Bank of England

"Muddling Through or Tunnelling Through?" UK monetary and fiscal exceptionalism during the Great Inflation

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The paper

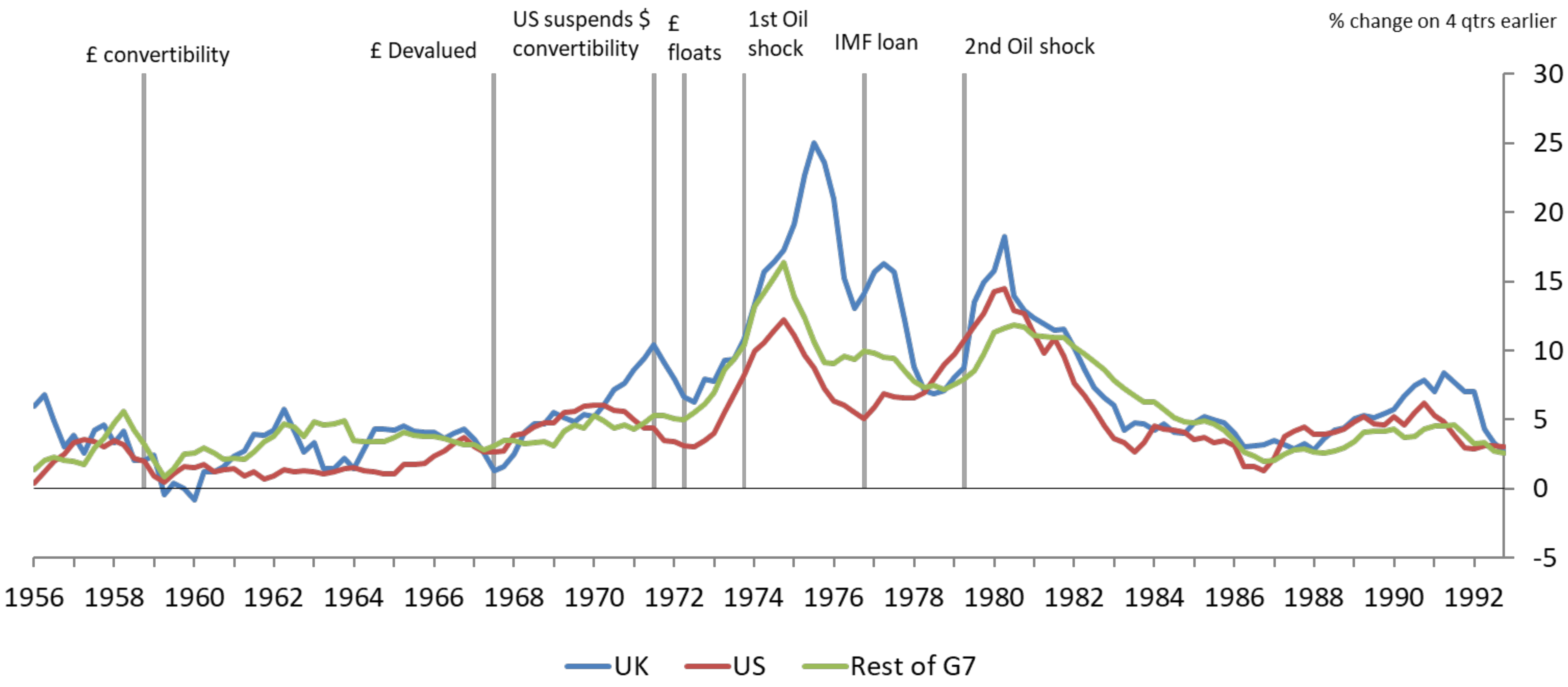
Part 1:

- Narrative history of the UK inflation experience from 1950s

Part 2:

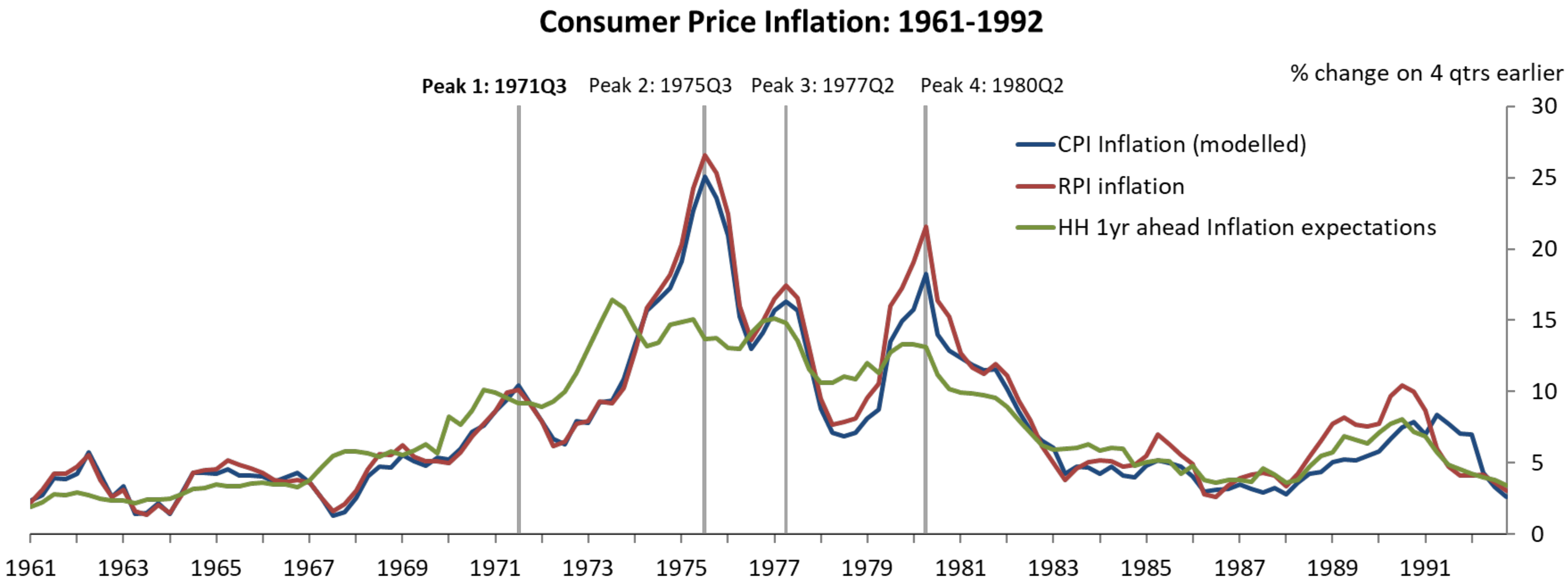
- Revisit existing hypotheses for the causes of the Great Inflation (based largely on US literature) and examine their relevance to the UK
- Re-examine monetary-fiscal interactions using old and recent fiscal theories of inflation
- Utilize available inflation expectations data
- Why was the experience different from the US and other countries ?

