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Round Table Discussion: Lessons from the 1970s – Inflation and Monetary Policy in Focus*

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On 5 October 2023, the Finance Section of the Hungarian Economic Association organised an online roundtable discussion with the title "*What can we learn from the past (essentially from the 1970s) concerning the current challenges linked to inflation, monetary policy and the banking sector?*". The organisers wished to highlight the importance of recalling economic history and historical experience when examining issues regarding inflation. The event was moderated by *Pál Péter Kolozsi*, President of the Finance Section of the Hungarian Economic Association, Director at the Magyar Nemzeti Bank (central bank of Hungary, MNB) and Associate Professor at the MNB Knowledge Centre of Neumann János University. After the opening address by *Barnabás Virág*, Deputy-Governor of the Magyar Nemzeti Bank responsible for Monetary Policy, Financial Stability and International Relations, presentations were delivered on the results of two foreign and two Hungarian research projects, describing the lessons and experiences of major inflationary episodes in the past fifty years in the light of the contemporary analysis of inflation.

In his opening address, Virág stressed the particular importance of economic history. This was especially true today, when standard analytical frameworks and traditional models were unable to provide a comprehensive explanation for nonlinear events. "It is through the lens of history that we can discern structural changes, trends and patterns from the different areas," he said. New economic models also need to show consistency with past events before they could be considered as sound economic principles. Although there was no historical precedent that provided a perfect analogy for the present situation, drawing parallels could lead to ideas that facilitate coordination and help to answer the questions that may arise. Insights into methodological pluralism and an understanding of long-term economic processes also contributed. While the extension of analyses from short to historical scales and qualitative methodologies did not replace the theoretical and empirical models already in use, it could complement them, allowing decision-making to be based on a broader base and more in-depth information. Recognising relevant historical

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patterns on issues such as the impact of the level of indebtedness, identifying the determinants of the nature of inflation or assessing the effectiveness of growth models was essential to ensure that monetary policy can respond quickly and adequately to the challenges ahead in a turbulent decade such as the 2020s.

The first presentation was given by *Laurent Ferrara*, Professor at SKEMA Business School, with the title *"The determinants of inflation: Lessons from past oil price shocks"* focusing on the experience of developed countries. Professor Ferrara attributed the emergence of the current inflation environment to the imbalance between household demand for consumer goods and the relative shortfall in supply during the pandemic, and to the impact of the Russian-Ukrainian war in 2022 on the price increases observed in industrial and agricultural goods and energy. In his presentation, he sought to answer questions about how central banks should respond to shocks in the price of strategic commodities such as oil. Should central banks raise interest rates in response to oil price shocks, and if so, by how much and for how long? By presenting the literature on the relationship between oil price shocks, interest rate hikes and recessions in the United States of America, he highlighted the potential non-intuitive effects of central bank measures.

The literature draws attention to the role of monetary tightening in response to negative supply shocks in amplifying recessions, the different effects of the various factors that trigger shocks and the questionable effectiveness of policy interventions. The theory argues that the oil price shocks in the USA were followed by recessions, and that central banks may have amplified this process by raising interest rates, which spread the impact of oil price shocks across the economy. A distinction could be made between supply shocks, aggregate demand shocks and the impact of news on global oil prices. While supply developments in general did not play a role in driving oil prices, aggregate demand shocks occurred with a three-quarter lag, while news shocks had an immediate impact. Academics have called into question the effectiveness of monetary tightening in response to such shocks: when comparing oil price shocks during normal periods and zero lower bound periods, the role of interest rate hikes in lowering the consumer price index and anchoring inflation expectations could not be isolated, whereas rate increases might have a negative impact on GDP developments. In other words, an interest rate hike following the oil price shock may have a negative impact on the economy without contributing to normalisation. Ferrara was therefore concerned that the Fed, the ECB, the Bank of England and the Bank of Japan had raised key policy rates rapidly and sharply to levels that pre-date the global economic crisis of 2008 in response to, *inter alia*, inflationary pressures from excess demand and geopolitical tensions in 2022. Accordingly, he stressed that it is crucial to be aware of the nature of the price shocks at the moment when policy interventions are introduced. In the case of news shocks, this could be achieved by *text mining* and *natural language*

processing models, while the co-movement of commodity prices could be used to identify supply-demand imbalances. Ferrara and his co-researchers found that the co-movement of commodity prices pointed to an aggregate demand shock, while the absence of such a co-movement indicated a supply shock.

The presentation by *Eric Monnet*, a professor at the Paris School of Economics, was entitled "*Do disinflationary measures distort central bank performance? Lessons from the 70s and 80s*". In his presentation, Professor Monnet sought to answer the question whether central bank losses were a necessary corollary of disinflationary monetary policy. In some countries where central bank losses had occurred, political discourse was generated around the phenomenon, and it was therefore important to answer the question of whether the losses incurred by central banks during their operation were problematic for monetary policy or for the credibility of the central banks concerned. His research found that, despite the disinflation environment, central banks' capability of making a profit in the 1980s surpassed that of the 1970s. Since this phenomenon was contradictory to what we see today, a loss incurred due to disinflation was not predetermined; however, it was important to highlight the differences between the composition of central bank balance sheets today and in the past. Monnet cited the remuneration of reserves and the legacy of past interventions in central bank balance sheets as the two main differences, referring to the importance of the stock of securities accumulated in a low yield environment. However, he also pointed out that the remuneration of the reserve requirement alone would not lead to losses, but the occurrence of the two phenomena together would. Although central bank losses were also incurred in the 1970s, these were foreign exchange losses on foreign currency reserves due to depreciation of the US dollar. However, the losses on foreign exchange reserves were only due to revaluation and were not realised. Today, the most important sources of central bank losses were the delinquency of securities held as central bank assets, the sale of central bank assets below market prices, and the difference between the interest paid on central bank instruments and the yield on the securities held as assets.

