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Comment Christina D. Romer

The premise of this chapter by Poole, Rasche, and Wheelock is brilliant. The Shadow Open Market Committee started business in 1973 as a self-appointed alternative to the official monetary policymaking committee in the United States. As such, their recommendations constitute a wonderful counterfactual to the policies that were actually followed. Like looking at the experiences of other countries in the 1970s (another great topic included in the conference), this counterfactual helps us to understand whether avoiding the Great Inflation was something that required knowledge not available at the time, or simply knowledge available but not used by American policymakers in the 1970s.

The SOMC's Economic Ideas

Poole, Rasche, and Wheelock begin their study with an extensive discussion of what members of the Shadow Open Market Committee (SOMC) believed about key economic relationships. This is, to my mind, the right place to start. I am a contributor to what Sargent (2002) has called the "Berkeley story" about the causes of the Great Inflation. This story emphasizes the crucial role of mistaken beliefs about how the economy operated in causing policymakers to take unfortunate policy actions. DeLong (1997) stressed the role of the Samuelson-Solow belief in an exploitable Phillips curve, along with a deep-seated fear of unemployment resulting from the trauma of the Great Depression, in leading both monetary and fiscal policy-

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makers to err far too often on the side of overexpansion during the late 1960s and the 1970s.

David Romer and I (2002, 2004) expanded on DeLong's analysis by examining policy and ideas over a much longer period. We found that beliefs about fundamental economic relationships were the driving force for macroeconomic policy from the Great Depression to today. We found that the central beliefs were more complicated and nuanced than just a yes or no belief in a permanent trade-off. For example, for the 1970s, we showed that the Federal Reserve's failure to control inflation resulted from both a belief that the sustainable level of unemployment was very low and the view that inflation was relatively impervious to slack. This emphasis on the crucial role of mistaken economic ideas, particularly in the 1970s, has been shared by numerous other researchers, including Mayer (1998), Nelson (2005), and Hetzel (2008).

If bad ideas were the fundamental source of monetary policy mistakes in the 1970s, a natural way to evaluate the Shadow Open Market Committee is to ask if its members had better ideas. And, in some ways, they clearly did. Indeed, from the authors' description, the SOMC seemed to hold the three views that Romer and Romer (2004) found have been consistent across successful Federal Reserve chairs. First, the members believed in the natural rate hypothesis with a sensible estimate of normal unemployment; they did not think we could buy permanently lower unemployment with some more inflation. Moreover, the SOMC thought inflation was very costly. In this way, they hit our second key view, which is a strong belief that low inflation is beneficial to the economy. Perhaps most important, the authors show that the SOMC had a firm view that the economy responded to changes in the money supply; they had no doubt that inflation would fall if money growth were reduced. In this way, they escaped Arthur Burns's and G. William Miller's paralyzing view that inflation was caused by special factors and so monetary policy was powerless to counteract it (at least, at any reasonable cost).

Given that its members held some very sensible views, does it follow that the SOMC would have been better at monetary policymaking than the Federal Reserve? I am not at all sure. The reason for my skepticism is that the SOMC also held some other beliefs that may have countered or confounded their sensible ones. Most of these auxiliary beliefs center on operating procedures and monetary relationships. Reading the authors' chapter, I was struck by the overwhelming sense that 1970s monetarism would have been very sensible if it weren't for all this silly stuff about money. One of the core auxiliary beliefs was that money demand is stable. In addition, the SOMC seemed to be almost obsessed with the notion that the Federal Reserve could not use interest rates as a reliable guide for policy. For example, in March 1983, the SOMC declared: "Proposals to set targets for interest rates—real or nominal—would be destabilizing." The fear of interest rate targeting,

combined with the over-optimism about the stability of money demand, might well have led the SOMC to erratic policy.