Great Inflation the UK compared to US and other G7



- Similar experience following 2nd oil price increase and Volcker disinflation in early 1980s
- But why so different to US and other G7 in the1970s ?

Several “bursts” in UK inflation



- Expectations drift up in late 1960s/early 1970s, but relatively stable thereafter
- Do not respond to oil price shocks

Key Takeaway

- We re-examine the role of demand management and interaction of monetary, financial and fiscal policy
- This had important implications for inflation expectations and wage determination in labour market
- Burgeoning fiscal and current account deficits in the 1970s coupled with double-digit inflation suggest major policy failures
- Fiscal policy was the key instrument used to manage aggregate demand before 1976
- The BoE was not independent and it was fiscal policy as much as monetary policy that was instrumental in ending the Great Inflation
- Large unexpected budget deficits were funded by the banking system, increasing broad money growth and believed to increase inflation
- Hence fiscal policy was more active and monetary policy more passive than they are today
- Resonant with modern fiscal theories of inflation such as Sargent and Wallace Unpleasant Monetarist Arithmetic (1981) and FTPL (Leeper (1991), Cochrane (2022)

Key hypotheses for the UK similar to US story

- **Bad policy**
- “Go-stop” policies continue into 1970s
- Monetary and fiscal policy over-accommodating
  - over-optimistic on potential supply
  - government reluctant to raise interest rates
- Monetary neglect – impact of financial liberalisation (Competition and Credit Control)

- **Bad luck**
- Declining supply side (rising NAIRU) and tradable performance
- Commodity price and wage push shocks
- Collapse of Bretton Woods, UK loses its nominal anchor

Bad policy - Theoretical and empirical underpinnings of Go-Stop

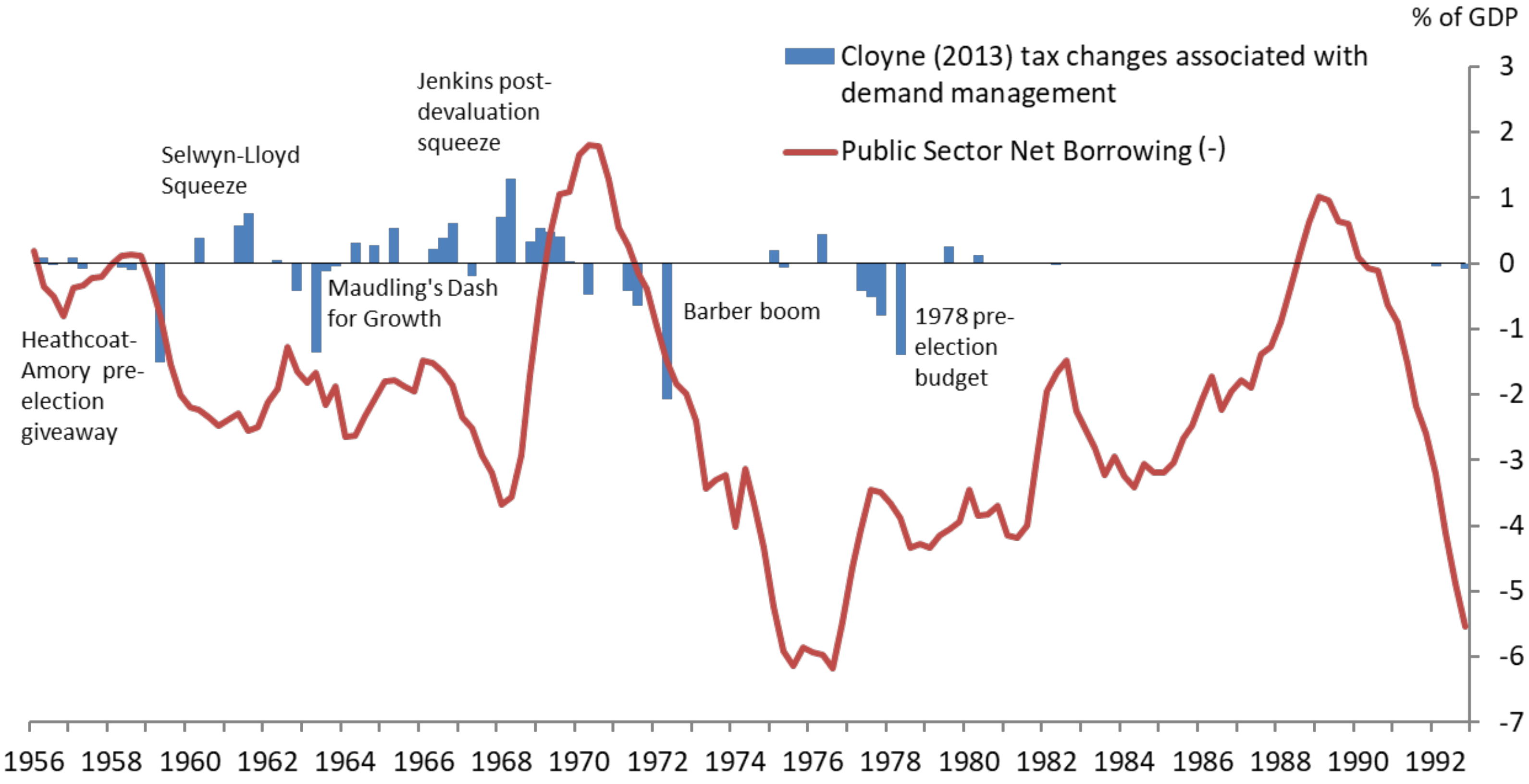
- **Post war-consensus on maintaining ‘full’ employment given the experience of the Great Depression – fiscal stabilization policy**

