policy rates, 2008–2025. *Note:* The call money inter-bank rate in the UK is closely correlated with the UK's policy rate, Bank Rate. *Source:* Federal Reserve Bank of St. Louis FRED database.

Another consequence of the period of slow growth of bank lending to the private sector was the extended use of QE to support monetary growth. Figure 6 shows the progress of bank lending to the private sector, and bank lending to the public sector, and the total of both together. Bank lending to the public sector in the Covid in the last 20 years has been essentially the consequence of QE.⁵

It also shows the extent to which QE is seeking to fill this gap to prevent too much of a squeeze on money supply. Surely, it would have been better if the capital requirements on banks had been less severe and we had a stronger growth of bank lending to the private sector, thus avoiding the need for the use of QE on this scale in this context. From my perspective as an observer, the period during and after the Great Financial Crisis was poor preparation for what was to come with the Covid pandemic. The Covid medical emergency was a major challenge in many respects. I don't want to second guess the decision to have the original lockdown or the principle of the furlough arrangements. However, the macro-economic dangers of continuing to use public money to pay people who were not producing output and who could not spend their income were understated, as were the consequences of building up future excess demand.

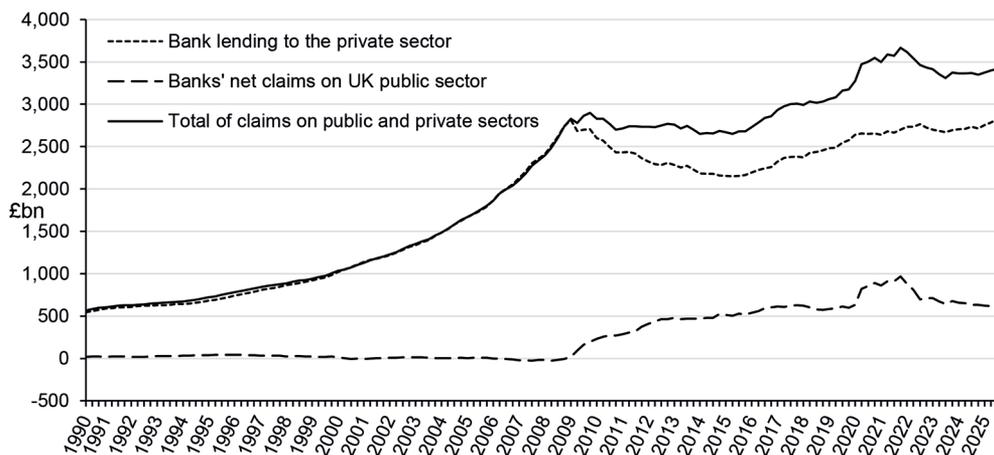


FIGURE 6 UK banks' claims on the private and public sectors, 1990–2025 (£bn). *Note:* Data are quarterly. Banks' claims on the UK public sector are in both sterling and foreign currencies, whereas bank lending to the private sector is lending by banks and building societies in sterling. Interpretation is unaffected. In the closing decade of the twentieth century and the early years of the twenty-first century, UK banks' claims on the UK economy were almost entirely claims on the private sector. From the Great Financial Crisis this changed, with claims on the UK public sector – which had dominated in the early post-war decades – again becoming important. *Source:* Bankstats in Bank of England database.

I understand the concerns about handling markets against a background of a large increase in public borrowing at the beginning of the crisis. However, engaging in large amounts of QE, with very low interest rates, has turned out to be very expensive. Too little attention was given to the monetary growth generated by QE.

My view is that the first step should have been higher interest rates sooner. If there were difficulties in handling markets, QE could have been used once both short and long rates had risen. The Bank of England policy rate did not move until the Ukraine war started and inflation had already exceeded 5 per cent (see Figure 7). Undoubtedly, the Ukraine War was an added ingredient that reinforced an emerging inflation problem. However, as in the 1970s and the 1980s, the impact on inflation of the rise in energy prices was not helped by the earlier rapid growth of the money supply.

My conclusion is that many of the monetary lessons of the 1970s and 1980s I described earlier were not given sufficient attention following the financial crisis of 2007–09. The earlier success in maintaining low inflation created over-optimism about the arrangements and the power of the targets. Success depends on the authorities reacting quickly when things go wrong and demonstrating a willingness to make difficult interest rate decisions. We ignore monetary developments at our peril, even if they do not always send the correct signals.

