The Legacy of High Inflation and Monetary Policy Rules

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MAIN IDEA OF THE PAPER

"legacy of high inflation"

$\Rightarrow$

stronger monetary policy response to inflation today

“LEGACY” = INFLATION FAR IN THE PAST

FINANCIAL TIMES

Letter + Add to myFT

Germany is still obsessing over hyperinflation

From Christophe Cauvy, Oxford, UK

German politicians need help with relativising the Weimar legacy

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8

OVERVIEW OF THE PAPER

- Theory – simple New Keynesian model:
  - When $\pi_t = 0$ and $\mathbb{E}_t \pi_{t+1} = 0$, then $i_t = 0$
  - When $\pi_t = 0$ and $\mathbb{E}_t \pi_{t+1} = \lambda^t \pi^H$, then $i_t > 0$
- Empirics – cross-country Taylor rule panel regressions:
  - RHS variable of interest is inflation
  - Interaction with *inflation long before inflation targeting adoption* $\rightarrow$ significant
  - Interaction with *central bank credibility proxies* $\rightarrow$ not significant

FINDINGS

Table 6: History Matters

VARIABLES	(1) Policy rate	(2) Policy rate	(3) Policy rate	(4) Policy rate
Policy rate (t-1)	0.8595***	0.8471***	0.8479***	0.8604***
	(0.0327)	(0.0410)	(0.0410)	(0.0418)
NEER percent change	-0.0203*	-0.0208*	-0.0207*	-0.0302***
	(0.0109)	(0.0111)	(0.0111)	(0.0107)
NEER percent change (t-1)	0.0202**	0.0209**	0.0208**	0.0213**
	(0.0097)	(0.0096)	(0.0096)	(0.0102)
US Pol. rate (t-1)	0.0893***	0.0801***	0.0799***	-0.1045
	(0.0269)	(0.0226)	(0.0227)	(0.0664)
Output gap	0.0676***	0.0722***	0.0638***	0.0739***
	(0.0154)	(0.0165)	(0.0146)	(0.0156)
Inflation gap	0.1951**	0.2006**	0.2007**	0.1677*
	(0.0819)	(0.0861)	(0.0858)	(0.1004)
Output gap x Pre-IT high inflation dummy			0.0264	0.0348
			(0.0215)	(0.0223)
Inf. gap x Pre-IT high inflation dummy	0.2601**	0.2694**	0.2672**	0.2412**
	(0.1178)	(0.1178)	(0.1176)	(0.1214)
Constant	0.4149***	0.3494	0.3451	0.8788***
	(0.1247)	(0.2761)	(0.2785)	(0.2941)
Sample	All	All	All	All
Time FE	NO	NO	NO	YES
Yeas as IT FE	NO	YES	YES	YES
Number of countries	32	32	32	32
Observations	2,617	2,617	2,617	2,617
Adjusted R-squared	0.902	0.905	0.905	0.916

Note: The inflation gap is computed using inflation expectations. Driscoll-Kraay standard errors in parenthesis.
*** p<0.01, ** p<0.05, * p<0.1

MY COMMENTS

1. Conceptual: observed vs. optimal responsiveness
2. Model: make slightly richer?
3. Empirics: the perils of Taylor rule estimation
4. Empirics: idea for a fun extension

CONCEPTUAL: OBSERVED VS. OPTIMAL RESPONSIVENESS

- Are countries unnecessarily (irrationally) influenced by their inflation legacy?
- Or are they optimally responding to inflation in a stronger way?
  - E.g. due to households behaving à la Malmendier and Nagel (2015)

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- Or are they optimally responding to inflation in a stronger way?
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- My impression is that the authors try to stay in the realm of positive analysis
  - But sometimes the wording drifts in normative directions
- It would be helpful if this conceptual difference were spelled out more explicitly

MODEL

- Expectation process $\mathbb{E}_t \pi_{t+1} = \lambda^t \pi^H$ is mechanical; "learning" is not modeled
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- All this is fine, since model serves mainly as illustration
- However, maybe some low-hanging fruits can be picked with slightly richer model
- E.g. it might possible to use model to examine my previous comment
  - Add simple learning process and central bank objective function
  - Is stronger responsiveness optimal when agents learn from shocks far in the past?

PERILS OF TAYLOR RULE ESTIMATION

- Lots of issues with estimating Taylor rules
  - E.g. simultaneity bias, omitted variables, lack of real-time data (Orphanides, 2001)
- At minimum:
  - Some general caution should be provided for the reader
  - Explain if/how the cross country-approach helps

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  - Explain if/how the cross country-approach helps
- Two particularly important issues in the context of this paper

1. Introduction of inflation targeting is not random (across country and time)
2. Bad controls? E.g. exchange rate response might also capture legacy effects

- I would appreciate a discussion of these points; maybe they can be addressed

EMPIRICS: IDEA FOR A FUN EXTENSION

- Focus on Euro Area countries
- One interest rate on the LHS, one inflation rate on the RHS
- Add many interaction terms: inflation prior to Euro introduction for each country
- Ask the question: which countries' inflation legacies shape today's ECB policy?

CONCLUSION

- I very much like the question the paper asks
- The results look interesting and plausible
- Based on my comments, the authors might want to:
  - Clarify some conceptual points
  - Get more out of the model, with simple extensions
  - Discuss (address) empirical caveats
  - Add Euro Area extension

BIBLIOGRAPHY

Malmendier, U. and S. Nagel (2015): "Learning from Inflation Experiences *," *The Quarterly Journal of Economics*, 131, 53–87.

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