

Discussion of

Riccardo DiCecio and Edward Nelson

“The Great Inflation in the United States and the United Kingdom:
Reconciling Policy Decisions and Data Outcomes”

by Matthew D. Shapiro

University of Michigan and NBER

NBER Great Inflation Conference—Woodstock, VT—September 2008

revised March 23, 2009

Riccardo DiCecio and Edward Nelson have produced a paper that evaluates monetary policy during the great inflation from several angles. First, it takes a comparative perspective on monetary policy. In particular, it argues that British attitudes about monetary policy affected the U.S. Federal Reserve during the 1970s. Second, it argues that policymakers emphasized non-monetary factors in both the determination of inflation and in policy reactions to inflation during this period. The central claim of the paper is that British thinking about monetary policy in the early days of the great inflation emphasized non-monetary factors, and that U.S. policymakers were affected by this thinking. Hence, the two lines of analysis in the paper combine to shed light on economic policy in the 1970s. Indeed, the culmination of non-monetary policies toward inflation in this period in the United States was the Nixon wage-price controls. Though implementing price controls was a presidential policy, they were supported by the Fed under Arthur Burns. While the paper does not focus on these price controls, it illustrates the background of policymaking and thinking about the economy that led to them.

The paper has two distinct parts. The first is a detailed narration of the policy perspective of U.K. and U.S. central bankers. This narration is supported by extensive quotations from their policy statements. The second is estimation and simulation of a medium scale new Keynesian macroeconometric model. Though the authors attempt to link these two parts of the paper, the connection between the narration is weak. Hence, the paper presents two separate, albeit complementary, approaches to understanding policy making.

The first part of the paper provides some valuable and compelling evidence on Arthur Burns's perspective on the function of the economy and how it related to policy choices. Here are what I take to be the central elements of the authors' characterization of Burns's perspective. First, the cost-push channel for inflation was important. Second, though monetary policy was viewed as an important regulator of aggregate demand, it was viewed as being insufficient by itself to control inflation. Third, Burns's had a notion that the economy had a speed limit that if exceeded would (nonlinearly) trigger inflation.

Why is this characterization so important? From the perspective of modern policy analysis, the cost-push/demand-pull dichotomy is a best a curiosum. But when combined with the notion that monetary policy alone could not control inflation it provides a powerful intellectual foundation for price controls. Though the authors do not emphasize this point, their narrative of the Arthur Burns's policy perspective brings into sharp resolution his support of President Nixon's wage and price freeze and controls. The price controls are an important episode.

- The Nixon wage-price freeze is the only instance of price controls in the United States outside of wartime.
- They were about fighting inflation *per se*, instead of a policy to deal with wartime rationing and shortages.

The controls cast a shadow over the entire 1970s.

- The Council on Wage and Price Stability (COWPS) continued to exist throughout the decade.
- Non-monetary approaches to inflation continued in the Ford Administration, for example, with President Ford's "Whip Inflation Now" initiative and the WIN button.
- Though most prices were decontrolled within a year or two of the Nixon freeze, oil prices remained controlled throughout the 1970s. These controls lead to shortages and queuing during the second OPEC price shock.

This episode of wage-price controls gets limited attention in the discussions of this period in general and this volume in particular.

The authors' discussion of Burns's policy perspective leads me to an aside on the relationship between Burns and President Nixon. In particular, to what extent did Nixon pressure Burns to keep interest rates low in order to abet his reelection, and to what extent did Burns yield to this pressure? Abrams (2006) surveys evidence from the Nixon White House tapes as well as from memoirs of participants in the Nixon administration. This evidence makes clear that Nixon placed considerable pressure on Burns to keep

monetary policy loose during the run-up to the 1972 election. He finds no direct evidence, however, that Burns acquiesced to this pressure.

I can add some evidence to this narrative. Arthur Burns's papers are housed at the Gerald R. Ford Library on the campus of the University of Michigan. I have looked through Burns's papers for evidence of political pressure on monetary policy. As on the tapes, there is evidence that the White House pressured the Fed to keep interest rates low. There is no evidence of acquiescence by Burns. Indeed, there are some annoyed notes written in the margins of the letters from the White House. The replies were, however, quite temperate.