- **Developed into a more dynamic theory of how to achieve faster growth**
  - Verdoorn’s Law/Kaldor – faster growth in manufacturing increased productivity through economies of scale
  - Harrod’s theory of growth suggested running the economy “hot” to achieve high investment ratio

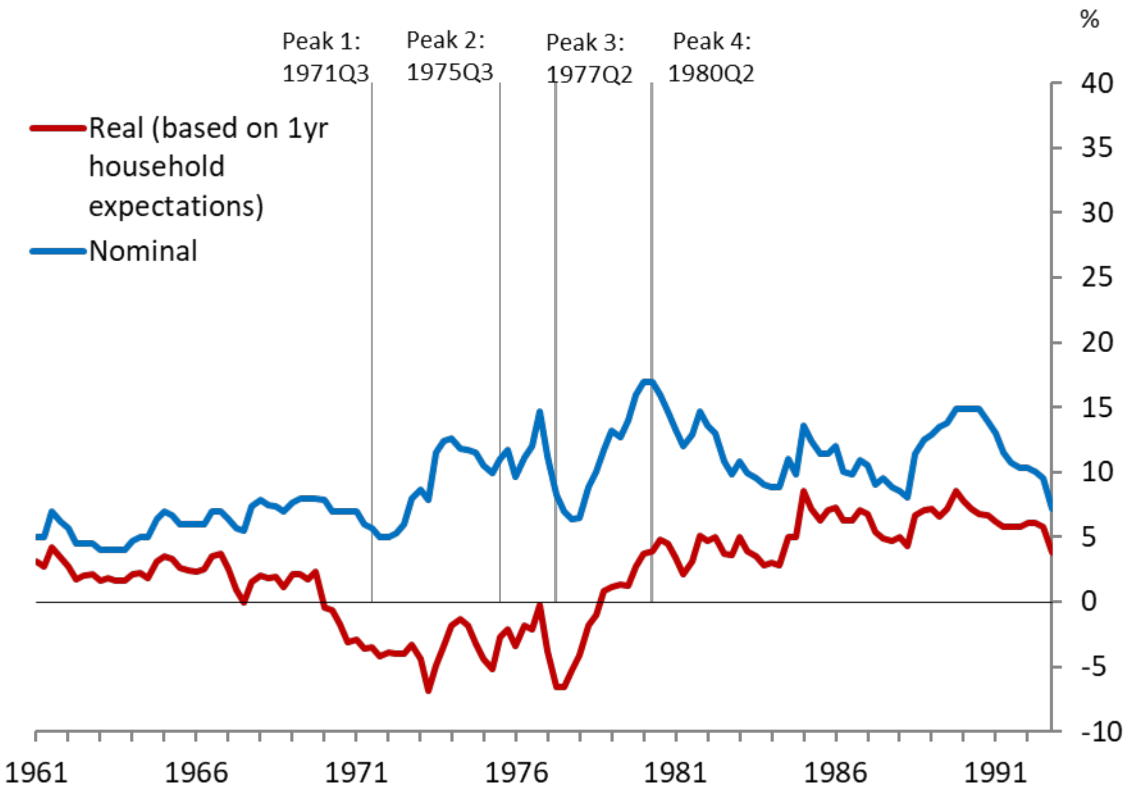
- **Misguided belief fiscal policy and demand stimulus could achieve faster growth**

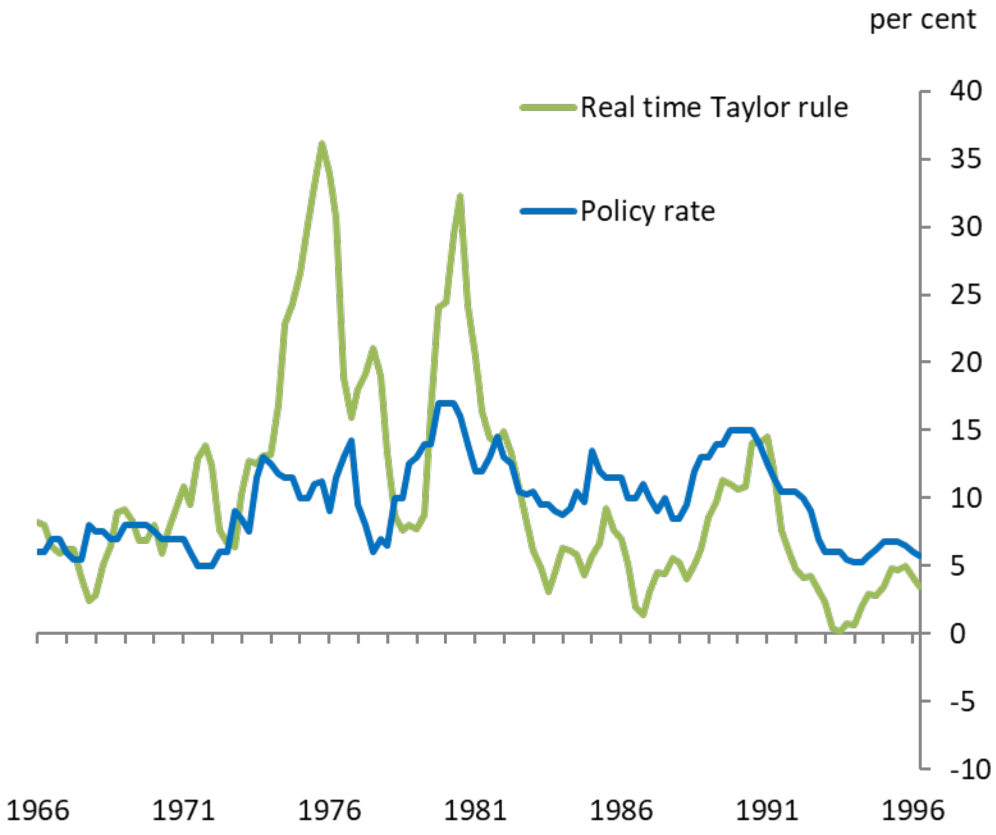
- **Before 1971:** Bretton Woods constraint would mean most of these attempts led to BOP deficit and “stop” phase in policy to maintain peg
- **After 1971:** future attempts to boost growth would lead to depreciation and inflation

