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From the Great Depression to the Great Inflation: Path dependence and monetary policy

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Abstract

There is substantial narrative evidence that the shadow of the Great Depression may have influenced the conduct of U.S. monetary policy during the 1970s. In this paper, we estimate central bank reaction functions for the United States and 12 other countries over the 1970s to examine the relationship between the magnitude of the Great Depression and the response of central banks to output gaps and inflation during the Great Inflation. The main finding is that countries which suffered the most during the 1930s had monetary policy reaction functions that responded substantially more aggressively to output gaps during the 1970s.

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1. Introduction

The period from 1965 to 1979, known as the Great Inflation, has been described as "America's only peacetime outburst of inflation" (DeLong, 1997, p. 247) as well as "the greatest failure of American macroeconomic policy in the postwar period" (Mayer, 1999, p. 1). In recent years, many potential reasons for this long and persistent increase in U.S. inflation have been proposed. Some of these explanations emphasize bad luck

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associated with exogenous non-policy shocks while others focus on the conduct of monetary policy.[2]

While macroeconomists have long been interested in modeling how the Federal Reserve responds to economic conditions, following Taylor (1993), it has become common practice to characterize Federal Reserve behavior in terms of policy reaction functions where the central bank sets the federal funds rate in response to deviations of the inflation rate from a desired target, as well as in response to deviations of output from potential. Many authors contend that an important cause of the increased inflation was that the Federal Reserve did not respond aggressively enough to inflation prior to 1979. Using the reaction function framework, Taylor (1999) argues that before 1979 the Federal Reserve did not raise nominal interest rates more than one-for-one when inflation increased.[3] As a result, real interest rates decreased when inflation increased which fueled further spending and higher inflation.[4] Judd and Rudebusch (1998) and Clarida, Gali, and Gertler (2000) reach similar conclusions for the pre-1979 period, using modified policy rules that take into account the partial-adjustment dynamics of interest rates and forward-looking behavior. All of these papers conclude that an important reason for the inflation during the 1970s was that the Fed did not react aggressively enough to inflation: the inflation-response coefficient was less than one prior to 1979, but substantially greater than one after 1979.

The view that the Federal Reserve did not respond vigorously enough to inflation before 1979 has been questioned, however. Using only data available to policymakers at the time, Perez (2001) finds that the response to inflation was roughly similar between the pre-1979 and post-1983 periods. In both periods, the inflation-response coefficient is greater than one. Similarly, Orphanides (2004) reports that the Federal Reserve responded more than one-for-one to inflation in both the 1966–1979 and 1979–1995 periods, based on real-time data.

Orphanides (2004), however, does find that the Federal Reserve responded much more aggressively to output gaps before 1979. While an aggressive response to output gaps is stabilizing with perfect information, Orphanides, Porter, Reifschneider, Tetlow, and Finan (2000) shows that a large response to output gaps can be destabilizing and lead to higher inflation in the presence of measurement error and noisy information. In particular, the authors find that the failure of policymakers to recognize the productivity slowdown that began by the early 1970s caused policymakers to systematically overestimate potential output and output gaps. The one-sided measurement error in the 1970s, along with the large response of policymakers to these mismeasured output gaps, led to excessive monetary ease, which contributed to the Great Inflation. The underlying cause as to why monetary

[2] While the economy experienced adverse supply shocks in the 1970s, due primarily to rising energy prices, DeLong (1997) and Barsky and Kilian (2002) provide persuasive evidence that these shocks alone are not responsible for the Great Inflation.

[3] The more than proportional response of nominal interest rates to inflation is now known as the Taylor Principle. Bullard and Mitra (2002) show that adherence to the Taylor Principle is both a necessary and sufficient condition to converge to a stationary rational-expectations equilibrium for certain classes of policy rules in which inflation and output fluctuate only in response to underlying fundamentals.

[4] Nelson (2001) tells a similar story for the United Kingdom. Prior to the adoption of inflation targeting in 1992, U.K. interest rates rose less than one-for-one with inflation, and rose very little during the 1970s.