I enjoyed reading the authors' narrative concerning non-monetary issues in inflation and learned from it. I would, however, like to challenge the authors' central point that U.S. policymakers acquired these ideas from Britain and that the ideas came to the fore in the late 1960s. In particular, non-monetary control of inflation was very much a feature of U.S. economic policy in the early 1960s.

- President Kennedy famously "jawboned" U.S. Steel in 1962 to rescind a price increase that was feared to be inflationary.
- The Kennedy Administration had wage and price "guideposts" that were meant to keep inflation in check.

Similarly, Britain pursued an "incomes policy" during the early 1960s. Hence, the non-monetary approach to inflation control has earlier antecedents than is clear from the authors' narrative, and these antecedents are well rooted in American soil. Hence, the

authors' notion that the British way of thinking spread to the United States ignores these early, significant attempts at non-monetary control on this side of the Atlantic. Their neglect of these earlier episodes also means the paper is silent on how the Fed interpreted them. I would be very curious to know what William McChesney Martin thought of jawboning.

Now let me turn to the econometric section of the paper. The authors posit an alternative Phillips curve for the UK in equation (1). It has some distinctive elements: the output gap enters only if positive, though the change in the gap is always in the equation. The authors do not estimate this equation. Indeed, it would not make sense to attempt to estimate it on actual data because the authors posit this equation characterizes the Treasury's thinking rather than fits the actual data. One could imagine estimating the equation based on Treasury projections, or calibrating it. The authors instead estimate a version of the Smet-Wouters model for the United Kingdom. This model has a conventional new Keynesian Phillips curve, so equation (1) does not figure in the empirical work of the paper.

The purpose of the estimates of the Smet-Wouters model in the paper is to identify policy shocks for the United Kingdom. These shocks are then used to evaluate the monetary policy during the period that is the focus of the narrative. These estimated shocks are useful for policy evaluation. Yet, since they have a close resemblance to the real interest rate, perhaps focusing on the raw data is easier. Figure 2a shows that there were two prolonged episodes in the 1970s where the nominal interest rate was below the inflation

rate. These episodes correspond to the two periods of persistent, expansionary policy shocks (low interest rates in equation (2)). Hence, the econometric model diagnoses the loose monetary policy that is readily apparent in the data. The authors only circumstantially relate the policy shocks to the non-monetary inflation policy that is the focus of the first part of the paper. Non-monetary considerations have no role in the model. Therefore, it is correct to look for them in the residuals. The paper would benefit, however, from a tighter link between the narrative in the first part of the paper and the estimates in the second.

Let me close with a criticism of the paper that applies broadly to a number of the papers in this conference. The story line of the conference is as follows: *Mistakes were made in the conduct of monetary policy from the mid-1960s through the 1970s. Policymakers now know better how to conduct policy.* This paper, as several others in the conference, makes this point by showing that a modern model fit to the period of the great inflation diagnoses policy errors. The paper connects these residuals to its narrative of non-monetary factors only by their temporal coincidence. Since the non-monetary features of policy, so well-documented in the paper, are not explicitly modeled, the case is circumstantial. More importantly, the authors do not show that policymakers using the model would have done substantially better than the contemporary ones in dealing with the actual shocks the economy faced during the period of the great inflation. This paper does, thankfully, not adopt the tone of self-congratulation of many of the contributions to this volume. Instead, it leaves implicit the “we know better” message that other papers make explicit.

This tone of self-congratulation at the conference was particularly grating giving the timing of the conference in September 2008, when the financial system was crumbling. Perhaps monetary policy had nothing to do with the conditions that led to the crisis. I tend to think otherwise. Indeed, I suspect that the papers in this volume will be fodder for an NBER conference some years from now about the complacency of monetary policy during the great moderation. Sustaining low inflation is of course an important goal. Central banks that achieve low inflation deserve commendation. Yet, I expect the message of that future conference will be that judging monetary policy solely by its achievement of low and stable inflation was a serious mistake.

REFERENCE

Abrams, Burton A. "How Richard Nixon Pressured Arthur Burns: Evidence from the Nixon Tapes." *Journal of Economic Perspectives* 20:4 (2006) 177-188.