Finally, I can't resist saying a word about the SOMC's belief in the crucial importance of credibility and the usefulness of transparent, rules-based policy. Now, I am as big a fan of transparency in monetary policymaking as the next person. But, I feel overestimating the value of credibility is potentially very destructive. There is remarkably little evidence that credibility in monetary policymaking buys one much when it comes to lowering the costs of disinflation. In this context, I would cite the work of Ball (1994) and Ball and Sheridan (2005), which shows that other factors, such as labor market institutions, are far more important than credibility in determining the sacrifice ratio. Blind faith in the value of credibility may lead policymakers to fail to respond to genuine developments for fear of losing some hypothetical power.

Simulating a Gradualist Monetary-Base Rule

Besides discussing the SOMC's beliefs, the main thing the authors do is simulate the effects of a gradualist monetary base rule in a dynamic stochastic general equilibrium (DSGE) model. This rule says that the growth rate of the monetary base is dropped 1 percentage point per year until the desired growth rate is achieved. The authors use the narrative evidence from the SOMC policy statements to suggest that such a rule is a stylized version of what the SOMC was recommending in the 1970s and, indeed, throughout its whole existence. The model they use for the simulation is standard in most respects. The main bells and whistles involve the nitty-gritty of the monetary side of the model, such as an assumption about endogenous velocity and incorporation of the term structure of interest rates.

Implicitly, I think what we are supposed to get out of the simulation is the sense that such a monetary base rule would have worked better than the policies the Federal Reserve actually followed. The simulations suggest that gradualist monetary base targeting would have achieved low inflation with virtually no output costs. Since we actually experienced high inflation and high costs of disinflation, the SOMC rule clearly looks better.

Now, this is not how the authors frame their simulation. Rather than making an explicit comparison with actual policy or some other operating procedure, such as an interest rate rule, they focus on a horse race between a gradualist monetary base rule and a cold-turkey drop in the growth rate of the base to achieve the desired disinflation. In my view, this is a distraction. I do not think what we really care about is whether Paul Volcker should have acted more gradually. Rather, what we care about is a base rule versus a policy of fine-tuning or versus making gross mistakes concerning the level of monetary stimulus.

The focus on the horse race also leads the authors to make modeling choices that obscure some of the key issues. For example, they assume that

there are no shocks to money demand. This is fine if one just cares about the relative success of one type of base rule versus another. But in evaluating the desirability of a base rule versus actual practice or an interest rate rule, assuming away money demand shocks comes painfully close to assuming the conclusion that a monetary base rule is desirable.

Likewise, the basic model, which includes a New Keynesian Phillips curve, is very forward-looking. The authors add the assumption that the stated policy rules are perfectly credible. These assumptions do not have big effects on the horse race the authors consider. But, for the implicit comparison to actual outcomes, they are surely very important. Credibility and forward-looking expectations practically ensure that any kind of a rule achieves disinflation with far less cost than a more ad hoc policy.

The SOMC's Actual Policy Recommendations

My comments so far are about the framework and assumptions the authors use for simulating the effects of a gradualist monetary base rule. It has taken as given that such a rule is a good proxy for what the Shadow Open Market Committee was recommending. In Romer and Romer (2012), David Romer and I take up that issue. Rather than using the narrative evidence on SOMC recommendations to suggest a stylized rule to be simulated, we look directly at those real-time recommendations. What money growth rate was the SOMC recommending at each meeting? Do these money growth rates appear to be moving policy in a desirable direction? Because the SOMC stopped consistently providing its recommendation for policy in terms of a growth rate of some monetary aggregate after 2001, we focus on the period 1973 to 2001.

It is important to be clear about the question we ask. We do not ask what would have happened if monetarists had been in charge of policy for the entire period we consider. I have no doubt that had we given Milton Friedman and Anna Schwartz free reign over monetary policy starting in 1973, macroeconomic history would have unfolded very differently. Indeed, many other features of the economy and policies might have been quite different had an effective monetarist regime been in place. But this regime did not occur, and so the records of the SOMC do not allow us to address this counterfactual.

Instead, we ask for each date in this period, what would have been likely to happen to policy in the short run if we had put monetarists in charge. It is reminiscent of the movie *Groundhog Day*: imagine each meeting is Anna Schwartz's first day as Federal Reserve chair. We can take the SOMC recommendations as an indication of the policies she would have followed in the short run.

