Credible and Incredible Disinflations

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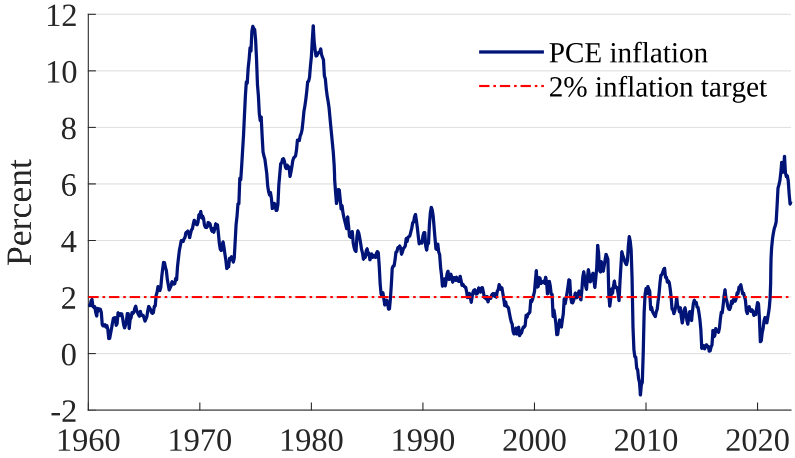
Introduction

Inflation near 1970s levels

- Inflation has been running near 1970s levels in the U.S.
- Will the Fed be able to disinflate to 2% 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.
- The story in this talk is different, instead emphasizing credibility issues and monetary-fiscal interaction, themes that echo the work of Guillermo Calvo.

Inflation in the U.S.



Source: BEA. Last observation: January 2023.

Incredible disinflations

- The Volcker disinflation was costly but *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, "The Reform of October 1979"), Nelson (working paper, 2022, "The Great Inflation of the 1970s"), Goodfriend and King (JME, 2005, "The Incredible Volcker Disinflation"), and Sargent (Goodfriend conference volume, 2022, "Rational Expectations and Volcker's Disinflation").

Credible disinflations

- Part of 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.
- This suggests that when real-world disinflations are costly, it is because central banks have to “earn credibility.”

Lesson for today

- The current situation for 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 in the 1970s, it appears that the Fed may be able to disinflate in an orderly manner and achieve a relatively soft landing.
- The path to the soft landing requires a credible switch of monetary-fiscal policy to the policy regime that existed before the "wartime" pandemic policy regime.

Pure Phillips Curve Disinflation

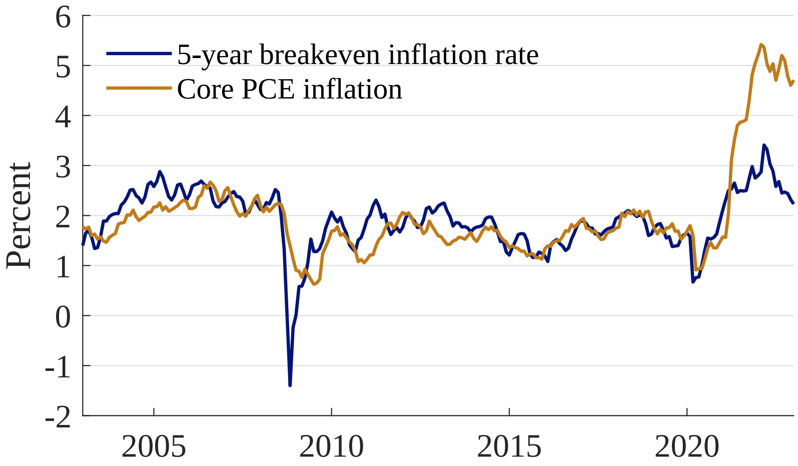
Disinflation and unemployment via pure Phillips curve

- 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; Nakamura (keynote talk at the Asian Monetary Policy Forum, 2022, "Inflation, Monetary Policy and the Phillips Curve") uses a slope of $-1/3$.
- Strictly speaking, using this mechanism alone with either one of these estimates would require unemployment to go to very high levels to get inflation to return to 2% in the U.S.
- But this is a mechanical calculation that says little 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 or the level of unemployment.

Actual and expected inflation



Sources: St. Louis Fed and BEA. Last observation: January 2023.

Costless Disinflations

THE IMPORTANCE OF EXPECTATIONS

- Sargent (1981, 1982), in particular, emphasized the role of expectations in a credible disinflationary process: It is the credibility of the future monetary-fiscal policy that causes substantial adjustment in inflation expectations today, and hence in actual inflation today.
  - 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.
- The historical episodes emphasized both monetary and fiscal adjustment.

"Earning credibility" implies costly disinflation

- 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.
- The subtext is that one has to back off of the rational expectations assumption to discuss how a policymaker could be earning credibility.
  - King and Lu (working paper, 2021) build a model of evolving reputation for commitment and fit it to the postwar U.S. inflation experience.
  - Gibbs and Kulish (EER, 2017, "Disinflations in a Model of Imperfectly Anchored Expectations") 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

CENTRAL BANK CREDIBILITY TODAY

- Compared with central banks in the 1970s, modern central banks have considerable credibility; see Nelson (2022).
- Modern central banking is characterized by *inflation targeting*, including the explicit naming of numerical inflation targets, and a *track record* of trying to achieve those targets. This was not part of the monetary policy regime in the 1970s.
- Modern central banks also have *political backing*, by treaty in the case of the ECB for the euro area, and by statute in the U.S., to provide low and stable inflation outcomes for their respective jurisdictions.
- These developments largely occurred after and in response to the 1970s inflation.
- However, the history emphasizes the monetary-fiscal mix, not just the credibility of the central bank.

THE MONETARY-FISCAL MIX TODAY

- Think of the COVID-19 pandemic as a global war that induced large-scale deficit spending combined with accommodative monetary policy.
- The spirit of the macroeconomic policy response to the pandemic was to err on the side of too much rather than too little.
  - This could be thought of as risking a 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 this literature, what is now required is a regime switch back to the previous, pre-pandemic monetary-fiscal regime that featured inflation near target.
- Is such a switch occurring?

A credible regime shift

- The regime shift back to the pre-pandemic monetary-fiscal mix does appear to be taking shape in the U.S.
- Fiscal situation in the U.S.: Additional large-scale deficit spending appears to be less likely going forward.
- Monetary situation in the U.S.: The Fed is committed to an inflation target, and it has taken actions to increase the policy rate sharply and to begin quantitative tightening (QT).
- This might be interpreted as a regime switch back to the pre-pandemic monetary-fiscal policy mix.

The financial market reaction

- Financial markets have taken on board the probabilities around a changed fiscal stance as well as the more aggressive Fed.
- Consequently, markets presently expect inflation to come under control in the quarters and years ahead.

INFLATION EXPECTATIONS CONSISTENT WITH 2% INFLATION?

Sources: Bloomberg and author's calculations. Last observation: Feb. 23, 2023.

Conclusion

Conclusion

- Inflation in the U.S. has been running near 1970s levels.
- The Volcker disinflation was costly, but it was not credible initially—Volcker had to earn credibility.
  - A post-Volcker literature illustrated how credibility might be earned in models that depart from rational expectations, and how the period of "earning credibility" might be costly.
- A separate literature on costless disinflation ("soft landings") emphasized policymaker credibility following the monetary-fiscal explosions associated with wars; one might view the pandemic as a "global war."
- The Fed has considerable institutional credibility compared with its 1970s counterpart, suggesting that a soft landing is feasible in the U.S. if the post-pandemic regime shift is executed well.

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