Discussion of "Exits from Recessions" by Bordo and Landon-Lane

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SNB Conference on Monetary Policy after the Financial Crisis,

Zurich, 24 September 2010

This Paper Provides Support for a Growing Literature

- Exits from recessions have changed in character
- Interwar and postwar recessions, the turn of interest rate (r^D or r^{FF}) was fast, between 0 and 2 quarters
- But after 1991 and 2001, turn was much slower, 9 and 10 quarters
- Previously noted about 1991, 2001.
  - Sluggish recovery of output
  - Longer lagged recovery of employment and unemployment ("the jobless recovery" was first noticed in 1991-92)
  - "Early Recovery Productivity Bubble"

What the Paper Does

- Part 2. Historical Narrative going back to 1920-21
- Part 3. Descriptive Evidence, Determining the Turning Points
- Part 4. Simple Regression Analysis
- Part 5. Predictions for the Current Episode

This Discussion is Based in Part on New Research

- NBER WP 16380, just released
- "The End of the Great Depression 1939-41: Policy Contributions and Fiscal Multipliers"
- New quarterly data bank 1919-51
- The source of several of my charts

A Central Conceptual Issue Is Not Addressed

- What is a monetary instrument?
- No controversy on r^D or r^{FF}
- But is Monetary Base an instrument?
  - Flat 1929-33
- Is M2 an instrument? (Endogeneity 1929-33)
- More controversial, real rates and real MB
  - Authors define relative to *current* inflation rate. Thus real rate and real MB growth have built-in negative correlation to inflation rate that is not addressed in the analysis
- Examples: 1974-75 negative real rate, 2009 high real rate, both due to oil prices rather than monetary policy instrument

Issues Regarding the Narrative (Part 2)

- 1920-21. Ignores the central role of the collapse in G:

G/Y* 29.1 (1919:Q1) 7.3 (1920:Q1)

11.0 (1921:Q1)

Compare with p. 7 “the cause of the recession was the Fed’s decision . . .”

This Illustrates a Problem with the paper

- A narrow view of economic history, the only thing that causes recessions or ends them is monetary policy
- The Great Depression was entirely caused by an increase in rD in Aug 29 and again in Oct 31
- No mention of MB, which was flat throughout 1929-33 and actually higher in 1933 ($7.2 B) than in 1929 ($7.0 B)
- No mention of endogeneity of money supply to non-monetary causes of the Great Contraction

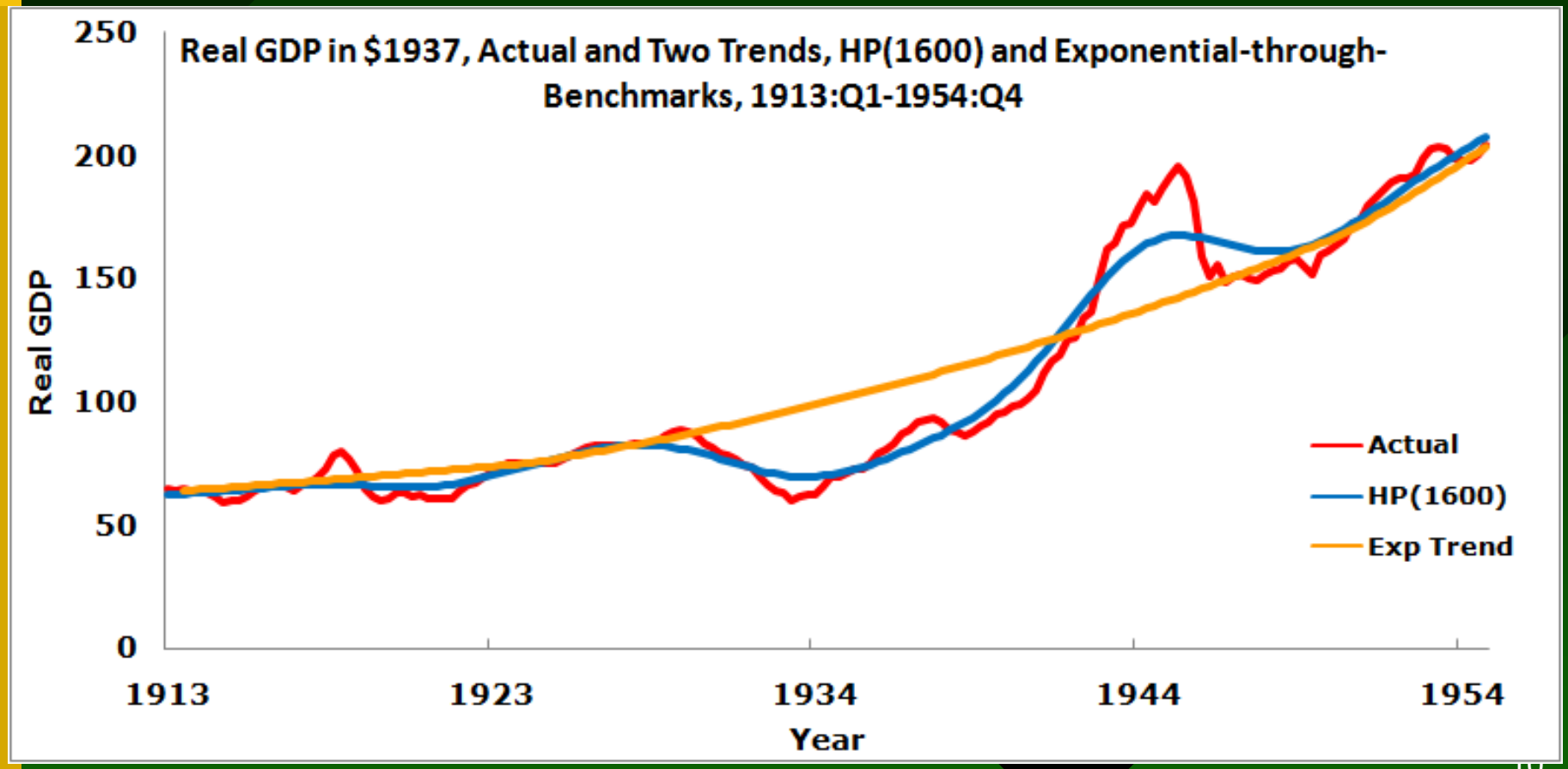
Other Examples of a Narrow Interpretation of History

- 1937-38. No mention of contractionary fiscal policy as Social Security taxes were introduced before benefits were paid
- 1938-41. Role of monetary vs. fiscal policy, see our new paper
- 1945-48. No mention of price controls or the inflationary impact of their termination on July 1, 1946
- 1953-54. No mention end of Korea war spending
- 1973-75. Role of oil shocks is recognized but not the exchange rate behavior post-Bretton Woods or the inflationary impact of the end of price controls in mid-1974.
- 1979-80, 81-82. No mention second round oil shock or appreciation of dollar 1980-85.

