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RESEARCH

Crisis as Opportunity: The Bank of England and the Rise of Monetarism in the 1970s

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Abstract

Since the 1970s, many countries in the Western world implemented radical fiscal and monetary reforms emphasising monetary targets and fiscal restrictiveness. Political economy scholarship has focused on globalisation, international organisations, and ideas to explain the similarity of reform. However, these explanations underestimate how the crisis itself, and the opportunity structures it provided for individual state actors, shaped policy outcomes. Process-tracing applied to a historical case study of the UK (1970-1979) demonstrates that we can best explain the shift as a critical juncture in which a global crisis provided an opportunity structure for central banks to shape the macroeconomic policy agenda.

Keywords: macroeconomic reforms, central banks, strategies, global economic crisis, capital mobility

1. Introduction

Critical junctures are moments of transformative institutional change which emerge in episodes of political and economic turmoil (Capoccia/Kelemen 2007: 343). One wave of radical reform stands for transformations of this kind like no other. Starting in the 1970s, governments in many advanced market economies responded to a crisis of economic stagnation, inflation, and speculative attacks on domestic currencies with a radical reorganisation of fiscal and monetary institutions from full-employment goals to price stability. The emergence of this juncture is striking because of the similarities in the overall direction of reforms across countries, and because of a

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concomitant shift in policy authority from the fiscal to the monetary sphere. In the old regime, governments were the key actors determining the direction of macroeconomic policy as fiscal policy held primary responsibility in macroeconomic steering. In the new regime, macroeconomic policy became set *first* in the monetary and *secondarily* in the fiscal realm where budget rules increasingly constrained policy decisions (Blyth/Matthijs 2017; Scharpf 1991). What explains governments' decision to curtail their own economic steering capacity and surrender macroeconomic policy authority to central banks?

The turn from a full-employment regime to price stability entailed several economic and electoral risks for elected governments: First, the emphasis on austere fiscal and monetary solutions has likely contributed to constrained domestic growth and stymied domestic demand (Stockhammer 2016; Stockhammer et al. 2019). Second, it distributed wage and wealth incomes from the median to top incomes entailing electoral risks for governments. While expansive fiscal and monetary policies benefit industrial production and lower and median incomes, price stability and balanced budgets benefit financial returns and higher incomes (Albert/Gómez-Fernández 2021; Dietsch 2020). Finally, the shift of policy authority from a democratically accountable realm towards a technocratic policy arena (central banking) does imply increasing limits to the responsiveness of the state towards voter demands in macroeconomic matters (Eriksen 2021).

In the scholarly arena analyses have situated the origins of macroeconomic change in one of two largely separate spheres. The first set of explanations focuses on the role of global economic crisis. It examines how globalisation kicked off domestic economic crises (Barta /Johnston 2021; Mosley 2003), how international organisations shaped policy outcomes during crises (Ban 2016; Polillo/Guillén 2005), and how ideas diffused from the global to the domestic level during global economic turmoil (McNamara 1999; Risse 2004). The second set of explanations focuses on the role of central banks in shaping domestic macroeconomic policy frameworks (Franzese 2002; Iversen 2000). While the two literature strands each examine important factors which may drive macroeconomic change, their analyses have remained largely separate from one another and have, thereby, neglected how the *interaction* of global sphere and individual state actors contribute to macroeconomic change. This interaction seems particularly relevant in light of the considerably different perceptions and policy prescriptions of governments and central banks in response to economic crises (Bodea/Higashijima 2017).

This study examines how the interaction of a global economic crisis and domestic responses of central bankers contributed to radical institutional change in the

macroeconomic sphere. Expanding on a *micro-strategy approach*, which I have elaborated on elsewhere (Rademacher 2021), I develop an account which links global crises with state-actor decisions. For this I join the institutionalist Critical Juncture (CJ) literature and Actor-Centred Institutionalism (ACI). CJ highlights that crises trigger radical institutional change due to political and economic turbulence which relaxes the usual structural (organisational, economic, cultural, and ideological) constraints on institutional change (Capoccia/Kelemen 2007: 343; Mahoney 2001). At the same time, I redirect the attention to state actor agency following ACI's understanding of state actors as self-interested agents which develop strategies based on institutional, structural, or ideational power resources (Mayntz/Scharpf 1995; Scharpf 2018). I stress that crises may not only disrupt existing institutional settings, but also generate opportunity structures for state actors to achieve pre-existing goals.

I conduct theory-testing process-tracing on a least-likely case: The UK between 1970 and 1979. At that time, the Bank of England was one of the least independent central banks in the world and this institutional dependence with limited capacity to shape policy outcomes in the macroeconomic sphere. The logic of applying process-tracing to a least-likely case is that if we find the expected mechanism here, it may exist in other cases as well (Beach/Pedersen 2013). The analysis is pursued in two steps. I first test the validity of alternative theoretical approaches through a congruence method which tests the correlation of the proposed independent and dependent variables in the literature. After the confidence in the validity of alternative approaches is diminished, I develop my own *micro-strategies mechanism* which links the crisis (x) and the policy outcome (Y). This mechanism is then tested through process-tracing and structured empirical tests.

The contribution of this article is two-fold. It develops a new central-bank *micro-strategies mechanism* which hypothesises that one way how economic crises may initiate similar policy change across countries is by triggering state actor self-interest to retain or expand control within the macroeconomic sphere. To achieve their goals, state actors may use the features of the crisis in strategic interaction with other state actors. Empirically, my findings contribute to the literature on fiscal and monetary policy which so far focused on global factors *or* the behaviour of individual state actors to explain similarities in policy change. This study integrates the two realms.

The argument proceeds as follows: The next section reviews the existing literature on radical change in the macroeconomic sphere. Section three introduces the *micro-strategies mechanism* based on theoretical conjectures about how an economic crisis and policy outcomes may be interlinked. I then introduce the methodology used to test the conjectures. In the empirical sections, I first test alternative theories

before tracing the evolution of the price-stability regime in the UK. The final segment of this article draws conclusions of the broader relevance of state-actor strategies for our understanding of critical junctures and transfers the findings to current changes in the macroeconomic policy realm.

