

CREDIBLE AND INCREDIBLE DISINFLATIONS

James Bullard

Federal Reserve Bank of St. Louis

The Credibility of Government Policies: Conference in Honor of Guillermo Calvo
Panel Discussion: Back to 2% Inflation?
Columbia University

Feb. 24, 2023

New York, N.Y.

Any opinions expressed here are my own and do not necessarily reflect those of the FOMC.

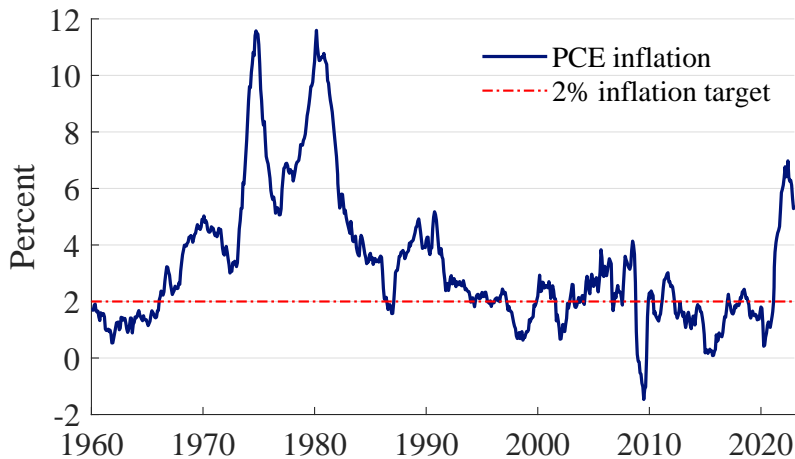


Introduction

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

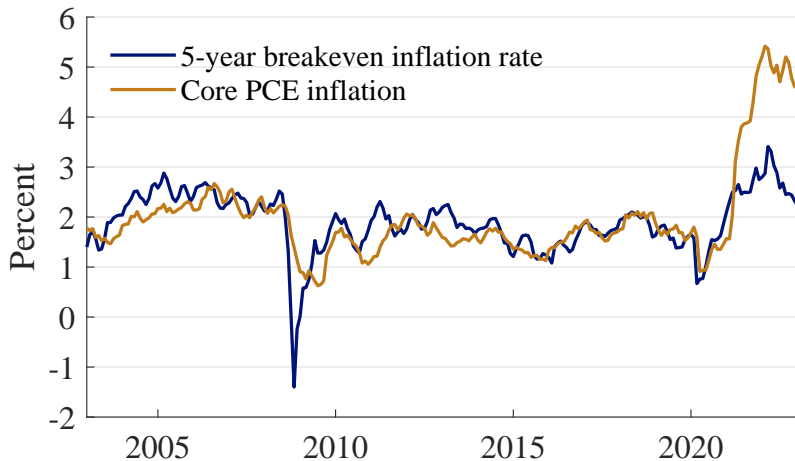
DISINFLATION AND UNEMPLOYMENT VIA PURE PHILLIPS CURVE

- 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.

REFERENCES I

- [1] Gibbs C.G. and M. Kulish (2017). “Disinflations in a Model of Imperfectly Anchored Expectations,” *European Economic Review*, 100, 157-74.
- [2] Goodfriend M. and R.G. King (2005). “The Incredible Volcker Disinflation,” *Journal of Monetary Economics*, 52(5), 981-1015.
- [3] King R.G. and Y.K. Lu (2021). “The Rise, Fall and Stabilization of U.S. Inflation: Shifting Regimes and Evolving Reputation,” NBER Working Paper No. 29585.
- [4] Lindsey D.E., A. Orphanides and R.H. Rasche (2005). “The Reform of October 1979: How It Happened and Why,” *Federal Reserve Bank of St. Louis Review*, 87(2), 187-235.
- [5] Nakamura E. (2022). “Inflation, Monetary Policy and the Phillips Curve,” keynote talk at the 9th Asian Monetary Policy Forum, May 27, 2022.

REFERENCES II

- [6] Nelson E. (2022). “How Did It Happen?: The Great Inflation of the 1970s and Lessons for Today,” Board of Governors of the Federal Reserve System *FEDS Working Paper* No. 2022-037.
- [7] Sargent T.J. (1981). “Stopping Moderate Inflations: The Methods of Poincaré and Thatcher,” in T.J. Sargent (2013), *Rational Expectations and Inflation*, 3rd ed., Princeton University Press.
- [8] Sargent T.J. (1982). “The Ends of Four Big Inflations,” in T.J. Sargent (2013), *Rational Expectations and Inflation*, 3rd ed., Princeton University Press.
- [9] Sargent T.J. (2022). “Rational Expectations and Volcker’s Disinflation,” in *Essays in Honor of Marvin Goodfriend: Economist and Central Banker*, ed. by R.G. King and A.L. Wolman, 279-87. Federal Reserve Bank of Richmond.
- [10] Stock J.H. and M.W. Watson (2020). “Slack and Cyclically Sensitive Inflation,” *Journal of Money, Credit and Banking*, 52(S2), 393-428.