

DISCUSSION OF

“EVALUATING POLICY INSTITUTIONS”

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An Ambitious, Impressive, and Valuable Paper

- Goal is to evaluate the performance of macroeconomic policy in different eras.
- The paper shows how it could be done without a full structural model.

A Very Simple Example

- One observable shock (s), one instrument (i), and one objective (keeping inflation, π , stable), and no dynamics.
- Suppose we find that under the actual policy regime, $d\pi_t/ds_t = a$, and suppose we know $d\pi_t/di_t = -b$, where $a \neq 0, b \neq 0$.
- Then π would have varied less if policymakers *changed* the response of i to s by a/b . This would make $d\pi_t/ds_t$ equal to $a - b(a/b) = 0$.
- This would reduce the variance of π by $a^2 \text{Var}(s)$.

Some Key Findings

- Paper focuses on 4 periods: 1879–1912 (“Gold standard”), 1913–1941 (“Early Fed”), 1954–1984 (“Post-WW2”), and 1990–2019 (“Post-Volcker”).
- Finds that the key difference between “Early Fed” and the periods just before and after was that the shocks were larger.
- “Post-Volcker” differs from the other periods both in that monetary policy was better and (especially) shocks were smaller.

Concern #1: What about the Constant Term?

- The paper ignores any impact of policy on average inflation and unemployment.
- Monetary policy can affect average inflation.
 - Roughly 1/4 of actual “loss” in the “Post-WW2” period was from average $\pi > 2\%$.
- And policy can plausibly affect average unemployment over a 30-year or so period.
 - “Early Fed” period as a candidate.

Concern #2: Are the “Shocks” Actually Shocks?

- Especially: If what the framework interprets as shocks are in fact due to policy, the loss from suboptimal policy will be underestimated.

Example 1: Banking Panics

- Researchers have focused on identifying panics or financial distress, not on finding “exogenous” panics.
- The panics in the 1930s were clearly due in part to the collapsing economy, which was partly the result of poor policy.
- And even when the panics started, the fact that they turned into full-fledged panics was due in part to the Fed’s failure to play the lender of last resort role for which it had been created.

Example 2: Shocks to Inflation Expectations

- The framework interprets all changes in expected inflation not explained by a set of other variables as shocks.
- Some of these changes are surely endogenous.
- More importantly: There are likely to be much larger unexplained movements in expected inflation in a period when policy was allowing inflation to fluctuate greatly than in one where policy kept it low and steady.

Concern #3: The Devil Is in the Details. *Examples:*

- Why do they find that the response to panics in the post-Volcker period is so close to optimal?
- How wide are the confidence bands around their point estimates of the bounds of the DMLs?
- How would errors in their shock series and impulse response functions affect their point estimates and confidence intervals?
- How would uncertainty about policy's effects change their estimates of how much differently policy should have responded to shocks?
- ...

Concluding Comments

- Very impressive paper tackling very important issues!
- At this point, I think its value lies more in being a major first pass at a potentially powerful methodology, and less in its substantive conclusions.
- Importantly, that's not a major criticism!