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Discussion

Matthew Shapiro began the discussion by claiming that the chapter had a rather self-congratulatory tone that came from running simulations of a model in which we know there is disconnected performance. He stressed that the authors should use the actual shock process that the model generates. Given the parameters, you can back out the shock process and show what history would look like with this policy and what the shocks would look like with the given equations. That way, it would be more consistent.

Robert King had a different interpretation of several of the figures in the chapter, notably the figure referring to the inflation targets of the period in question. He proposed that perhaps under the Paul Volcker and Alan Greenspan regimes, the Federal Reserve had a target inflation rate of 4 percent, while under the earlier period it was 0 percent. He felt it was improper to say that policy was optimal under the Federal Reserve and 4 percent off under the Shadow Open Market Committee (SOMC).

Bennett McCallum mentioned how Romer criticized the details of the SOMC's recommendations, and went further by saying that implicitly going along with that is a lack of attention to the dynamics. He advertised the policy rules he developed in the 1980s, which he felt were an attempt to write down in a dynamic and operational way what he thought the SOMC was promoting. Simulations he has made would indicate you would get pretty good performance with the policy the SOMC was arguing for. McCallum continued on by referring to comments made by Romer on how credibility was not important for reducing the sacrifice ratio (i.e., the trade-off between stabilizing inflation and maintaining sustainable employment or growth). He pointed out that reducing the sacrifice ratio is not necessary for successful policy, and even argued that most of the models used today for stabilization purposes do not have changing sacrifice ratios. Thus, a reduction might be attractive, but it is not at all necessary for good rules-based policy.

Alan Blinder referred to figures 1.5 and 1.6 in the chapter, and stressed that under either a gradualist or cold turkey approach to policy, the sacrifice ratio would be zero or infinity depending on how one wrote it. This left him with two deductions: either this model is totally at variance with reality, or Paul Volcker was probably the least credible head of the Federal Reserve in its history.

Andrew Levin referenced a paper he had written with Michael Bordo and Christopher Erceg that talked about credibility. Look at the convergence of Greece and Italy during the approach to monetary union, and Levin believed that experience looks very similar to the figures in the chapter presented here. There was credible disinflation, and everyone understood that they were converging to a monetary treaty. Output expanded, and the sacrifice ratio was probably close to zero. In the chapter presented here, the authors look back at US history. There are cases where having strong credibility is important. In the paper Levin referenced, it was shown that if you have imperfect credibility, then a gradualist policy is not the best. If you do something like Volcker, where you hit the rates hard to send a clear signal that the inflation objective has changed, you can reduce the sacrifice ratio, since the key issue is conveying to the public that things have changed so that they change their expectations.

Michael Woodford commented on the gradualist versus cold-turkey policies. Analyzing this under the assumption of immediate, perfect credibility is probably not the realistic way to analyze it. But assuming that one does that, is it really the case that it leads to superiority of the gradualist policy? If one actually assumes one can adopt a policy and have it be immediately credible, then it should be possible to immediately stop inflation without there being a required recession. The policy that would do this requires a onetime increase in the money supply and low money growth thereafter. You can announce that and have it be perfectly credible even while the onetime increase is occurring, and agents will perfectly anticipate lower money growth in the future. So, it is not actually true that a gradual process is optimal.

Benjamin Friedman returned to the comments of McCallum, noting that the idea of enhanced credibility of lower inflation in the future giving you an improved sacrifice ratio is a consequence of any model based on Calvo pricing, Taylor's overlapping contracts, Rotemberg quadratic adjustment costs, Leahy and Gertler Ss pricing, and so forth. McCallum added that the experiments being discussed here involve starting at a given point in time and assuming expectations are correct. Is this sensible dynamic analysis? One must look over a span of time. This all creates confusion between ex post and model-based sacrifice ratios. In reference to Woodford, McCallum did not believe you can just change policy and expect expectations to be rational immediately.

Alex Cukierman stated that stabilization and credibility must go together, and strongly disagreed with Romer's comments. The first element you need for stabilization is establishing credibility, since all the work involves changing expectations. If expectations do not capture ahead of time what the subsequent path will be, it does not mean they are not rational. It means there is uncertainty. When Volcker came into office, was he going to be strong or weak? Given this uncertainty, he had to prove himself and demonstrate after the failed policies of Chairmen Arthur Burns and G. William Miller. Was the recession needed to establish credibility?

Anna Schwartz stressed that Milton Friedman believed that the lessons of the Great Inflation would not be long-lasting, that inflations would recur because central banks would yield to the temptation to be overexpansive, and because they would be reluctant to tighten monetary policy. Her guess is that he would regard the recent performance of the Federal Reserve during this financial crisis as confirmation of his belief.

Allan Meltzer provided the group with a bit of history, stating that when Chairman Volcker came into office, he informed then-President Jimmy Carter that he would be tougher than his predecessors. Carter said that was what he wanted. Why did Carter and Congress change their minds? Inflation had become the biggest problem that the country had, and thus they supported Volcker. Volcker gave up the interest rate as the monetary policy instrument because he wanted markets to set the interest rate and did not want to be blamed for it. During a deep recession, he even enacted policy that raised the interest rate. This established his credibility as a tough central banker. What the public did not believe was that he would be able to stick to it when unemployment got high, and he showed that he would stick to it. In terms of the SOMC's influence, he said he was a practical monetarist and would not go to a rigid rule, but that he would get money growth and inflation under control.