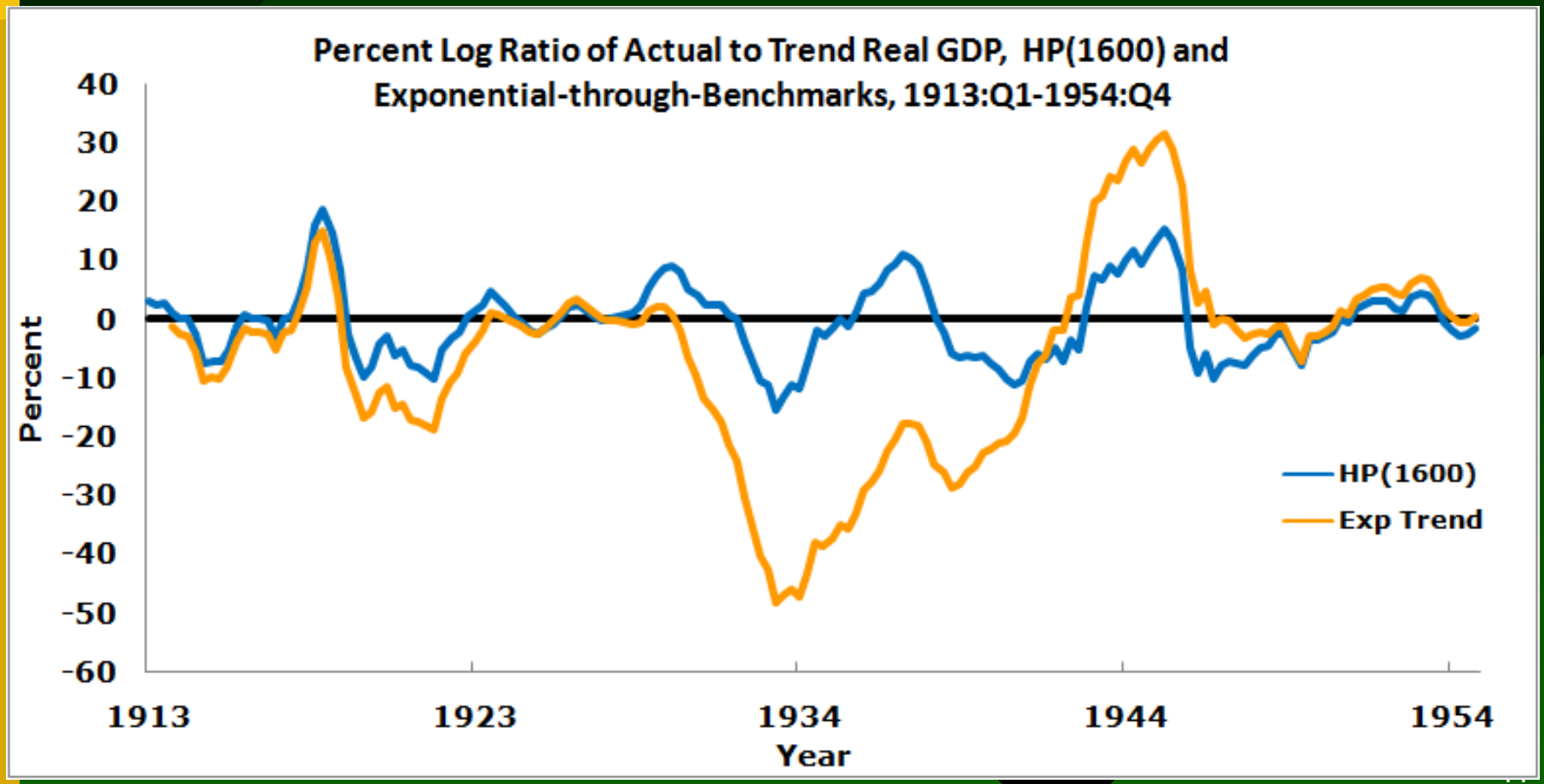
Part 3, Descriptive Evidence

- This would have been easier to follow with a few simple time series charts
- What you'll see next for the interwar period
  - Pitfalls of using H-P trend method with parameter 1600 to measure the output gap
  - Improved interwar trend that captures the sharp differences between 1920s and 1930s
  - Interwar Comparison of discount rate with improved output gap