2. Explaining Critical Junctures in Macroeconomic Institutions

Critical junctures are moments of radical institutional change which place institutions on a new developmental path (Capoccia/Kelemen 2007: 343). A burgeoning literature has emerged since the Global Financial Crisis (GFC) interested in how crises trigger institutional breaks. This literature aligns topics that have traditionally been relevant in International Political Economy (IPE) – focusing on global economic factors like capital mobility – and Comparative Political Economy (CPE) – focusing on domestic institutions – to explore how global factors are intertwined with the domestic institutional sphere (Béland et al. 2020; Mandelkern 2016).

The 1970s juncture triggered a wave of reforms across advanced economies which replaced the post-war Keynesian regime with monetarism. On the one hand, goals and instruments shifted into new directions. Full-employment and expansive welfare spending was replaced with objectives of price stability, free markets, and competition (Bremer/McDaniel 2020; Notermans 2000). Instruments of discretionary macroeconomic management, fiscal expansion, and the printing press made way for deflationary fiscal policy, budgetary cuts, and a greater role of markets in the determination of interest rates (Carlin/Soskice 2009). On the other hand, the juncture shifted macroeconomic policy authority from the fiscal to the monetary sphere. The use of pegged exchange rates and capital controls in the post-war Bretton Woods system curtailed central bank power assigning finance ministers as key decision makers, this distribution of authority changed after the 1970s (Goodman/Pauly 1993).

Table 1 depicts growth rates of inflation and government spending in 16 OECD countries before and after the regime break.[2] All 16 countries experienced considerable expansion in the realm of government fiscal expenditure and inflation rates until the juncture, followed by a decline (or significantly reduced expansion) thereafter. This break in the data implies that the two macroeconomic regimes were characterised

2 I have chosen the break point for monetary policy in the year 1973 and the break point for fiscal policy in 1984 because efforts of regime change took place in the monetary realm first – around the breakdown of the Bretton Woods system – and fiscal reforms often followed with some delay due to government resistance (Fernández-Albertos 2015).

by radically different policy orientations. The data also show differences in the changes between countries. The decline in government spending after the break, for instance, was much more pronounced in the Netherlands, Canada, Austria and Germany compared to the US, Japan and Spain. I will return to this concomitance of similarities and differences in section 3.

Table 1 Spending and inflation in 16 OECD countries

	Increase in government expenditure		Increase in inflation rate	
	1956-1984	*1984-2011*	*1956-1973*	*1973-2011*
UK	38.30%	-7.42%	29.57%	-65.50%
US	55.50%	10.92%	53.39%	-52.92%
Canada	69.35%	-13.21%	72.81%	-65.69%
Austria	53.86%	-5.85%	83.08%	-70.57%
Belgium	66.43%	-9.57%	48.26%	-67.86%
Netherlands	61.28%	-14.54%	92.74%	-75.64%
Germany	37.38%	-2.73%	52.27%	-73.20%
Japan	43.52%	22.95%	91.83%	-95.45%
Denmark	71.11%	2.02%	23.97%	-73.28%
Norway	62.50%	0.50%	47.58%	-59.14%
Sweden	53.86%	2.77%	17.74%	-55.99%
Spain	66.27%	37.77%	29.25%	-63.89%
France	58.14%	7.38%	68.71%	-71.15%
Italy	66.82%	0.15%	41.17%	-65.82%

Sources: own calculations; increase in government expenditure from the first to final year of the time period presented (IMF 2018); increase in inflation rate between first and last year depicted (OECD 2019).

Four literature strands explored radical change in macroeconomic regimes: the globalisation literature, the literature on international organisations, the literature on ideas and institutionalism. While these approaches provide important insights into how, respectively, the global sphere and individual state actors shape policy change, the links between those two spheres, and how those might contribute to producing macroeconomic change, have received less attention.

The first literature strand stresses that the juncture was a function of capital mobility which triggered economic turmoil in many advanced market economies enforcing a convergence of macroeconomic outcomes (Boix 2000; Rodrik 1997). The main argument follows on from Thomas Friedman's (2000) concept of the *golden straightjacket* which states that once capital markets were liberalised, governments became subject to three critical disciplining forces of financial markets. First, currency exchange rates and interest rates were increasingly set in international markets (Cerny 1997). Second, capital flows and investors increasingly responded to fiscal and monetary decisions (Brooks et al. 2015; Mosley 2000). Finally, credit rating agencies increasingly included fiscal and monetary policy indicators into ratings enforcing domestic policy change (Barta/Johnston 2021; Leblang/Mukherjee 2004). While globalisation clearly presented hurdles to the free choice of macroeconomic policy, this literature tells us little about how developments in the global economy became translated into policy considerations within the state. This is particularly important in light of the considerable differences in which governments and central banks perceive crises and their remedies (Fernández-Albertos 2015).

A second explanation focuses on the influence of international organisations. After capital mobility and stagflation made deficit economies more vulnerable to speculative attacks of global financial markets, many governments became dependent on loans from international organisations (Polillo/Guillén 2005). The IMF, for instance, supported inflation targets, budgetary institutions, and central bank independence in a range of deficit countries in exchange for credit lines (Goldstein 2001; Rodrik et al. 1999). There are two core arguments of how the IMF shaped macroeconomic outcomes. First, the Reagan presidency granted it coercive powers to monitor and impose economic discipline on debtor countries (Ban 2016). Second, the IMF provided a platform for professional networks of economists, policy makers, and financial market communities to disseminate ideas about restrictive policies (Chwieroth 2007; Madariaga 2020). These networks also shaped ideas in domestic central banks leading to restrictive policies (Johnson 2016). While this literature offers critical insights into the international dynamics of loan conditions, more could be said about how different state actors perceived the pressures of international organisations and responded to them in intrastate interactions.