Bad-policy: Go-stop cycle from 1950s and 1960s continues into 1970s



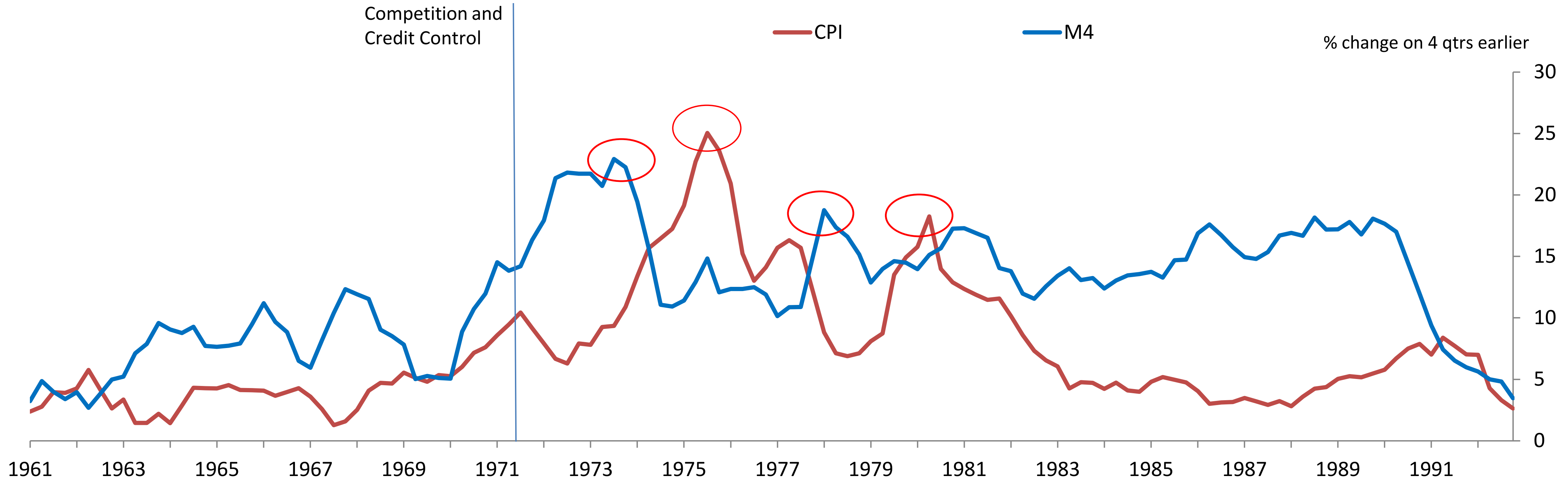
Bad policy – real interest rates negative and well below Taylor-rule prescription based on real time data





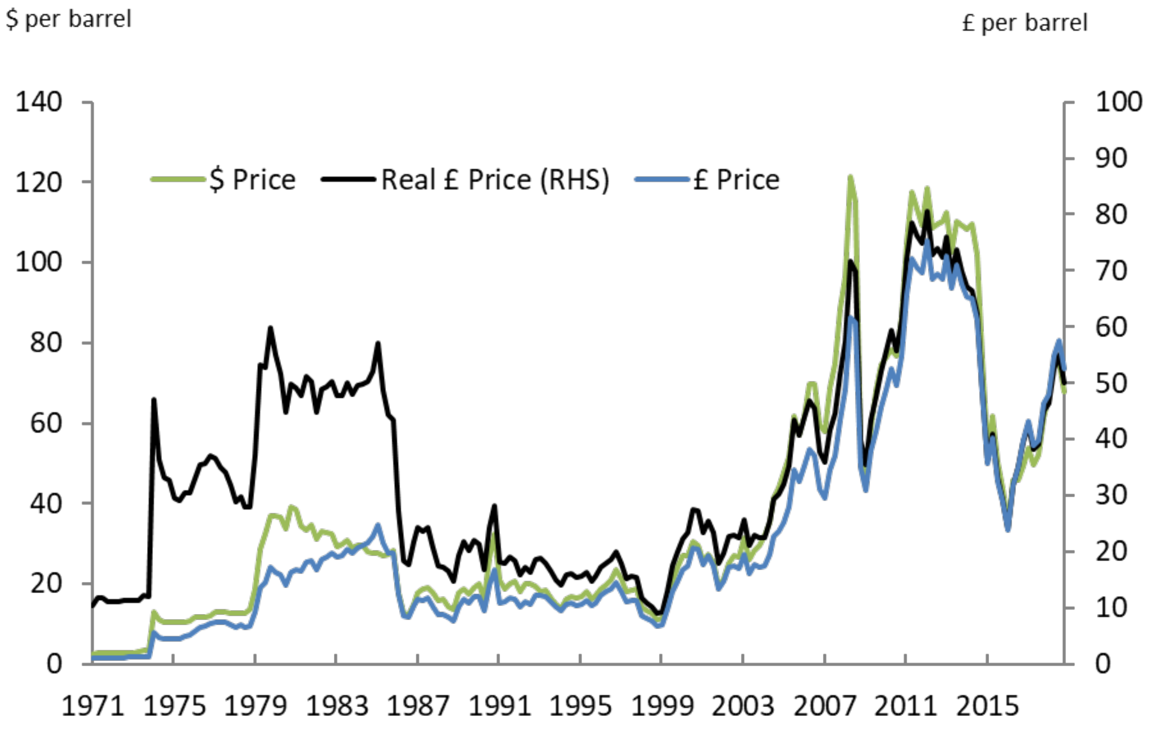
Based on Nelson and Nikolov (2001)