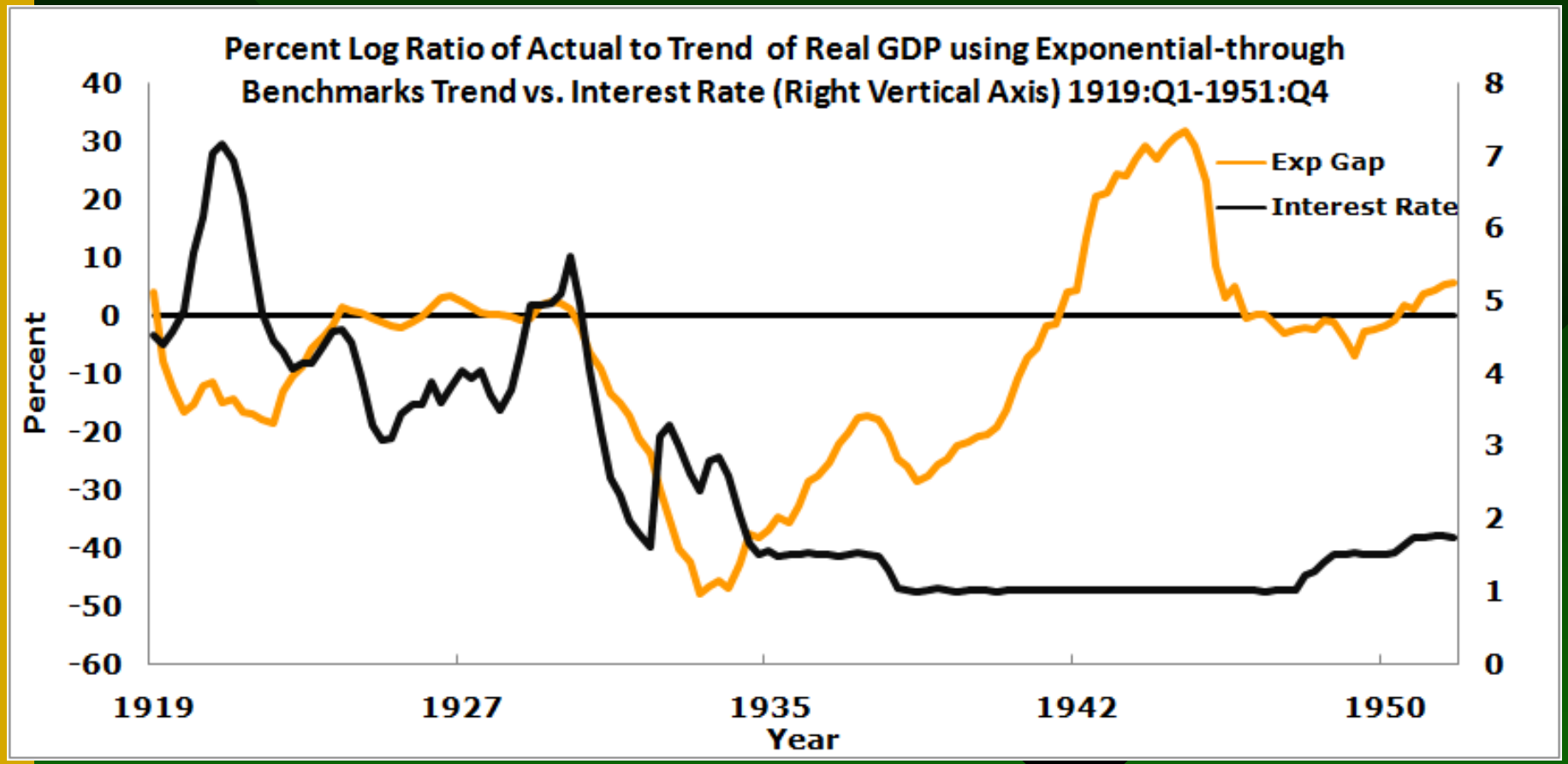
H-P 1600 Trend for Interwar Years? Utter Nonsense



Actual to Trend Log Output Ratio using HP(1600) Trend vs. Exponential Trend



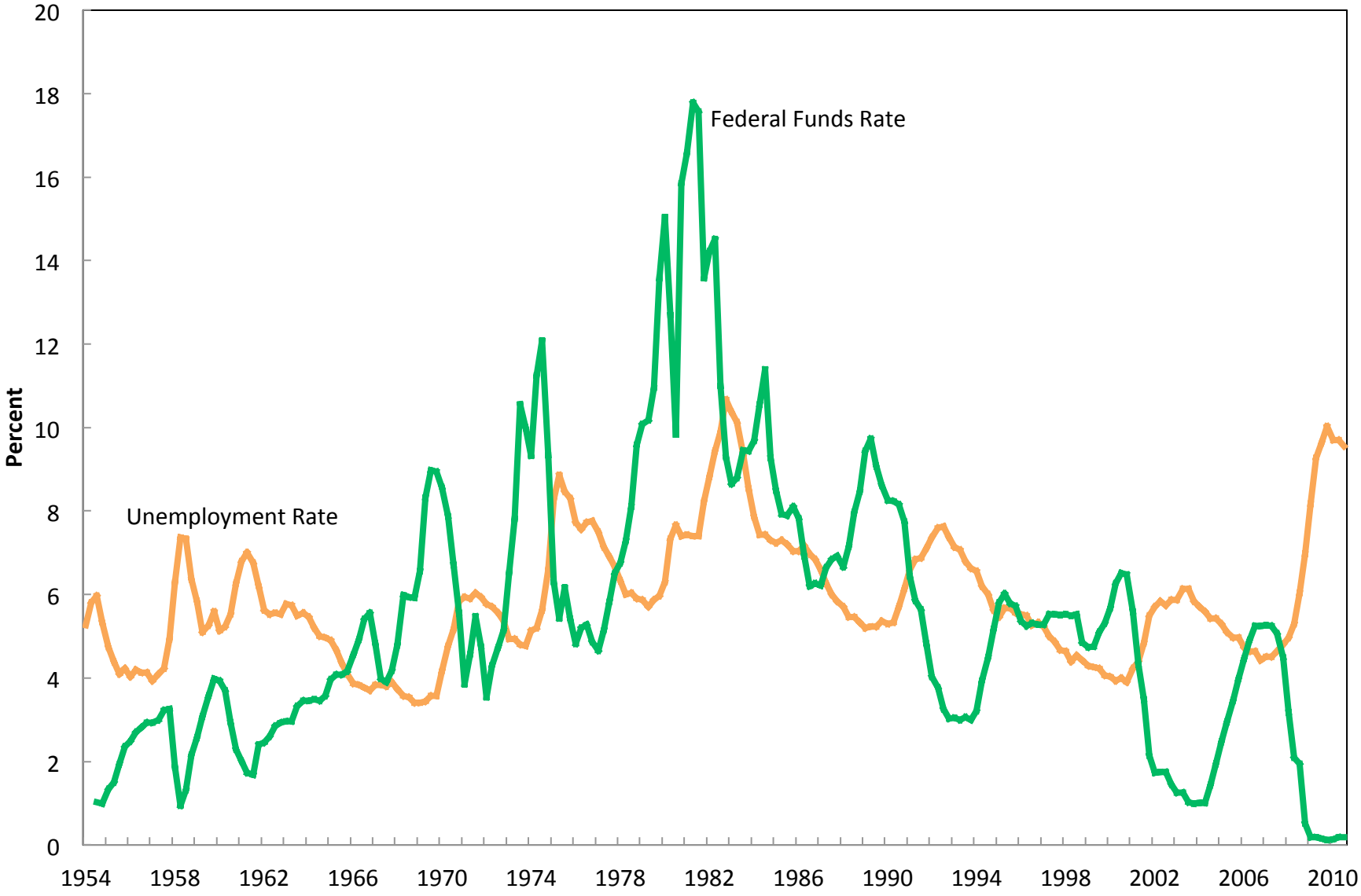
My Output Gap vs. FRNY Discount Rate, Quarterly, 1919-51



