

Panel Discussion 2

Allan Meltzer opened up the discussion. You should keep it simple, don't always state what you know, and tell them when you are going to deviate. The only thing missing from the papers presented, and it came up in the first panel discussion, was the fact that politics, certainly in the U.S., play an enormous role. Chairmen Martin and Burns were not free agents. Chairman Volcker was more of a free agent, but he is an exception. Even Chairman Greenspan was sort of an exception. But, most Federal Reserve Chairmen get called to Congress and are told over and over again what to do as an agent of the Congress.

Donald Kohn began his remarks by apologizing for lack of attendance, noting that he'd much rather be learning history than creating more data points in reference to the financial crisis. When he thinks about the period of the Great Inflation, he starts from the premise that high inflation could not have emerged without an accommodative policy. But policymakers did not seek the result that they obtained. Many people overestimated and/or underestimated the response of inflation to tightening interest rates and underestimated the persistence of inflation. All you have to do is look at the charts presented by *John Williams* about real interest rates. Medium- and long-term real interest rates were often ex-post negative or zero, so clearly people in financial markets did not anticipate the inflation that occurred. There are a whole lot of things, in addition to bad policy or things that made it hard to run good policy, which contributed to this. They included excess demand, the fusion of faulty ideas, the underestimates of the costs of inflation, supply shocks, slowdowns in productivity, demographic shifts, institution factors, labor contract, political independence, etc. *Kohn's* conclusion is that policymakers were dealt a bad hand. But what are the lessons that we can draw from this to avoid big mistakes in the future, either from sustained inflation/deflation and/or recession?

Lesson One: Central banks must remain focused on effective price stability over time as the most important long-run objective of policy, and it is the responsibility of central banks to do so. Central banks often don't need convincing on this idea, but they do operate in a democracy most of the time. Political support for price stability is essential. *Kohn* was struck, looking at the charts presented by *Edward Nelson* on the U.K. inflation. Both the U.K. and U.S. inflation came to an end in the late 1970s and/or early 1980s, so you could argue that it took fifteen years for the political systems to get sufficiently upset with results they were getting to validate a disinflationary policy. Even as late as 1977 and 1978 in the U.S., the Humphrey Hawkins Act was more focused on price stability. After the contrast between the 1970s and the 1980s/1990s, support for price stability was strongly captured in most countries by the use of inflation targets. This was one of the most critical elements in terms of the political buy-in. Chairman Greenspan's latest book struck *Kohn*, particularly the final chapter where he discussed how good policy performance of the 1980s and 1990s was in part due to fortuitous circumstances that could easily reverse themselves. There were increases in globalization, deregulation, productivity increases, higher growth, lower inflation, all which were compatible but were not necessarily always going to be present. The current financial crisis will pose interesting challenges when trying to focus on price stability. *Kohn* stressed that the Federal Reserve is dealing with it now and that they need to focus simultaneously on financial stability and tail risks while keeping the long-run focus on price stability. But, seeing your way through the current mess and not losing sight of the big picture can be challenging. The intellectual framework for inflation targeting and its goals is also being challenged. Was it a macroeconomic policy that focused on medium-term price stability that was partly responsible for the bubble that happened in financial markets, and how should central banks take account of the potential for financial instability? As a corollary to the political support issue, *Kohn* was a firm believer that independent central banks are essential and need to utilize the score for action they get from this. *Kohn* agreed that many of the statements about the 1960s and 1970s Federal Reserve not exercising independence are factual, mostly due to the fact that the Federal Reserve did not have political support. The late 1960s struck him as interesting in the sense that there was a lot of coordination between monetary and fiscal policy, in terms of thinking about the outlook and what fiscal authorities should do. If the government raises taxes, then

the Federal Reserve will lower interest rates. This sort of coordination does not pay off. There is a lot more support for independence today.

Lesson Two: Inflation expectations are critical for controlling inflation. Increased inflation expectations make it more costly to get inflation down. Changes in the dynamics of the economy are hard to calibrate. This lesson has been taken onboard by central banks when responding to supply shocks.

Lesson Three: Vigorous debate inside institutions, public understanding, and informed comment by the public provide safeguards against severe, persistent mistakes. You need alternative perspectives heard and understood within the institution supported by good analysis and research. Having a panel of experts making monetary policy is good, but the Federal Reserve under Chairman Burns was not a friendly place for alternative viewpoints of staffers. *Kohn* discussed how he was there from 1975, and there was a lot of discussion among staff at the Federal Reserve Board that they were not sure bubbled up to the policymakers. There was also very tight control of publications written by the staff. When you start controlling research, it feeds back negatively on the incentive to do research, which evolved into an environment in which alternatives are not well off. Given this, you'd think there would have been a lot of dissents in the FOMC at the time. Ironically, there were far less than even in the Volcker era and most of the Greenspan era. Mostly, this is due to the lack of serious discussion under Chairman Burns. The FOMC is much more tolerant now. External communication is critical for building understanding, support, and getting public perspectives. Why are decisions made? It is imperative that policymakers have confidence that alternatives were considered and provide reasons why they were not taken. There is a point of tension with regards to diversity of views within the FOMC versus external communications. There have been issues where because there are good views within the FOMC, the external communications have tended to confuse the public about where policy is going. It's hard when you've got potentially nineteen people talking. The Federal Reserve is a natural institution given the number of people and it encourages diversity of views.

