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Discussion

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Taylor's paper is a useful and balanced discussion of the implications of forward-looking behavior for how monetary policy should be conducted. However, he might leave the reader with a misleading impression that the nonmarket clearing, rational expectations approach that he advocates is an outlying position that is not widely accepted. To the contrary, a high, and I think growing, percentage of economists adheres to this position, although not necessarily to all the details of Taylor's model. This is occumng because as more empirical evidence accumulates, it tends to be favorabe to forward-looking expectations formation, but is much less so to the other implications of the new classical macroeconomic models: the importance of misperceptions to the business cycle, the absence of effects from anticipated policy, and the required degree of price-wage flexibility. The policy prescriptions in John Taylor's paper thus deserve to be taken very seriously by policymakers.

Obviously, I am sympathetic to John's approach, and I suspect that I am just the kind of discussant that he would like to have hired for this conference. Instead of trying to find a set of criticisms to level against this paper, I would rather try to give a little more perspective to the approach and expand on some of its policy implications.

The approach that Taylor advocates is very much in the research tradition of Keynesian macroeconometric modeling. It involves estimating a structural econometric model which has a wage and price setting sector where markets do not clear in the short run. However, the policy implications of his approach are much closer to those of the "new classical macroeconomics" than to the "Keynesian."[1] To see this, we should look at the response of these different approaches to the basic question of concern to policymakers right now. Is the fight against inflation worth pursuing and should monetary policy be less accommodative than it has been in the past? Advocates of the Keyne-

1. These are Taylor's labels

sian approach usually respond in the negative. With exogenous expectations and hence an exogenous distributed lag pattern in wage and price setting behavior, Keynesian models imply that a significant lowering of the inflation rate requires many years of substantial output loss and unemployment. Also, the prevention of inflation with nonaccommodating monetary policy will be quite costly for similar reasons. Because the output loss is so large, it is not clear whether the welfare gains from reducing or preventing inflation are worth the huge social cost in terms of high unemployment and low output. The new classical macroeconomics, on the other hand, leads to the position that inflation should be fought with contractionary monetary policy. In these models, the cost of fighting or preventing inflation can be extremely small. In fact, if the contractionary policy is expected, then the elimination of inflation can be immediate with no output loss. The nonmarket clearing, rational expectations approach of Taylor also indicates that the current inflation should be reduced with contractionary monetary policy and future policy should be less accommodating. The simulations in his paper show us that the reduction in inflation can be achieved with no output loss, although the path to price stability takes longer than in the new classical models. Thus, Taylor's and the new classical macroeconomics approach are in complete agreement on this critical issue.

The nonmarket clearing and new classical macroeconomics approach are also in complete agreement on the importance of the credibility of monetary policy to its effectiveness in fighting inflation. They both imply a negligible cost to reducing the inflation rate only if the contractionary monetary policy is known in advance, is believed, and is then actually carried out as expected. Achieving credibility is an extremely critical element to a successful monetary policy. This is obviously easier said than done and it is hard to believe that it can be achieved overnight. This is why the simulation results in the paper are overly optimistic on the low cost of reducing the inflation rate. Some output loss will probably occur when reducing the inflation rate because of the time it would take to establish credibility. But the main point of Taylor's research and that of the new classical macroeconomists is that this cost will be far lower than has been suggested by the Keynesian approach.

How we can achieve credibility quickly is not an easy question. The case of the hyperinflations that Sargent (1980) discusses are not very

helpful. There, credibility was achieved by the threat of foreign military intervention if contractionary policies were not pursued. Holding a gun to a person's head is always a quick way to establish credibility, as every mugger knows, but it is not a feasible solution to the situation that currently exists in the United States. On the other hand, we can make several suggestions that might help our policymakers make their anti-inflationary policy more credible. The current unusually high volatility of M1 growth has been strongly criticized by many members of the economics profession.[2] Although there is no convincing evidence that short-run fluctuations in money growth lead to significant business cycle fluctuations, money growth volatility might render the Fed's monetary policy less effective. The problem is that this volatility makes it harder to ascertain whether the Federal Reserve will deviate from its inflation fight. My feeling is that it is this resulting uncertainty that has led to the sometimes vehement attacks on the Federal Reserve's current policy. One issue that this raises for Taylor's simulation results is that the paths of monetary policy he suggests might not be easily believed because they involve only a very small decline in money growth at first, with a sharper deceleration later. A more substantial decline in money growth initially may be necessary to establish credibility in the Federal Reserve's anti-inflationary policy.

Clearly, the Reagan administration also has an important role in establishing monetary policy credibility, and so far they do not get a high grade on this score. The inability of the Reagan administration to get the budget deficits under control may be a factor in the current high nominal and real interest rates. The resulting pressure on the Federal Reserve creates the suspicion that it might try to lower these rates by printing money and that it may revert back to its old policies and reignite the inflationary fires. A less expansionary fiscal policy might go a long way to making the Federal Reserve's job easier and to establishing the credibility it needs to eliminate inflation quickly without substantial output loss.

References

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2. For example, see Meltzer (1982) and Rasche (1982).

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