Ideational scholars have highlighted the role state actors' *social learning* in response to global economic events. Some argue that state actors selected new policies along their individual crisis experiences and experimented with new policy tools until they found promising ones (Béland 2006; Dunlop 2009; Dunlop/Radaelli 2020). Others have stressed that the crisis may have generated new beliefs about economic policy making. In this view, currency crises instigated acts of emulation among countries

that had not already successfully fended them off (McNamara 1999; Risse 2004). These approaches make significant contributions to our understanding of the interaction of global developments and domestic responses. However, the particular and conflictual relationship of the fiscal and the monetary realm in moments of crisis are not fully explored.

While institutionalists disentangle the role of different state actors in macroeconomic policies, the global crisis does not play a critical role in these approaches. Scholars in this tradition stress that one critical determinant for macroeconomic policy developments is central bank independence (CBI) which leads to low-inflation policies and non-accommodative fiscal solutions (Carlin 2013; Franzese 2002; Hall 1994; Iversen 1998, 2000). The pressure of CBI on policy outcomes is particularly pronounced for left-wing governments (Bodea and Higashijima 2017) and becomes more effective through multiple constitutional checks and balances as well as a free press (Binder 2021; Bodea/Hicks 2015; Keefer/Stasavage 2003). This literature also explicitly highlights that as preferences of governments and independent central banks differ interactions between the two spheres are often conflictual (Goodman 1991, 1992). While this literature has made an important contribution by highlighting the institutional differences in the macroeconomic sphere across countries, these differences cannot explain similar macroeconomic policy trends. Therefore, a dynamic factor, like a global crisis, must be interwoven with its tenets to explain critical junctures.

3. Critical Junctures and State Actors

This article develops a set of theoretical conjectures about central banks' influence on macroeconomic policy outcomes in moments of crisis. It draws on Critical Juncture approaches (CJ) which stress that crises cause the breakdown of existing institutions. This insight is combined with tenets about self-interested state actors from Actor-Centred Institutionalism (ACI) which allow me to flesh out how different state actors perceive the crisis and how they may use it to achieve policy goals.

Crises assume an essential role for path-breaking change in Critical Juncture approaches. In normal times, inertia, transition costs, and *lock-in effects* prevent radical institutional change (Pierson 2004; Scharpf 2000). A crisis may lead to the breakdown of institutions or trigger conflicts over basic rules in existing institutional configurations (Ikenberry 1989: 223-24). Often global developments, including changing macroeconomic dynamics or a shock to international norms, trigger radical institutional change in the domestic sphere (Cortell /Peterson 1999). The conjecture which can be derived for the British case is that the 1970s global economic crisis of capital mobility triggered the *central-bank micro-strategy mechanism* as rising levels

inflation and exchange rate crises rendered existing monetary instruments increasingly ineffective (Walter/Wansleben 2019).[3]

Traditional CJ approaches stress that once the crisis has relaxed the structural constraints to change, state actor *choices* determine the direction of policy change (Mahoney 2001). However, if different state actors are involved in this process, conflict and strategy should be important as well. ACI views governments and central banks as purposive state actors endowed with individual and organisational self-interest which they pursue through *institutional, structural,* or *ideational* power resources (Mayntz/Scharpf 1995; Scharpf 2018: 22, 37). While state actors may not hold fully equal capacities to achieve institutional change (which explains the differences in outcomes in table 1),[4] two factors may explain the trend in similar policy changes across countries.

First, depending on their position within the state, individual state actors hold somewhat intrinsic preferences for the outcomes of political processes. Governments are interested in (re-)election and tend to support economic stimulation which benefits powerful societal groups (farmers, manufacturers, and workers). Central bankers, on the other hand, tend to be interested in price stability due to their close alignment with inflation-adverse financial interests. Moreover, central bankers aim at expanded control within the larger macroeconomic policy framework (Goodman 1991: 333, 1992: 15). From this insight the following conjecture can be deduced for the British case: Conflicts between the Bank of England and government officials were generally comparatively unlikely due to the nationalisation of the Bank after the war – which makes the UK a least likely case for the mechanism. It was the Chancellor of Exchequer rather than the Bank who determined monetary instruments (Wass 2008: 22). Compared with countries with independent central banks, where fiscal and monetary policy are set in two distinct administrative spheres, conflicts should be muted in the British case where the Bank was subordinated to government

3 While much of the Critical Juncture literature has customarily focused on different paths of institutional change adopting a branching tree metaphor (Collier/Collier 1991), it is also possible to focus on the shared elements of change across countries (Capoccia/Kelemen 2007: 360). This study relies on this concept because it uniquely highlights the relationship of a crisis and policy responses. However, it also amends the previous use of the concept by stressing that the crisis itself may change the opportunity structures for specific state actors to achieve policy goals.

4 Mayntz (Mayntz 1983, 1987) has argued that even if state actors have clearly defined interests, they may encounter a range of obstacles in implementing policy effectively. These obstacles may result in different policy outcomes. Table 1 shows that there are similar trends across countries, but also, especially for the policy field of spending, differences between countries. These differences may go back to implementation problems. This article focuses on the similarities but does not deny that some differences have prevailed between countries.

(Marsh 1993). However, it is still possible that some level of conflict did arise with the onset of stagflation, as government officials and Bank officials may have developed opposing policy plans (Needham 2014).

Second, if conflicts emerged, then the nature of the crisis may have opened new avenues for central bankers to pursue their interests. As CJ scholars recently pointed out, crises may not only relax constraints to institutional breaks but may also offer opportunity structures for actors to strategically push for policy change (Burnham 2017; Keeler 1993). The literature proposed to split permissive from productive conditions of change: *Permissive conditions* are necessary but not sufficient for radical change and may include crises that open windows of opportunity. *Productive conditions* are specific activities of actors that lead to change. The two spheres may be more closely related than traditionally expected in the literature, e.g. actors may use the nature of the crisis to enforce change (Soifer 2012; Weyland 2004). Most economies in the 1970s suffered from a combination of stagflation as well as exchange rate volatility driven by increasingly mobile international capital. Both problems could in principle be addressed by the central bank getting a better grip on liquidity in the economy. Thus, central banks may have been in a superior position to offer solutions at this moment in time. Thus, while the Bank of England held few institutional resources to pursue its policy goals, it had access to structural resources (the nature of the crisis) and ideational resources (narratives of the crisis).