Previous Slides Largely Confirm Paper's Interwar Timing

- Policy was prompt and countercyclical during the 1920s except perversely procyclical in 1920
- Early tightening in 1932 while Y/Y* was still declining
- No discount rate policy at all between 1935 and 1950
- Next, postwar comparison of nominal Fed Funds rate with unemployment rate

Fed Funds Rate and Unemployment Rate, 1954-2010

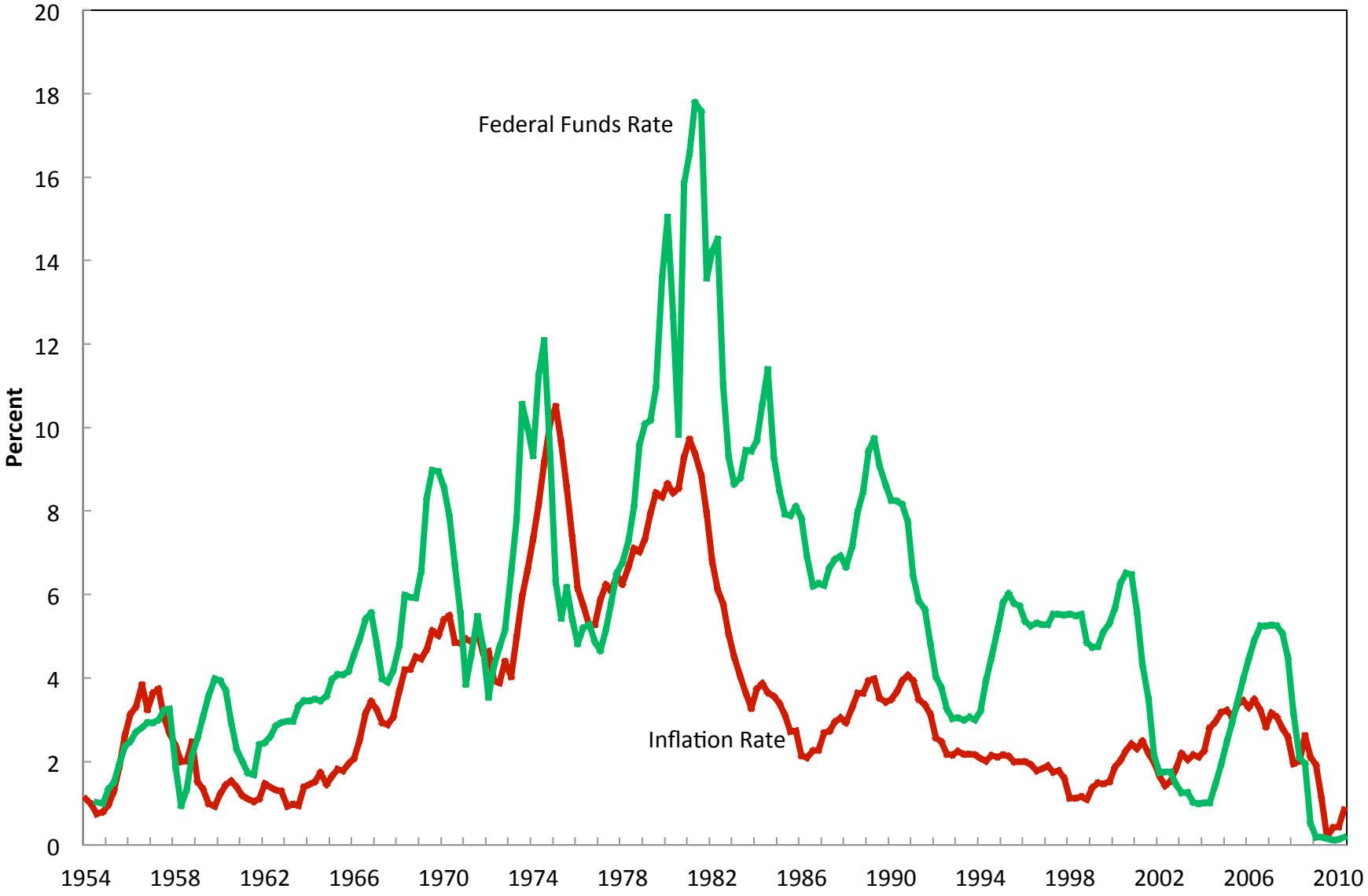


Source: Federal Reserve Database and Bureau of Labor Statistics

Summary of Fed Funds Rate vs. Unemployment Rate

- Dominance of unemployment rate is clearly seen
- Pre-1990 strongly countercyclical Fed Funds rate and movements of U rate coincide with NBER dates
- Post-1990 Fed Funds rate response delayed until unemployment begins to decline, because of jobless recoveries in which U lags NBER
- Paper's conjectures in Part 5 about Fed's response in 2010 are off base because it ignores the post-1990 change

