Funding the Future

Did the 1970s really kill Keynes?

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We’re told that the 1970s proved Keynesian economics failed, that inflation and unemployment could rise together, and only neoliberalism could fix it. But the truth is very different. External shocks, not excessive spending, drove that crisis. Governments panicked, misunderstood money, and abandoned Keynes when they needed him most.

In this video, I unpack what really caused stagflation — and why repeating those mistakes today risks another lost decade for Britain.

https://www.youtube.com/watch?v=OcrGuICZUWc?si=Z2bweYm9nM1oqiuO

This is the audio version:

https://www.podbean.com/player-v2/?i=q39mw-19bbd44-pb&from=pb6admin&share=1&download=1&rtl=0&fonts=Arial&skin=f6f6f6&font-color=auto&logo_link=episode_page&btn-skin=c73a3a

This is the transcript:

Some people are saying that we face the risk of 1970s-style stagflation in the UK, where inflation is above expectations, and unemployment is also higher than anybody would wish.

We've got 4% inflation at the present point in time and around 5% unemployment, although I think the real rate is higher than that, so is this a real problem? And what, anyway, was 1970s stagflation, which is what gave rise to this term? It's something we need to talk about because the truth is it's deeply misunderstood, and the chance of getting it back is very low indeed. But that requires us to understand the causes of the problems that gave rise to the end of Keynesianism in the 1970s.

Back then in the 1970s, and I was around at the time, inflation rose while unemployment stayed high. This wasn't what people expected. Under the Keynesian model, people expected those two to, broadly speaking, work in an inverse relationship. High inflation meant low unemployment. High unemployment meant low inflation. But people realised that you could have high inflation and high unemployment, and economists and politicians declared, as a result, that Keynesianism was dead, the model didn't work, and that they had to find something else.

The trouble was they ignored the fact that there were key global shocks that had given rise to the crisis, and inflation, and that the consequences were ones that would pass through the system in due course, as they always do.

There were two oil price shocks in the 1970s, one in 1973 and one in 1979; and they effectively quadrupled energy costs overnight - quite deliberately, as OPEC countries - Arab countries in the main - took action as a consequence of what Israel was doing with its attacks on Arab states, including Egypt in particular, but also on the West Bank.

The conflict there gave rise to this stress. As a consequence of the rise in oil prices, other global commodity prices also surged, and inflation was imported.

As a consequence of that import of inflation, which was unprecedented at the time, unions sought to protect real wages and went on strike to demand pay rises, and the government panicked. Now that use of union power was something that the unions had got used to because in the post-war period, unions had in fact done an extraordinary job of increasing the real wages of working people in the economy in the UK, and as a result, increased real living standards enormously. So the fact that they fought back against the reaction to rising prices by asking for pay rises was hardly surprising. But the government's panic reaction by tightening money supply, and trying to cut spending, and basically putting into place austerity measures, simply created a worsening situation that approximated to the onset of recession.

There was total policy confusion. It wasn't that Keynesian economics was failing. It was that politicians didn't understand the new world they were looking at.

And there was another factor in all this as well, and that was that they were dealing with the type of money they'd never seen before. In 1971, the world finally came off the gold standard. It was the USA that broke the relationship. And then we all broke our relationship with the dollar by letting the pound float. Now, we were getting towards that point as the 1970s progressed, but the fact was that the monetary system that had been put in place in 1945 had come to the end of its life because there was no underpinning in the reserve currency relationship between the dollar and gold. And there was no relationship left that could be relied upon between the pound and the dollar, and the opportunity to float wasn't something that politicians had understood.

But in practice, of course, when they did, pretty much everything went right with regard to currency. We just discovered a new level at which the pound could be traded, and the problem was over. But until politicians realised that they tried to maintain the value of the pound against imported inflation, which was being priced in this overvalued currency, with the consequence that working people were being punished. That is what caused the stagflation above all else, in my opinion, plus, of course, those external shocks, which they couldn't manage.

But in the middle of the confusion that was created by this, and the claim that Keynesianism was dead, monetarists like Milton Friedman seized the moment. They claimed inflation was always and everywhere a monetary phenomenon. They claimed that state spending was too high, there was too much government-created money in the economy, and that the government must be cut in size, and that the whole of the state should need to 'cut its cloth' to suit its current situation, and that the private sector should be allowed to pick up the slack and grow, and that was how the economy could be returned to prosperity. The mantra was simple: markets are good, governments are bad, and neoliberalism was born from that myth.