The first hypothesised strategy is *projecting a worsening of the crisis*. A crisis can leave a sense of urgency among state actors which may stoke fears that inaction will worsen present conditions (Keeler 1993: 441). Central bankers were particularly well positioned to point out economic emergencies in relation to the stagflation and exchange rate crisis. Through their expertise in monetary affairs and their close ties with the financial community monetary officials could make it sound costly to ignore developments in financial markets (Braun 2018; Goodman 1992: 7). This strategy should have been available to Bank officials. First, British monetary policy rested on qualitative lending controls since the post-war era which made officials dependent on the cooperation of commercial banks for monetary policy (Needham 2014: 14-15). This dependency may have become more salient during the crisis and Bank officials may have used it to convince the government of policy reforms. Moreover, the British economy experienced a series of exchange rate crises in the 1960s and 1970s which made macroeconomic policy dependent on international financial markets and creditors (Burk/Cairncross 1992).

Moreover, central bankers were in a superior position of *window creation*. In Kingdon's (1984) garbage can model of organisational choice' a policy window opens when

three conditions interact: a *problem* is recognised, *viable solutions* are thought of and the latter are *politically feasible*. However, state actors may not only use a window of opportunity they may *create* one. They may use privileged access to economic information to highlight the right moments for change (Burnham 2017; Keeler 1993). Through their expertise in macroeconomic developments described above, central banks may have been in a superior position to analyse and present data suggesting the right moment for radical institutional change in midst of exchange rate crises. In the British case the Bank of England not only oversaw monetary policy, but also accommodated fiscal policy through manipulation of the gilt market, closely monitoring market responses to macroeconomic policies. Thus, monetary authorities were in a powerful position to suggest the direction and timing of change to stabilise markets.

Inertia, costs of transitions, and *lock-in effects* generally raise the hurdles for radical change (Pierson 2004; Scharpf 2000). Thus, one of the most important strategic abilities of state actors is to read the opportunity structures in a specific economic and political environment. Below I list the process of the *central-bank micro-strategies mechanism*:

- **Step 1**: Capital mobility triggers a crisis of limited steering capacity of monetary policy.
- **Step 2**: Step 1 triggers tensions between the government and the central bank and leads to the central bank determining its self-interest in the current crisis.
- **Step 3**: The central bank strategically uses the developments in the economy to achieve its goals through projecting a worsening of the crisis and creating a window of opportunity.
- **Step 4**: After the strategic interaction with the central bank, the government implements the instruments suggested by the central bank.

4. Methodology and Archival Material

To test the expectations developed in section 3, this article applies a method of theory-testing process-tracing (TTPT) (Beach and Pedersen 2013; Collier 2011). While most case-study methods aim at establishing correlation between variables, the analytical goal of process-tracing is to establish whether a causal mechanism connects x and Y – in this study whether central-bank micro-strategies connect an economic crisis (x) and macroeconomic reforms (Y) (Beach/Pedersen 2013: chapter 8).

Since the primary purpose of TTPT is to test the existence of a mechanism in an empirical case, cross-case inference is not possible unless the method is combined with a comparative-case study approach. This is why this article applies TTPT to

a least-likely case – typically a case in which theoretical expectations are unlikely consistent with the outcome because it does not fully satisfy the theoretical assumptions and scope conditions (Eckstein 1975). A case of this kind can offer strong analytical leverage to increase our confidence in the existence of the causal mechanism in a wider population of cases due to what Levy (Levy 2008: 12) called the Sinatra inference – "if I can make it there, I can make it anywhere". I have laid out the probability of the mechanism in the British case in section 3 emphasising the limited chances of *conflict* between government and central bank and the limited *institutional power* of the Bank of England to enforce change.

I first test my own mechanism against alternative approaches using a congruence method. This method establishes whether the predicted outcome of alternative explanations matches the actual outcome if the hypothesised independent variable is present (George/Bennett 2005: chapter 8). I present a process-tracing table in Appendix A which lays out case-specific observable implications (OIs) for each alternative explanation and tests their validity.

In a second step, I test the mechanism of interest. Appendix B develops case-specific expectations, or observable implications (OIs) for each of the steps of the *central-bank micro-strategies* mechanism. For each expectation, I develop structured empirical tests which assign values of uniqueness and certainty to assess the relative test strength. OI 1 to 4 are assessed through *hoop, smoking-gun,* and *doubly decisive tests*. A hoop test establishes a necessary but not a sufficient criterion for the presence of the mechanism – it is most useful to eliminate alternative theories; a smoking-gun test provides a sufficient but not a necessary criterion for causal inference – it is mostly useful to confirm a theory; and a doubly decisive test confirms necessary and sufficient criteria for causal inference – it establishes high levels of explanatory power (Collier 2011: 826-827). While hoop tests can be found at the lower end of the spectrum of test strengths, smoking-gun tests and doubly-decisive tests assure strong causal relations. Therefore, if the combination of these three tests is affirmed, we can infer with reasonable degree of certainty that the mechanism was present in the case (Collier 2011).

The empirical basis of the article is comprised of 2,103 pages of archival documents from three different sources: The Bank of England Archive, The National Archives, and research reports. Since it is the goal of this study to find detailed insights into the interests and strategies of monetary officials, the collection of archival material focuses on interactions between Bank officials (Governor, Deputy Governor, Chief Cashier, Chief economist, Court and the Executive Directors) and government officials (represented by the Prime Minister, the Chancellor of the Exchequer, and their

immediate staff). The Bank of England Archive material entails notes on monetary policy and economic developments, communication among central bank officials and communication of central bankers with HM Treasury and government officials about fiscal and monetary policy (sources used from this archive are designated with the signature 'BOE' in the citations). The National Archives material contains transcripts of meetings of the Bank of England with Treasury, Chancellor and Prime Minister as well as notes written for communication within government. All documents were collected in a MaxQDA file and coded to test which independent variable got closest to explaining the critical juncture.

