General Discussion of Perry and of Cagan-Fellner

Robert J. Gordon noted that the main difference between the price-wage system implicit in his price equation that George Perry reported and the wage equations in the paper by Perry and the one by Phillip Cagan and William Fellner was the elasticity of past inflation on current inflation. He argued that by hypothesizing norm shifts—or in the case of the Cagan-Fellner paper, a succession of cyclical shift dummies—the Perry model estimates a coefficient on past inflation that is too low. That is why the Gordon price equations track the present disinflation well while the Perry equations start to develop large overpredictions of wage inflation. Perry replied that the residuals in the present period did not tell anything about which formulation was superior because the wage norm equations specifically expect residuals of the kind that are being observed. Those equations would be failing if there were not positive residuals in the present period. The choice between fitting long lags on past inflation or allowing for norm shifts to characterize the inflation process had to be settled on other grounds, such as the evidence he had discussed in his previous paper (*BPEA 1:1980*).

James Medoff agreed with Perry's conclusion that the slowdown in wage growth did not result from unusual expectations about economic policy. He viewed these wage developments as coming from both the unusually severe recession and from secular developments in relative wages. Senior union members, the last to be laid off, tend to resist wage concessions or even slowdowns in wage growth as long as the probability of plant closing or bankruptcy is low. Wages weakened much more in 1982–83 than they had in the 1974–75 recession because this time the jobs of senior union members were threatened by the prospect of shutdowns. In addition, the wages of major unions relative to the economy-wide average had risen throughout the 1970s, building up pressure for a return toward more typical differentials.

Gordon offered two explanations for the instability of the exchange rate in his price equation as reported in Perry's paper. First the timing and size of the exchange rate impact is hard to determine because the period of flexible exchange rates is so short and the start of that period coincided with controls, decontrol, and the effect of the first OPEC price

increase. Second, there may be asymmetries in price setting, with firms more willing to pass through increases than decreases in their costs induced by exchange rate movements. Stephen Marris noted that the inflationary impact of exchange rate depreciation had been generally overestimated in European countries during this same period. He reasoned that the explanation in both cases might be that firms respond fully in their pricing only when they believe the exchange rate movements will be lasting, and they did not believe the large changes at that time would be maintained. In general, such changes in the exchange rate tend to be initially perceived as "overshooting" and hence prices do not move in the same proportion as they do for smaller changes expected to last. Jeffrey Shafer responded that historically large exchange rate movements seem to have produced a fuller price response than have small movements, so that the present period, with one of the largest movements in history, remains a mystery. Perry observed that there is no way to tell from the performance of the price equation whether the partial effect of the exchange rate is as large as expected because the estimated effects of the other variables in the price equation may have been larger or smaller than the equation predicted.