Discussion of Ricardo Reis, "Losing the inflation anchor"

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Outline: Where I'm going

1. "Anchor" is both a **noun** and a **verb.**

2. How important is π^e in the determination of π? Which way does (most of) the causation run? (And whose π^e is it, anyway?)

3. The extreme difficulty of the task Ricardo set for himself

4. Appraisal of his story of the 1965-1974 episode

1. Nouns and verbs

- **An anchor (as a *noun*)** is an object. Reis's analogy: It's either in the seabed or adrift.

- **To anchor** is a ***verb***. It's about how something—in this case, π^e—gets fixed, or at least greatly stabilized.

- Ricardo concentrates on the ***noun***—in fact, on a specific *numerical* anchor for long-run π^e.

- To me, the ***verb*** is more important. It's *how* the CB is supposed to achieve whatever π^* it selects.

Among the methods of anchoring π^e that have been used or proposed are:

- the gold standard; Bretton Woods system; other exchange rate pegs
- k% rule for money growth
- Inflation targeting
- Price level targeting
- Taylor rule
- "earned credibility": the Buba standard, the Volcker standard, the Greenspan standard,…
- You can read Reis's message as: There was no "Martin standard, and Bretton Woods did not discipline the US."

Among the important issues raised by the verb "to anchor" are:

1. **Feasibility** of actually doing it (ex.: k% rule)

2. **Sensitivity** (or lack thereof) to shocks (ex.: headline v. core in IT)

3. **Effectiveness** in pinning down π^e (ex.: Fed's switch to "PLT")

4. **Credibility**—and how to attain/retain it

   ▪ It won't be credible if it can't be done or doesn't work.

2. Does π^e drive π or does π drive π^e?

- Clearly causation runs in both directions. (Ricardo states that.) But which direction is dominant?

- Modern macro often makes π^e the whole show.

$$y_t = E_t y_{t+1} - \sigma(i_t - E_t \pi_{t+1} - r_t^n) \qquad \text{(AD)}$$
$$\pi_t = \beta E_t \pi_{t+1} + \kappa y_t \qquad \text{(AS)}$$

- Example: Hazell, Herrêno, Nakamura, Steinsson (2021):

$$\pi_t = -\psi \tilde{u}_t + E_t \pi_{t+\infty} + \omega_t,$$

Does π^e drive π or does π drive π^e?

- But is that emphasis right? π^e is not RE. Contracts, lags, inertia, inattention,…

- Alternative hypothesis: π^e normally reacts to and follows behind π.
  - Adaptive expectations is one specific version.

- Is there any compelling reason to think that workers/households and bond traders have the same π^e ?
  - In the RE world, YES. In the real world, NO.
  - Current data are a great example (Michigan v. TIPS).

- In his earlier 2021 paper, Ricardo invents a clever way to "add apples and oranges." He shows there is useful cyclical information in the divergence.

But despite all this…

- Ricardo's historical narrative strains to put "everything" in the Procrustean bed of π^e : supply shocks, Fed misperceptions, even Nixon-Burns political manipulation:

"Beyond supply shocks, the literature has offered two other factors that contributed to the acceleration of inflation in these years. Each is also loosely tied to expectations." (p. 10).

[He is referring here, *inter alia*, to Fed errors and political manipulation.]

- I wouldn't put these things in the π^e bucket.

3. To dream the impossible dream

Ricardo set himself an almost Quixotic task:

- The questions *"require having, for the same period in time, both an explosion in inflation and available data on inflation expectations. Yet,... between 1970 and 1995, many anchors were lost, but there are almost no expectations data; between 1995 and 2020, there are data, but no lost anchors."* (p.2)

- Furthermore, *"One concern with the survey data... is that its horizon [is] for the most part one year. Yet, economic theory would suggest that it is longer-horizon inflation expectations that provide the anchor for the persistent component of inflation."* (p. 19)

To be clear…

- Ricardo's creative efforts make reasonable, even ingenious, choices to minimize these problems.

    - I'm not sure anyone could do better.
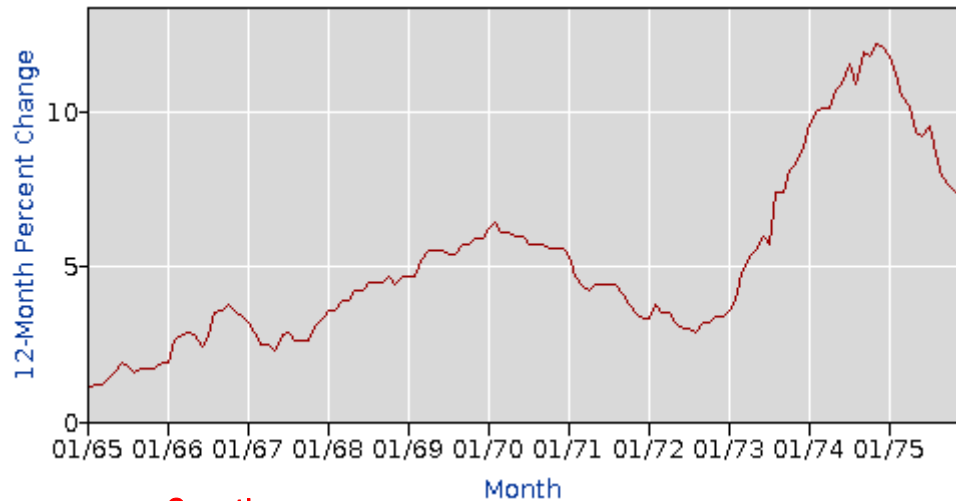
- But in the end, is the story believable?