5. The Demise of British Demand Management (1970-1979)

In two critical reform periods in the 1970s, British policy makers converted the macroeconomic policy framework from Keynesian demand management to monetarist goals and instruments. First, the 1971 Competition and Credit Control (CCC) Programme deregulated the British banking system and radically reformed monetary policy by replacing the existing system of regulatory control with a cost-driven system with flexible interest rates (Hill 2013; Silverwood 2021). Then, in 1976, policy makers agreed to publish a monetary target (£M3) to control bank lending to the private and the public sector. By including public borrowing, this target did not only curtail credit expansion but also considerably constrained government spending (Capie 2010: 28). Both reforms were implemented against resistance in the Conservative Edward Heath (1970-1974) and the Labour government of Harold Wilson (1974-1979).

5.1 Testing the Role of Globalisation, International Organisations, and Ideas

This section tests the validity of existing theoretical explanations of the macroeconomic policy shift. Account evidence, sequence evidence and statements of policy makers are used to test whether the hypotheses in the literature can be confirmed or disconfirmed. I first assess the hypotheses of the globalisation literature, then international organisations, and finally, the role of ideas in the development of macroeconomic regime change. We can rule out a considerable impact of institutions (independent central banking) because the Bank of England was under public ownership since the 1946 Bank of England Act.

Table 2 Existing explanations

Explanations	Hypotheses
Institutions	– independent central banks force governments to keep deficits low in exchange for low interest rates
Globalisation	– Capital market openness makes governments subject to financial market discipline – interest rate increases enforce policy change
International organisations	– Governments are dependent on loans from international organisations with conditionality
Ideas	– social learning of policy makers through the crisis; they implement new policies because economic conditions force them to do to rethink old paradigms

Own summary

The globalisation literature stresses that capital mobility made macroeconomic policy subject to financial market discipline. With rising interest rate volatility policy change was enforced externally (e.g. Barta/Johnston 2021). The documents do not confirm this hypothesis. If British officials were confronted with a *golden straightjacket* in the 1970s, they did not (yet) accept it. We can see this most evidently during the conservative Heath term. Heath had won the general election in 1970 on a campaign which promised to revitalise the competitive ethos in the British economy (Silverwood 2021: 97-98). Despite this orientation towards free-market ideals, Heath opposed flexible interest rates which the Bank of England viewed as necessary to remedy market instabilities. Instead, Heath planned to implement an economic stimulus package to fight rising levels of unemployment (TNA/T318/326, 18.08.1970; Wass 2008: 9). As one official put it: higher interest rates would "damage the impact of the package just presented" and present a blow to investment (TNA/T326/1062, 25.10.1970). When in 1974 Harold Wilson's Labour government was elected its response to the stagflation crisis was to reflate the economy by raising public borrowing from £2.6 billion to £6.3 billion (Burk/Cairncross 1992: 15, 18; TNA/CAB129/17932, 01.11.1974). Instead of supporting a published monetary target, promoted by Bank officials, Chancellor Denis Healey planned to use the dirigiste special deposits (the so-called "corset") to curb deposit liabilities of the banks (Needham 2014: 80-81; Wass 2008: 197). At a press conference the Chancellor argued that he did not believe a target would "give you support under the ball of your foot" and found that "there are literally four other countries in the world that do it only, America, Germany, Switzerland and Canada and many of them treat their targets with a very cavalier fashion and can afford to" (BOE/6A50/19, 23.07.1976). The hesitancy of government officials to embrace flexible

interest rates and monetary targets disconfirms the hypothesis that the pressures in the market had forced governments into macroeconomic reforms.

The archival material also offers important insights on the role of international organisations (e.g. Ban 2016). International organisations were strongly prevalent in UK macroeconomic politics in the 1970s. Following the frequent currency crises of the 1960s, the UK received lines of credit from the International Monetary Fund (IMF), support from several European countries, the US and Canada and a swap facility from the Federal Reserve Bank of New York totalling $4,370 in 1966 alone (Bordo, Macdonald, and Oliver 2009:444). IMF missions laid out conditionality for credit lines which included short-term lending freezes, borrowing limits for the Exchequer and a ceiling on total Domestic Credit Expansion (DCE) (Goodhart 1986:82). However, it is unlikely that the influence of the IMF alone triggered radical macroeconomic change. First, the UK government held significantly greater sway over the negotiations of credit conditionality compared to other debtor countries. Due to sterling's position as second reserve currency, a radical loss in value would have jeopardised stability in the Bretton Woods system (Oliver/Pemberton 2006: 8). More importantly, critical to the IMF conditionality was the objective to raise export levels. In the realm of monetary targets the IMF therefore proposed the implementation of a target called Domestic Credit Expansion (DCE) which ensured that external deficits were kept low. External deficits were, however, not included in the £M3 target which was eventually implemented under Bank guidance (TNA/T233/3021, 1975). Moreover, in line with the goal to increase export levels the IMF often sided with the government on plans to devalue the pound. But devaluation was fiercely opposed by the Bank of England and did not become the main cornerstone of the policy response (TNA/PREM16/832, 1976).

Finally, the ideational literature has argued that policy makers learned from the exchange rate crises leading to the adoption of monetarist beliefs (Mandelkern and Shalev 2010; McNamara 1999). The archival material, however, contains little indication of an emergent *academic* monetarism within the Bank. The Bank staff, including senior Bank officials like Charles Goodhart, were not convinced of what they dubbed the *neo-quantity* theory. While a seminar on monetarism initiated by the IMF was turned into a standing Money Supply Group (MPG) where officials debated monetary targets and financial deregulation (TNA/T318/1062, 1970), central bankers remained wary of monetarist tenets. Bank officials explicitly stated that they did not aim for *Friedmanism* and a report published by the MPG in the fall of 1969 mentioned that the group had only found weak evidence of the core tenet of monetarism: that money supply drove incomes changes (Needham 2015: 94-95; TNA/T318/1062, 1970). They had not found any "degree of certainty as to the nature of the relationships between

monetary changes and changes in the main component of national income and expenditure" (TNA/T318/1062, 1970). Instead, central bankers increasingly came to support targets for more pragmatic reasons: to place stronger emphasis on price stability, signal to the private sector on their intentions and shaping inflations expectations. These measures promised to get them closer to the goal of regaining control and shaping fiscal policy outcomes (Cobham 2003:16).

