General Discussion: Monetary Policy and the Well-Being of the Poor

Chairman: George Shultz

Mr. Shultz: Christina wants to ask the first question of herself.

Ms. Romer: No, I want to ask David to make a few comments.

Mr. Romer: One comment of Alan Blinder's that we want to respond to concerns the question of how much emphasis the central bank should put on unemployment. Alan wasn't clear, at least to me, about the distinction between stabilization on the one hand and erring on the side of low unemployment on the other. Nothing we've said implies that Alan Greenspan's role as a fine-tuner is not very important. Our long-run evidence says that greater stability is good for the poor. And concerning the short run, if you swing the economy through big booms and recessions, then as Alan said, if you have a nonlinear Phillips curve, that would raise average poverty. So we didn't mean to say, and we don't say, that you shouldn't worry about keeping the economy stable. Now I couldn't quite tell whether Alan was saying that these are arguments for erring toward low unemployment. He argued that these considerations mean that Alan Greenspan's role in preventing recessions is very important. But they also mean that his role in preventing the economy from overheating is very important. So they don't provide a reason for concluding that central banks should err on the side of avoiding unemployment.

Also, we're willing to stand by the second-to-last paragraph in the paper even if you edit it in the way Alan did in his comments, putting in "unemployment" for "poverty." If you err on the side of preventing unemployment, then you make sure to avoid recessions, but occasionally you overheat the economy. Over time, therefore, inflation creeps up irregularly and you end up in the quandary that central bankers don't like to be in—that of facing high inflation and either living with it or putting the economy through a recession. You haven't done the poor, or anyone else, a favor by getting yourself in that position.

Mr. Shultz: Thank you. Questions? Wayne.

Mr. Angell: Alan Blinder, how can there be an Iron Law of Poverty without an Iron Law of the Estimated Natural Rate of Unemployment? Don't you believe that when monetary policy is good, and is pursuing price stability that the estimated natural unemployment rate tends to fall? And when monetary policy is very bad, and tries to create wealth through monetary expansion, that the estimated natural rate of unemployment then rises? So how can there be any Iron Law of Poverty?

Mr. Blinder: Just briefly, what I meant when I said that is the following. If you remember, when Milton Friedman originally talked about the natural rate of unemployment, he talked about the rate "ground out by the Walrasian equations," or something like that. There are a lot of microeconomic determinants of unemployment that monetary policy can't do anything about, and that is what determines the natural rate of unemployment. The "natural" rate of poverty would be the poverty rate corresponding to that natural rate of unemployment. Now, to the second part of the question. Wayne suggested strongly that Friedman had it wrong. So I want to answer your question in two parts. If Friedman had it right, I've just given the answer. But then you suggested that Friedman had it wrong, that a sustained period of good monetary policy would lower the natural rate. In that case, Milton was wrong, and there is no natural rate. If that were the case, there would not be a natural rate of poverty, either.

Mr. Sinai: I've got a technical question and comment on the Romers' paper regarding the rule-of-thumb calculation. That gets us back to the natural rate again—the "usual rule of thumb that unemployment one percentage point below the natural rate for a year raises the inflation rate by one-half of a percentage point" and the extension of it to two years. In light of the sample evidence of the 1990s, can you really use that rule of thumb? As you know, whatever view of the natural rate you might have—its level, its existence, whatever—we have had for a number of years a very low unemployment rate relative to any number that people with a natural rate will use that would suggest accelerating inflation, and we haven't had that. We have had decelerating inflation. So all I am suggesting to you is that you either note that or don't use the rule of thumb to make that calculation. I don't think it changes the thrust of what you're saying. I'm just really quarreling with that calculation in light of what is going on in the 1990s.

Mr. Romer: As you politely point out, that calculation is hardly crucial to any of our conclusions. I guess we're traditionalists in still thinking that the natural rate hypothesis is right and that a lot of what has been happening recently is supply shocks that are hard to figure out exactly. But a few years from now, if you make that comment again and the evidence is still that way, we would be on weaker ground in saying that.

Mr. Sinai: We hear from the natural rate people, those of us who are skeptical about the application of the natural rate hypothesis, is just what you said: if you wait long enough, it certainly will apply. And so, I think we have waited a long time and it has not applied, so I would suggest that you be more modest about the calculation in your paper.

Mr. Stiglitz: I want to pick up three things that Alan briefly mentioned. The first is the fact that the key issue here is the nonconvexity or the linearity of the Phillips curve. The regressions tend to show that it's either linear or slightly convex, and the cost of disinflation is actually lower than the benefits from the high employment and output during the period with increasing inflation. These results are statistically

significant and quite robust for the United States. (Steven Braun at the Council of Economic Advisers has also shown these kinds of results.) In particular, there is no statistical support for the assumption of a concave Phillips curve that seems to underlie the Romer analysis.

