



FEDERAL
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REFLECTIONS ON THE DISINFLATIONARY METHODS OF POINCARÉ AND THATCHER

James Bullard

Federal Reserve Bank of St. Louis

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Expectations in Dynamic Macroeconomic Models

June 17, 2022

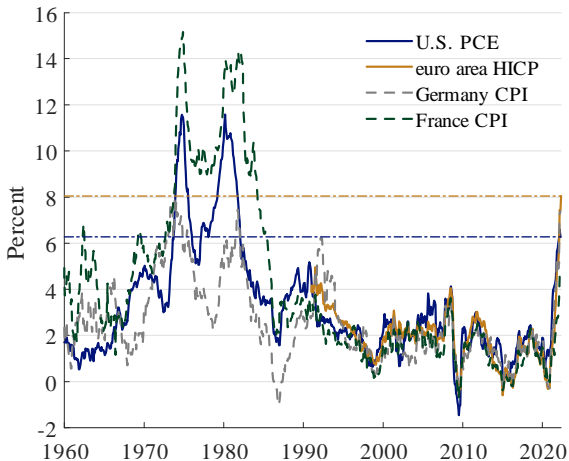
Barcelona, Spain

Introduction

INFLATION NEAR 1970S LEVELS

- Inflation is running near 1970s levels in the U.S. and the euro area.
- How will the Fed and the ECB return inflation to the target level of 2%?

INFLATION IN THE U.S. AND THE EURO AREA



Sources: Eurostat and BEA. Last observations: May 2022 and April 2022.

DISINFLATION AHEAD

- Rhetoric from the Fed and the ECB suggests disinflationary monetary policy ahead.
- The Fed is raising its policy rate sharply and allowing its balance sheet to decline, while the ECB looks set to pursue related actions.
- With inflation near 1970s levels, will the Fed and the ECB be able to disinflate relatively easily and quickly, or will a substantial recession occur as was the case of the Fed under Volcker?
- Many financial market observers and participants are arguing that a substantial recession is likely.

INCREDIBLE DISINFLATIONS

- This talk reviews *selected* literature post-Volcker on credible versus incredible disinflations.
- The Volcker disinflation was incredible: Initially, few believed that the Fed was serious about reducing inflation after an entire decade of allowing inflation to build.
- For instance, see Lindsey, Orphanides and Rasche ([StL Fed Review, 2005](#)), Nelson ([working paper, 2022](#)), Goodfriend and King ([JME, 2005](#), “The Incredible Volcker Disinflation”), and Sargent ([Goodfriend conference volume, 2022](#), “Rational Expectations and Volcker’s Disinflation”).

CREDIBLE DISINFLATIONS

- The post-Volcker literature turned to analyze credible disinflations, inspired by Sargent (1982, “The Ends of Four Big Inflations,” and 1981, “Stopping Moderate Inflations: The Methods of Poincaré and Thatcher”).
 - Available in Sargent (2013), *Rational Expectations and Inflation*, 3rd ed., Princeton University Press.
- This literature explored the idea that credible disinflations do not have large output costs.
- Rather, because of rational expectations, they can be costless.
- The apparent real-world “cost” only comes from having to “earn credibility.”
- “If you have to cut off the tail of a dog, don’t do it one inch at a time.”

LESSON FOR THE COMING DISINFLATION

- The current situation for the euro area and the U.S. seems to fall more closely under the rubric of a “credible disinflation,” rather than the “incredible disinflation” experienced by Volcker.
- Since modern central banks have more credibility than their counterparts 50 years ago, it appears that both the Fed and the ECB may be able to disinflate and achieve a relatively soft landing.

Pure Phillips Curve Disinflation

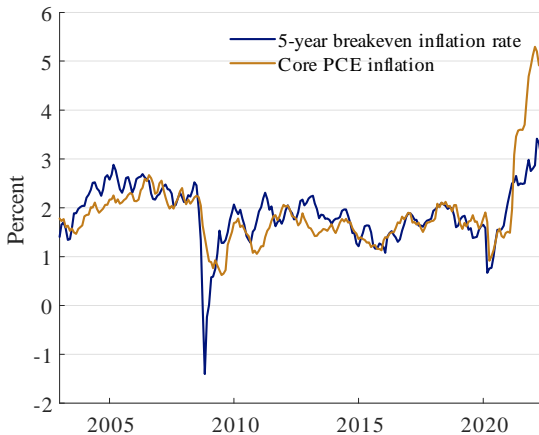
DISINFLATION AND UNEMPLOYMENT

- Let's suppose we begin with a pure Phillips curve analysis (not something I advocate).
- Current estimates for the U.S. point to an essentially flat Phillips curve.
 - For instance, Stock and Watson ([JMCB, 2020](#)) report a slope of -0.03 for both core and headline PCE inflation post-2000.
- Strictly speaking, using this mechanism alone would require unemployment to go to very high levels to get inflation to return to 2% in the U.S.
- While numbers could vary, this is the genesis of the idea that there will have to be a large recession to get inflation under control in the U.S.
- But this is a mechanical calculation that says nothing about inflation expectations.