Lesson Four: There should be no shortcuts taken to price stability once inflation becomes embedded in the economy. Attempts to reduce the pain of disinflation are doomed to fail, and they also distort market signals to agents and other central banks. The incomes policies of the 1970s and the credit controls of 1980 made it hard to figure out the extent to how bad the inflation pressures were. Financial markets were confused how these artificial controls might affect inflation. In addition, policymakers cannot expect instantly credibility once they adopt a disinflationary policy. One lesson the FOMC learned is that gradualism, when you have an inflation problem, shocks hitting the economy, and expectations building up, it is not a good place to be. Therefore, we need regimes that can make major changes in policy. The whole "let's try just a little" is a recipe for failure.

As a final point, *Kohn* agreed with much of the previous discussion, stressing that humility is essential. The Federal Reserve did a poor job predicting what would happen to inflation and what policy would need to be. Expectations are critical, but we don't know how they are formed and we don't even measure them that well. There are also the issues of potential GDP, the NAIRU, the nature and persistence of shocks, and the full economic dynamics of shocks that we are still not sure of. We need to continuously remind ourselves that, admit when things aren't working out, and be ready to adapt to change.

Harold James continued off of *Kohn's* final point. There are very clever people trying to find out as much as they can, and then in the end they make terrible mistakes. In general terms, this humility lesson is the beginning one starts from and the end one should return to. This and the entirety of the discussion provided *James* with four types of questions that remained uncertain.

Question One: What is the chronology of the Great Inflation? If it began in 1965, when did it end? This issue is also relevant to the German hyperinflation. Many people make many cases. Then look at where

we are now in 2008. Are we at the beginning of another one of these phases? We have seen upticks in inflation worldwide.

Question Two: What causes inflation? In particular, how are people trying to understand the causes? The general rule is that when you are in the middle of an inflation, there is a lot of disagreement on what caused it. Is it cost-push shocks, reaction to demand shocks, a relationship to supply shocks? This also happens in other episodes. When Germany came out of World War One, people at the time thought the inflation was coming from a big deficit and a balance of payments problem rather than monetary readjustment. There is a process of learning, confused learning, and people don't like to give clear answers of causes when they are in the middle of it. *Meltzer* characterized Chairman Volcker as a practical monetarist, and *Otmar Issing* talked about pragmatic monetarism. Had *James* looked at some of the documents of the time, he often concludes that no one was pragmatic in the Milton Friedman sense. Why so much uncertainty? This is a problem that existed all throughout this conference. What's the long-term relationship to short-term movements in variables and shocks? One can always find some episode like this where you can think of something bad coming in from the outside that throws you off and you need to focus on the long-term story. This brings us back to the issue of endogenous versus exogenous. Some of the developments in the 1970s, like the commodity price shock, came out of the world and the inflation of the 1960s and 1970s. Oil producers saw a commodity that was priced in dollars that were suffering with inflation. *James* used a relationship to Hamlet reacting to things that seemed to disturb his long-term vision. In the end, the bits of bad news are individual, but their accumulation is really terrible.

Question Three: Why are we upset about all of this? Why should we worry about inflation? *James* provided two possible answers. One of them involved the fact that the process of inflation itself is something you cannot grab hold of, you cannot get an accurate sense of prices, and there are distortions in the price mechanism that affect incentives. It evolves into irrational decisions about allocations of investment resources. The second common way of thinking why we should worry is that inflation is a bad social policy because it represents an unjust redistribution of wealth and resources. When you begin to think from this perspective, then you are looking at a whole new aspect of inflation dynamics. It is redistribution. It's not just a question of policy mistakes or mistaken views, but there are people and interest groups that are beneficiaries of the inflation process and will frustrate attempts to stop or slow down the inflationary process.

Question Four: How can inflations be ended? The answer to this question has the most consensus, in that we need better information and better policy. If you believe the interest group view of inflation, there is a political element at work, too. This all may vary across countries. In smaller countries, it's often important and politically desirable to institutionalize the better policy approach, often from an external reference. It's all about credibility that comes from the outside. In the domestic case, it has to come from thinking about monetary policy and inflation targets. You must institutionalize the good policy.

Anna Schwartz concluded the panel discussion. She felt that one lesson of the Great Inflation from a social welfare viewpoint is that the Federal Reserve assigned entirely too much weight to job loss that disinflation would impose and not enough weight on the losses that inflation imposed on households and firms, as well as on lenders who accepted loans when the price level was lower than when the loans were repaid. The irony is, of course, that finding reasons for not responding earlier to the evidence of inflation means that when the central bank finally took action to curb the inflation, the loss ratio was much greater for a disinflation than it would have been if it had been taken at a more timely point.