Comments on paper by Kozicki and Tinsley

Alan S. Blinder
Princeton University
FRBSF conference
March 19, 2004
What I like most about this paper:

It makes sense!
A recent episode

- In Greenspan’s “H-H” testimony last month, he said $p^* = p_t$ (under 1% for core PCE).
- This surprised several (many? but not all) FOMC members (quotes on p. 19).
- Bond yields adjusted **down** => market’s perception of Fed’s inflation target **fell**?
- According to Fig. 9, long rates should rise and output should **fall**.
  - Why? Lower $p^*$ => policy should **tighten**
  - Maybe this “news” was more about *perceived* $p^*$ than *actual* $p^*$. 
It makes sense

• “…the inflation goal is assumed only to be known by the monetary authority” (p. 4)
  ✓ We *know* the Fed has not revealed $p^*$; it’s been a guessing game.
  ✓ Maybe the FOMC does not even know $p^*$! (an interesting variant?)

• The estimated target reflects changing aspirations (See Fig. 1)
  ✓ rose in the inflationary 1970s (resignation)
  ✓ fell sharply in the Volcker disinflation (determination)
  ✓ settled in near 3-4% when $p$ did (satisficing)
  ✓ drifted down as $p$ did in 1990s (opportunism)

• It’s estimated, not calibrated
The model of target inflation

• “The [Fed’s] inflation target follows a martingale process…” (see eq. 2, p. 10)
  ✓ I wonder about this. Aspirations idea suggests lagged/current p should affect p *.
  ✓ Volcker “dummy” is a sharp counterexample (or example): target falls for 13 consecutive quarters.

• Public perceptions are adaptive (see eq. 5, p. 14), so they lag p *
Other aspects of the model

- **Same perceived inflation target in the SR (funds rate) and LR (bond rate)**
  - Odd when movements in \( p \) are predictable?
  - Compare situation today

- **Constant real natural rate**
  - 3% seems high for the funds rate

- **No structural breaks other than in the inflation target**
The history told by Figure 1

- p * moves a bit too rapidly? Smooth it?
  - 1969-1971: drops ~ 3 points
  - 1979-1982: drops ~ 8.5 points (Text, p. 18, attributes 4.5 points to the “dummy”.)
  - Dips below zero in 1982-83
  - Falling in 1994-1996 period
- Large discrepancies between actual p * (fast-moving) and perceived p * (slow moving)
Major changes in impulse response patterns

- $p$ reaction to an AD shock is drastically reduced (Fig. 5)
- All reactions to an AS shock change dramatically (Fig. 6)
  - $y$ response changes sign
- $p$ and $y$ responses to a transitory policy shock change dramatically (Fig. 8)
  - $p$ response changes sign => no price puzzle
Conclusions

• The new wrinkle matters.
• The new wrinkle makes sense.
• Smoother behavior of $p^*$ might make even more sense.