4. Ricardo's main conclusion about 1966-73

"*During the US Great Inflation, the expectations data shows a drifting anchor already between 1967 and 1970, well before the end of Bretton Woods or the oil price shocks.*" (p. 41)
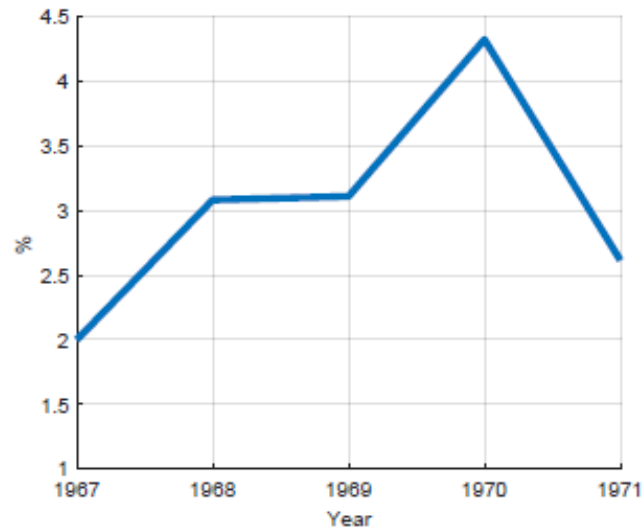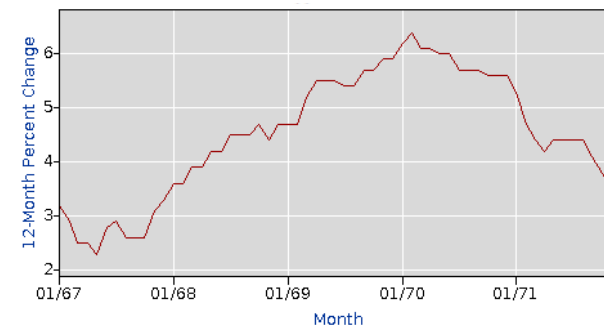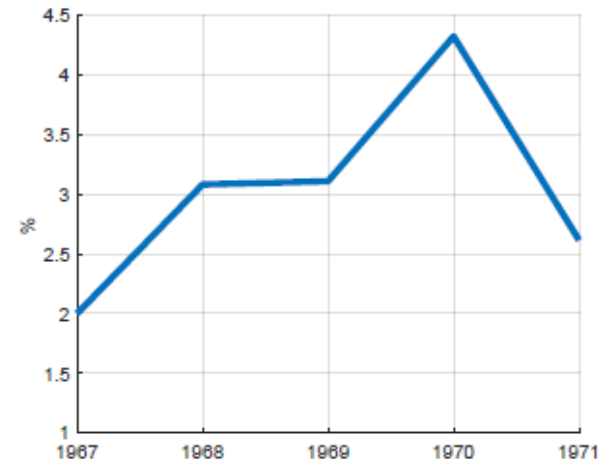
The anchor
(Figure 10)

Was the anchor lost in the late 1960s, not in 1972-74?

Growth recession   surtax   Price controls   Nixon-Burns   OPEC I

← Vietnam buildup →

Allowing for alignment in time (annual v. monthly), these look basically the same.

Ricardo condemns the Fed for being insufficiently aggressive in 1966-1968

Maybe, but:

- Johnson famously "barbecued" Martin in December 1965. Yet the Fed raised rates anyway.
  - There was a "credit crunch" and a "growth recession" in 1966-1967.

- Amazingly, the view that the Fed controlled inflation was *not* widespread then!

 From the February 1968 *Economic Report of the President: "It has been and remains the conviction of **both the Administration and the Federal Reserve System** that the Nation should depend on **fiscal policy, not monetary policy,** to carry the main burden of the additional restraint on the growth of demand that now appears necessary for 1968."*

- The income tax surcharge finally passed in mid 1968.

I would emphasize instead…

… the food and oil price shocks of 1972 and 1973 and the bounce back from price controls--all of which naturally disappeared, but left a mark on core inflation (which is inertial).
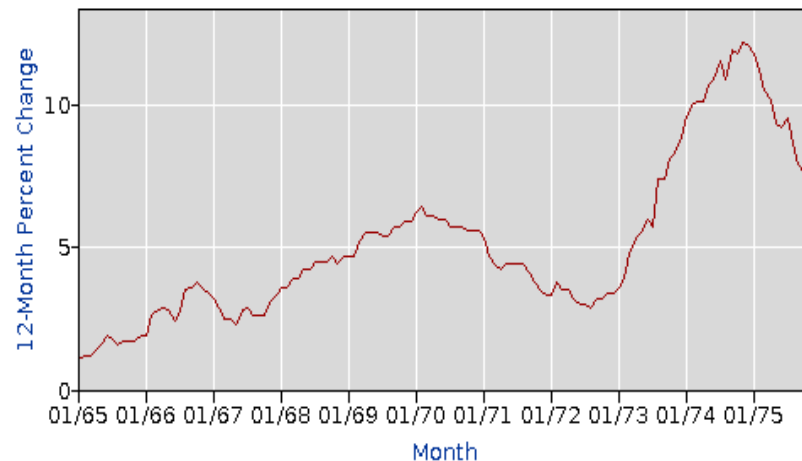
Then the Volcker standard—the first anchor in years--was established in the early 1980s, after OPEC II.