5.2 Tracing the Impact of Central Banker Micro-Strategies

We cannot understand the critical juncture without taking stock of how the global sphere triggered domestic policy decisions. In the British case, changing global conditions of capital mobility kicked off a crisis in the domestic macroeconomic sphere leading to macroeconomic change (OI1). The archival material clearly indicates that this crisis rendered monetary instruments, which had worked in the post-war era, increasingly ineffective. British monetary policy was heavily dependent on regulatory instruments including qualitative lending controls and credit ceilings. While these measures were effective in the post-war era when capital mobility was low, their efficacy waned in the 1960s with the rise of the Eurodollar markets. Traditionally, the Bank Rate was set through a clearing-bank cartel which offered non-competitive lending rates to different economic sectors.[5] While this rate was effective as long as credit was created mostly domestically, with the rise of the Euro-currency and the wholesale markets in the 1960s, an increasing share of lending took place outside of the cartel system considerably limiting Bank control over lending rates. To illustrate, between 1951 and 1966 the ratio of clearing bank deposits to wholesale deposits dropped from 9 to 1.6 percent (Needham 2014: 41). The second important instrument of the post-war credit control were liquidity ratios. In 1946, the clearing banks agreed to hold 8 percent of their deposit liabilities at the Bank and held a "prudent" percentage (28 percent in 1963) of total deposits in easily realisable assets with the Discount Houses (Needham 2014: 16). However, since the ratio was only held by deposit-taking banks their effectiveness faded with rising capital mobility (Capie 2010: 28-29). Finally, banks had to keep a share of gross advances at the Bank as special deposits which could be called in moments of credit expansion in the post-war regime. But the clearers grew increasingly resentful of the costs associated with these measures generating friction between Bank and the banks (Green 2016; Ross 2004).

5 The tariff was tied to the Bank Rate which determined the cost of funds for clearing banks. It ensured that priority sectors such as shipbuilding and exports received a guaranteed rate (Capie/Billings 2004: 86-87).

The recurrent experience of currency crises made up an essential element of the story of how macroeconomic policy change evolved. Since 1944, the international monetary framework of the Bretton Woods system had functioned as a safeguard against destabilising floating exchange rates and capital flows (hot money movements) which had pushed many Western economies into crisis in the 1930s. However, speculative attacks soon returned because officials were unable to fully regulate capital flows. And currency crises – attacks on the exchange value of a currency by foreign exchange markets (Bordo/Schwartz 1996: 438) – returned as international financial capital responded to mismatches of domestic financial policies and the peg. Sterling was particularly vulnerable to these incidents and experienced frequent currency crises between the years 1964 and 1967 as balance of payments deficits stoked concerns that the pound could devalue. Therefore, demand management moved to the centre of policy concerns as it appeared to worsen inflation tendencies and external imbalances (Oliver/Pemberton 2006). While the IMF and central banks offered credit lines and swap networks between 1964 and 1967, the international community grew increasingly impatient with the British government in the late 1960s.

This crisis did not only trigger a breakdown of domestic institutions – as expected by traditional Critical Juncture approaches. It also fundamentally shaped the interests and the behaviour of central bankers vis-à-vis the government (OI2). To demonstrate this, we first have to examine the nature of the crisis. The Mundell-Fleming trilemma states that under fixed exchange rates and low capital mobility, attempts to stimulate economic activity may result in balance of payments deficits, while fixed rates and capital mobility impair policy makers' ability to stimulate economic activity entirely. In the early 1960s, when the Bretton Woods system was still intact and capital mobility limited, the British economy therefore generated massive balance of payments deficits (Capie 2010: 21-22). Over time, these deficits became further aggravated by the traditional overvaluation of the pound. Current account deficits put pressure on the balance of payments which had to be settled through foreign exchange reserves. When exchange reserves were depleted, exchange rate crises erupted (Baker 1999; Schenk 2002: 346-48; TNA/T318/326, 1970). These crisis tendencies were accelerated by high levels of sovereign debt and the Bank's mandate to buy gilts to keep the Exchequer's financing costs low (Capie 2018: 363).

Account evidence, comprised of statements by central bank officials, demonstrates that this specific nature of the crisis shaped central bankers' policy interests and incited conflict with the government. Not being in control over international capital flows, Bank officials viewed the fiscal realm as the prime point of attack to regain steering capacity. Governor Gordon Richardson frequently expressed his dismay

about persistently large public sector deficits and suggested developing clearer definitions and goals for monetary policy with "a lead coming from the Bank as opposed to the Treasury". Chief Cashier John Fforde commented in a similar vein that restrictive fiscal solutions were critical in solving the inflation and exchange rate crisis (Dow 2013: 14, 49). In a policy note these arguments were presented to the government: the "effectiveness of [...] monetary techniques" required "restraining of the growth of public expenditure". Large net purchases of Government debt returned money back into circulation, but "restraining the growth of public expenditure" could "transform the monetary environment" (TNA/T318/326, 1970). The Bank's statements also clearly demonstrate its self-interest in retaining power within the macroeconomic framework, threatened by the crisis. Senior officials Charles Goodhart and John Fforde argued that a more competitive financial structure coupled with "control weapons" – reserve ratios, market operations and Bank rate – would make banks more "responsive to official monetary policy" (BOE/4A153/1, 30.3.1971). Moreover, Bank actors supported a "counterparts approach" which coordinated fiscal policy, debt management, and monetary policy with the goal to accomplish a restrictive monetary aggregate (TNA T318/326, 1970). Finally, the Bank argued that the price weapon required flexible interest rates and dismantled controls, measures which the government strongly opposed (TNA/T326/1062, 19.10.1970). Taken together, the Bank proposed a radical transformation of the macroeconomic framework to enhance its own steering capacity.

