Andrew Levin and John B. Taylor

“A Positive Analysis of Stop-Start Monetary Policies and The Great Inflation"

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Objective of paper

- Provide new insights into developments during “The Great Inflation”
  - (the term attributed to the US experience in the 1970s with occasional double-digit yearly inflation rates)
- Using empirical analysis combined with narrative evidence, Levin and Taylor come up with new insights about, and explanations for, this episode
- Based on findings, some general prescriptions for monetary policy conduct are derived
- While a new “Great Inflation” may not be a current fear, the paper is very interesting and an excellent example of how science should not succumb to current conditions
New approaches and results

- Reassess the timing of episode
  - Using Livingston survey data for inflation expectations, it appears that the episode started earlier (mid-60s) than usually thought.
  - Inflation expectations furthermore came out of control in late 70s after being stable in first half of decade.

- A new measure for the *ex ante* real interest rate is derived with these inflation expectations to assess the policy stance.
  - By graphical inspection the resulting stance is well captured by a Taylor-type rule with *shifting intercept* (interpreted as a time-varying implicit inflation target).

- A partial-adjustment (nominal) Taylor-type rule is then estimated on quarterly data.
  - Dummies capturing the inferred shifting inflation targets are included, and the rule performs well—and depicts and *active* rule in contrast with most existing evidence.
Interpretation and implication of findings

Three instances of “Start-Stop” policies, 1968-70, 1974-76, 1979-80, are identified as containing:

1) A passive policy phase (“allowing” inflation to creep up)
2) A contractive phase (dampening inflation increases somewhat)
3) A reversal to accommodating policy (due to unemployment concerns), thereby not stopping inflation

A host of previous explanations for the episode are discarded as unable to capture these “Start-Stop” patterns

Main explanation is judged to be occasional political pressures on the Federal Reserve (Nixon’s famous remark to Burns still stands out), as well as imprecise mandates

Normative implication: Commitment to a Taylor rule with a constant inflation target
A changing intercept could just as well reflect a changing implicit output target

In choosing output gap measure, the CBA measures are dismissed as politicized. Couldn’t they then indeed be consistent with a lower intercept created by political pressure?

As for the “Start-Stop” patterns: For 1979-80, three phases of policy is characterized by six observations (?) !)

Also, the episode is included in estimations; but the nominal interest rate is endogenous in the period

The 1974-76 episode is slightly unclear from Figure 6. It seems like a two-phase event: contractive for a while, and then strongly expansive already in late ’74

Why make narrative analyses on the constructed real rate, and then estimations with nominal rate?

How can suggested rule avoid “pitfalls” on relying on “any given model”? The natural rate is not known.
Comment: Barro and Gordon credibility model (partly) irrelevant?

- Warning: I am biased: I LOVE that model *per se*
- Levin and Taylor only focus on the predicted positive relationship between inflation and the natural rate of unemployment
- This is not the only determinant of inflation in model
  - A higher relative weight on unemployment stabilization increases average inflation—this is consistent with the narratives on political pressures in the period
  - Worsened perceived sacrifice-ratio increases average inflation (flatter Phillips curve increases incentive to stimulate)—again consistent with the cited US experiences
- Barro and Gordon model in simple form is obviously not suited to match dynamics of “Stop-Start” policies
  - Nevertheless, its normative implications are strikingly relevant for the US 1970s case:
    - Target output at the natural rate and make the monetary policy authority independent
Comments: Econometrics?

- Disclaimer: I am no econometrician!
- Educated in Aarhus and working in Copenhagen econometricians have been hard to avoid
  - In Aarhus, Svend Hylleberg often brought Granger, Mizon and Hendry to the Department; in Copenhagen Juselius and Johansen bring in a host of time-series econometricians
- My question (which makes me somewhat happy not being an econometrician):
  - How come that so many US economists get away with regressions like Table 2 in Top-5 journals?
  - I have been/are being repeatedly told that these are heavily misspecified (generally ignore failure of rejecting unit-roots)
  - Are they or are they not? Can one really just say (when pushed hard) that “Yes we cannot reject that data is non-stationary, but these tests have low power, so we just regress away ...”?
- I know colleagues who would (almost) fail students’ bachelor theses if these issues were side-stepped
The suggestion to avoid a repetition of the 1970s is commitment to a simple Taylor-type rule:

\[ r_t = \bar{r} + \alpha_\pi (\pi_t - \pi^*) + \alpha_y (y_t - y^n_t). \quad \alpha_\pi > 1, \quad \alpha_y > 0 \quad (1) \]

According to which metric is this “simple,” and therefore “valuable in providing transparent benchmarks”?

An alternative is to provide clear mandates for non-politicized policy in terms of goals for aggregates. E.g.

\[ \min L = \sum_{t=0}^{\infty} \beta^t \left[ \lambda (y_t - y^n_t)^2 + (\pi_t - \pi^*)^2 \right], \quad \lambda > 0 \quad (2) \]

Is (1) “simpler” than (2)? Is (1) more “transparent” than (2)?

- With (2) (as I believe inflation-targeting central banks use), policy could look like (1), even though it is not followed
- If policy is a success, (1) could look like a failure in equilibrium (e.g., Jensen, 2009). On the other hand, (2) is looking just fine
Concluding comments

- A very exciting read!
- Combines historical insights with economic theory in an absolutely admirable way—I learned a lot!
- Could be interesting with a more detailed time-series investigation of the “regime shifts” during the period, but the conclusions are quite convincing nevertheless (on p. 20 it is, however, slightly unclear whether you have tested for structural breaks, or whether you note it can be done)

- Shows that some events in history still can provide valuable insights and lessons for modern policymaking

- Finally, the cartoons are hilarious!