Comments on ‘The price level, relative prices, and economic stability: Aspects of the inter-war debate’, by David Laidler

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I am happy that the conference starts with a session on the history of economic thought on the topic. Contrary to what we might have dreamed, macroeconomics is not a Markov process, in which truth remains and becomes part of the core, and the rest is discarded. Often, ideas indeed get discarded because they are wrong. But, sometimes, they get discarded because they do not fit the then prevailing paradigm. Rummaging through old books can have high returns, especially when it is done by an economist with the wisdom and the knowledge of David Laidler.

This being said, I am happy he did it and not I. Reading old classics, I often feel like Benjy Compson, the idiot in “The Sound and the Fury”. I think I understand the pieces, but I do not understand how and whether they fit. And I am never quite sure whether this is my problem, or theirs.

Even with the help of David, I have somewhat the same feeling this time. I am not sure I see a coherent set of answers, or any forgotten pearl of wisdom. But I find a number of themes which are very much worth revisiting.

One in particular keeps coming back throughout David’s review: Namely, that there is a tight connection between expansions in bank credit, increases in prices (inflation), increases in asset prices, and increases in activity; that they all come together, going one way in booms, the other way in troughs.

Today, I believe, we see these movements as often connected, but conceptually separate. That is, either as a matter of logic and as a matter of fact, we believe they may but need not happen together. Are we wrong, and should we reexamine some of these connections? This is what I shall do in my comments. I shall focus on four subthemes.

1 Is inflation causal? Increases in prices as a cause of increased activity

There are two ways of thinking about the relation between inflation, expected inflation, and activity.

The first is that inflation, or at least unexpected inflation affects output. It is clear, from David’s paper, that this is the dominant pre-war view of the link between inflation and output. In that view, increases in prices “excite” producers in various ways, leading them to produce more, invest more, and altogether create a boom. A modern version of this story is the Lucas island paradigm, in which misperceptions of relative prices induced by inflation lead suppliers to mistakenly increase their output, at least for a while.

The second is that, given expected inflation, an increase in activity leads to an increase in inflation. Under this interpretation, the causality runs from output to inflation. This is the standard interpretation of the Phillips curve relation, in which low unemployment “puts pressure” on inflation. It is also the causal story underlying modern staggered price-setting and wage-setting models, from Fischer to Taylor to Calvo.

These two ways of thinking have very different implications for the way we think about policy, and in particular, about the implications of stable inflation:
Under the first, stable inflation directly leads to stable output. By stabilizing inflation, macroeconomic policy provides a stable and reliable environment, which in turn, leads firms to make fewer mistakes, and thus stabilizes output directly.

Under the second interpretation, stable inflation per se does not lead to stable output. But in trying to stabilize inflation, macroeconomic policy takes policy measures which end up stabilizing output as well.

Most economists today subscribe to the second interpretation: Inflation is not causal, but caused. Trying to stabilize output by stabilizing inflation is trying to stabilize the dog by stabilizing the tail, not an obvious task. And so, as desirable as stable inflation is, few economists today believe that it will by itself lead to stable output.

Is the modern view the right one?

The empirical evidence shows that inflation substantially lags rather than leads output. This appears hard to reconcile with the notion that higher inflation is what leads to the increase in output in the first place. Inflation surely makes it harder to assess relative prices and take the right decision and so leads to serious micro inefficiencies; but this by itself does not seem to easily explain fluctuations in aggregate output.

At the same time, there is a fact, upon which others and I have stumbled (for example [1]), and which gives me some pause: In the United States, both the variance of output and the variance of inflation have considerably declined, and have done so very much in lockstep, over the last forty years. This is shown in Figure 1, which plots the rolling standard deviations of output growth and inflation since 1955. The strong correlation remains there even after controlling for movements in the price of oil, the price of materials, and a number of other observables. I would not have expected such close movements in the two series, and this fact makes me suspect that there is perhaps a tighter underlying connection between stable inflation and stable output than I thought earlier.
Standard deviation of output growth and inflation

24 quarter average

S_OUTPUT__GROWTH
S_INFLATION_RATE
2 Inflation and asset prices/bubbles.

In the pre-war literature, goods price increases and asset price increases are often linked, both seen as “exciting” production and demand.

The modern view is that there is not much connection between the two.