Second, I think the hysteresis effects, although they are hard to prove, are quite convincing and provide part of the possible explanation for what is going on in the United States. We have successfully brought in marginalized groups; they've attained skills to make them productive members of the labor force. This "hysteresis effect" is certainly a consistent alternative explanation to that of supply shocks for the behavior of the U.S. economy in recent years, and certainly in the case of Europe, I think, there is convincing statistical evidence for the presence of hysteresis effects, which means that you don't have the symmetry postulated in the Romers' analysis. And finally, even if you had symmetry and linearity, the fact is that there is a positive discount rate. And if you are facing the risk today of erring a little bit—this is not saying erring a lot but erring a little bit—and causing a little bit lower unemployment rate than the nonaccelerating inflation rate of unemployment (NAIRU), then at the margin, having that for a little while before you have to disinflate, if you do have to disinflate, has significant benefits to the poor, given the high interest rates at which they are discounting.

Mr. Romer: I want to respond to two things. One is the hysteresis point that several people, starting with Alan Blinder, have mentioned. If that were, in fact, important and if there weren't something else going on, then when you went to the cross-country evidence, you would see that countries that had high inflation would have permanently benefited the poor by running high-pressure economies. One way of reading our cross-country evidence is that in the long run, the opposite effect, which Wayne Angell discussed, dominates. In the long run, messing up the price system raises the natural rate, or lowers the normal level of output. In any event, I think that the OECD evidence pretty clearly refutes the idea that the poor do better under high inflation.

Second, Joe Stiglitz is right that if you have a positive discount rate

you shouldn't ignore unemployment completely and go to the perfect level of inflation. You should end up with an inflation rate a little bit above the optimal level. But I am really skeptical of this idea that the fact that the poor pay very high discount rates to pawnbrokers should be a major guide to monetary policy. If you look at the behavior of all consumers, including the poor, the idea that it is well described by any consistent time discounting is strongly refuted. It is also the case that if you think about monetary policy over the long run, you are not talking about the same individuals at different times, but trading off the people in the lower tier of the distribution today versus other people in the lower tier in the future. In any event, using pawnbroker interest rates to guide monetary policy strikes me as a mistake.

Mr. Brinner: I just wanted to back up what David said in his response to Alan. Robert Gordon and I have re-estimated very traditional wage and price equations and there is incredibly strong evidence that nothing has changed. Indeed, all we have seen is a set of reinforcing supply shocks on energy and the price of imported goods, and some unique temporary fringe benefit movements. The traditional wage equation relating to unemployment shows absolutely no shift other than the kind of standard demographic adjustments George Perry talked about. So I think that some of your conclusions about unemployment and poverty still do stand up without adjustment.

Mr. Lawrence: The Romers are prudent in noting that you can't really discern causation between these two variables in the long-run analysis of inflation and poverty. And I think that's an appropriate caution. I wonder whether it isn't worth reflecting on whether increased poverty and inflation are both responses to something else, like social conflict—that societies that have a lot of inequality have a lot of social conflict. The battles over income shares result often in hyperinflation and inflation and indeed may result in poverty. But to draw any implication for monetary policy is to tell the story of Hamlet without the prince.

Mr. Romer: Very briefly, we are quite clear in the paper that that may be part of what is going on. I believe Alan Blinder said some-

thing very important (and something that we should emphasize more) when he pointed out that there is no evidence of effects going the other direction. There is no evidence that inflation benefits the poor in the long run. Maybe it does and it's masked by other things, but if so, it's masked very well.

Ms. Romer: I would like to come back to this idea of taking the role of a monetary policymaker more generally, the point we made at the end, which is one we actually heard Allan Meltzer make five years ago. Regardless of the direction of causation, what is true is that low inflation tends to go with a package of reforms. And monetary policymakers typically have more influence than just by what they do to the interest rate. They are players in all of these reforms. And that role should not be downplayed; it certainly is a key role of monetary policymakers.

Mr. Darby: I just wanted to correct an error in the history of economic thought that Alan proposed, which was that Milton Friedman was wrong. I can't remember whether it was the AEA presidential address or the Nobel Prize lecture when he talked about the intermediate Phillips curve being positively sloping.

Mr. Mishkin: The Nobel Prize lecture.

