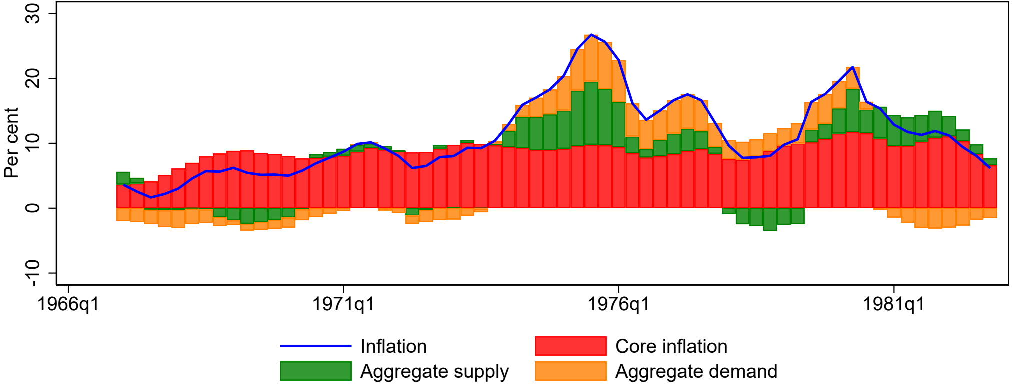
Fiscal dominance and the British Great Inflation

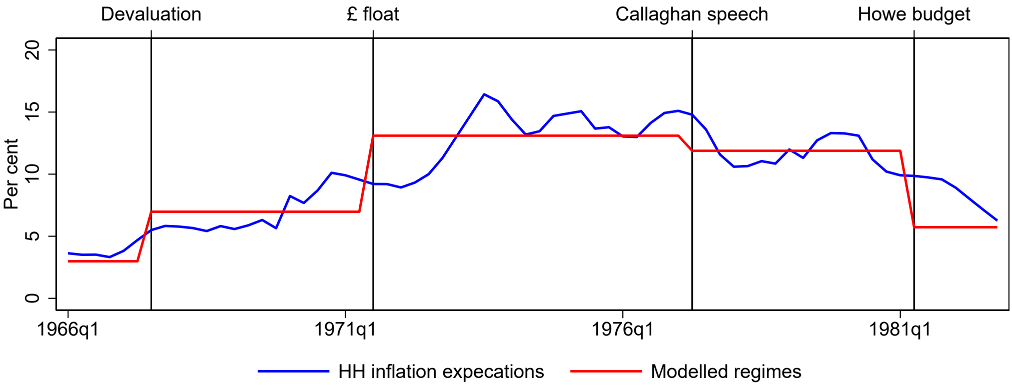
- Narrative evidence discussed so far suggestive of a role for fiscal policy
- Inflation expectations correlate with news on monetary / fiscal policy mix
- Can a simple model with fiscal dominance help us understand what happened?
  - Set out very simple model and show IRFs
  - Compare with narrative record on the fiscal policy process
  - Compare with the empirically estimated counterpart IRFs

Evidence from SVAR



- Aggregate supply and demand shocks explain bursts in inflation in mid 1970s and at the end of the decade
- But the big picture is a significant rise in core inflation shock contribution in the late 60s – before commodity price shocks – and fall in the 80s

Household inflation expectations



- Follow similar pattern to core inflation shock contribution
- Simple VAR exercises suggest that inflation expectations not Granger caused by inflation surprises: evidence against adaptive expectations hypothesis
- Moves correlated with news about monetary/fiscal regime

The government debt valuation equation

$$\frac{B_{t-1}}{P_t} = b_t = E_t \sum_{j=0}^{\infty} \beta^j \frac{s_{t+j}}{y_{t+j}} y_{t+j}$$

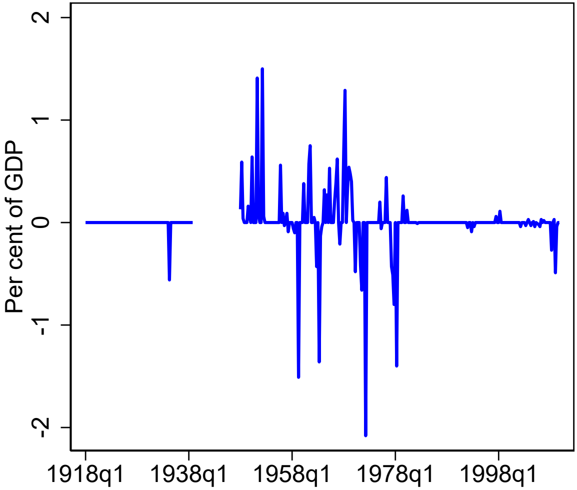
- Very simple (ad hoc) model with fiscal dominance: $\frac{s_{t+j}}{y_{t+j}}$ does not respond to debt and discount factor is exogenous
- Is narrative evidence consistent with:
  - this reaction of fiscal policy to debt?
  - the monetary counterpart?
  - people believing in a fiscal theory of inflation?