THE ROLE OF EXPECTATIONS

- The New Keynesian Phillips curve (NKPC) has two arguments, an output gap term as well as an inflation expectations term.
- The NKPC has a coefficient near unity on the inflation expectations component, which theoretically suggests that the relationship between actual inflation and expected inflation should be very close.
- The following chart seems to confirm that this relationship holds in broad terms.
- These considerations suggest that inflation expectations may play a large role in the coming disinflation, as opposed to the size of the output gap.

ACTUAL AND EXPECTED INFLATION

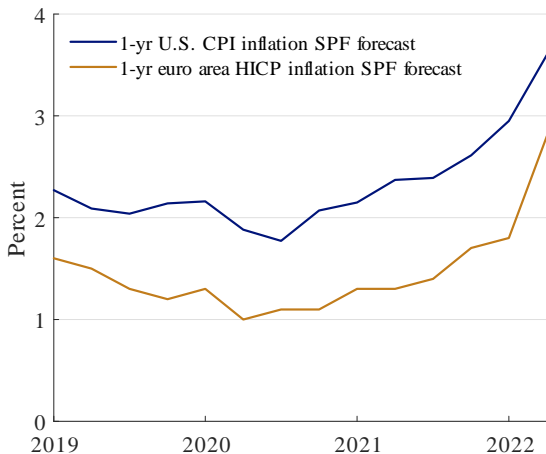


Sources: St. Louis Fed and BEA. Last observations: May 2022 and April 2022.

THE ROLE OF EXPECTATIONS

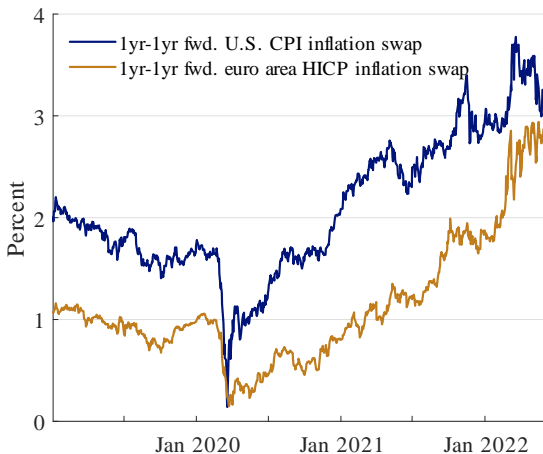
- The NKPC inflation expectations term is for near-term inflation expectations—strictly speaking, one period ahead.
- When expectations are discussed in policy circles, the emphasis is often on longer-term inflation expectations and the notion that longer-term expectations remain “well anchored.”
- Nearer-term inflation expectations in the U.S. may be on the precipice of becoming unmoored.

SURVEY-BASED INFLATION EXPECTATIONS MOVED HIGHER



Sources: Philadelphia Fed and ECB. Last observation: 2022-Q2.

MARKET-BASED INFLATION EXPECTATIONS MOVED HIGHER



Source: Barclays. Last observation: June 7, 2022.

Costless Disinflations

SARGENT ON THE IMPORTANCE OF EXPECTATIONS

- Important arguments concerning the role of expectations were going on in macroeconomics during the early 1980s disinflation.
- Sargent (1981, 1982) emphasized the role of expectations in a credible disinflationary process: It is the credibility of the future policy that causes substantial adjustment in inflation expectations.
 - In “Methods of Poincaré and Thatcher,” he drew a contrast between the successful and rapid monetary-fiscal adjustment of Poincaré in France in 1926 and the then-proposed slow and gradualist approach of the monetarist Thatcher government in the U.K. circa 1980.
 - In “The Ends of Four Big Inflations,” he documented how ongoing hyperinflations came to sudden ends following credible monetary-fiscal adjustments in post-WWI economies.
- Sargent emphasized both monetary and fiscal adjustment.