Fed Funds Rate and Inflation Rate, 1954-2010

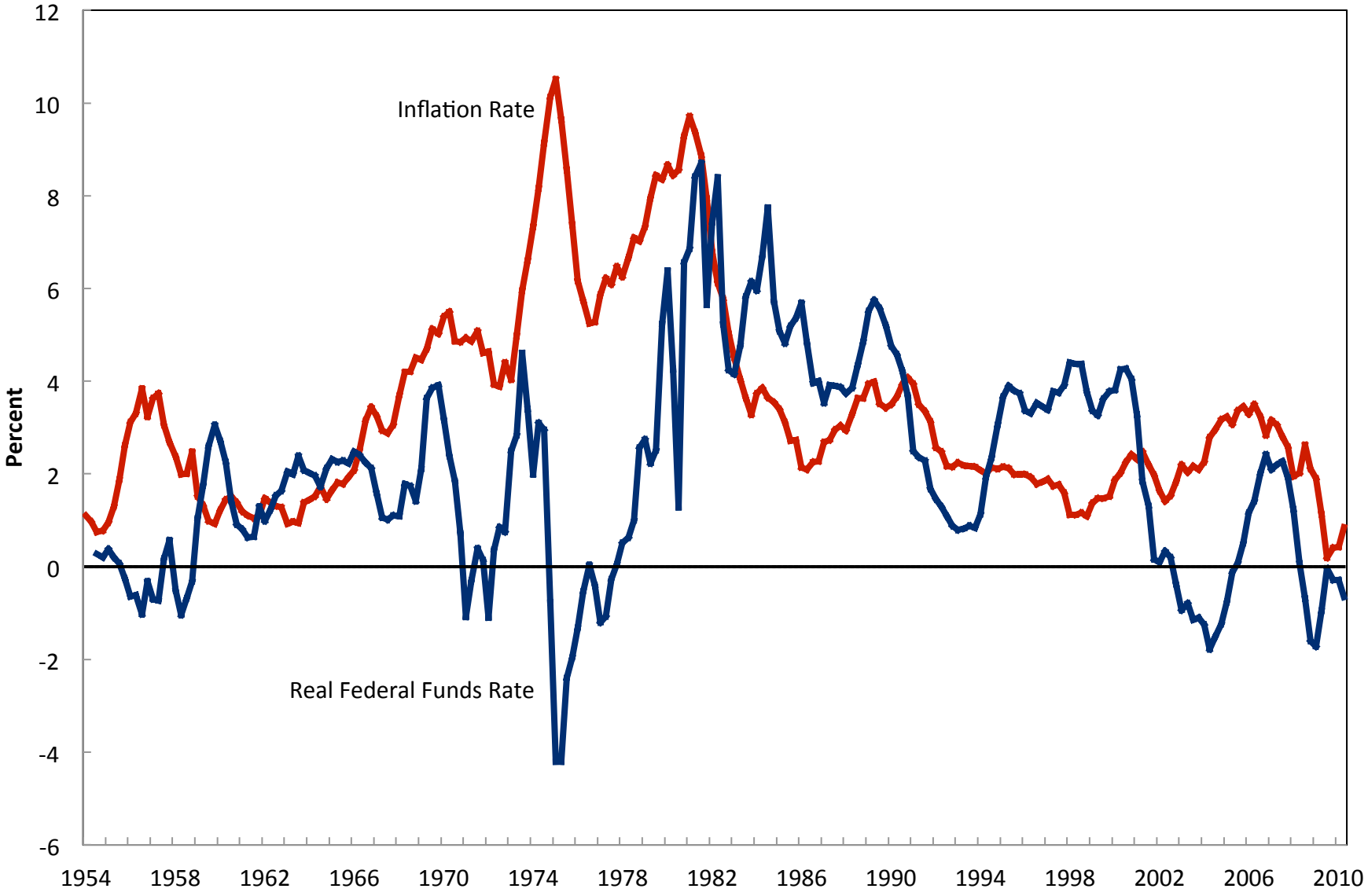


Source: Federal Reserve Database, BEA *NIPA Tables* and Bureau of Labor Statistics

Fed Funds rate vs. Inflation

- Much looser relationship than with unemployment
- Inflation provides no information on Fed funds rate responses after 1990
- Next slide. Endogeneity of real Fed funds rate

Fed Funds Rate and Inflation Rate, 1954-2010



Source: Federal Reserve Database, BEA *NIPA Tables* and Bureau of Labor Statistics

