

Jason Lennard (LSE), Solomos Solomou (Cambridge) & Finn Meinecke (Bank of England)

‘Measuring inflation expectations in interwar Britain’

What triggered the recovery from the British Great Depression? A leading explanation is a shift in inflation expectations. According to Howson (1975) and Booth (1987), there was a macroeconomic regime change (Sargent, 1982; Temin and Wigmore, 1990) to a “managed economy” in the early 1930s. This involved ending the gold standard, implementing the “cheap money” policy, imposing the General Tariff and announcing a price level target. Crafts (2013, 2014) argues that these policies raised inflation expectations, lowering real interest rates and stimulating consumption and investment. Chouliarakis and Gwiazdowski (2016) develop a DSGE model for interwar Britain that lays the theoretical foundations for an expectations channel in the recovery.

While inflation expectations are regarded as the key stimulus to recovery from the slump in theory, there has been little empirical work in practice. In this paper, we measure inflation expectations in the United Kingdom between the wars. In order to do so, we construct a number of high-frequency estimates using primary sources. The first is a new approach based on forward and spot exchange rates and a dynamic factor model. The second is an established measure derived from future and spot commodity prices. The third is an index measuring inflationary and deflationary coverage in a sample of newspapers. The fourth approach is to consult a variety of archives for qualitative information.

An important contribution of this paper is to test a leading theory of the British recovery from the Great Depression by constructing the first estimates of inflation expectations. In order to advance our understanding of this important historical episode, data is needed to accept or reject the expectations hypothesis.

Another contribution is the collection of high-frequency data, which allows us to understand the events that drove fluctuations in inflation expectations. With low-frequency data, many events are likely to occur simultaneously, which makes it difficult to identify causal effects. With high-frequency data, however, many variables remain fixed from one period to the next so it is easier to identify the cause.

A final contribution of the paper is the development of a new methodology for estimating expected inflation, which can be applied in many other historical contexts for which exchange rate data is rich but inflation expectations data is scarce.