Narrative evidence (1)

- Did fiscal policy respond to debt?
- Treasury view gave way to Keynesian economics
- Wass:

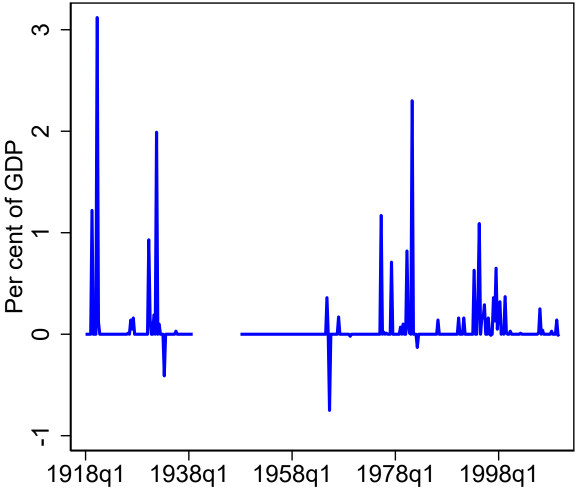
  Whether the budget was in balance or had a surplus or deficit was a secondary consideration (indeed for some policy makers it was of virtually no importance)

Narrative evidence (2)



Tax changes for purpose of demand management

Narrative evidence (3)



Tax changes for purpose of deficit reduction

Narrative evidence (4)

- Nelson (2009) advances convincing narrative that monetary policy was passive:
  - Policymakers attributed considerable portion of inflation to ‘cost-push’ factors
  - They believed monetary policy could not reduce inflation when it was a ‘cost-push’ phenomenon
  - Other policies such as incomes policies and credit controls used instead (with limited success)

Narrative evidence (5)

- Credit counterparts theory of inflation, widely held in policy and financial market circles
  - ‘Broad’ monetisation: 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
- Major changes in LT forward rates often associated with fiscal news

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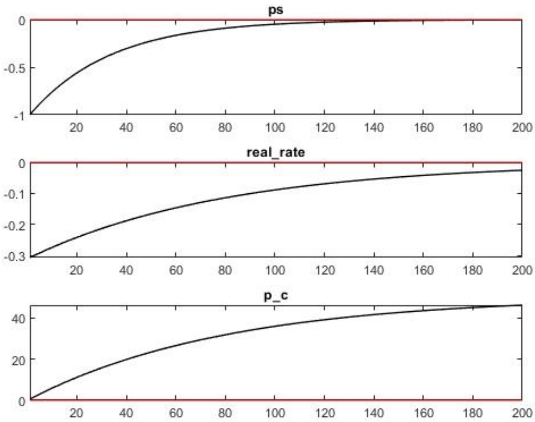
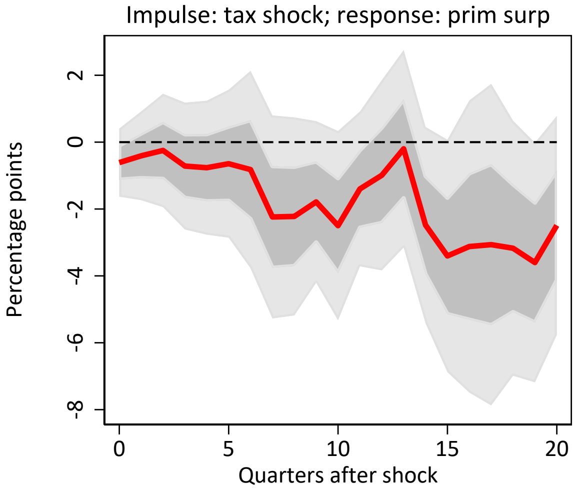
- UK hypotheses
  - Fiscal shocks (Barber boom but no Vietnam / Great Society)
  - Commodity supply shocks
  - Productivity shocks

Theory: fiscal shock

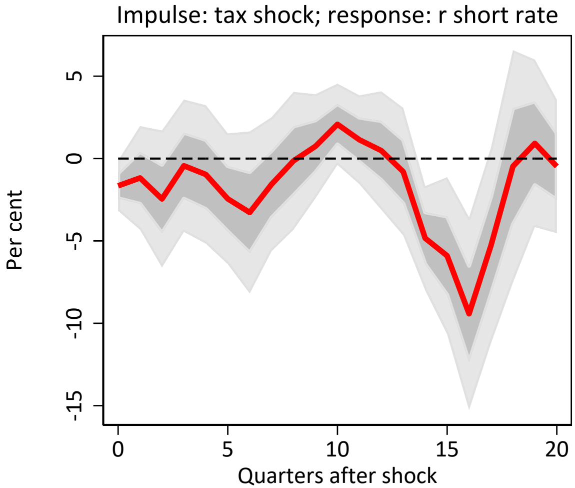


- A surprise tax cut reduces the primary surplus and the real short rate and raises prices