Traditionally, Critical Juncture approaches expect that in an episode of crisis state actors select new policies which change the path of institutional development. However, actors do not only *choose* new policy paths. They may also use the crisis context to pursue individual policy interests. The Bank's first strategy was to use the state's structural dependency on the banking sector to *project a worsening of the crisis* (OI3a). The role of crisis projections can best be observed during a conflict in late 1970 and early 1971. In this conflict, two different proposals to counter accelerating credit expansion and speculative attacks were debated: The government proposed to expand special deposits, while the Bank suggested to dismantle the clearing bank cartel, implement a uniform and competitive banking system with reasonable measure of monetary control and to use interest rates flexibly. Within this struggle, the Bank strategically highlighted material crisis conditions to portray special deposits as inferior tools for credit control. The first material condition stressed vis-à-vis government officials was the state's structural dependency on the banking sector. Bank officials stressed that special deposits curtailed the efficient allocation of resources in the banking sector with long-lasting consequences for the state's ability to influence credit creation:

> *Almost without interruption since 1964 the authorities have sought to induce the banking system to lend less than commercial and banking considerations would have indicated, and to lend in a different pattern. The underlying and long-run disadvantages of intervening in the private sector to produce an effect of physical rationing are obvious (TNA/T326/1062, 19.10.1970).*

Bank officials also worried that special deposits were crisis instruments that were never meant to stay in place for an extended period of time (BOE/4A153/1, 30.3.1971). A situation in which crisis controls became the norm could lead to a precarious capacity to respond to the next crisis because the Bank would have expended this ammunition (TNA/T326/1062, 25.10.1970). In meetings with the Chancellor, John Fforde made clear that these instruments were not only dangerous because they no longer effectively curbed the rise in bank advances but also because they restricted lending business in the banking sector on which officials were heavily dependent. A large call of special deposits would "have the most adverse effect on the relationship with the banks" and would "make it difficult to keep their cooperation" (TNA/T326/1062, 25.10.1970). The Governor, Sir Leslie O'Brien, suggested that it may be more advisable to "take steps to end the cartel" so that the banks would not be reluctant to put up their lending rates once credit creation had to be curbed again (TNA/T326/1062, 25.10.1970). The point of structural dependence was reiterated in a policy paper to the Chancellor which proposed to heighten competition: the government was dependent on the goodwill of the banks which were often asked to step in to "act in the national interest" and this may not happen in the future, if ceilings were retained (BOE/4A153/1, 30.3.1971).

Five years later, the Bank projected a future run on sterling to highlight the need to announce a monetary target (BOE/6A50/19, 21.07.1976). After more than ten years of recurrent currency turmoil and periodic reliance on international assistance, the locus of the crisis had shifted from the domestic banking sector to global finance and international creditors. To influence policy decisions, the Bank adjusted its strategy to this new reality in the economy. Following the oil crisis of 1973, British external payments deteriorated, and rising levels of inflation led to a selling of sterling (Harmon 1997: 143). The Bank vigorously protected the value of the pound buying sterling of $1.25 billion and $1.5 billion in the first two months of the year. When conditions worsened, the Prime Minister and the Chancellor developed plans to devalue the pound – this would also improve the competitive position of the British industry in the world economy, the government reasoned. But the Bank objected because invoicing in sterling entailed a critical advantage for British financial markets (Burk/Cairncross 1992: 12). Bank officials found that a monetary target and fiscal restrictiveness, policy outcomes long desired by central bankers,

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would soothe global financial responses. First, actors highlighted that officials were dependent on the IMF: "influential official opinion abroad" including the IMF and the contributors to the General Agreement to Borrow (GAB), an initiative led by the IMF to acquire new sources of international liquidity for the UK, found a "normative monetary target" greatly important. It was further elaborated that it had to be expected that this opinion would become reflected in market sentiment, especially in US markets. Actors found that confidence in the government's ability to contain inflation did "not seem at all assured" (BOE/6A50/19, 20.07.1976).

Aside from the general condition of market dependencies, central bankers also highlighted the negative externalities emerging from a mismatch between the new institutional infrastructure and capital mobility. By 1976, a monetary target had been implemented but the government refused to announce it. Leaving the target unannounced in a context of international speculative flows, the Bank argued, could spur a further acceleration of money supply and have "an adverse effect on confidence". A publicly-announced target would "allay the generalised fear of excessive monetary expansion", giving markets a clearer idea of policy commitments and greater confidence that necessary action would be taken to achieve the policy goals (BOE/6A50/19, 20.07.1976). It was also stressed that leaving the target unannounced directly affected the ability to finance government spending: "The adoption of the [unannounced] monetary target is likely to reinforce both the rapidity and amplitude of moments in market rates, so that gilt rates would be more volatile and might well rise higher this winter than would otherwise be the case" (BOE/6A50/19, 20.07.1976).

According to Kingdon (1984), policy windows emerge when a policy *problem* is identified for which *viable solutions* are available that are also *politically feasible*. However, agreement on these three factors does not always arise naturally. Instead, state actors with superior access to information may use it to *generate a policy window* (OI3b). This strategy can be observed in the behaviour of the Bank in both reform periods. Coupled with capital mobility, the Bretton Woods system of fixed exchange rates constrained the effectiveness of monetary policy. Only under two conditions could central bankers regain capacity to influence credit creation: a surplus in the current account and the release of parity through floating. These conditions did arise in different years in the 1970s and were used by central bankers to suggest a window for policy reform. In 1970, the year when the Bank was pushing for the implementation of the CCC, an unexpected surplus emerged in the current account easing the pressure on currency reserves and providing space to focus on domestic monetary developments (Capie 2018: 361). Bank officials argued that the surplus offered an unusual opportunity to resolve the crisis because it distributed new institutional capacity to the monetary realm. The surplus would re-establish macroeconomic

control through the management of the gilt-edged market and control of bank credit *if* financial markets were deregulated and an interest-rate weapon was implemented (TNA/T318/326, 1970). Interest rates were falling, demand for loans was stagnant, and balance of payments were strong: These were the conditions under which a more flexible interest rate structure and more competitive banking would make a real difference: this was "perhaps the most propitious moment [for change] that is likely to present itself for some time" (BOE/4A153/1, 30.3.1971).