Monnet pointed out that during the Volcker shock, central banks did not realise losses because they did not sell their assets. The ratio of central bank balance sheet totals to GDP increased by 15 percentage points in the 1980s, reaching 20 per cent of GDP by the end of the decade. It was important to see the reasons behind why any central bank suffers a loss. Just as in the 1970s, when the need to hold reserves was not challenged even after depreciation of foreign exchange reserves, it should be stressed today that the current losses resulted, in part, from past central bank measures. Discussions were already under way on changes in the rationale behind interest-bearing required reserves and in the medium term as the interest rates paid on central bank instruments were expected to normalise, and accordingly, it may well be possible to avoid such losses altogether. In summary, the current

and past losses were caused by different factors, and just as in the past when the independence of and confidence in central banks was not called into question after the losses incurred on foreign exchange reserves, there was a need today to coordinate policy instruments and objectives, and to justify and communicate the necessity of the activities that caused the losses, according to Monnet.

Kristóf Lehmann, Director at the Magyar Nemzeti Bank and Head of the Knowledge Centre for Sustainable Finance at Neumann János University, delivered a presentation on "*Inflation similarities and differences between the 1970s and nowadays*". One common feature of both periods was that they were fueled by geopolitical tensions. In the 1970s, war-related sanctions prompted OPEC countries to cartelise, while the presence of sanctions and the popularity of protectionism was making a mark on global trade again today. That said, in addition to geopolitical factors, the pandemic also had an impact on the price of consumer goods and commodities, with energy prices rising in 2021 at rates approaching those seen in the 1970s.

The two decades differed in several important respects, however, such as the composition of the global economy and global trade and the direction of capital flows. While in the 1970s, developed countries were characterised by an increase in the share of the working-age population, the opposite was true today as part of a long-term trend. In the past, the level of trade union membership was two and a half times higher than today, and accordingly, as the role of trade unions has faded, their bargaining power has deteriorated, and the emergence of a wage-price spiral similar to that of the 1970s appears less likely. The decline in energy consumption per unit of real GDP was welcomed in terms of exposure to energy prices; in addition, the pricing power of OPEC countries was not as formidable as it was in the 1970s. Increased shale oil production and the accumulation of strategic oil reserves had contributed to this as well. However, it was already evident at the time that price caps were most likely to be effective in the short run, and thus they should be applied only temporarily because, as pointed out in the presentation, they would become persistently costly over the long term.

One of the most important conclusions to be drawn from the examples of the 1970s is that in countries where crisis management was successful, there was a strong commitment to intervention and coordination was in place between monetary and fiscal policy instruments. This characterised the economic policy in the Federal Republic of Germany, where there was no double-digit inflation. In the United States, however, economic policy efforts in the 1970s focused on breaking the wage-price spiral. The real change only came about with Paul Volcker and his positive real interest rate policy in the 1980s. In the United Kingdom, the fiscal stimulus in collaboration with deflationary monetary policy pushed the consumer price index up to 25 per cent, while in Japan, inflation peaked on the back of the interest rate

cuts resulting from exchange rate pegging agreements. It is also worth noting the differences in trends in demography and real wages, and in the indebtedness of the public and private sectors.

Balázs Spéder, Head of the Economic History and Theory Department of the Magyar Nemzeti Bank presented the results of a study entitled "*Inflation shocks and disinflation: Stylised facts from the past 50 years*". In his presentation, he sought answers to a number of questions: whether the inflationary pressures of recent years were temporary or would lead to persistent inflation; whether it was possible to generalise and establish stylised facts about the four inflation shocks observed since the early 1970s; what conditions were necessary for fast-paced disinflation after a strong inflation shock; what were the real effects of disinflation, and what was the role of central banks in defining the growth rate that may be potentially traded off? To answer these questions, the authors examined the evolution and distribution of macroeconomic indicators using a sample of 201 countries between 1970 and 2022.

The consumer price index, the GDP growth rate, short-term interest rates, fiscal balance and other indicators were examined to identify patterns in the evolution of these indicators before, during and after inflation shocks. Successful and unsuccessful disinflation attempts were distinguished. Successful disinflation processes were characterised by inflation below 10 per cent in the second year following the peak of the inflation shocks, while disinflation processes that were deemed unsuccessful still had inflation above 20 per cent in the second year. The results also demonstrated that, while successfully stabilising countries did not experience a decline in GDP growth, countries that failed to stabilise started to do so even before inflation peaked. Fiscal balance may be an important precondition for disinflation, as countries that successfully implemented intervention started to improve this indicator in the year preceding the peak of inflation, while countries with an unsuccessful attempt began to perceive a sharp deterioration in the indicator in the same period. It can also be observed that in successful cases, interest rate hikes started more than one year before inflation reached its peak during the shock, while in unsuccessful cases the tightening cycle began later and lasted longer.

In conclusion, in successful disinflation cases, a hawkish monetary policy stance was adopted earlier, and therefore interest rate hikes started – and ended – earlier; moreover, the growth rate of GDP was not decelerated by the inflation shock. Successful interventions were also characterised by an earlier stabilisation of the debt-to-GDP ratio. Unsuccessful attempts tended to stabilise inflation above 40 per cent in at least half of the cases; interest rate hikes began later and remained higher for longer relative to successful attempts; GDP growth started to slow even

before inflation peaked; the debt-to-GDP ratio of the government increased and the fiscal balance deteriorated.

The presentations were followed by a discussion amongst the participants. The event can be accessed and viewed in full using this link: What can we learn from the past - YouTube