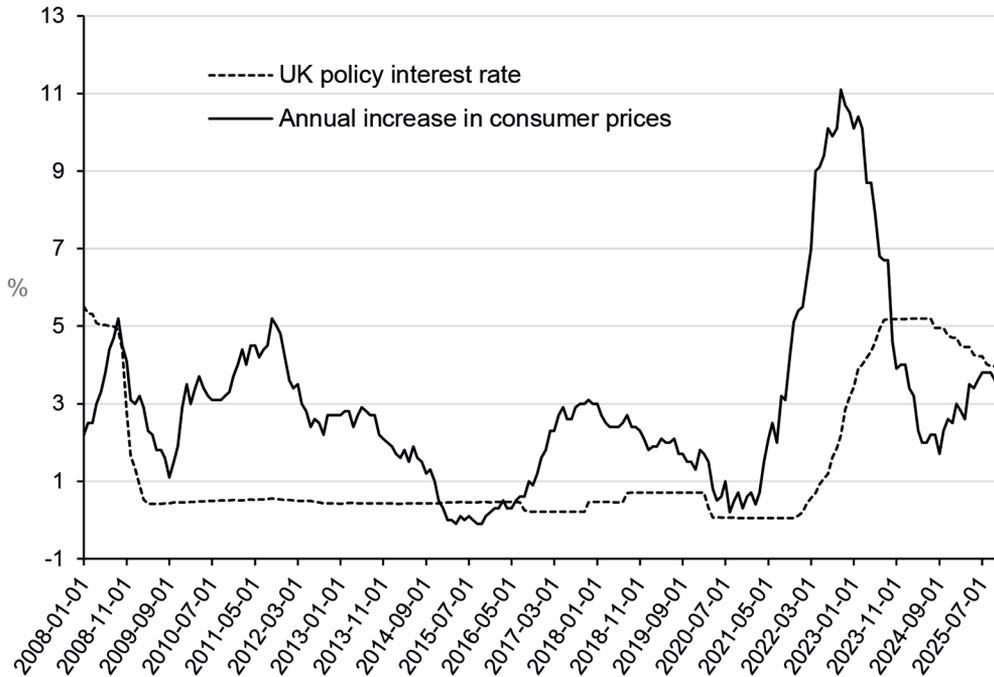


FIGURE 7 UK policy rate and inflation, 2008–2025. *Note:* Observe that the first increase in interest rates in early 2022 followed several months after the annual increase in consumer prices had started to rise and was already over 5 per cent, more than twice the target figure. (The annual increase in consumer prices is itself a lagging indicator, as it is affected by inflation numbers nine, ten and eleven months ago. In the six months to December 2021 the Consumer Prices Index rose by 3.4 per cent, or at annualised rate of 6.9 per cent.) *Source:* Bank for International Settlements.

5.3 | Fiscal policy

My final topic is fiscal policy, which has also been fundamentally affected by the banking and Covid crises. The cost of bank rescues and recession meant that by 2012–13 the debt ratio had more than doubled to around 80 per cent and remained at this level for much of the decade following the crisis. Despite the attempt to constrain the growth of public spending and the notion of ‘austerity’ at the time, the weak growth of the economy meant lower growth of tax revenues at existing tax rates. The consequence was that throughout the 2010s it was difficult to make significant progress in reducing the debt ratio and to begin to pay for the cost of the banking crisis.

The costs of the Covid crisis have now made this position significantly worse, and we now have national debt close to 100 per cent of GDP. This leaves the government with little room for manoeuvre if we were to face another crisis. Even without such a crisis, the nation confronts future fiscal challenges from the cost of the transition to net zero, an ageing population and rising defence expenditure. Another risk is of spiralling debt interest costs, as illustrated in Figure 8. My view is that much more should have been done earlier by raising taxes to begin to reduce the debt ratio, both in the period leading up to the Covid crisis and since.