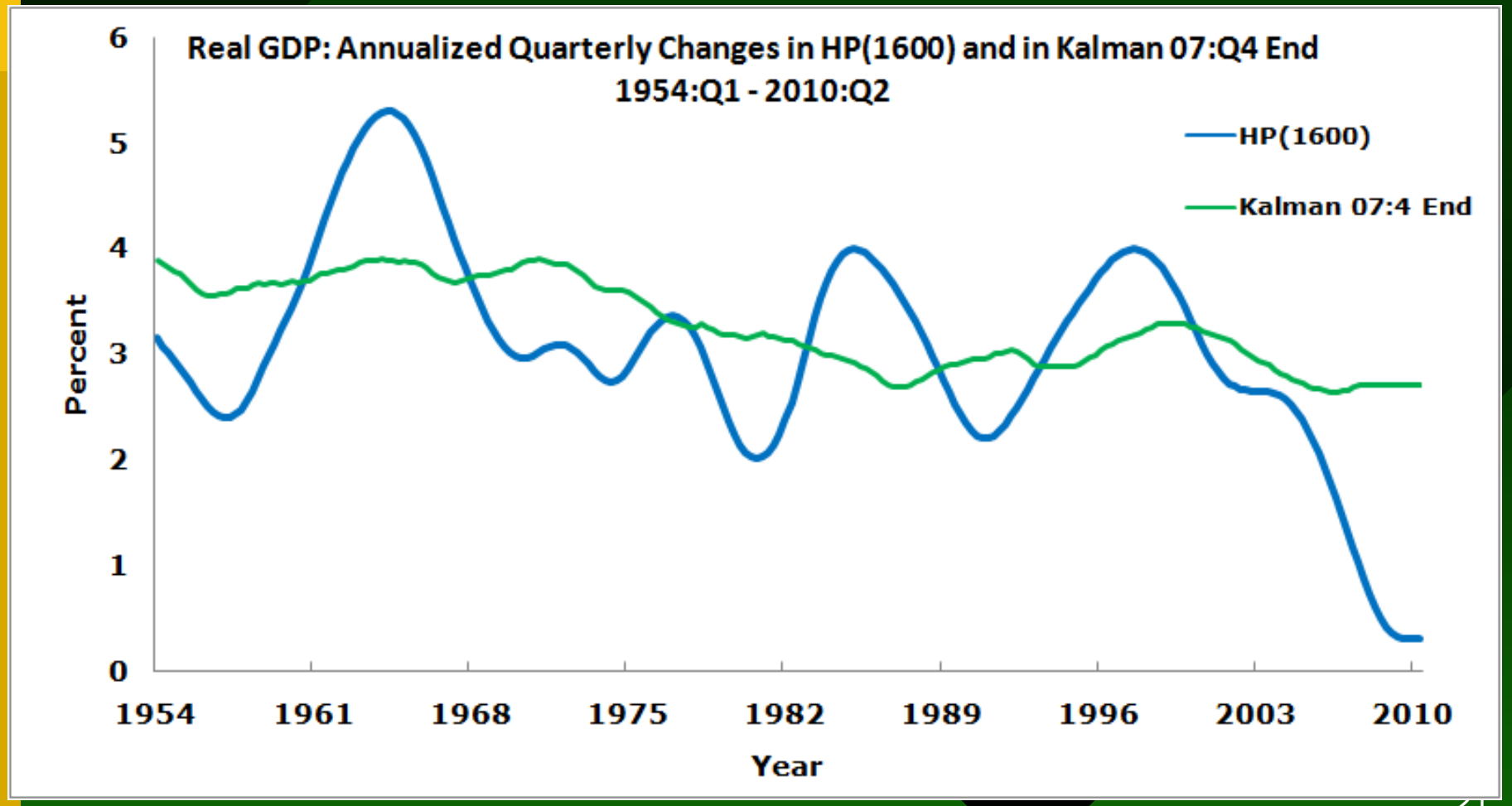
Regression Methodology

- Imagine that everything responded one quarter after the NBER trough quarter
- Dependent variables would be 1 1 1 1 1
- Explanatory variables would be 1 1 1 1 1
- Regression equation y = 1 + 0*x
- How do they get positive and significant betas?
- Their results hinge on the pre vs post 1990 change in the lag of the fed funds rate and of the unemployment rate
- Data looks more like 1 1 1 1 1 1 1 1 9 9
- Regressed on 1 1 1 1 1 1 1 1 9 9

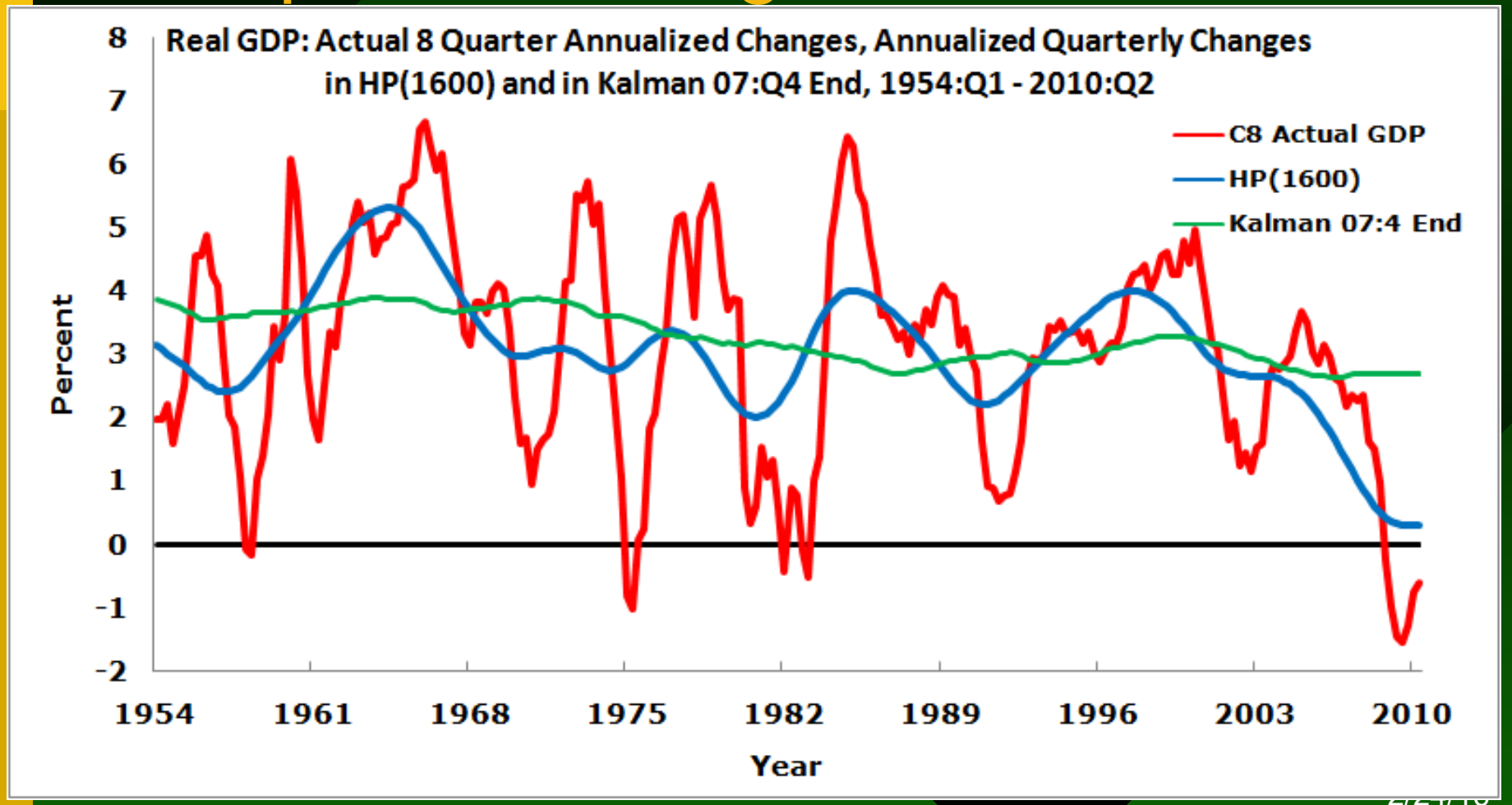
Other Regression Comments

- They have too many policy variables, should focus on rates and cut out nominal M2, real rate, real MB, and real M2
- They have too many explanatory variables, should focus on inflation and unemployment
- Strong negative correl U rate vs. Y/Y* makes it redundant to use both
- Their measure of Y/Y* for the postwar is flawed as in the interwar period, helping to explain why unemployment rate performs better