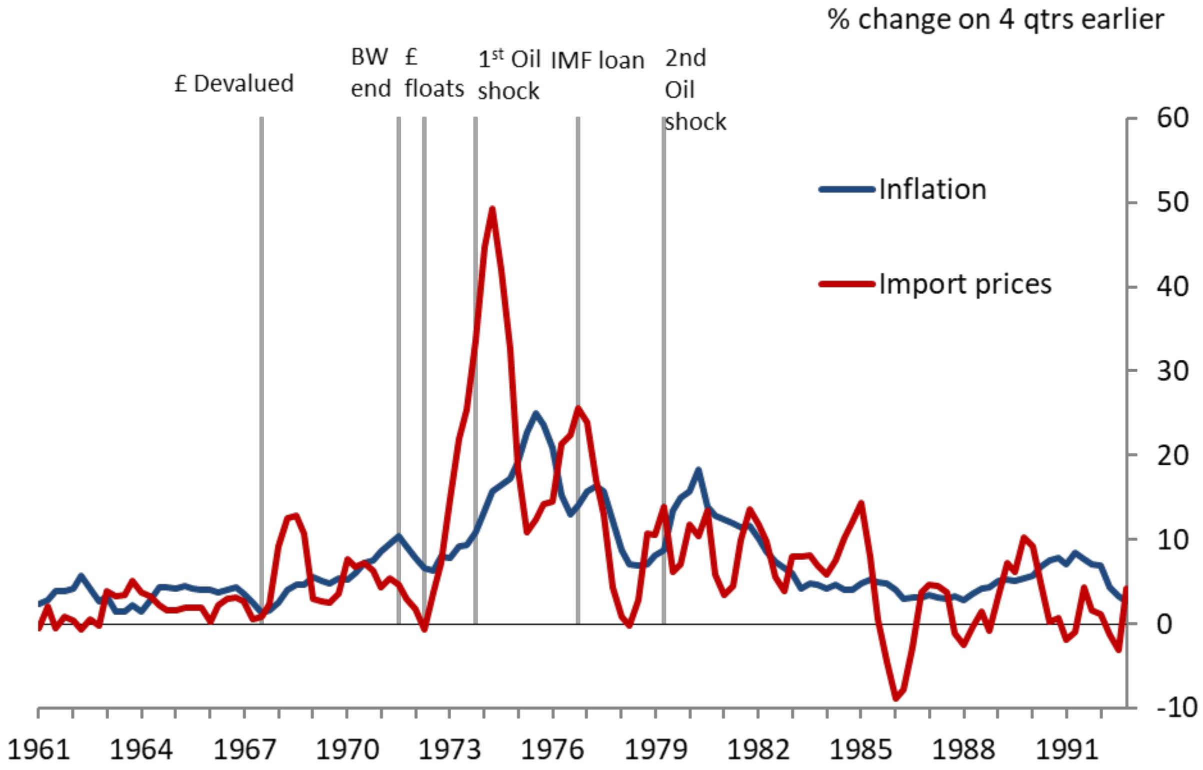
Monetary Neglect – broad money growth and inflation



- Competition and Credit Control (CCC) in 1971 led to boom in money and credit
- Money growth peaks two years ahead of inflation peaks, but unique to 1970s ?

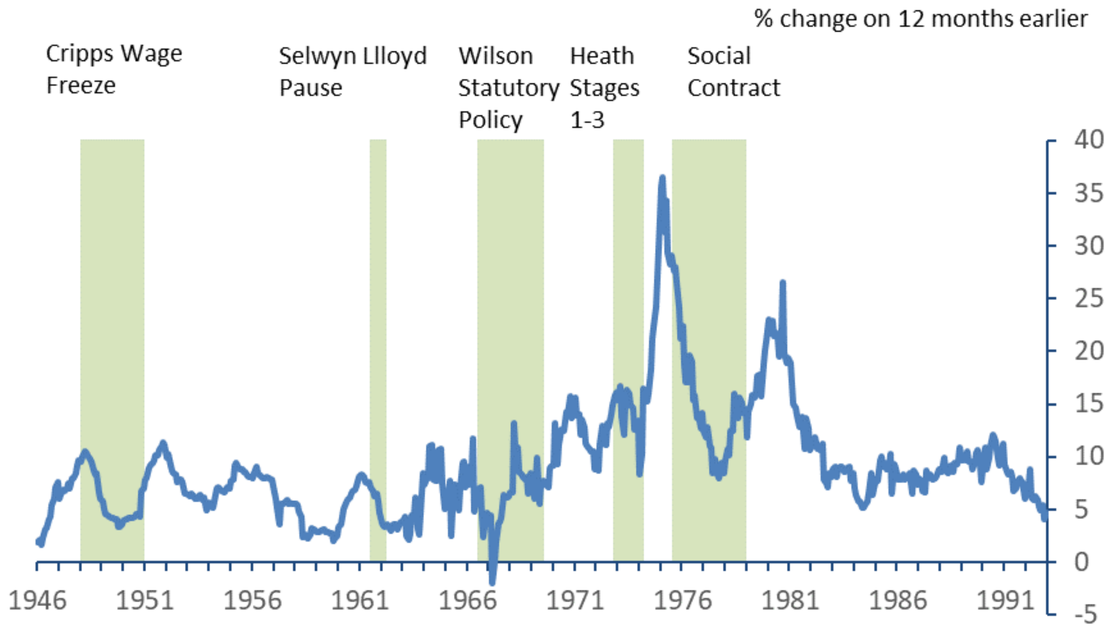
Bad luck: Commodity and import price increases



