Treasury orthodoxy and Black Wednesday

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The new Prime Minister and Chancellor are clear that we need to challenge Treasury orthodoxy. They want to do so not because they want more inflation, or care less about the prudent management of the public finances than those who went before. They recognise that the current orthodoxy has failed. It has given us 10 per cent inflation and put us through several violent cycles in the past few decades that could have been avoided.

Indeed, yesterday marked the 30th anniversary of Black Wednesday, when the UK crashed out of the European Exchange Rate Mechanism (ERM). Part of today's orthodoxy is derived from the self-same Maastricht Treaty thinking on debt and deficits which caused our grief in 1992, allied to the exchange rate requirements to prepare us for the euro.

The ERM was a case study in Treasury groupthink. It recommended joining the ERM strongly to successive chancellors. John Major finally drove the policy through against a prime minister who knew it was wrong. I had advised Mrs Thatcher that the ERM would be destabilising, lurching from creating too much money and credit to too little. Nicholas Ridley was a lone voice in the Cabinet making the case against joining. I wrote a pamphlet describing the possible difficulties. I took the listed company I chaired out of the CBI in protest at the group backing the ERM policy, telling them it was bound to damage business and the rest of the country. And so it proved.

But the ERM disaster was not unique among official advice in the last 50 years. There was the early 1970s secondary banking crash, made worse by the Opec oil price hike. There was the end of 1970s policy depression meant to purge the high inflation that loose monetary policy and Labour's fiscal policy caused. There was the great banking crash of 2008-9, which followed a period of over-easy money when we were told by government that banks could lend far more without bad consequences. These were all boom-bust cycles like the ERM one, all of which harmed us and slowed the longer term growth rate.

Treasury orthodoxy has evolved as it has drifted from one bad international fashion to another. If there is a single leaden thread, however, it has been an unwillingness to take money and credit growth seriously, ending in them each time expanding excessively and then contracting too far and too fast in shock at the error.

Today the orthodoxy that needs changing is the one which said it would not be inflationary to carry on creating money and buying bonds. The Treasury throughout the last 13 years ignored inflation in financial assets. It was only a matter of time before asset inflation spread into general inflation. I assume the new team will rightly rule out any more special bond buying . The Treasury also needs to grasp that lurching from excessively easy money as in 2020-21 to excessively tight money is the way to bring on a slump.

Steering the economy to achieve lower future debt ratios when forecasts are often wildly out on tax revenues and inflation is also not a good model. In the last two years, revenues have outperformed the official forecasts, meaning we borrowed a lot less and worried needlessly about the deficit. In the recession which official policy now seems to favour, the opposite is likely to happen with revenues falling short and the deficit rising. The new policy needs to take money and credit seriously. But it also needs to set tax rates that help grow revenue, not stifle it, as well as removing obstacles to growth throughout the private sector, which the old rules failed to do. Leaving the ERM allowed us to reduce interest rates and get out of the recession it created. Today, we have to see off the recession the Bank is forecasting. That requires new thinking. The only way to work our way out of our present difficulties is to produce more energy, make more, and sell more.