The SOMC's policy recommendation at each meeting had two key features: the monetary concept used, and its recommended growth rate. In terms of the monetary concept, the authors are certainly correct that the

monetary base was used most often. But, it was only used about two-thirds of the time. For most of the 1970s and for two brief periods in the 1980s, the committee stated its recommendation in terms of M1. And for two meetings in 1990 and 1991, it stated its recommendation in terms of M2. Thus, the notion that one should model the Shadow Open Market Committee as having a base rule is not obvious, especially for the period covered by this conference. More importantly, the fact that real-life monetary prescribers were clearly struggling with what concept to use indicates that the choice was difficult. It suggests that the relationship between monetary measures was not stable, and that the money demand and velocity shocks assumed away in the simulations were important.

Identifying the recommended money growth rate from the SOMC policy statements is usually straightforward. The main exceptions occur when the SOMC described policy in terms of a onetime correction and then a growth rate. These recommendations need to be converted to effective growth rates. In each case, we look only at what the SOMC was recommending for money growth over the next six months (until the next meeting) at an annual rate, since that was often the committee's central focus and since the committee consistently provided such recommendations.

Figure 1C.1 shows the recommended money growth rates of the SOMC. The markers are coded to show the concept being used (white circles for M1, black circles for the base, and white triangles for M2). We have made no attempt to standardize the measures. That is, we have not tried to guess how a recommendation of 6 percent base growth would translate into a recommendation for M1 growth. But, the few times when the SOMC says what a base growth rate corresponds to for M1 growth, the two are within a percentage point of each other. So, not standardizing may be fine.

Assessing the SOMC's Recommendations

The first thing to say about the SOMC's prescriptions is that one cannot help but notice how incredibly far they were from Milton Friedman's famous "*k*-percent" rule. Recommended money growth varied sharply—from a low of less than 1 percent annual growth to a high of over 9 percent. Now some of this extreme variation comes from the onetime corrections the SOMC sometimes included. The uncorrected rates are certainly smoother, but still highly variable. They fluctuate in a range of 4 to 8 percent, plus one recommendation of 2 percent growth.

There is also little change in the volatility of recommended growth rates over time. One might have expected the recommended rates to be particularly volatile in the 1970s, when the SOMC was reacting to often erratic Federal Reserve policy. However, consider the period from 1985 to 1997. This is the heart of the "great moderation," during which actual monetary policy was quite well-tempered. Even in this period of relatively low inflation and stable real growth, the money growth rate advocated by the SOMC fluctu-

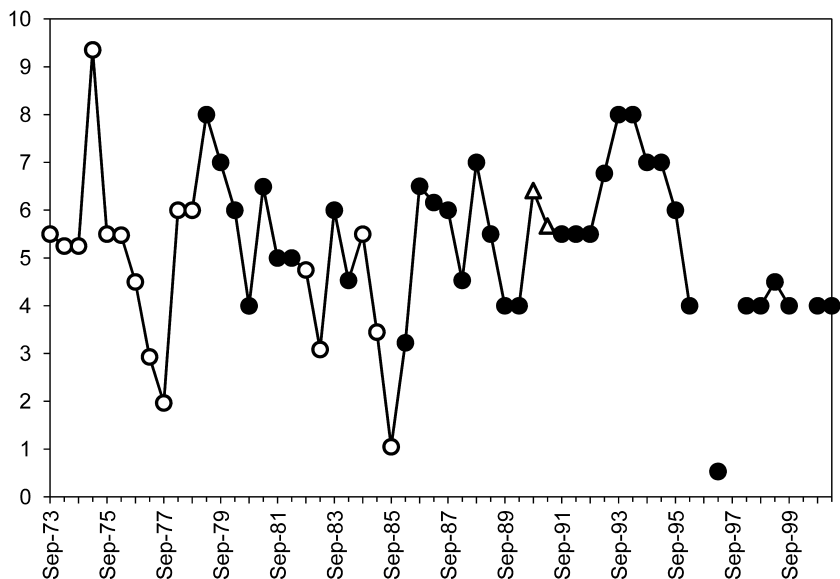


Fig. 1C.1 SOMC recommended money growth

Notes: The figure shows the money growth rate recommended by the SOMC. The color and shape of the marker shows the money concept being used: M1 is represented by white circles, the monetary base is represented by black circles, and M2 is represented by white triangles.

ated sharply. Only in the final few years of the sample are the recommendations stable.