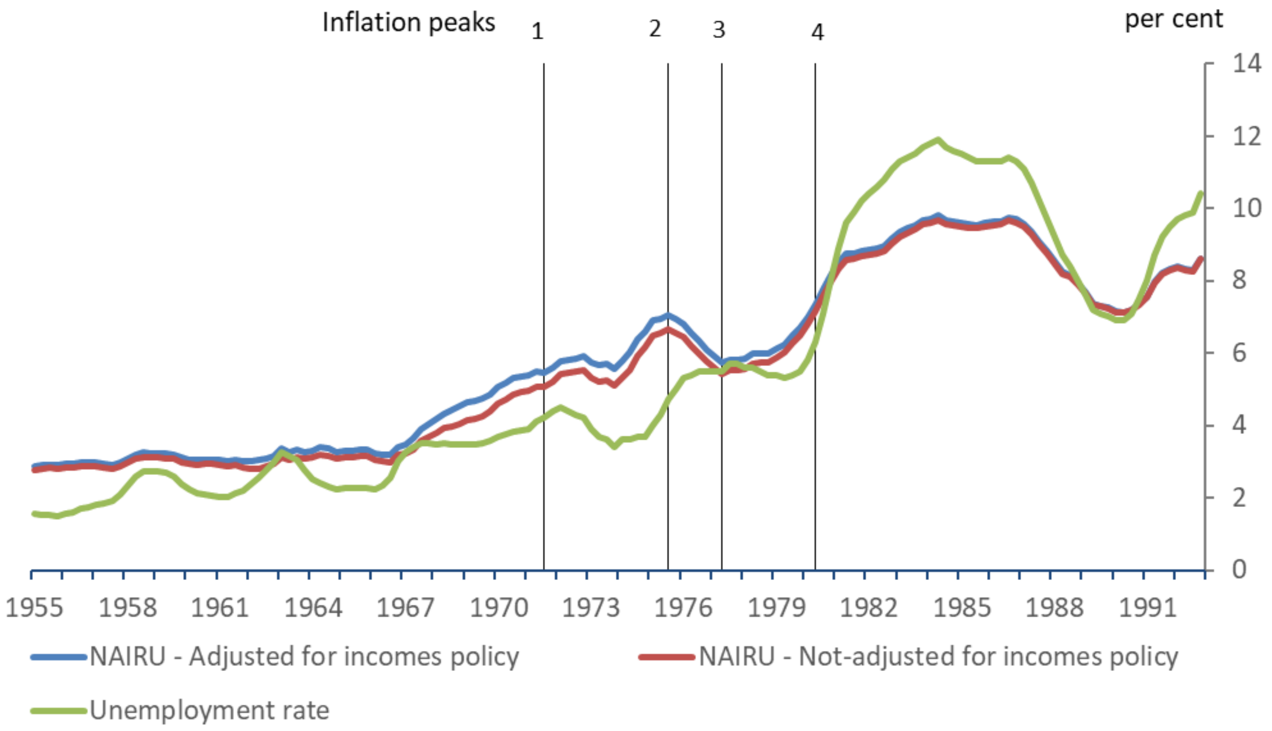


Bad luck: Wage Pressure and increasing NAIRU

Earnings growth and incomes policies

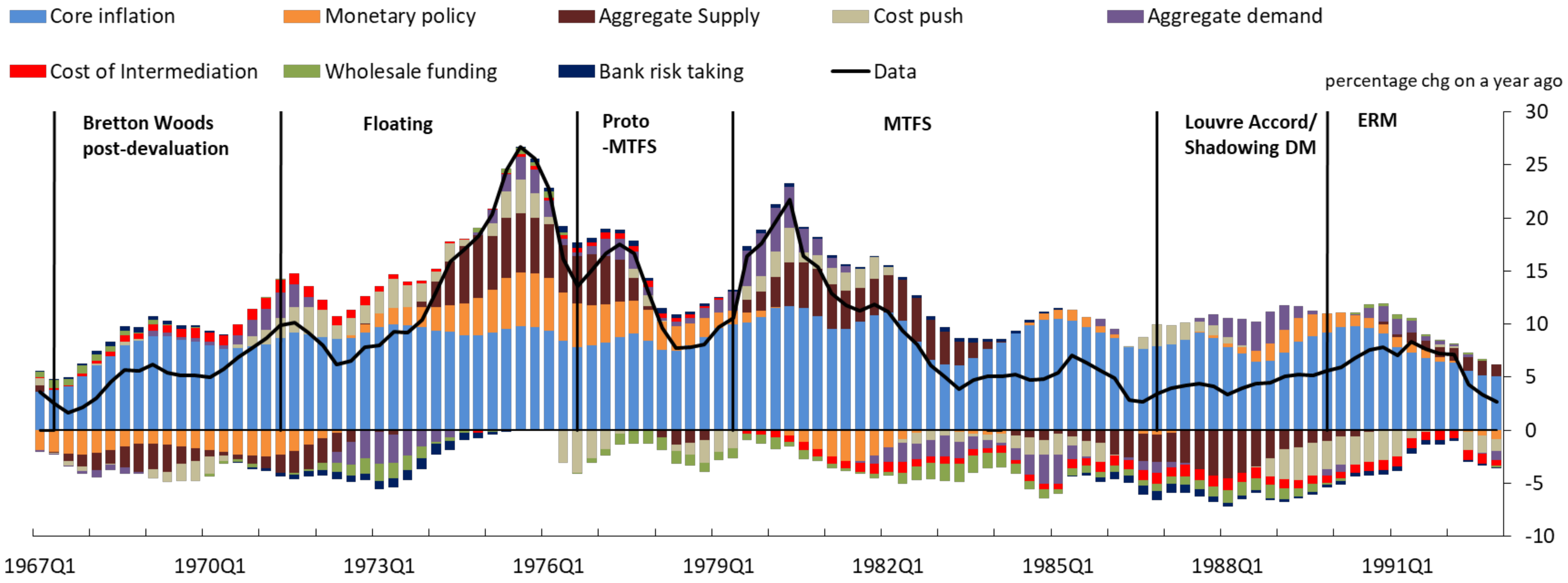


NAIRU increasing from late 1960s



- Wage pressure a growing problem
- Incomes policies frequently in place but led to wage explosion once lifted
- Threshold agreements in 1973 automatically indexed wages to prices ahead of 1st oil shock

Evidence from a Structural VAR



- Aggregate demand, cost push and potential supply factors explain inflation “bursts”
- Evidence of “over-accommodation” (monetary policy shocks) in mid-1970s

A role for fiscal theories of inflation ?

- Would tighter monetary policy on its own have been enough to lower inflation in the mid-1970s ?

- New Keynesian model suggests increase in interest rates also requires expected tightening of fiscal policy to stabilise debt if inflation impact is to be lower

- Active monetary policy, passive fiscal policy regime (Leeper (1991))

But not clear this was the regime in the early-mid 1970s

- **No explicit commitment to run future primary surpluses to stabilise debt**

Whether the budget was in balance or had a surplus or deficit was a secondary consideration (indeed for some policy makers it was of virtually no importance).