H-P 1600 vs. Kalman Trend Postwar, Notice 2008-10



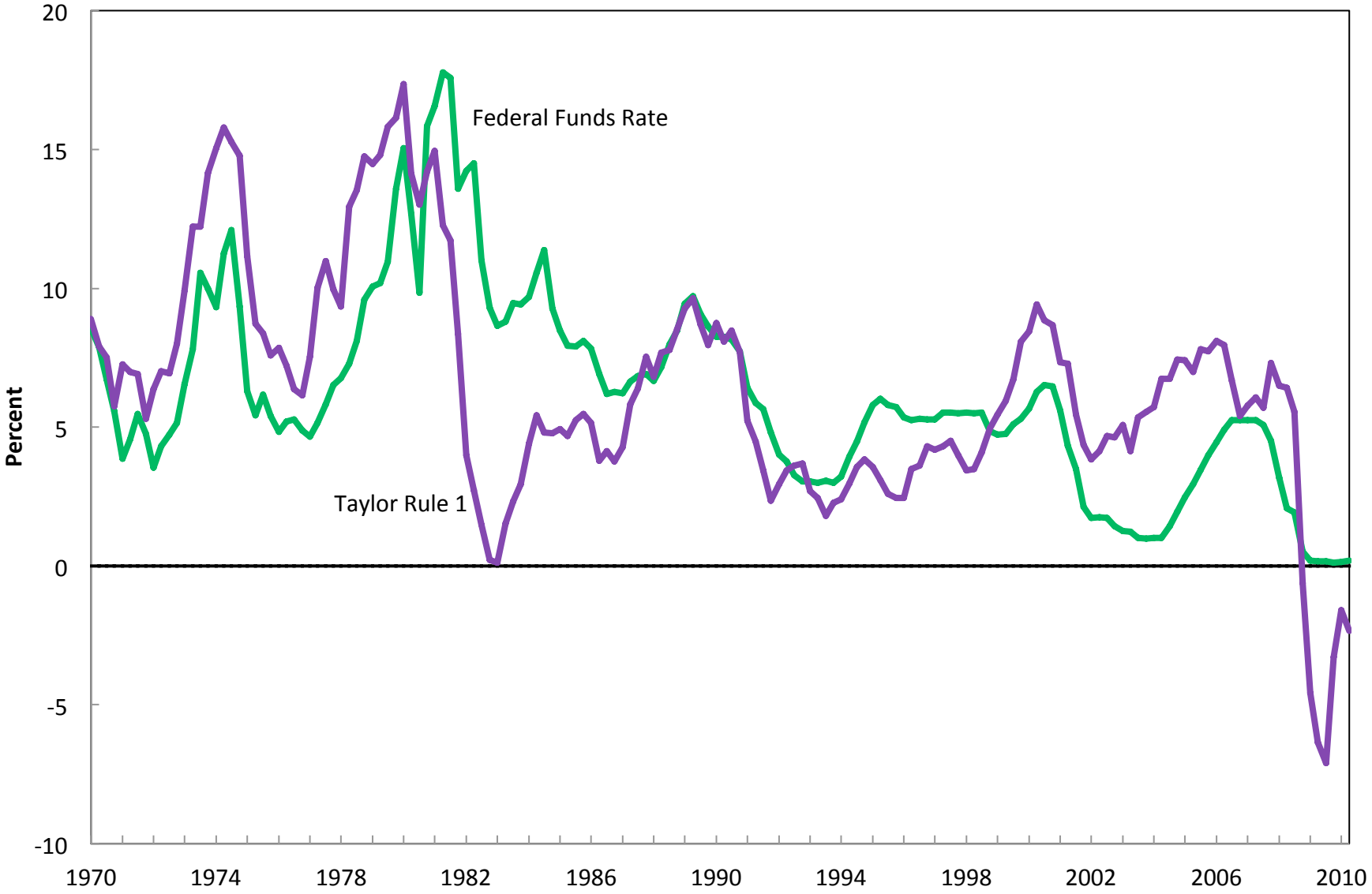
Take Previous Graph and Add 8-quarter Change in Actual GDP



To Take a Broader View, Compare Their Method to Standard Taylor Rule Plots

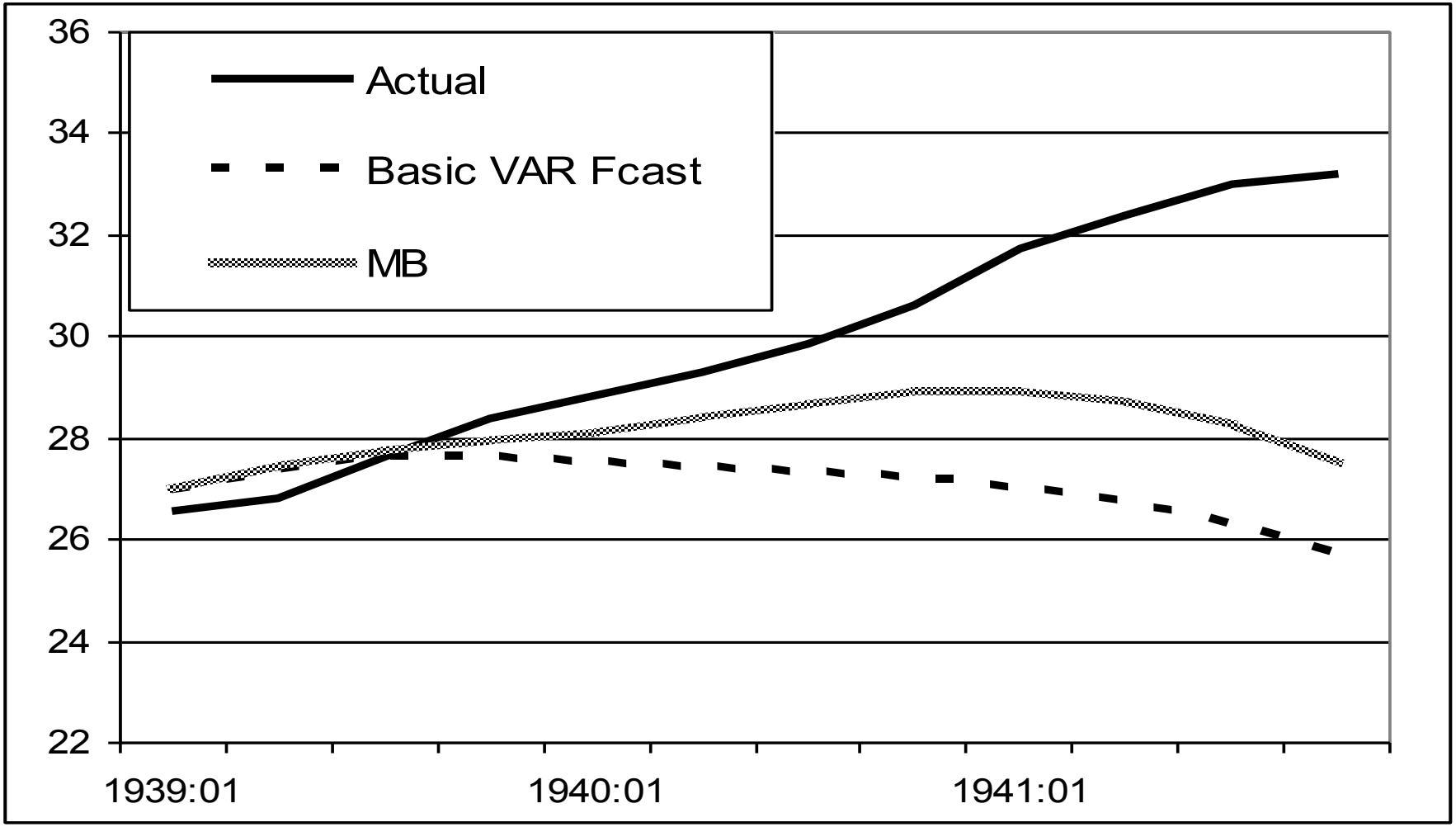
- One can estimate the Taylor Rule responses to illustrate that the Fed switched from an inflation target to a gap target (U or Y) after 1990
- Taylor Rule plots can illustrate deviations of Fed policy from a rule in a way that the paper's methodology cannot
- Magnitudes matter, not just timing
- Taylor Rule plots don't just study exits from recessions but place all periods, expansions and recessions, on equal footing
- Next chart, Taylor Rule, nominal Fed funds rate responds by 1.5 to inflation gap and by 1.0 to output gap