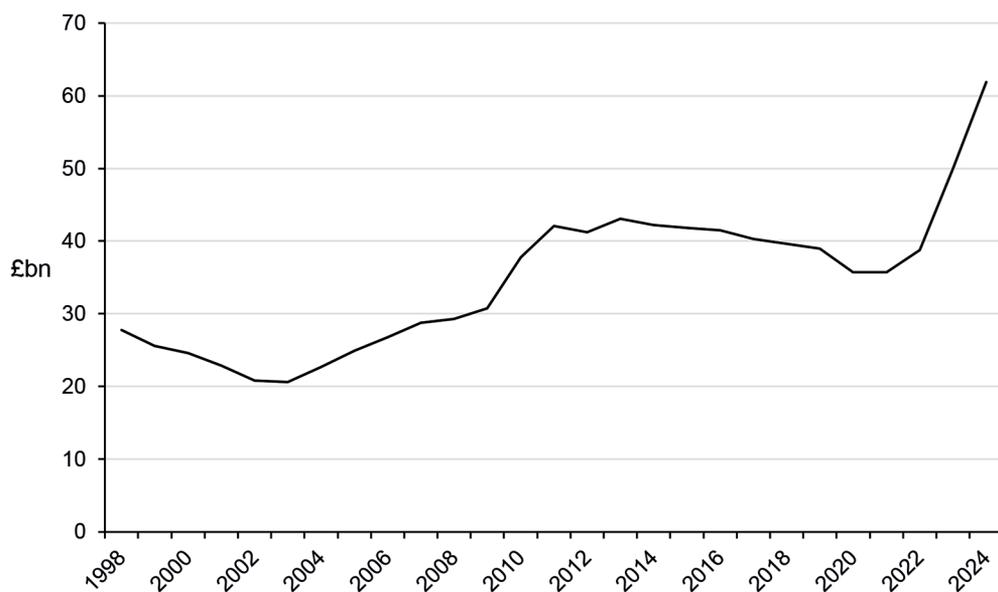


FIGURE 8 Interest payable on the UK's national debt (£bn), 1998–2024, excluding index-linked effect. *Note:* The 2024 figure for debt interest, excluding the inflation element in the redemption amount due on index-linked gilts, was £61.9bn. In the same year the inflation uplift on index-linked gilts was £20.0bn, much less than the remarkable figure of £69.1bn in 2022, which was due to very high double-digit inflation. The Office for Budget Responsibility forecasts total debt interest payments – including the index-linked inflation adjustment – to climb from an estimated £113.7bn in the 2025/26 fiscal year to £140.4bn by 2030/31. This assumes the national debt will exceed £3 trillion next year (i.e. in 2026) and reach £3.5 trillion by 2030/31. (A trillion is a thousand billion.) *Source:* JNYX mnemonic in the Office for National Statistics database.

During lockdown, Alan Budd, Bill Robinson and I spent hours online discussing Keynes's *How to Pay for the War* (Keynes, 1940) and the case for a temporary tax surcharge. Many people were at home being paid but producing less output, while most were consuming significantly less than they were earning. A temporary Covid income surcharge would have reduced both the need for the government to borrow and the excess demand pressure that emerged afterwards.

In the current political debate about spending and taxation participants frequently fail to address the costs of first the banking crisis and then Covid, and to consider how we arrived at the present position. I also doubt that we have been served well by the succession of Budget rules that have been in operation since 2010. Successive governments have either failed to meet them or have wished to change them. I have already stressed the perils of forecasting, and I understand the benefits of transparency and predictability of policy. But if rules are too sensitive to unpredictable events, the gains from rules can easily be lost.

As the headroom built into the rules has been insufficient, constant pressure has arisen to revise them. Moreover, on those occasions when some margin has emerged, it has been quickly used to ease taxes or increase spending. Setting insufficient room for the margin of error also leads, like now, to unsatisfactory periods of speculation ahead of budgets about the scope or necessity for further measures.

One of the lessons I learned from the attempt to establish a new monetary anchor was that it was better to set a clear objective which is achievable and to which government is committed, rather than setting detailed short-term intermediate rules that are constantly revised. My own view is that the government's main fiscal goal should be set on a medium- to long-term basis, and should be aimed at reducing the ratio of national debt to GDP. At the same time, they could set out their expectation for other indicators that would be consistent with this, such as public spending, tax revenues, debt interest and the current balance.

