Discussion of Bianchi, Fang & Melosi "Fiscal Inflation in the UK"

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The views expressed are my own and do not represent those held by the Bank of England or any of its committees

Summary of BFM (2024)

- Model allowing for “funded” and “unfunded” fiscal shocks
  - Builds on “shock-specific rules” (Bianchi and Melosi, 2019)
  - Nice way to mix FTPL with standard, monetary-led regime
    - Funded shocks: standard monetary response, fiscal authority adjusts its stance to ensure debt sustainability
    - Unfunded shocks: central bank remains passive, debt sustainability through inflation tax → “fiscal inflation”

- Ultimately leads to a Taylor rule with a time-varying target
  - $i_t = \phi_M(\pi_t - \pi_{F,t})$: rule that solely responds to deviations from “fiscal inflation”, $\pi_{F,t}$
  - In this framework, the central bank “tolerates” inflation needed to stabilize debt in response to unfunded fiscal shocks ($\pi_{F,t}$)

Thoughts

- Great paper, idea of shock-specific rules also holds great potential in different contexts
- Very well-written paper[1] & of great pedagogic value too
- Some general questions + a couple of UK-specific considerations

[1] Interestingly, the entire paper has no more than 3 footnotes! Where is all the important stuff???

Narrative

- Debt position typically not central to monetary policy decisions
  - In case of BoE, fiscal assumptions are those in the Budget
  - "Government debt" is hardly ever mentioned in BoE Monetary Policy Reports or MPC Minutes

- Inflation forecast more central to the process
  - Transitory inflation (with a duration < transmission lag) can be "looked through"
  - $i_t = \phi_M(\pi_t - \pi_{T,t})$, rather than $i_t = \phi_M\left(\pi_t - \pi_{F,t}\right)$
  - Could it be that $\pi_{F,t}$ is often mistaken for $\pi_{T,t}$?
    - Persistence of $\pi_{F,t}$ is controlled by the CB (=ϕ_F) → ϕ_F=0 optimal?

Core

- Horse race between persistent cost-push shock and unfunded transfer shock
- Data like the conditional correlations produced by the unfunded transfer shock → wins