Taylor Rule vs. Actual Federal Funds Rate, 1970-2010

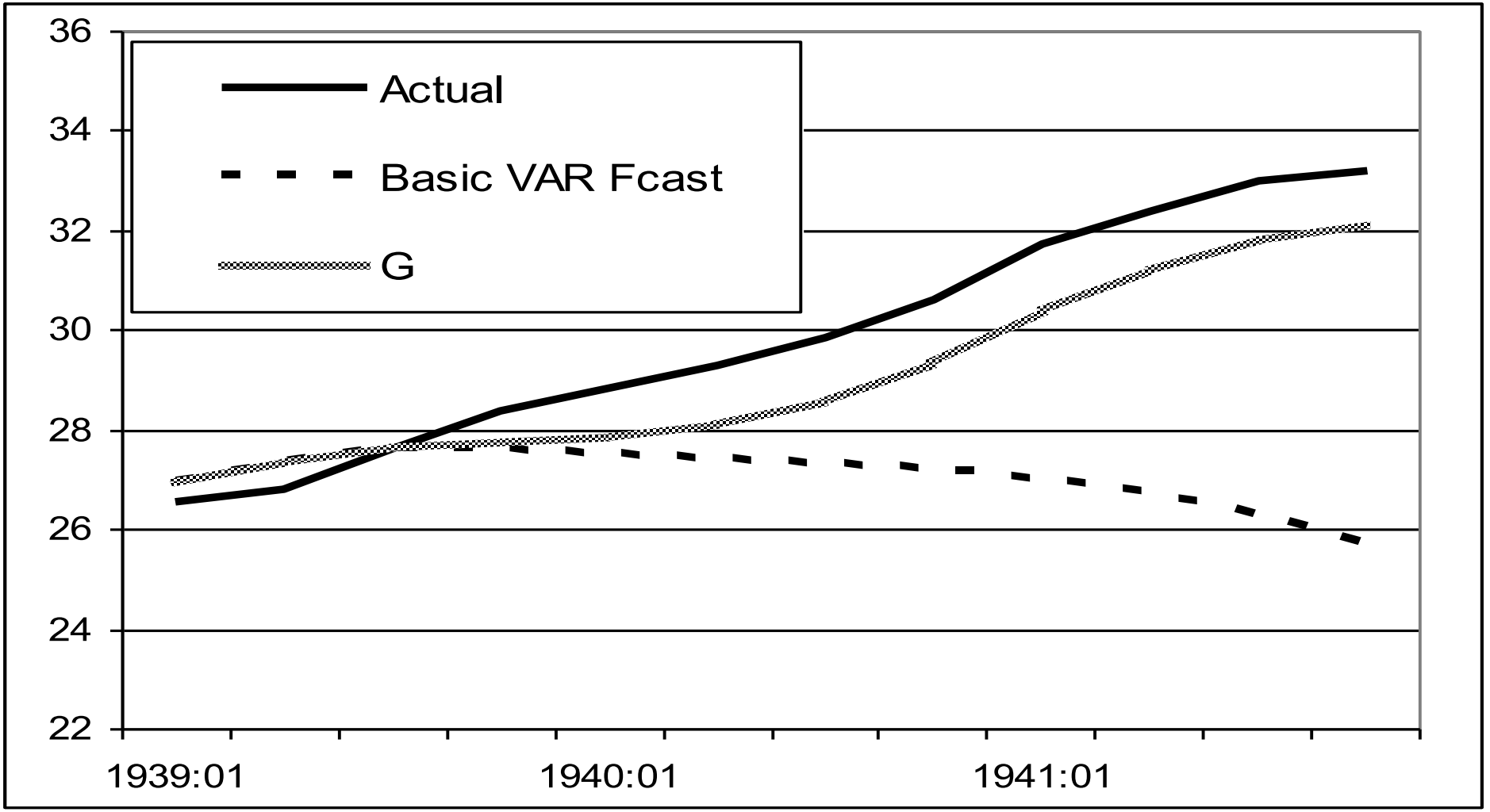


Source: Federal Reserve Database and BEA *NIPA Tables*

Last Comment, Endogeneity of Money Supply



What Explains Most of the Rise in M1, G Itself



Conclusions

- The paper provides a new way of looking at the timing of Fed policy responses at the ends of NBER-dated recessions
- The basic finding is correct: fast countercyclical responses pre-1990 and slower responses post-1990 timed to U Rate
- Paper's predictions of a quick Fed response in 2010 are off base because it doesn't pay attention to its own findings
- Many problems with the interpretation and execution. Doubtful that this method will replace analysis of Taylor Rule regressions and plots
- Scope for many more VAR-type analyses of controversial topics in the interwar period, including the endogeneity of monetary variables, the role of G vs. M in causing the 1920-21 recession, and much more