Douglas Wass, Permanent Secretary to the Treasury 1974-1982

- **Public Sector Deficit used to absorb cost push pressures**
  - Public sector pay increases (larger than private sector settlements) financed by borrowing
  - Subsidies on food, rent and mortgages to try and put a lid on wage and commodity price pressures
  - Tax cuts in some budgets were directly linked to wage restraint under the "Social Contract" with unions

- **Hope in "tunnelling through" to North Sea Oil revenues that were expected to come on stream in the late 1970s**

Potential Fiscal *theories* of inflation

- **Credit counterparts approach**
  - **Government borrowing (from banking system) affects the broad money supply**
  - **Limit on flow of borrowing from non-banks**
  - **Residual finance from the banking system creates bank deposits**

- **Sargent and Wallace unpleasant monetarist arithmetic**
  - **Limit on debt stock**
  - **Persistent deficits may cause stock limit to be breached**
  - **Anticipated monetary financing raises inflation today**

- **Fiscal theory of the Price level**
  - **Fiscal policy needs to stabilise debt through running appropriate primary surpluses**
  - **Otherwise increasing rates can lead to "Neo-Fisherian" effects or "Stepping on a rake" where inflation can increase rather than decrease in response**

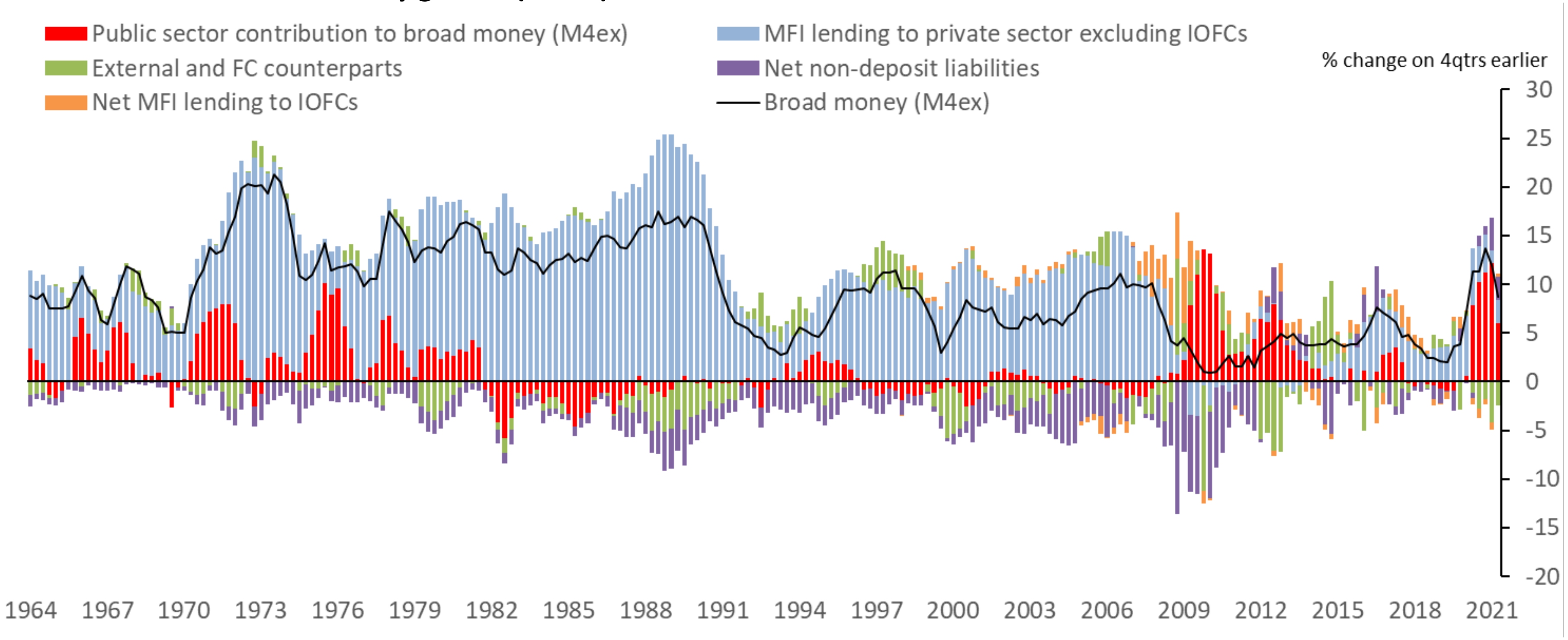
Credit counterparts approach

- **Public sector contribution to money growth = financing of public sector from banking system**
- **Periods in the 1970s when it was contributing a large amount to money growth**

Based on identity: Δ Broad money = Δ MFI £ Lending to the private sector + **PSBR - sales of government debt to non-banks**

+ Δ Net FC lending + Δ net £ lending to overseas residents - Δ net non-deposit liabilities

Contributions to broad money growth(M4ex)



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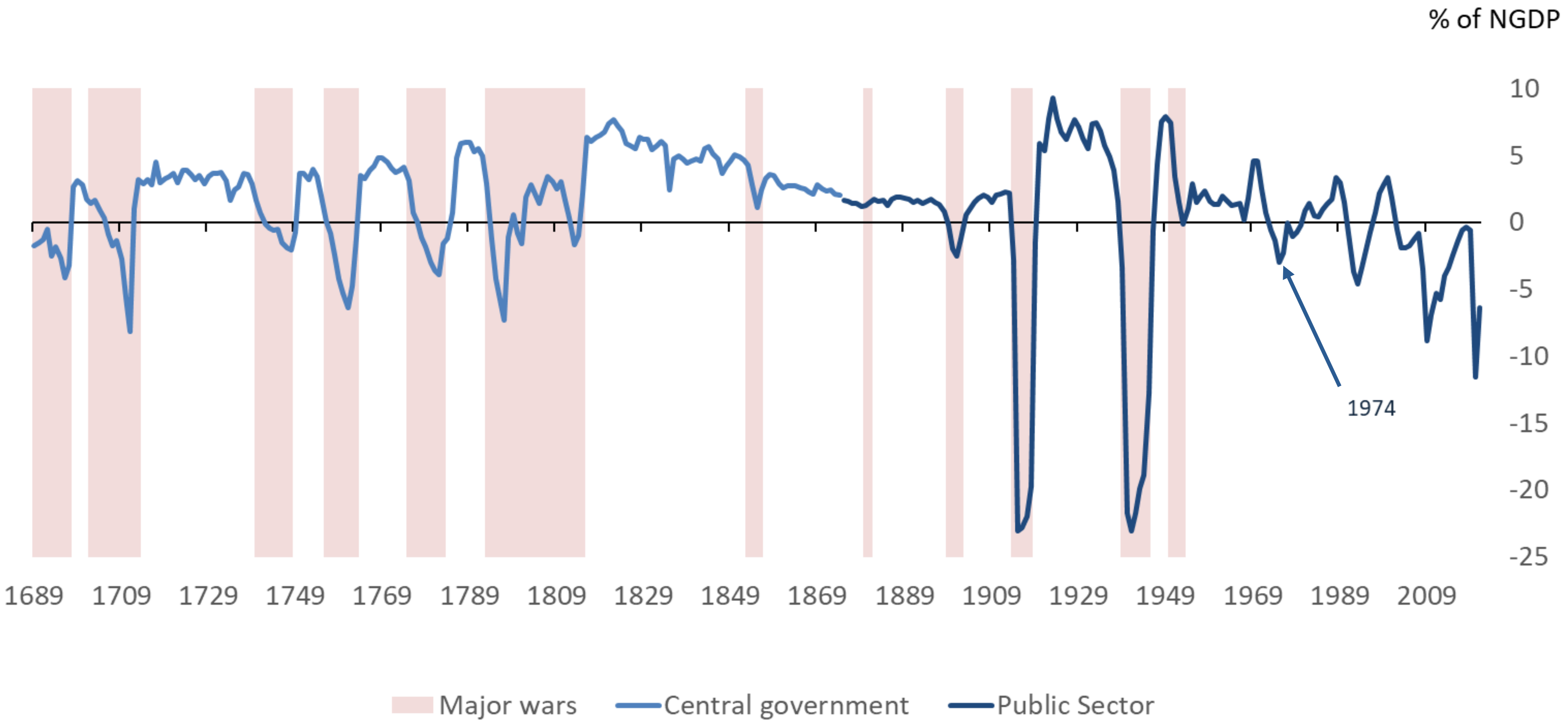
1974 would be the first peacetime primary deficit in 300 years



