

Notes on Ch. 10 Did Time Inconsistency Contribute to the Great Inflation?

## **Introduction**

This paper considers the role of the time inconsistency problem as an explanation for the emergence of inflation in the 1970s

The approach is anecdotal – we examine what Fed policymakers actually argued at the time when the decisions were made. We look at the validity of the model's assumptions and also some “comparative static” implications.

Data sources: Transcripts of meeting discussions and *Memoranda of Discussion*.

## **Key Features of the Time Inconsistency Argument**

Period-by-period discretionary choice making.

Expectations considered given at the time a policy choice is made.

Economy characterized by an “expectational” Phillips curve.

The Fed values unemployment below its natural rate, but dislikes high inflation.

Expectations are rational.

## **Criticism of the Time Inconsistency**

Alan Blinder (1997, p. 14):

Well, I can assure you that my central banker friends would not be surprised to learn that academic theories that assume that they seek to push unemployment below the natural rate then deduce that monetary policy will be too inflationary. They would doubtless reply, “Of course. That's why we don't do it.”

Rejoinder: In equilibrium in the time inconsistency model, there is no attempt to push unemployment below the natural rate --- rather, there is simply a reluctance to fight an existing steady inflation with contractionary policy when there is no credible commitment to maintain such a policy.

## **Documenting Applicability of Assumptions**

*Preferences of the Public and Policymakers*

Governor Jeffrey Bucher on the outcomes that Congress might consider appropriate:

Although many people now regarded a rate of unemployment in excess of 4 percent as acceptable, he was not convinced that Congress as a whole was prepared to accept a rate as high as 5 percent; certainly, it would not find a 6 percent rate acceptable. [*Memorandum of Discussion*, February 20, 1974, p. 191]

### *Phillips Curves*

Morris on the short-run Phillips trade-off:

... I think every sheet of this kind that I have seen in the past eight years around this table suggested that a more expansionary policy would produce benefits in greater real growth and very little price effects, and I think that reflects the fact that the time horizon for this kind of exercise has got to be longer to be useful to the Committee. [*FOMC Transcripts*, July 20, 1976, Longer Run Targets, Tape 1, pp. 6-7]

Partee on the role of expectations:

“We certainly know that there’s a built-in inflation rate of some considerable size resulting from the cost increases and the labor contracts [that] *have been negotiated and will pay off regardless* in this period to come” [*FOMC Transcripts*, February 28, 1978, Tape 4, p. 10, emphasis added].

St. Louis Fed President Darryl Francis on long-run Phillips Curves:

... the rate of unemployment had averaged about the same whether the trend growth of money was 6 per cent, 3.5 per cent, or 1.5 per cent. The trend growth had had its chief impact on prices, whereas fluctuations around the trend had had the greatest impact on production and employment. [*Memorandum of Discussion*, May 11, 1971, p. 476]

### *Period-by-Period Discretionary Policymaking:*

Burns’s response to Morris’s lament for a longer-run outlook:

Let me just make a comment, that to do what we can in the way of longer run objectives, I think is salutary. ... But we have to do something very specific today. Mainly to set monetary growth ranges for the next 12 months for the interval between the second quarter of this year and the second quarter of next year. [*FOMC Transcripts*, July 20, 1976, Longer Run Targets, Tape 1, p. 7]

San Francisco Fed President John Balles:

“... the Committee doesn’t seem to have any systematic way of getting from here to there in terms of the two-month range versus the twelve-month range” [*FOMC Transcripts*, October 17, 1977, Tape 8, p. 10].

Roos summed up his experience on the Committee in this fashion:

I liken what we have done in the last year sort of to the alcoholic who should do something, but he takes a little drink this time and a little drink [next time] and he’s always going to do something down the road ... We’ve set ranges until we’re blue in the face ... we’re just deluding ourselves if we think that we are really doing anything to correct the excessive growth of the money supply. [*FOMC Transcripts*, January 17, 1978, Tape 6, pp. 15-16]

*On Expectations and Equilibrium:*

Dallas Fed President Phillip Coldwell supported the easing, but opposed a discount rate change, noting that

“... in continuation of the gradual approach ... the System should not take any overt actions to ease at this time” [*Memorandum of Discussion*, October 14-15, 1974, p. 1133, emphasis added].

### **Comparative Static Arguments**

Why was inflation high in the Burns years compared to other periods?

Preferences: Nixon was more blatantly willing to advocate economic stimulus for electoral purposes than most other presidents. Consider the role of price controls ....

Natural Rate of Unemployment: An increase in the natural rate of unemployment leads to a higher equilibrium inflation rate in the Barro model.

$$p_t = \frac{a}{b}(1-k) E_{t-1} u_t^n$$

Consider this discussion [*FOMC Transcripts*, July 19, 1977, Tape B, p. 9]:

*Zeisel (staff):* I think in terms of our reference toward unemployment, I think one has to, as you know, recognize structural changes that have tended to occur in the labor market [that] tended to bias up the unemployment rate and in addition we’ve just been through a period of enormous growth in the labor force which was very largely made up of

women who tend to have high frictional rates of unemployment. I think the 6-1/4 per cent rate, really, for comparison with past periods, has to be adjusted down somewhat.

*Partee:* You mean 6-1/4 might be a pretty good rate of unemployment.

*Zeisel:* Well 6-1/4 by capacity, yes.

*Partee:* Although I haven't heard anything here in the city that would suggest acceptance of that.

### **Alternative Explanations:**

Others have suggested that “mistakes or misperceptions” explain the rise of inflation in the 1970s, others suggest supply (oil price) shocks.

The documents show a deliberate willingness to risk inflation at times, suggesting that mistakes are not a complete explanation. Further, if there were mistakes, it appears that they were not quickly corrected when they became obvious.

On oil price shocks, consider Bernanke:

My reading of the evidence suggests that the role the conventional wisdom has attributed to oil price increases in the stagflation of the 1970s has been overstated, for two reasons. First, the large increases in oil prices that occurred in this period would not have been possible in an environment that was not already highly inflationary because of previous monetary expansion ... Second, without Fed accommodation, higher oil prices abroad would not have translated into domestic inflation to any significant degree. [Bernanke, Speech to the Money Marketeers of New York University, February 3, 2003]

In 1975 Gramley had in fact argued for accommodation:

Given the demand and supply conditions for [foods and energy], an adjustment in relative prices had to take place, and because of the downward inflexibility of most prices, it was just about impossible to get the adjustment in relative prices without a rise in the general level of prices. Thus, if policy did not accommodate the price increases for foods and energy by permitting a higher rate of monetary expansion, the rate of growth in real GNP would be reduced. [*Memorandum of Discussion*, August 19, 1975, p. 933]

CMV summary on oil price shocks:

If the FOMC had consistently followed a Friedman-type constant money growth rule in the 1970s, inflation would not have accelerated as it did. However, the time inconsistency theory implies that unfavorable shocks to natural rates *will* affect monetary policy and the equilibrium rate of inflation. When the equilibrium inflation rate rises, inflation expectations rise, as well. Changing expectations are, in turn, reflected in wages and prices, and policymakers see what they perceive to be a “cost-push” phenomenon. In the midst of this “cost-push” inflation, policymakers recognize that failure to accommodate will precipitate recession. As a result, they choose to “ratify” the higher equilibrium inflation rate, as they apparently did in August 1975.

## **Conclusions**

“The current time consistent equilibrium is more pleasant than the one prevailing in the 1970s, not just because the Fed is more enlightened, but also because of a fortunate confluence of exogenous economic and political forces.”