Core

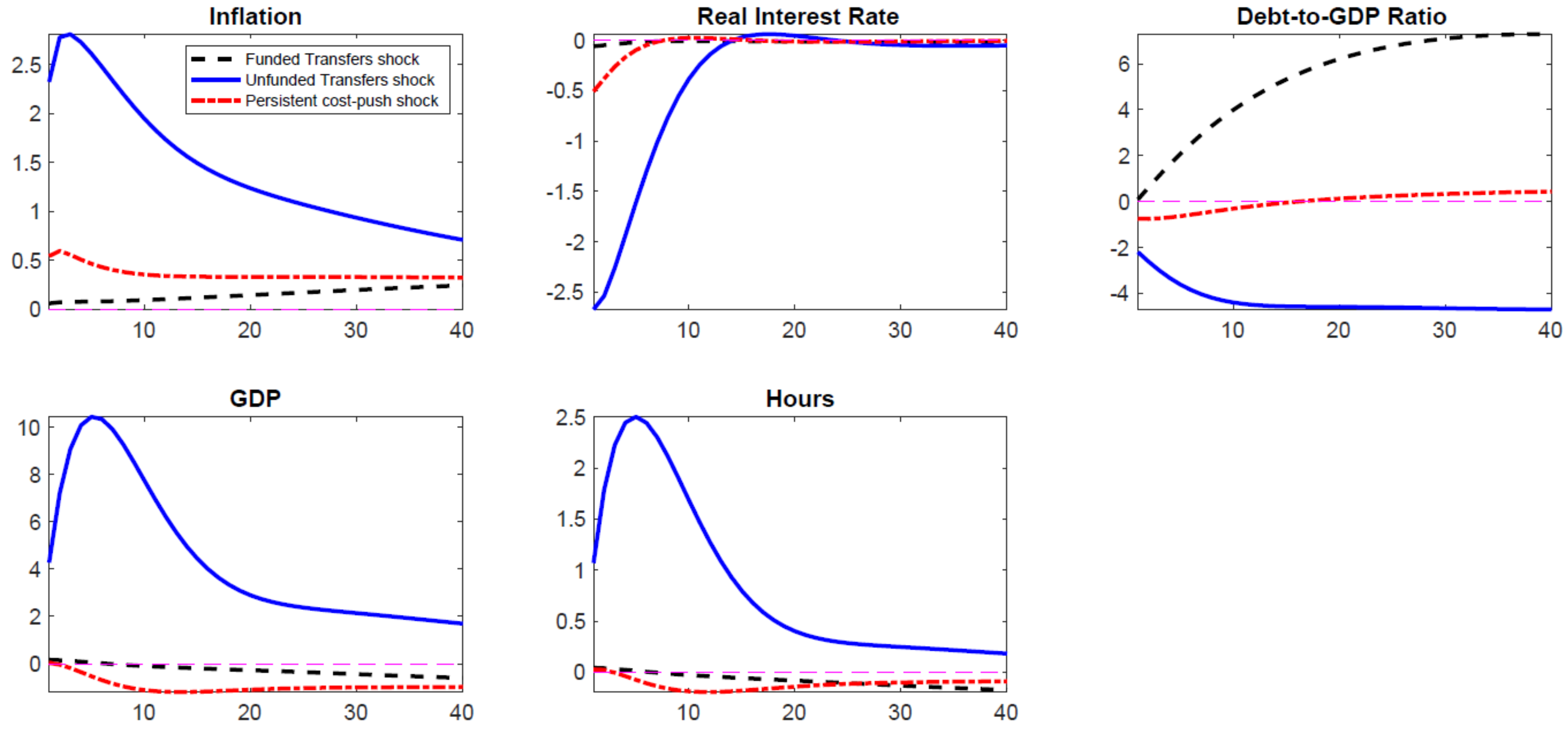


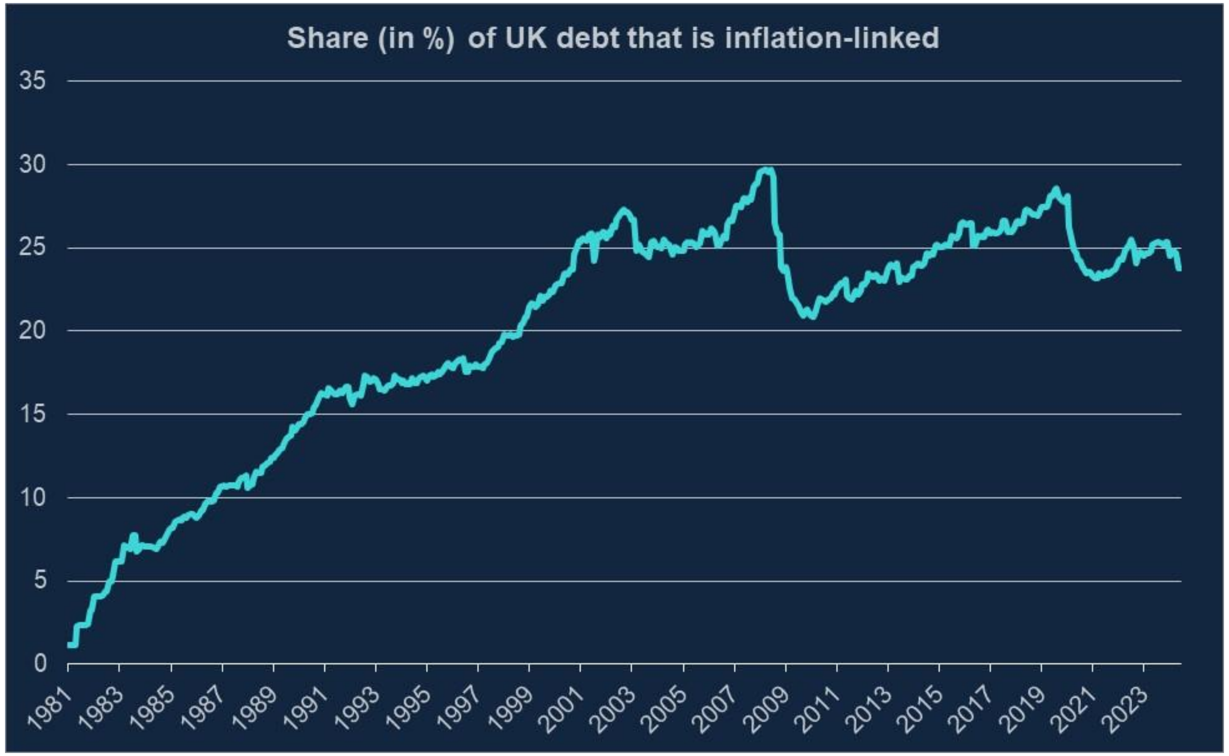
Figure VI – Impulse Responses to Government Transfer Shocks. Impulse responses for inflation, real interest rate, debt-to-GDP ratio, GDP and hours to a shock to funded transfers (black dashed line), to unfunded transfers (blue solid line), and to the persistent cost-push shock (red dash-dotted line). Units: percentage deviations from steady-state values. The magnitude of the initial shocks is set to be equal to one-standard deviation as estimated in the second sample (2008:Q1-2024:Q1).