Mr. Darby: Okay, it was the Nobel Prize. And I think that is exactly what the Romers, along with everybody else who looks at the relationship, kept confirming.

Mr. Blinder: There is a difference between unemployment and employment and GDP. I think the arguments that the Romers were making and what Milton Friedman made in the Nobel Prize lecture had to do with productivity, that a unit of labor was more productive in a lower-inflation society. That doesn't necessarily say anything about the level of employment. It says you get more output.

Mr. Mishkin: He did also talk about unemployment.

Mr. Blinder: Okay, thank you.

Mr. Shultz: Reminds me of that old saying that everybody likes to argue with Milton Friedman, particularly when he isn't there. You were going to ask a question. Yes.

Mr. Christensen: I have a question concerning the title. I totally agree with Alan Blinder on this issue of monetary policy versus macroeconomic performance. On monetary policy issues, I think you should be very distinct whether you consider a purely interest rate channel or an exchange rate channel. I think the exchange rate channel is basically missing in this respect. Considering the impact of income distribution, I think one can easily see how the exchange rate could lower the income of the working class, creating, I would say, a greater dispersion in income distribution. That's one case and another case would be expansionary monetary policy; namely, a lowering of interest rates without any impact on the exchange rate would have the opposite impact. Therefore, if "monetary policy" is going to remain in the title, I think it is quite important to have this distinction between these channels in mind.

Mr. Romer: I'd like to defend our title. If you think about the effects of monetary policy in the short run, the effect on the poor through its differential impact on different sectors is probably small compared with the fact that it moves the economy into a boom or a recession. The exchange rate in small countries can have a big effect on standards of living, and so it would be right to discuss that. But it's not obvious that that has a big effect on distribution. As for the long run, if you are talking about what is the key determinant of inflation and the variability of the demand side of the economy, well, we know from Milton Friedman—who we've just learned is always right—that inflation is always and everywhere a monetary phenomenon. So it seems correct to attribute a country's average inflation and its demand volatility mainly to monetary policy. I therefore think our title is appropriate.

Mr. Shultz: Thank you. I think we have come about to the end of our discussion. However, I would like to make a few comments, since I've been invited to do that.

It seems to me there isn't that much difference of opinion on this

subject. That is, the main thing that monetary policy and monetary authorities can do is the job that is laid out for them—namely, to produce a noninflationary, healthy economy. That tends to benefit everybody, including the poor, (as contrasted with other things that they might do and other times when the monetary authorities haven't been so successful as they have in recent times). At same time, it seems to me, the talk about an Iron Law of Poverty, or something of that kind, simply doesn't stand up to even a cursory look at the figures. The fact of the matter is that poverty has been reduced a lot. Presumably, it can be reduced further. How would you go about that? Well, and here I'm referring to what Christina said, there are other things to be worked on. The people who emerge with a lot of wisdom on economic matters—for example, by doing a good job in a particular area, such as monetary policy—will be listened to. And when they say that it is very important to have widespread access to high-quality education, well, that's an important observation. In fact, it's the heart of the matter. Also, when they say that obviously we are going to have a safety net, that's important. But the real question is how do you design that safety net so that you give people access to work, without putting a lot of negatives in the system, as I think the Europeans clearly have done. Or, as I suggested in one of my earlier comments, how do you work on the cultural causes of poverty so you can recognize those problems, even though they certainly are outside the traditional boundaries of economic policymakers. These are big problems and, if they get out of hand, they really can have a very negative impact on our society. So, these are things that you have to work on, but you have to go about it in some sort of different way.

I think there is an additional factor that hasn't been mentioned here, one that is going to become more and more important in the United States and most particularly in the European countries and Japan. I'm talking about the huge demographic changes that are taking place right now. These changes surely will have an impact on productivity and on the distribution of income in those economies, so people need to be thinking ahead about them.

I am an advocate of the notion of limited purpose organizations. There is a tendency when an organization does something well to

give it additional things to do, which often tends to undermine the ability of the organization to do its main job. Let me give you an example. I'll take universities since I am a university person. I think our universities are emerging from a difficult period, when they aspired to solve every problem. That's not our role. We are limited purpose organizations; we are about learning. That is our role, and we should stick to it. By the same token, I think the Fed should stick to its role and not try to solve every problem. At the same time, people in institutions like the Fed should explore various economic problems, including those that may be outside the scope of monetary authority. They should be ready to observe, to comment, and, when appropriate, to pitch in because people pay attention to their opinions and it's important to have them weigh in on some of these major problems that our societies face.

My thanks to this panel and the others that have appeared here and to all of the people who have participated in these discussions.