

Discussion of “The price level, relative prices, and economic stability: Aspects of the inter war debate”, by David Laidler

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Preliminary remarks

- Happy that we start this way. Who better than David Laidler.
- (Macroeconomic) science not a Markov process. What does not fit is discarded.
- The Sound and the Fury. Claiming incompetence.

Recurring themes

A very close connection between:

- Expansions in bank credit
- Increases in prices (inflation)
- Increases in asset prices
- Increases in activity

Today, we see these as connected, but quite separate.
Wrong?

No pearls, but some questions. Shall take four subthemes.

1. Inflation as causal? Increases in prices as a cause of increased activity

Two ways of thinking about the relation between inflation, expected inflation, and output:

- $P - P^e$ affecting Y . Lucas island parable, and most prewar thinking.
- Y affecting P given P^e . Standard Phillips curve, and most recent formalizations (Fischer-Taylor-Calvo)

Look the same to a first approximation:

$$P - P^e = aY$$

But very different conceptually, and with different implications for the way we think about policy.

- In the first: by trying to stabilize inflation, macroeconomic policy leads firms to make fewer mistakes, and stabilizes output directly.
- In the second: by trying to stabilize inflation, macroeconomic policy is forced to take policy measures so as to achieve stable output.

Modern view:

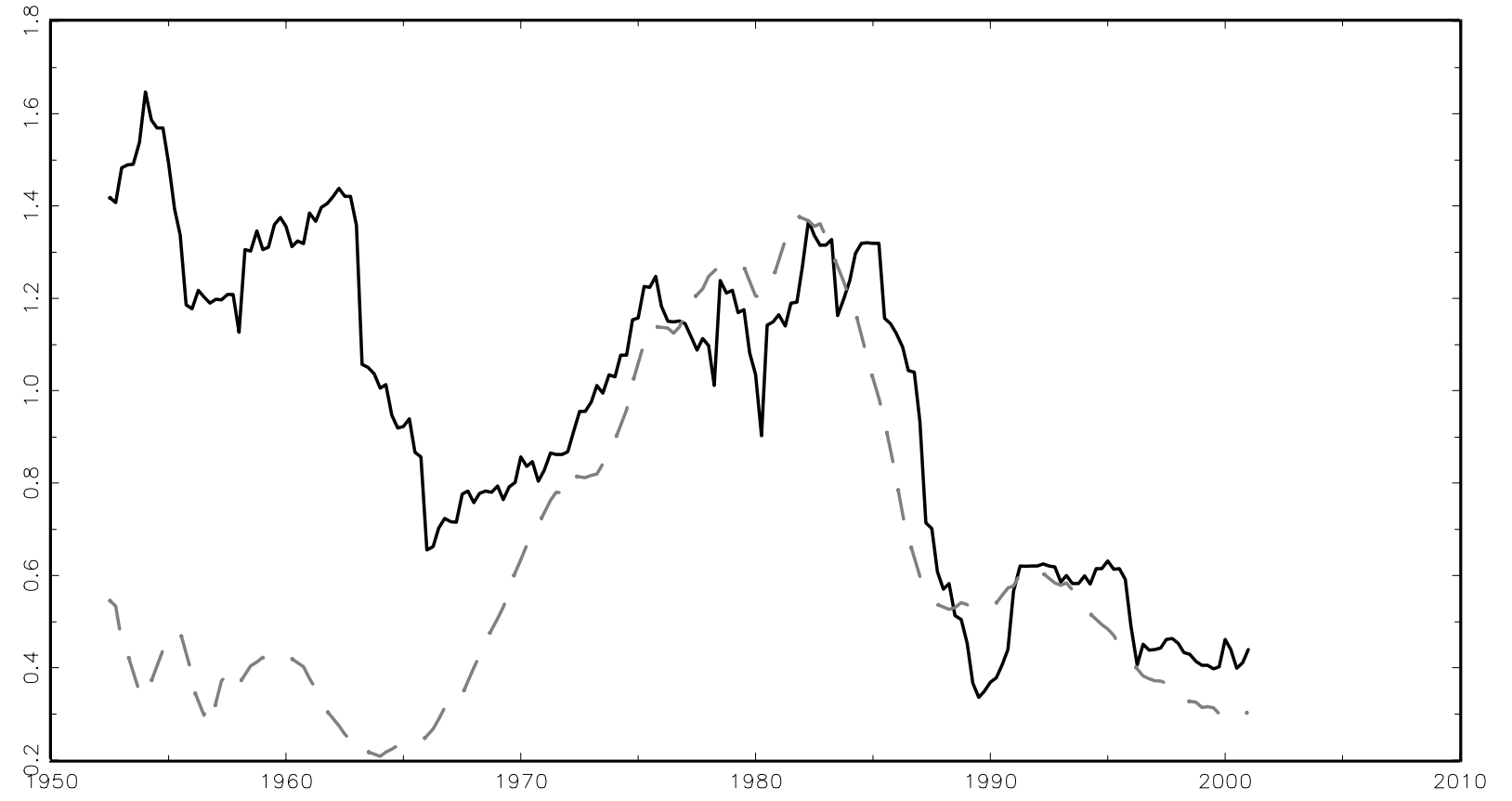
Inflation not causal, but caused. So much less obvious that controlling the tail will wag the dog.