Core

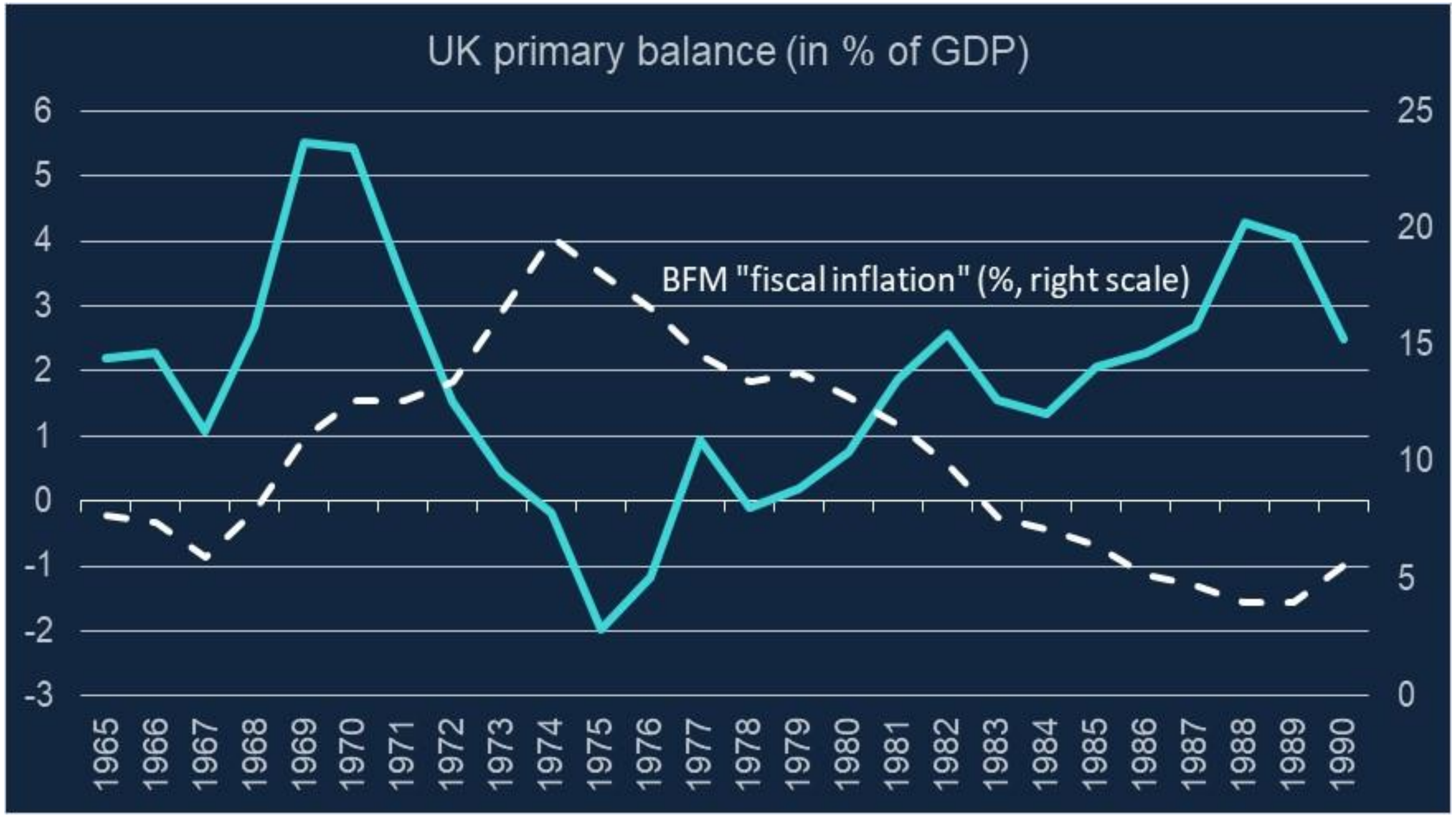
- Horse race between persistent cost-push shock and unfunded transfer shock
- Data like the conditional correlations produced by the unfunded transfer shock → wins
- Are there other shocks which can put up a tougher fight?
  - Sentiment shock?
  - News shock?