The second opportunity to highlight a policy window presented itself in 1976 when the Bank proposed an announced monetary target. Once the Bretton Woods system started to crumble and the dirty float became implemented in 1972, the Mundell-Fleming trilemma was resolved: flexible exchange rates restored monetary capacity. When forecasts predicted a brief slowdown of monetary expansion in a year characterised by strong inflationary pressures, the Bank saw an opportunity to shift the policy focus from international policy targets (exchange rates) to domestic targets (price stability) (Capie 2010: 21-22). The Bank presented these changes in the global economic and institutional sphere as a window to regain macroeconomic control *if* the government published the £M3 target and signalled to markets its dedication to further fiscal restraint. Central bankers wrote in a policy note that the "pause [of monetary expansion] will be more pronounced the more favourably the present [fiscal] package is received". However, this was only the case if public borrowing levels and the expected rise in bank lending stayed below their current level (BOE/6A50/19, 20.07.1976). The stability in monetary and fiscal indicators was critically dependent on how markets perceived the development of the budget. Under these conditions announcing a target was the most effective tool to signal commitment to fiscal restraint to the markets (BOE/6A50/19, 20.07.1976).

The CCC was implemented in September 1971 and included three policy elements desired by the Bank: a shift to a cost-based credit system, the dismantling of the banking cartel and flexible interest rates. Moreover, the £M3 target became announced for the first time in 1976, considerably restricting the government's monetary and fiscal room to move (Needham 2015: 109). The fact that government officials first strongly objected to the implementation of flexible interest rates and an announced target but later implemented these measures in midst of a worsening crisis and under the influence of central bank officials, suggests that the agency of the Bank contributed to the emergence of the price-stability regime (OI4). The validity of this causal chain of events is further undergirded by statements made by government officials. Government officials increasingly adopted the Bank's narratives of market dependency to explain the need for reform. Government officials increasingly agreed that effective monetary control was obstructed through the

inability to control the lending of London clearing banks which were increasingly "drawing on foreign currency resources" (TNA/T259/663, 18.02.1970). The Chancellor concluded that quantitative restrictions on bank lending had to be removed to allow for "freedom for financial enterprise" and "more effective control of the money supply" (TNA/CAB184/40, 28.9.1971).

After almost twelve months of discussions, Chancellor Denis Healey published a 12 percent £M3 target in July 1976 and presented a fiscal package that cut spending by £1 billion (Cobham 2003: 16; Harmon 1997: 131). The archival material shows that with the continuing pressure of the crisis and central bank narratives, external confidence became a factor increasingly difficult to refute for the government (IO4). In his last defiant letter to the Governor, Healey argued: "I do understand very well why you feel that an explicit target would do more for confidence". And he promised to "take [it] very seriously" if monetary growth further expanded (BOE/6A50/19, 22.07.1976). This promise turned into a reality in September 1977, when the government decided to uncap sterling, focus on £M3 and cut spending (Burk/Cairncross 1992: 18; Needham 2014: 116-18). Healey explained, along the Bank's logic, that the target had to be announced and spending cuts had to be large enough to "re-establish confidence in sterling" (TNA/CAB129/191/6, 21.7.1976). Following the sense of urgency created by the Bank, he argued that if the planned deflationary measures were too "mild" they "would fail to carry convictions in the markets" (TNA/CAB/128/60/12, 25.11.1976).

6. Conclusion

This article set out to explore the role of state actor strategies in the emergence of monetarism and fiscal austerity. So far, the literature has focused on macro-level variables like globalisation pressures, the influence of international organisations, ideas, and institutions to explain radical institutional change. However, the micro-level interactions of different state actors have received less attention. The article proposes and tests a causal mechanism which links the interests and strategies of individual state actors in relation to a global exchange rate crisis and accelerating capital mobility and shows how these have contributed to the economic policy revolution in the 1970s.

The article finds that the crisis provided an opportunity structure for the Bank of England to pursue a monetarist reform and budget cuts. It shows that in the run up to the macroeconomic policy reform the Bank of England developed an interest in regaining control in the monetary sphere and developed strategies: Central bankers first projected a worsening of the crisis stressing the dependency of the British state

on the domestic banking sector for effective macroeconomic outcomes. Later, when speculative attacks moved further to the centre of the crisis, the Bank projected a run on sterling. Only if officials published an £M3 target global financial markets and international lenders would regain confidence in British fiscal and monetary policy. Moreover, the Bank highlighted windows of opportunity in which greater control of the central bank, through financial market deregulation or the implementation of a target, would allow for the resolution of the crisis. These initiatives were highly effective as the reasoning of the Bank was later adopted by policy makers when implementing the reforms.

Future research will have to investigate whether more recent crises also provided opportunity structures for central banks. Since the 2008 Global Financial Crisis (GFC) and the 2019 COVID-19 Crisis advanced market economies again experienced radical transformations in fiscal and monetary policy. While some accounts highlight the differences in fiscal and monetary responses to the crisis, Mandelkern (2016) stresses that there are also striking similarities: while monetary measures became strongly expansionary during the crisis, fiscal policy was not expansive enough to work against a downturn. Moreover, contractionary austerity returned soon after the peak of the GFC.

Since both crises were characterised by the collapse of a highly deregulated global financial system, central banks became key actors in providing crisis remedies and were able to further expand their control over the macroeconomic institutional framework. The GFC was a financial crisis characterised by a collapse of derivative values and mortgage-backed securities, followed by an international banking crisis. The COVID-19 Crisis was triggered by an external factor (the virus SARS-CoV-2) which instigated a crisis in asset markets – the market for American Treasuries in particular (Tooze 2021: 14). In both cases central banks have considerably expanded their remit to regain stability in the system. Central banks were able to present themselves as the actors with the capacity to solve the crisis by recovering lending capacity, resolving the credit crunch, and restoring faith in the commercial paper markets. Through unconventional policy programmes central banks bought significant shares of government and private sector bonds (Langley 2015: 84). This not only expanded their balance sheets to unprecedented sizes but may have also significantly expanded their capacity within the overall macroeconomic framework.

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