Evidence?

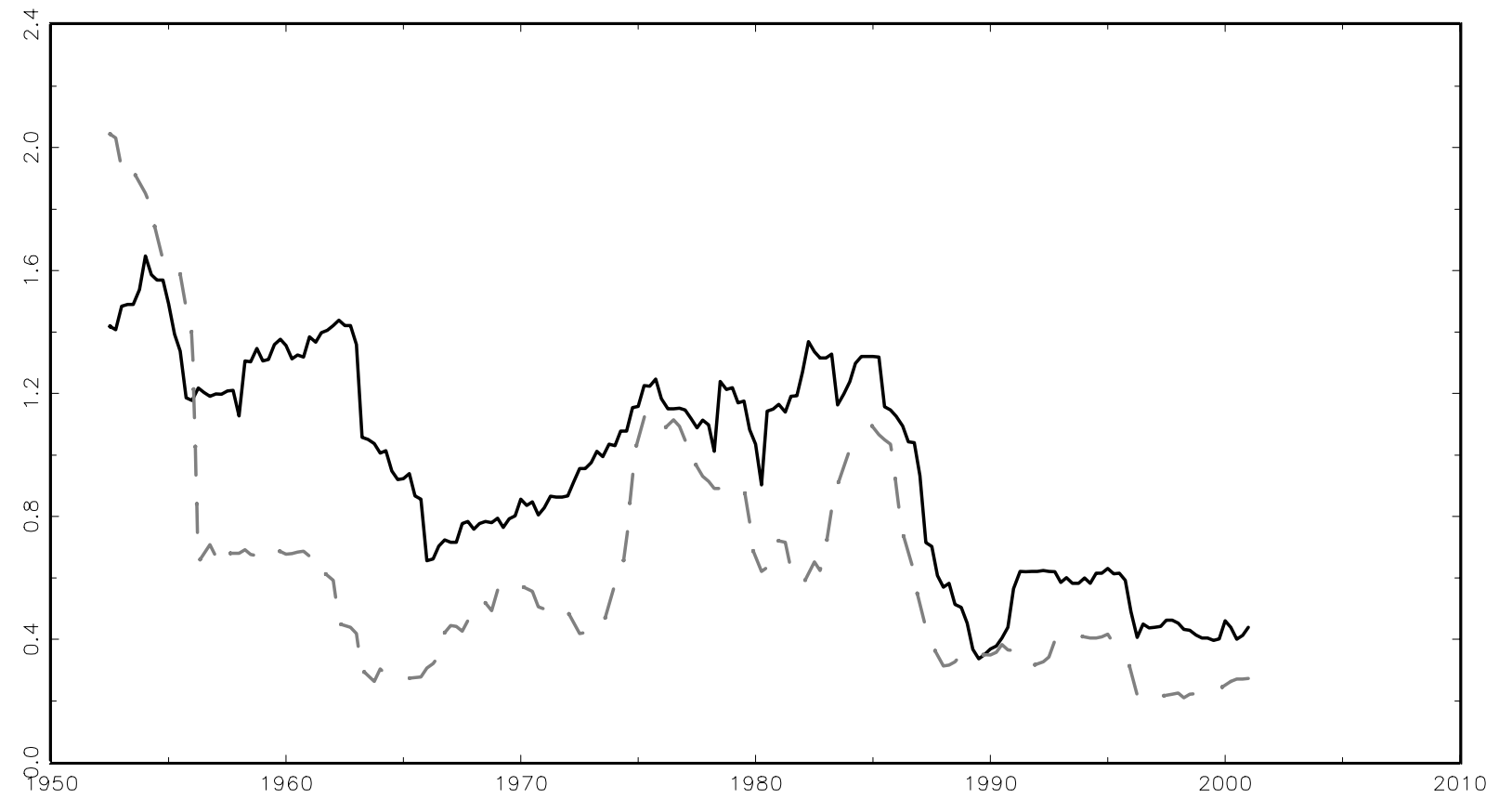
- Inflation lags, not leads.
- But: The parallel evolution of volatility of output and inflation. (even controlling for price of materials, and various other observables).