UK-context: inflation-linked bonds

- About 25% of the UK's debt stock is inflation-linked
    - Should be modelled/treated separately for this paper's purposes



UK-context



UK primary balance (in % of GDP)
BFM "fiscal inflation" (%, right scale)
6
5
4
3
2
1
0
-1
-2
-3
25
20
15
10
5
0
1965
1966
1967
1968
1969
1970
1971
1972
1973
1974
1975
1976
1977
1978
1979
1980
1981
1982
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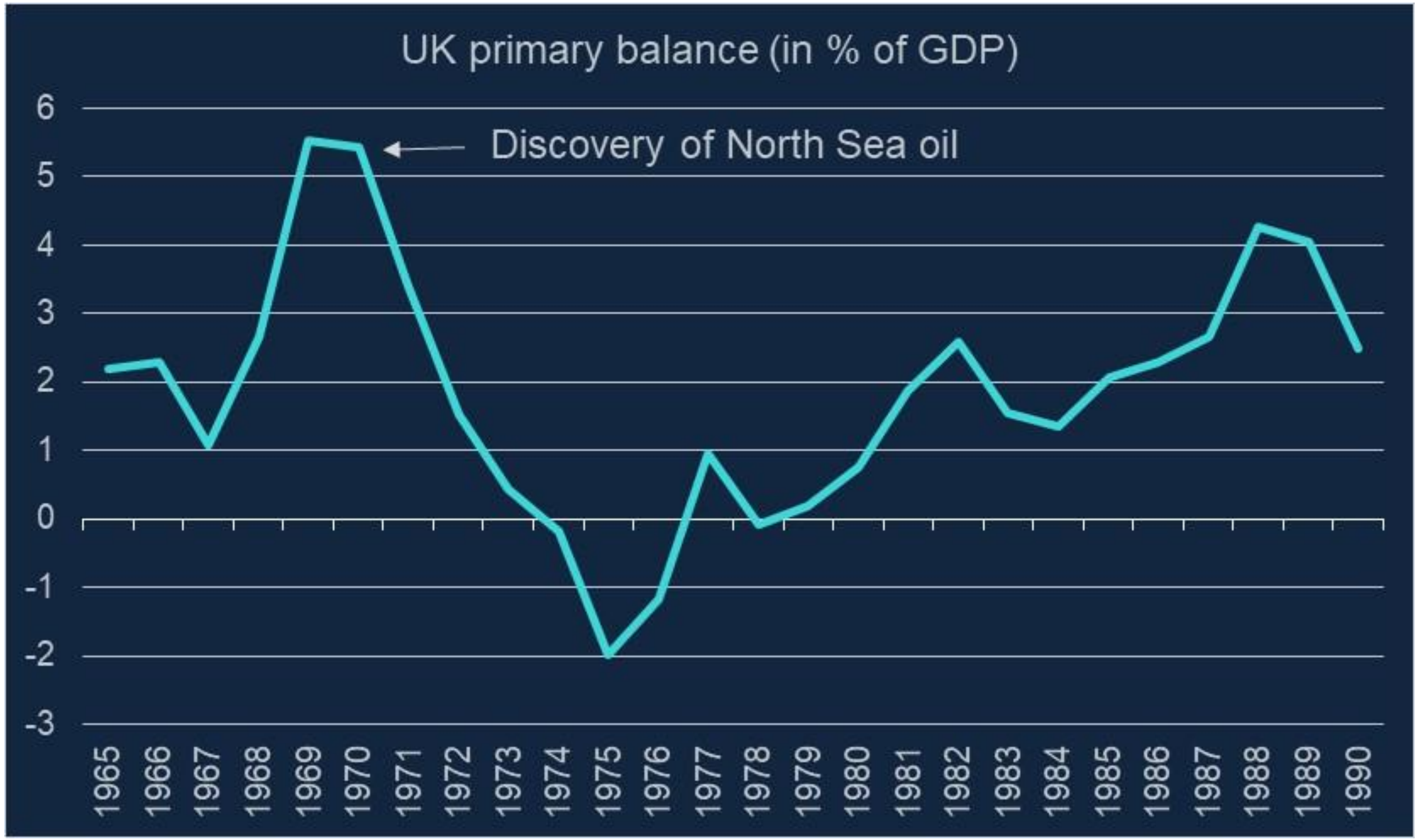
1988
1989
1990

UK-context: North Sea oil



UK-context: North Sea oil

- BFM find that “fiscal inflation”, stemming from “unfunded shocks”, ran particularly high in the mid-70s

- Was the 70s fiscal loosening really an unfunded shock?
  - Discovery of North Sea oil led to a news-dynamic (Arezki, Ramey & Sheng, 2017)
  - Perception was that deficits would be funded from future oil revenues
    - Estimated to generate over 5% of UK GDP per annum (Forsyth & Kay, 1980)
    - Claim to oil revenues also provided the UK government with a nice inflation hedge
  - Oil discovery brought a large improvement to the *asset side* of the UK’s public sector balance sheet → paper solely focuses on public liabilities

In sum

- Great formalization of concept of "shock-specific rules", enabling us to mix fiscally- and monetary-led regime
- What if we horse-race the unfunded fiscal shock against some other (demand-side) shock, e.g., sentiment- or news-related?
- Application to UK inflation dynamics somewhat complicated by:
  - Prevalence of inflation-linked gilts
  - More generally: how to think about developments on the asset side of the public sector balance sheet?