

Andrew Levin and John B. Taylor

“Falling Behind the Curve  
A Positive Analysis of Stop-Start Monetary Policies  
and The Great Inflation”

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7<sup>th</sup> Norges Bank Monetary Policy Conference  
June 24-25, 2010

- 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 an *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

## Comments: Minor quibbles

- 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.

# Comments: 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

## Comments: Taylor-type rule as solution?

- The suggestion to avoid a repetition of the 1970s is commitment to a simple Taylor-type rule:

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

- 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.

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

- 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!