

4.3 Other Countries Experiences during the Great Inflation

Beyer, Gaspar, Gerberding and Issing. Germany (and Switzerland) were two advanced countries which largely avoided the Great Inflation. This chapter explains the monetary targeting framework followed by the Bundesbank from 1974 to 1998. The Bundesbank was founded in 1953 as an independent central bank whose sole mandate was to maintain monetary stability. During the Bretton Woods era its domestic price stability objective was constrained by the external peg. After the breakup of the Bretton Woods system in 1973, the Bundesbank shifted to a quantity theoretic monetary targeting strategy in 1974. The policy followed used a short –term policy rate to hit the preannounced monetary targets based on forecasts of money demand. With the exception of the OPEC I oil price shock in 1973 which was partially accommodated, the Bundesbank was the most successful major central bank in keeping inflation low in the 1970s and 1980s.

The paper describes how the monetary targeting framework was used ,both as to control inflation and anchor inflationary expectations. Thus when the Bundesbank missed its targets it would always clearly state its reasons. The authors embedded the Bundesbank monetary targeting rule in a DSGE model. Based on the model they derive an interest instrument rule like the Taylor rule. Estimation of the rule over the period 1965 to 1998 demonstrates that the Bundesbank always followed the Taylor principle that real interest rates would rise sufficiently to offset inflation. This is compared to the U.S. where the Taylor principle was violated in the Burns/Miller era and the UK where it was violated throughout the Great Inflation.

Bejmamin Friedman in his comments is critical of the authors derivation of their Taylor rule which he argues does not clearly isolate the contribution of monetary targeting to the outcomes of monetary policy described by the Taylor rule.

Takatoshi Ito. Ito analyzes Japan's experience during the Great Inflation in the 1970s. The Bank of Japan followed a loose monetary policy in 1972 under government pressure to restrain appreciation of the yen after the breakdown of Bretton Woods. Then when OPEC I hit in 1973 the Bank was too slow to tighten, leading to an inflation rate of 20% in 1974. Ito attributes this policy failure to the Bank's lack of independence. Later in the fall of 1975 the Bank tightened monetary policy aggressively attenuating the inflation spike. In the face of OPEC II in 1979 the Bank, according to Ito, having learned from its mistake in the early 70s kept monetary policy tight and avoided the inflation that affected the U.S., U.K., and other countries. The author argues that the Bank had achieved de facto monetary policy independence since the Japanese government did not oppose the tight policy in 1979.

To back up his story, Ito estimates a Taylor rule for the period of low inflation from 1982 to 1995 and then uses the coefficients of the Taylor rule and real time data to calculate counterfactual best practice interest rate policy for the 1970s. He finds that interest rates between 1972-75 should have been much higher than they were but between 1979 to 1980 actual policy rates were very close to those based on the Taylor rule.

Frederic Mishkin in his comments doubts that the Bank of Japan achieved de facto independence in 1975. Rather he sees the Bank as continuously subordinated to government pressure throughout the period. What differed at the end of the 1970s was that the government favored tightening. He also posits that the Japanese experience demonstrates that if the central bank has credibility for low inflation that oil price shocks need not be inflationary.

Riccardo DiCiccio and Edward Nelson. The authors argue that UK experience with inflation in the 1970s was very similar to that of the U.S. This they attribute to common adherence to the same mistaken nonmonetary views of the source of inflation. A narrative analysis of the U.K. Treasury's views in the 1960s and 1970s shows their emphasis on cost push factors (wage push) rather than monetary expansion as the key source of the run up of inflation in the 1970s. The dominant role of wage driven inflation was used to make the case for incomes policy rather than tight money to reduce inflation. The authors argue that the U.K. Treasury did not believe in a long-run Phillips curve tradeoff nor did they emphasize the output gap in their analysis. Instead their analysis posits that the economy has a 'speed-bump'—the first difference of the output gap—that if exceeded would in a non linear way trigger inflation. Hence monetary policy would be ineffective in stemming inflation without wage price controls.

The authors further posit, based on narrative analysis, that Arthur Burns adopted this framework after he became Federal Reserve chairman in 1970. This framework they argue explains Burns' advocacy of the wage price controls adopted by the Nixon administration in 1971.

To back up their story they estimate a DSGE model with sticky wages and prices for the U.K. They show that the UK didn't follow a Phillips curve in the 1970s but did follow the speed-bump theory—policy rates did not respond to the output gap.

Matthew Shapiro in his comments doubts that U.S. policy makers acquired their non-monetary sources of inflation view from the U.K.. Non-monetary control of inflation was a very prominent feature of U. S. economic policy in the early 1960s (eg the wage price guide lines of the Kennedy administration). He also criticizes the authors for not explicitly including non monetary considerations in their model.