We also look at how different the SOMC's recommended money growth was from actual money growth in the six months following each SOMC meeting. In calculating actual money growth, we are careful to use the same monetary concept as the SOMC. This difference (SOMC minus actual) is given in figure 1C.2. The figure also shows actual inflation in the six months following each SOMC meeting. The idea is to look at the difference between recommended and actual money growth in relation to inflation, to see if the SOMC seemed to be urging policy in the right direction.

Let me just go through the results episode by episode. (In Romer and Romer [2012] we also take a more systematic approach to the entire sample period.) For four of the first five meetings, the SOMC recommended slightly faster money growth than what actually occurred. I was quite surprised by this result. The first meeting of the Shadow Open Market Committee was in September 1973. Inflation was over 7 percent and the economic expansion had not yet peaked. It seems unlikely that the SOMC formed itself to argue that Arthur Burns was not being expansionary enough. My guess is that their early behavior is testimony to the fact that it is hard to use money growth targets as a reliable indicator for policy. At the very least, the first two and a half years of the committee do not

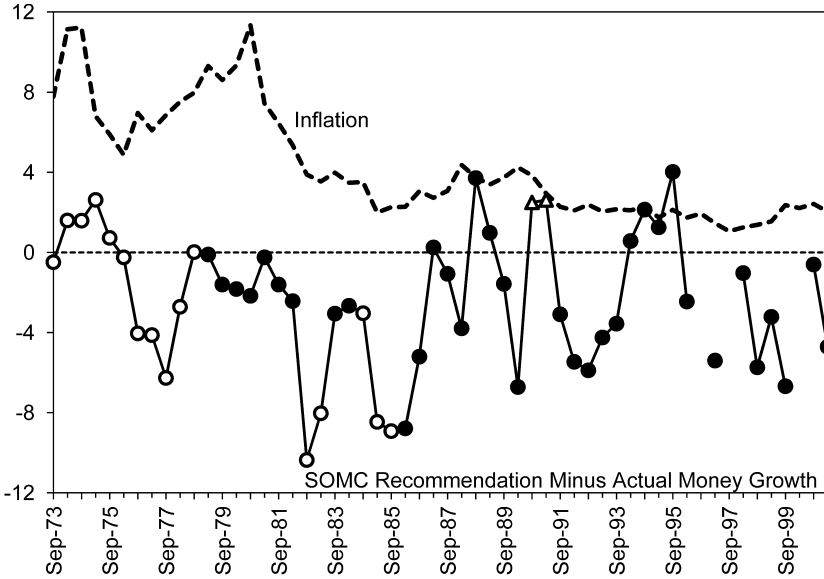


Fig. 1C.2 Actual inflation and the difference between SOMC and actual money growth

Notes: Actual inflation is measured as the percentage change at an annual rate in the price index for GDP in the two quarters following the SOMC meeting (from the first to third quarter for the March meeting and the third to first quarter for the September meeting). Actual money growth is calculated using the same concept as the SOMC was targeting. The change is for the six months following the meeting (from February to August for the March meeting and August to February for the September meeting). The color and shape of the marker shows the money concept being used: M1 is represented by white circles, the monetary base is represented by black circles, and M2 is represented by white triangles.

suggest that the SOMC would have been more successful in preserving nominal values.

