Can We Put Humpty Dumpty Together Again?

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An Overview

- Ricardo´s is a very enjoyable paper
- Conclusion: IT with interest rates as policy instrument works: don't kill it because of one year of inflation
- How did we get here?
  - Explanation 1: Shocks
  - Explanation 2: Expectations
  - Explanation 3: Credibility
  - Explanation 4: r*

The Fragility of IT

- For most of you think IT is a sturdy stable regime
- Theory says it is not:
  - Money is endogenous
  - This means there are multiple equilibria
  - Requires the Taylor principle to pin down a unique equilibria
  - But the equilibria is pinned down because it is globally unstable
  - And hinges on strong credibility which we don't model (nor understand)
  - Let´s remember that standard models have self fulfilling expectations a la Cagan (1958) as in Obstfeld and Rogoff (1983)
- For those of us that have had to deal with these issues in volatile contexts we know how unstable this can be

- Is it possible to rescue IT once its credibility has been tampered?
- Argentina and Turkey couldn't

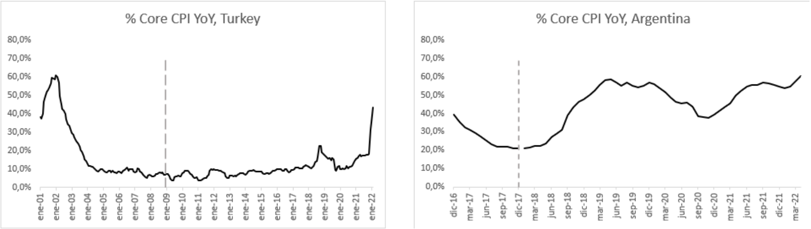


Figura: Turkey and Argentina

Explanation 1: A Tale of Two (Oil) Shocks

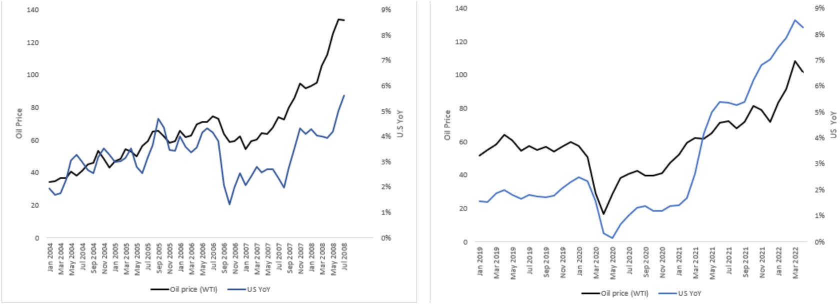


Figura: Two oil shocks, different responses

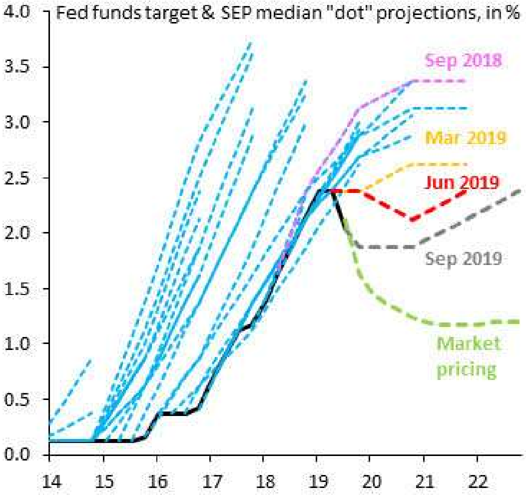
Explanation 1: Shocks

- Obviously there is a correlation
- But let me argue that shocks don't create inflation
  - With flexible prices and exogenous monetary policy ...
  - In a NK framework with IR policy, money is endogenous. Inflation increases because the CB reacts so that there is more inflation
  - In short: it is not the shock, it is monetary policy!

Explanation 2: Expectations & Credibility

- Reis' Brookings paper: need to look beyond means
- Professional vs households expectations
- The role of salient prices in forming expectations (dollar, regulated prices, fuel, stock market): did not find it in Argentina.

Did it start here...?



How Not to Improve Credibility

- Argentina's inflation theorem: "the number of stories for inflation is proportional to the rate of inflation".
- When you say inflation is transitory...
- When you say inflation is a supply shock...
- You affect credibility (in a bad way)
- And directly violate the Taylor principle

Subtleties in Building Credibility

- Once credibility is lost things get nasty
  - Increasing interest rates affects credibility not necessarily the right way
  - Fiscal monetary interactions start to become relevant
  - For the US, money abroad adds to the dilemma
- How to recover credibility? Open research question.