- **At the time it was forecast to get even worse, financial markets responded negatively**
- **Gilts strike and sterling crisis in 1976 would lead to government calling in IMF**

1976 – a fiscal turning point ?

Jim Callaghan "We used to think that you could spend your way out of a recession and increase employment by cutting taxes and boosting government spending. I tell you in all candour that that option no longer exists"

- **Rejection of Keynesian consensus**
- **Fiscal policy no longer to be used for demand-management**
- **Monetary targets introduced**
- **Cash limits introduced on public spending which had previously been set in volume terms**
- **Limited public sector pay feedback into primary deficit**

1981 – a fiscal turning point ?

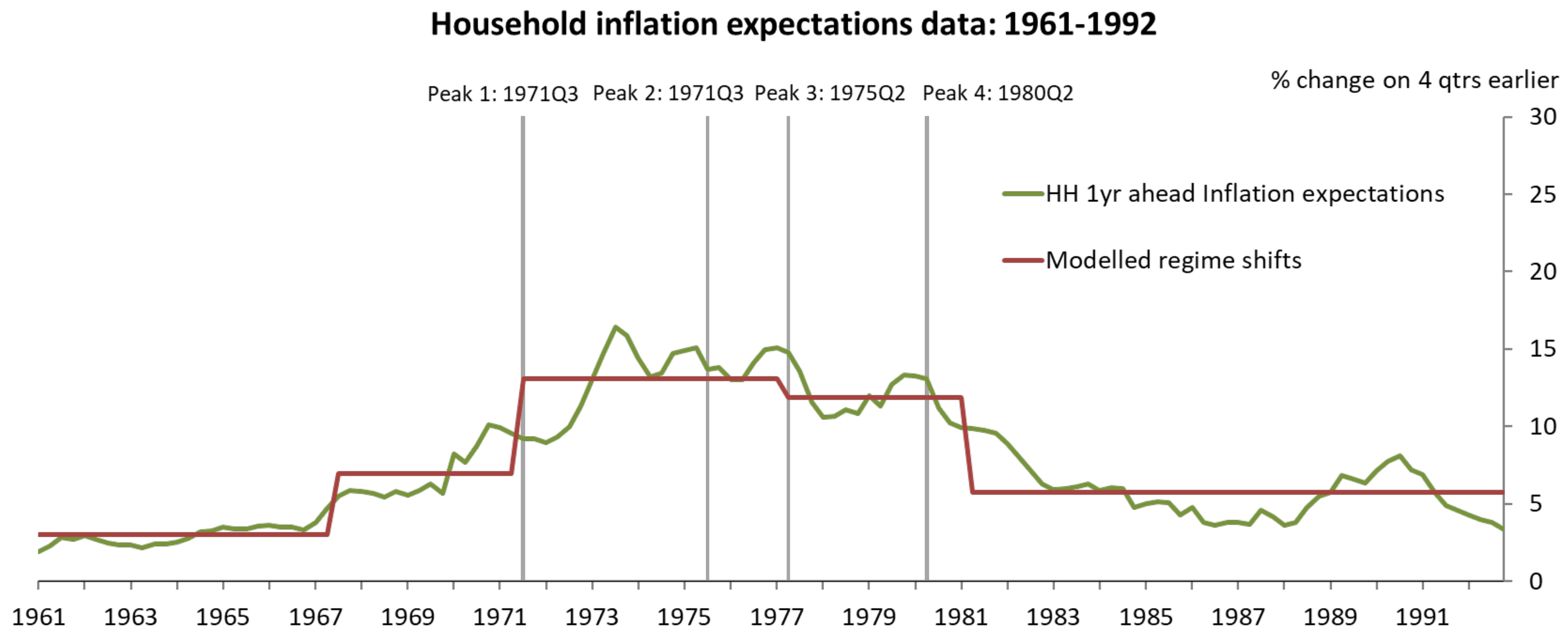
- **Thatcher Government Medium Term Financial Strategy (MTFS)**
  - Monetary gradualism through declining targets for broad money growth (and public sector borrowing)

- **But monetary targets were exceeded**

- **Geoffrey Howe tightens fiscal policy in the midst of 1981 recession to bring MTFS back on track**

- **Unlike the Volcker shock in US, fiscal tightening and monetary gradualism went hand in hand**

Some evidence HH inflation expectations shift with fiscal regime



Conclusion

- **Some of the conventional “bad policy”/“bad luck” hypotheses apply to the UK**

- **Fiscal policy becomes the focus of both the authorities and financial markets in getting inflation down in the late 1970s and early 1980s**
  - Belief in “a” fiscal theory of inflation ?
  - More eclectically, was seen as a co-ordinating/disciplining device

- **Evidence that ending the Great Inflation in the UK as much about shifts in fiscal regime as the monetary policy regime in line with Sargent (1981)**