To my mind, it is in the period 1976 to 1978 that the SOMC shines. This is the period when the Federal Reserve made its most blatant errors. It is sometimes hard to imagine just how close we came to avoiding the worst of the Great Inflation. By mid-1976, inflation had come down to just over 5 percent and real growth had recovered to robust levels. It is at this point that the Federal Reserve, I think because of misguided ideas, expanded recklessly. Notice how much lower money growth the SOMC was recommending. Proposed money growth rates were at times close to 5 percentage points below what actually happened. This is stunning suggestive evidence that the SOMC did, in this crucial period, seem to know substantially more than the Federal Reserve.

For the downward movement during the Volcker disinflation, the SOMC was essentially recommending policy similar to what the Federal Reserve actually did. There is a striking difference, however, coming out of the

1981 to 1982 recession. The SOMC recommended dramatically lower money growth in both September 1982 and March 1983 than the Federal Reserve actually created. The difference in September 1982 is a whopping 10 percentage points. By March 1983, the Shadow Open Market Committee was convinced that the Federal Reserve was losing its nerve and that inflation would return. The policy statement declared: “The current inflationary policy should end.” In retrospect, given how well inflation behaved subsequently and the genuine risks to the world financial system caused by the sustained high interest rates, I believe few would argue that the 1981 to 1982 recession was not deep enough and did not last as long as it should have.

The record of the SOMC after the Volcker disinflation looks to me to be truly dismal. And remember, this is the time when the SOMC could chart its ideal course in a low-inflation, relatively stable economy. Look at the difference between what the SOMC was recommending in the period 1985 to 1986 and actual money growth. At a time when the inflation rate was down at approximately 2 percent, the SOMC was recommending money growth up to 9 percentage points below actual.

A similar phenomenon occurs in 1992 to 1993 and 1998 to 1999. In both cases, inflation was low, yet the SOMC recommended money growth roughly 5 percentage points below actual. The September 1998 recommendation is particularly interesting. Despite the August 1998 Russian financial crisis, the SOMC explicitly refused to respond to the international turmoil. The report for the September 14 meeting stated: “We urge this policy though we are aware of the risks in the world economy. . . . Stability of the U.S. economy should continue to be the Federal Reserve’s primary goal.”

Then, just to complete the sorry picture of the more recent era, look at 1994 to 1995. For some reason, the SOMC was proposing money growth considerably above what actual policy was producing. Inflation was still low—roughly 2 percent—and stable. As I recall that period, people were talking about the Clinton miracle and the robust expansion of the high-tech economy, not incipient recession and deflation. Overall, it appears that had the SOMC had its way in the period since the Volcker disinflation, the results might have been far less desirable than they actually were.

Besides looking at the twists and turns of what the SOMC was recommending, it is helpful to think about the overall thrust of their proposed policies. One cannot help but notice that the money growth the SOMC was recommending at each meeting over this twenty-five-year period was on average well below what actually occurred: the average difference over the full period is -2.4 percentage points. Now, given the inflation that occurred in the 1970s, it is tempting to take this difference in the overall thrust of policy to mean that the Shadow did indeed know better. And, as I have suggested,

this interpretation is surely correct for a critical period in the late 1970s. But it seems to me that considering the twenty-five-year period as a whole, it is a sign that the SOMC might have known far less than the Federal Reserve. The Shadow Open Market Committee generally recommended money growth far below actual in a period when inflation was low and stable. Had the SOMC had its way in the period since the Volcker disinflation, the results most likely would not have been pretty.

Conclusion

So where does all of this leave us? I have to say, disappointed. I wanted to believe that the SOMC knew better. Certainly, given some of their ideas about basic economic relationships, they should have known better. But, in this case, the devil truly seems to have been in the details. The SOMC's attachment to certain operating procedures and assumptions led it to get the details severely wrong. If this analysis is correct, the SOMC's policy prescriptions would have led to superior macroeconomic performance than the Federal Reserve's only for a short, but admittedly very important, period. For the most part, the SOMC's recommendations would almost surely have led to less desirable macroeconomic outcomes. Or to put it in terms of Federal Reserve chairmen: I would have preferred the SOMC to Arthur Burns at his worst and certainly to G. William Miller, but give me Paul Volcker and Alan Greenspan any day.

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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.