FURTHER SARGENT COMMENTARY

- Goodfriend and King (2005) stressed the idea that Volcker had to take actions to earn credibility.
- In recent comments on Goodfriend and King, Sargent (2022) notes that there can be little concept of earning credibility under rational expectations.
- In fact, the “communism” of the RE model—all actors forecast the same way—makes it hard to attribute outcomes to particular players at all.
- The subtext is that one has to back off of the rational expectations assumption to discuss how a policymaker could be earning credibility.

LEARNING AND CREDIBILITY

- A literature subsequent to Sargent (1981, 1982) investigated credible disinflations in models.
 - Credibility: Ireland (JMCB, 1997), Goodfriend and King (2005), Sargent (2022), Bonomo and Carvalho (JMCB, 2010), Walsh (working paper, 2022).
 - Learning: Barnett and Ellison (JMCB, 2013), Cogley, Matthes and Sbordone (JME, 2015), Nunes (MD, 2009), Schaling and Hoerberichts (DE, 2010), Bomfim, Tetlow, Von zur Muehlen and Williams (working paper, 1997), Nicolae and Nolan (JMCB, 2006), Gibbs and Kulish (EER, 2017), Lu, King and Pasten (JME, 2016), Wieland (book chapter, 2009).
- As one example, Gibbs and Kulish (2017) consider a model with learning along with evolving credibility, and they fit the model to a range of observed disinflations across time and place. Their model attributes the cost of disinflation to the degree of credibility.

Disinflation Today

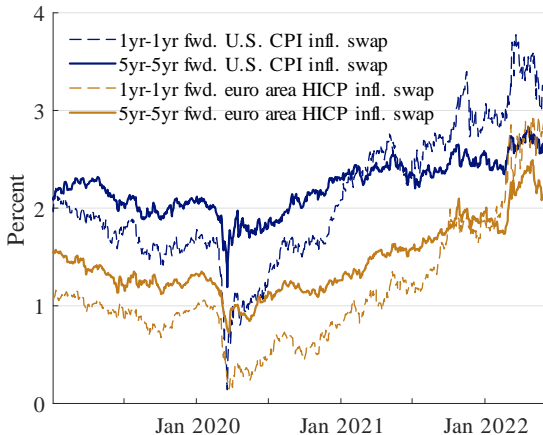
THE MONETARY-FISCAL MIX TODAY

- The COVID-19 pandemic induced large deficit spending combined with accommodative monetary policy, including large-scale asset purchases.
- This could be thought of as akin to an intentional, temporary, high-inflation regime, as the monetary authority did not attempt to offset the inflationary impulse unleashed by the fiscal authority.
- In keeping with the spirit of Sargent (1981, 1982), what is now required is a regime switch back to the previous, pre-pandemic regime that featured inflation near target.
- Is such a switch occurring?

DISINFLATION TODAY

- The regime shift back to the pre-pandemic fiscal-monetary mix does appear to be taking shape in the U.S.
- Fiscal situation in the U.S.: Additional large-scale deficit spending may be less likely due to the possibility of divided government following the 2022 midterm elections.
- Monetary situation in the U.S.: The Fed is committed to an inflation target; it has taken actions to increase the policy rate and to begin quantitative tightening (QT).
- Consequently, medium- and longer-term inflation expectations currently tend to be lower than shorter-term inflation expectations.
- A similar narrative for the euro area?

MEDIUM- AND LONG-TERM INFLATION EXPECTATIONS LOWER THAN SHORT-TERM EXPECTATIONS



Source: Barclays. Last observation: June 7, 2022.

Summary and Conclusion

SUMMARY

- Here is a 2x2 matrix intended to illustrate the spirit of the post-Volcker literature:

		Fed actions	
		Enhancing credibility	Reducing credibility
Private-sector assessment of Fed credibility	High	Poincaré: costless disinflation; soft landing	Erosion of credibility
	Low	Volcker: costly disinflation	1970s: High and variable inflation & volatile real economy

CONCLUSION

- Current inflation in the U.S. and the euro area is near 1970s levels.
- The Volcker disinflation was costly, but it was not credible initially—Volcker had to earn credibility.
- Sargent initiated a literature on costless disinflation that emphasized inflation expectations as the key variable, not the Phillips curve.
- Subsequent literature illustrated how credibility might be earned in models that depart from rational expectations.
- The Fed and the ECB have considerable credibility, suggesting that a soft landing is feasible in the U.S. and the euro area if the post-pandemic regime shift is executed well.