Figure 6: Volatility of output and inflation

Standard deviation of output and mean inflation



Standard deviation of output and of inflation



2. Increases in prices and increases in asset prices/asset bubbles.

Often seen as closely linked, both “exciting” production and demand. If true, then stabilizing prices may stabilize asset prices.

Modern view: Not much connection

- Inflation the result of pressure on prices from activity. (“Inflation caused”, not causal)
- Asset price movements due to changes in expectations about the future, and perhaps (over) optimism/pessimism.

Other things equal, the second will increase activity and thus increase the first. But no tighter connection.

Historically, clearly no close link. Stock prices before the Great Depression. Stock prices in the 1990s in the United States. Inflation decreases stock prices.

Raises one potentially interesting question. Two lines of work on cycles

- (Major) Shocks, perhaps with nominal rigidities, but correctly priced assets.

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- (Minor) Bubbles, fads, leading to movements in activity.

Largely independent. Question: Are they not more closely connected?

Is (over)optimism a general feature of expansions, affecting both decisions, and valuations?

If so, how does this change the welfare analysis, and the advice we give to policy makers?

3. Booms, bubbles, and bank credit

Emphasis on bank credit: Credit allows for investment, the boom, the build-up in asset prices.

How crucial? A reason for monitoring $M3$?

I am skeptical. Historical reason for focus on bank credit: Answering the central question: If investment demand increases, how/why does saving increase also?

- Credit as proximate cause of investment. So natural to start there.
- Forced saving: A non explanation, and a dead end (Exceptions: Money creation. Inflation tax; Decreases in reserve ratios; Increases in the ratio of demand deposits to currency.)
- Keynes solved that one. The increase in output is what reconciles saving with higher investment.

Anything to save here? Specific forms of credit, and specific asset prices. Bank credit and housing price increases?

4. Imbalances and implications

A major theme: Cycles come with imbalances, between consumption and investment. (Marx, but others later).

The evidence: Not balanced, but no stable pattern of imbalances. Sometimes recessions due to drop in consumption (1990-91), sometimes to drop in investment (current one). Same for expansions.

Still, each expansion likely to have some form of imbalance: For example a bubble leads to high investment in capital, or housing. (Many current examples).

Then trade off.

- What do to during? Stabilize output with excess capital accumulation. Stabilize capital accumulation, with a potential recession?
- What to do after? If there is too much capital (the “credit deadlock”) eat some: High consumption, to maintain output at the natural level.

Composition effects are important.

5. General lessons

- Stable inflation will not eliminate asset bubbles.
- Nor will a focus on this or that measure of credit.
- Stabilizing inflation will tend to dampen asset price movements (through interest rates)
- Stable inflation may still come with large imbalances: investment/consumption.
- Large imbalances create a difficult trade off.