

Discussion of 'The Decline of Activist Stabilization Policy'

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1 Stagflation

- The U.S. postwar experience with high inflation and volatile output, *a.k.a.* “The Great Inflation.”
- Lesson for a generation: “Don’t let the inflation genie out of the bottle.”
- What happened? Could it happen again?
- Many recent papers. Explanations more precise than mere “poor policymaking.”

2 Three elements

- There was a large misperception of the natural rate of unemployment circa 1970.
- Monetary policy was more “activist” circa 1970—policymakers reacted more strongly to the perceived state of the real economy than they did after 1980.
- The expectations of private sector agents evolved and influenced the dynamics of the economy in an important way.

3 Natural rate misperceptions

- Posit that today's CBO estimates of the natural rate of unemployment represent the truth.
- Construct a series representing contemporary beliefs concerning the natural rate. Use historical records, including discussions by policymakers at the time.
- Call the difference a misperception.
- Result: The misperception peaked at about 1.5 percentage points 1965-1975, and is essentially zero in the later portion of the sample.

4 The model

- A simple three-equation hybrid model, with some elements from New Keynesian microfounded models.
- The model is specified in deviation-from-steady-state form, but where the natural rate of unemployment is time-varying.
- The unemployment and inflation equations involve forward-looking terms.
- The interest rate equation is a monetary policy feedback rule, and also has forward-looking terms.

5 Estimation

- Expectations enter, and the authors use real-time data from the Survey of Professional Forecasters.
- The authors also use first-announced, real-time unemployment and inflation data: gaps are those “first announced”.
- Does the model provide a good empirical fit to the data?

6 Policy activism

- The authors want to study the idea that policy became less “activist” circa 1980. (“Activism?”)
- A structural break on the parameter describing the reaction of policy-makers to the unemployment gap.
- Do we know that this is the only parameter that describes the break well?
- Goal: Conduct counterfactual experiments with the estimated model.

7 Learning

- What to assume about expectations in the counterfactual experiments?
- The authors assume private sector agents use constant gain learning.
- The learning algorithm is calibrated so as to mimic the SPF data.
- Expectations adjust endogenously to structural and policy changes, accomodating the Lucas critique.

8 Incorporating learning more fully

- Replacing expectations in the model with the learning algorithm creates a more complicated dynamic model. Bullard and Eusepi (2003); Collard and Dellas (2003).
- This more complicated model could be estimated using the same data the authors use.
- The private sector learners can converge to something close to REE. “Expectational stability.”
- How far off are the learning agents from RE in the counterfactual simulations?

9 Quantitative exercises

- Inflation would have been lower, less volatile, and less persistent if ...
- ... policymakers had the correct estimate of the natural rate of unemployment, OR
- ... private sector expectations had been formed the same way they were circa 1966, OR
- ... policymakers had followed a rule which did not respond to perceived unemployment gaps.

10 What to make of it

- The misperception of the natural rate of unemployment, and of potential output, circa 1970 should not be taken lightly.
- Most macroeconomic models in use do not address issues like this well.
- Structural change is not often confronted by theorists—but empirical analysis often abstracts from expectations.
- This paper takes an important step in trying to address these problems.

11 Points to ponder

- This paper suggests policy activism can lead to serious problems if the economy's potential is misperceived, as it evidently has been in the past.
- One solution is to adopt Milton Friedman's position: do not attempt to do too much.
- If you think misperceptions of this type are no longer a problem, then the cautionary tale may not be so alarming.