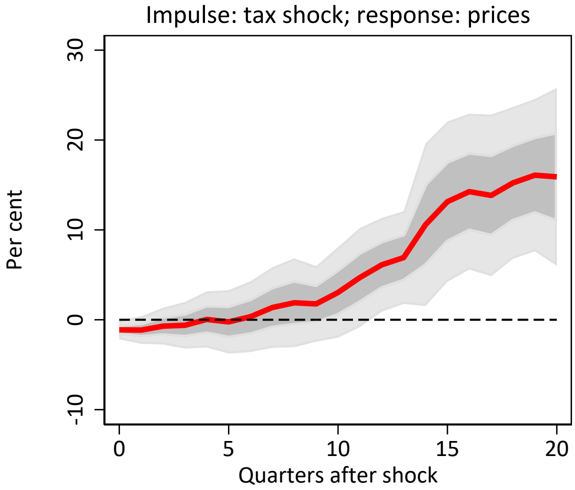
Empirics: tax shock / primary surplus



Empirics: tax shock / real short rate



Empirics: tax shock / prices



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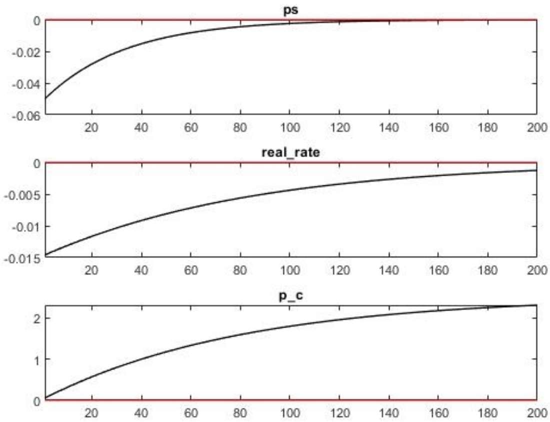
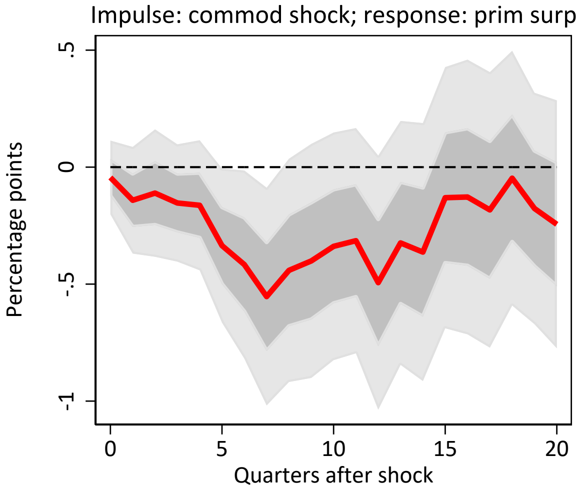
Theory: inflationary commodity supply shock

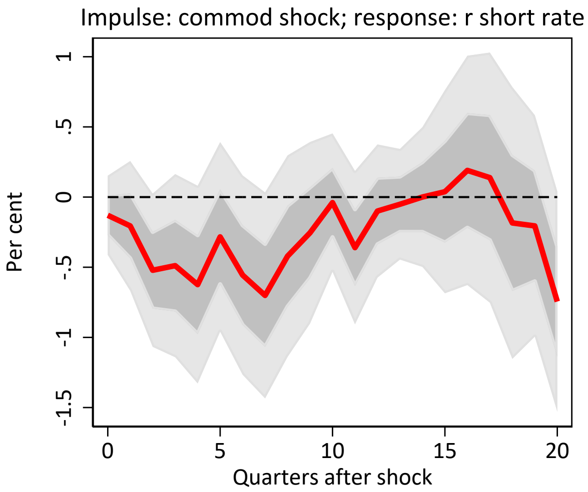


- A surprise increase in commodity prices reduces the primary surplus and the real rate and raises prices

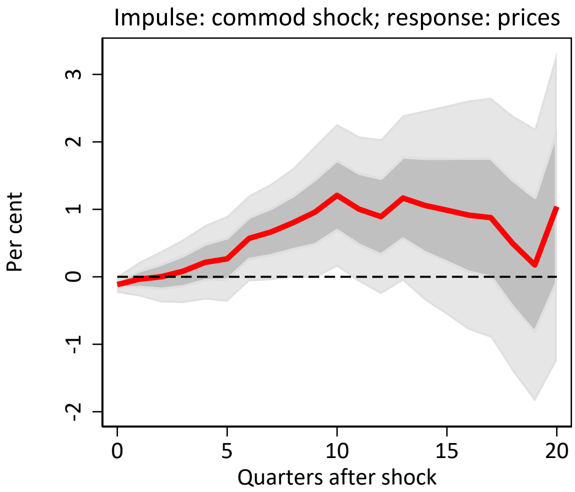
Empirics: commod shock / primary surplus



Empirics: commod shock / real short rate



Empirics: commod shock / prices



Conclusions

- Inflation moves to double digits in late 60s and early 70s before oil shocks
- Narrative and empirical evidence consistent with simple model with fiscal dominance
- HH inflation expectations appear less adaptive than might be expected and more a series of regime shifts linked to news on the monetary *and* fiscal policy mix
- Fiscal policy becomes the focus of both the authorities and financial markets in getting inflation down in the late 1970s and early 1980s
- Evidence that ending the Great Inflation in the UK as much about shifts in the fiscal regime as the monetary regime in line with Sargent (1981)