For me, the implications are clear. We need an aggressive fiscal retrenchment covering both taxes and spending to begin the process of reducing the weight of debt and to build more fiscal headroom into the rules that better reflects the margins of error in year-by-year forecasts. We also need to keep an eye on tax buoyancy. Over the years since 2000 we lost 2 per cent of GDP through the failure of key taxes to keep pace with GDP – these include fuel duties, vehicle excise duties, tobacco and alcohol duties, although in the case of tobacco this is in part down to falling consumption. None of this needs to happen immediately but measures to reduce spending and increase taxation should be legislated to come into effect over the course of the parliament.

6 | FINAL THOUGHT

I leave you with one final thought. At times I can see a dark thread through these different aspects of policy since 2007. The thread is as follows. The financial crisis, and the subsequent overreaction contributed to the slowdown of the economy, the long period of low inflation, low interest rates, the resort to QE, forward guidance, and the reduction of official interest in the money aggregates and other financial indicators.

It also contributed to the difficulty of making any significant progress in paying for the costs of the financial crisis. Consequently, we were ill-prepared for the Covid crisis, when we resorted too quickly to QE, failed to pay enough attention to monetary growth and were too slow to raise interest rates.

We also lost sight of the eventual need to pay for both the financial crisis and the Covid crisis.

ACKNOWLEDGEMENT

I would like to express my thanks to Bill Robinson. Over the past 50 years, along with Alan Budd, we have travelled much of this road together. We have discussed the issues raised here many times and Bill has been particularly helpful with both the text and the presentation for this lecture.

REFERENCES

FSA (Financial Services Authority) (2011). *The Failure of the Royal Bank of Scotland: Financial Services Authority Board Report*. FSA.

Keynes, J. (1940). *How to Pay for the War: A Radical Plan for the Chancellor of the Exchequer*. Macmillan.

King, M. (2022). Monetary policy in a world of radical uncertainty. *Economic Affairs*, 42(1), 2–12.

ENDNOTES

¹ Chancellor Ken Clarke and Governor Eddie George.

² The ‘corset’ was an artificial restriction on banks’ balance sheets, which imposed a penalty on them if their interest-bearing liabilities grew too rapidly. It was at work in the late 1970s, but banks bypassed the restriction by conducting credit business in the form of bills and other off-balance-sheet transactions. When the corset was scrapped in 1980, the business was newly registered on their balance sheets, leading to a one-off jump in deposits and broad money of at least 3%. The Big Bang came in October 1986, with the intention of ending fixed commissions on the Stock Exchange. (Leading trade unionists argued that fixing of commissions was a restrictive practice.) Fixed commissions were duly ended, but a number of other changes resulted in a huge influx of risk-taking capital into London’s securities trading and an associated boom in financial activity.

³ The discussion of QE is beset by huge debates about both the meaning of words and the substance of the economic processes involved. In essence, in the UK public debate it has been taken to consist of central bank purchase of assets from non-banks to boost the quantity of money. The purchases have been financed by the issue of new cash reserves to commercial banks. This understanding of QE is not always shared in other countries.

⁴ In his 2021 lecture to the Institute of International Monetary Research, Mervyn King – the former governor of the Bank of England – said that it was unrealistic for central banks to behave like King Canute, as if their mere statement of good intent could deliver low inflation (King, 2022, p. 9).

⁵ QE operations are usually in government securities, because the absence of default risk reduces the risks to the central bank. But central banks can buy securities issued by the private sector, as the Federal Reserve has done on an extensive scale in the USA.

LORD BURNS GCB

Lord Burns began his career in 1965 at the London Business School, becoming Professor of Economics in 1979. In 1980, he was appointed Chief Economic Advisor to the Treasury and Head of the Government Economic Service. In 1991 he became Permanent Secretary to the Treasury, a post he held until 1998, when he was appointed a life peer.

Most recently, Lord Burns was the Chair of OFCOM (2018-2020), and a Non-Executive Member of the Office for Budget Responsibility (2011-2017). His previous appointments include being Chairman of Santander UK plc, Marks and Spencer plc, Welsh Water, and The Royal Academy of Music.

This paper has not been previously published.



INSTITUTE OF INTERNATIONAL MONETARY RESEARCH

Analysis and insight into trends in money and banking,
and their impact on the world's leading economies

www.mv-pt.org

Please direct enquiries to enquiries@mv-pt.org

Charity registration number : 1155226

Registered charity address: University of Buckingham,
Hunter Street, Buckingham MK18 1EG