But the fact is that actually Keynes had never promised growth without limit. He'd always understood that inflation control was necessary to keep the management of the economy within the real constraints that it faced. He knew more than almost anybody on the planet that shocks like war or oil scarcity created situations that demanded state activity to deliver economic coordination. He had, after all, effectively planned the wartime economies of the UK in 1914 and 1939. He was the person who had literally underpinned the economic situations that had delivered the victory in two World Wars. So he wasn't blind to the risks that existed; he knew about them. But what he also knew was that it was fiscal policy and not blind monetarism that was the tool for stability, even though he did fully understand what monetary policy was, which is something that few people now appreciate.

The fact was, he knew that inflation wasn't just about money. What he knew was that it was also about power. And about the conflict between labour, capital and consumers over who bears the cost of scarcity.

He knew that because he had had to face that in 1941, when he realised that the scale of the conflict that the UK was involved in at that point of time required massive sacrifice by the wealthy in order to fund the war effort. And he solved that conflict at that time with very high tax charges and a reallocation of resources, and effectively enforced savings to make sure that the resources that were required to win the war were made available to that war effort.

So he understood this real relationship between money and resources. And in the 1970s, governments had forgotten about that process. They had effectively lived for 25 or more years from 1945 onwards in a world that was, well, unbelievably good for most people. Let's be clear, I was brought up in that era, and it was one of hope.

And then in the 1970s, when crisis came, governments had to decide between labour, capital and consumers. And under the influence of Friedman and Hayek, they sided with capital and not labour. But let's be clear, that was a political choice and not a Keynesian theory failure, and it broke the post-war consensus. The economics didn't fail. The politics that came in did, however, change everything, and in the end, as we know, for the worse.

Unions were weakened. Wages stagnated. Inequality soared. Real wages did in fact simply not rise for decades to come. Deregulation and privatisation claimed to be free markets when, in fact, they were anything but because they represented financialisation rather than the placement of savings into productive investment, which is what had happened beforehand. And today's crisis of low pay, asset bubbles, and rentier dominance all can be traced back to the point when Thatcher came into office and put Keynes behind her.

The trouble is that Rachel Reeves and Labour now echo those 1970s fears mouthed at the time by Labour Chancellor Dennis Healey and Labour Prime Minister Jim Callaghan, who said, "We must control inflation first." They mistook price pressure for fiscal irresponsibility when it wasn't. It was all about a demand for the government to control the allocation of resources, which they failed to do, and it was that failure which created the crisis.

And inflation now, just as then, is supply-driven, not wage-driven. In the 1970s, it was oil that drove price increases. In the 2020s, it has been oil, gas, fertiliser and wheat that have driven inflation. Those are the drivers now, pretty much the same drivers as they were in the 1970s. The trouble is, we are still repeating the monetarist errors because we believe that we could control this inflation by changing interest rates within our domestic economy, when doing so has absolutely no impact at all on what is driving the inflation in the first place. And pushing wages down in response to those external price changes is just going to make the economy worse.

Stagflation didn't disprove Keynes. It proved we misunderstood him. Keynes argued for full employment, public investment, and cooperation. When energy or supply shocks hit, he said the answer is planning and not austerity. And of course, he proved it during the wartime era. He said, "The state must invest to build resilience", and in the 1970s, it chose not to do so. Instead, neoliberal spin was created.

We now need to reclaim economic policy for people. We need to reject the call from markets that they must be given more, and people must be given less, because that's just absurd, because people with less haven't got money to spend in markets, and therefore, giving the markets more solves nothing because people without spending power literally cannot drive market growth. We have to stop blaming public spending for the excesses of private greed, which we see. And instead, we need a politics of care, a politics that delivers stability, and fairness and proper distribution of the benefits from the economy across everyone within it.

That way, we can truly build a legacy for Keynes, a legacy of justice that ensures that not only markets prosper - and I have no problem with that - but government prospers too, and as a consequence, people prosper on the basis of the security that governments can provide, letting them take the risk of engaging with the private sector.

It's that golden mean that we want to look for. It failed in the 70s because people did not understand what Keynes was saying. They did not understand how to deal with price shocks imported from external sources. And they didn't understand money and how to let it float on international exchanges, or how to use the power of the state to create money for social purpose, which we now do.

Get all those things right, and we don't need stagflation now. We don't need to face stagflation now. We could face prosperity now, but that requires people - politicians - with courage to accept that they have to make the decisions on how to allocate resources and resolve the conflicts between capital and labour and consumers, so that people get the resources they need to prosper, because that is what the role of government is - making sure that people prosper.

What do you think? Do you think the 1970s went wrong because Keynesianism failed? Do you think that neoliberalism was the answer to all known questions? Do you think that markets are still the solution to our problems? Do you think that the government should play a bigger role? Do you simply not know?

There's a poll down below. Let us know.

Poll

[poll id="245"]

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