Inflation is seen as the result of pressure on prices from too high a level of activity (this is the view of inflation as caused rather than causal, discussed in the previous point).

Asset price movements on the other hand are due to changes in expectations about the future, rational or the result of waves of excessive optimism and pessimism.

Other things equal, an increase in asset prices will increase activity, and thus lead to higher goods prices. But the connection is seen as no tighter than that.

Is the modern view right? I think the answer is yes. Historically, as David emphasizes, there is no close link between inflation and large asset increases. The rise of stock prices before the Great Depression was not associated with high inflation. Nor was the increase in stock prices in the late 1990s in the United States. Indeed, there is considerable evidence that stock prices are adversely affected by inflation, unexpected or expected.

But the pre-war literature, with its focus on business cycles and asset bubbles, raises what I find to be an interesting and unanswered question.

The current dominant approach to business cycles is to think of fluctuations as coming from a number of fundamental shocks, interacting with nominal rigidities and other imperfections to lead to fluctuations in output. Given these shocks, and the relevant market imperfections, firms and consumers have rational expectations and take rational decisions.

An alternative approach, more in the spirit of this older literature, is to think instead of business cycles as being driven by waves of optimism and pessimism on the part of consumers and firms. In that interpretation, the shocks are deviations from rationality (of expectations) of consumers and firms, and large asset movements are a natural side product of cycles.
That alternative approach feels potentially quite relevant. (What the fundamental shocks are in the dominant approach remains rather mysterious. Calling them taste and technology shocks represents only limited progress.) It would be fun to explore whether and how this alternative approach can be tested against the dominant approach. To the extent that it is right, it appears to imply a rather different welfare analysis of cycles, and maybe different policy recommendations. We should definitely explore it.

3 What is the relation between booms, bubbles, and bank credit? What about forced saving?

David Laidler describes the importance given by the pre-war literature to bank credit, both in generating booms and asset bubbles.

But, as I listen to the arguments summarized by David, I am skeptical that the pre-war literature makes a convincing case that bank credit plays indeed such a central role. I see the emphasis on bank credit as coming out of an intellectual puzzle faced by the pre-Keynesian literature. If investment demand increases—say in response to increases in prices “exciting” firms—, what is then the mechanism that insures that saving also increase?

In trying to answer this question, it was logical for the economists of the time to look at bank credit. After all, this is how firms largely financed the additional investment. But this only raised the next question: How were banks able to increase the amount of bank credit? Who was saving more?

This is where the concept of forced saving conveniently came in. Banks were able in some way to force more saving out of consumers, went the answer. I see this as basically the wrong answer. The right answer was, I believe, given by Keynes: The increase in output is what generates the additional saving in response to higher investment. There is no such thing as forced saving. I know David disagrees, but I do not see what wisdom can be saved here.
4 Imbalances, and implications

Another major theme of the pre-war literature is that cycles come with fundamental imbalances, especially between investment and consumption. David reviews a number of theories, from Marx to Robertson, in which investment plays the central role in generating as well as ending booms.

The evidence is not kind to the idea of such systematic imbalances. True, most cycles are unbalanced, but there does not appear to be any stable pattern of imbalances across cycles. Witness the recession of 1990-1991, where the proximate cause of the recession was a drop in consumption, versus the current recession/slowdown, in which the primary factor is instead the drop in investment. In that respect, each expansion, each recession, seems to be sui generis.

Still, there is an important point here, and one often ignored in discussions of inflation targeting today. To the extent that most expansions are likely to have some form of imbalance, either too much consumption, or too much business fixed investment, or too much housing investment (as appears to be the case in the UK currently), policy indeed faces potentially difficult trade offs:

Take for example an investment driven boom. And suppose that monetary policy works by reducing all components of aggregate demand proportionally. Should policy aim at stabilizing output, resulting in too much investment and too little consumption? Or should it aim at stabilizing investment, resulting in the right amount of investment, but too low a level of output. Replace “investment” and “asset bubble” and the trade off remains the same. And the questions apply on the way down as well. If investment comes to a halt—if the asset bubble collapses—should the monetary authority aim at stabilizing output, or at stabilizing investment? (I think the answer here is: Output.) These questions were central in the pre-war literature; they deserve indeed more attention today.
References