Reflections on the Disinflationary Methods of Poincaré and Thatcher

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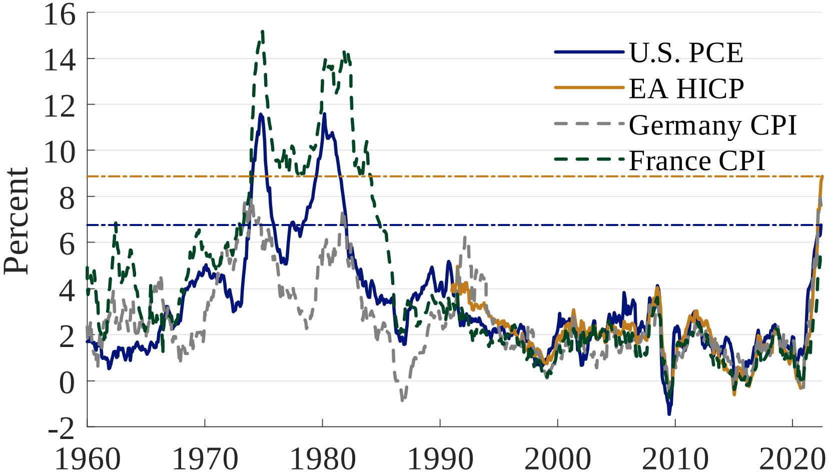
Any opinions expressed here are my own and do not necessarily reflect those of the FOMC.

Introduction

Inflation near 1970s levels

- Inflation is running near 1970s levels in the U.S. and the euro area (EA).
- How will the Federal Reserve and the European Central Bank (ECB) return inflation to the target level of 2%?

Inflation in the U.S. and the EA



Sources: BEA, Eurostat and IMF. Last observations: June 2022 and July 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 recently started raising its key policy rates.
- 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, "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

- 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.
- When real-world disinflations are costly, it is because the central bank has to "earn credibility."
- Credible disinflations also tend to be relatively rapid, not gradual.
  - "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 EA 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 in the 1970s, it appears that both the Fed and the ECB may be able to disinflate in an orderly manner and achieve a relatively soft landing.

Pure Phillips Curve Disinflation

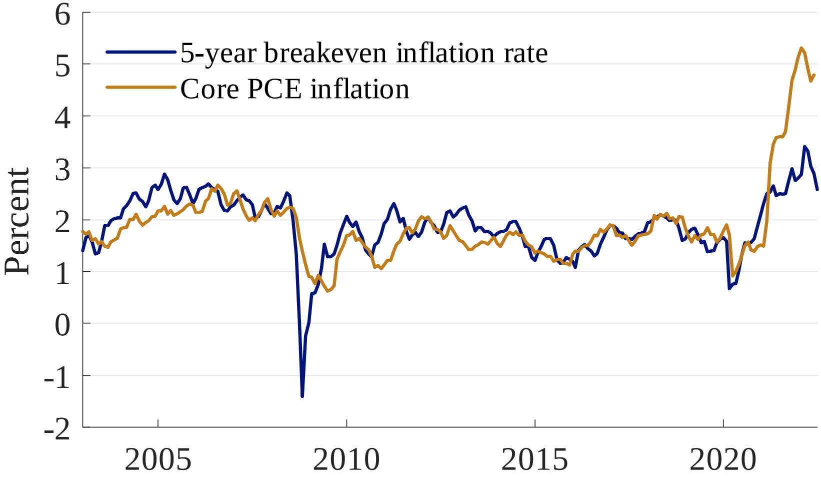
Disinflation and unemployment

- 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.
    - Nakamura (Keynote talk at Asia 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.
- While precise estimates 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 or the level of unemployment.

Actual and expected inflation

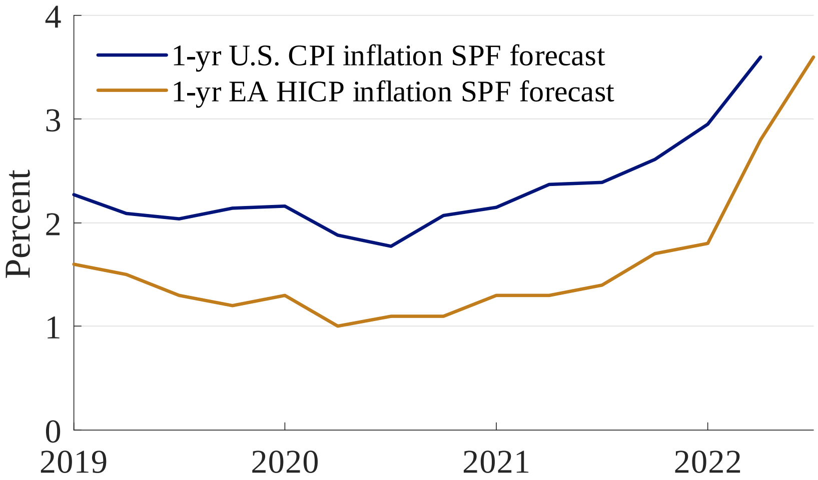


Sources: St. Louis Fed and BEA. Last observations: July 2022 and June 2022.

THE ROLE OF EXPECTATIONS

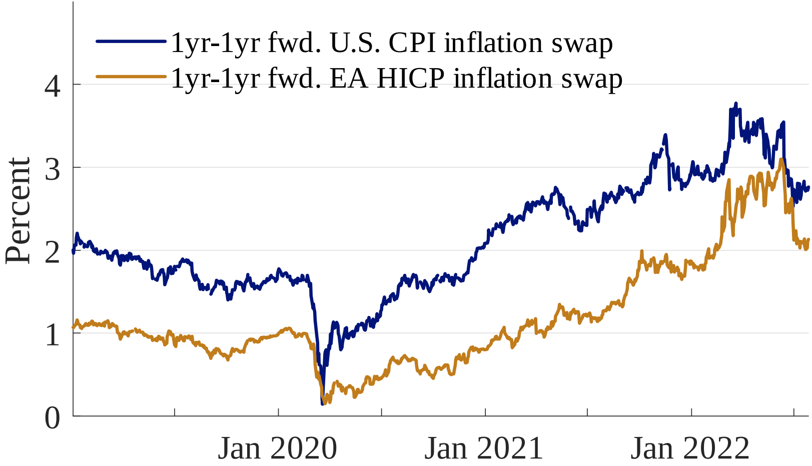
- The NKPC inflation expectations term is for near-term inflation expectations—strictly speaking, one period ahead.
- When expectations are discussed in policy circles, the emphasis is often on longer-term inflation expectations and the notion that longer-term expectations remain "well anchored."
- Nearer-term inflation expectations in the U.S. have been on the move.

Survey-based inflation expectations moved higher



Sources: Philadelphia Fed and ECB. Last observations: 2022:Q2 and 2022:Q3.

Market-based inflation expectations volatile



Source: Barclays. Last observation: July 27, 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 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.
- Sargent emphasized that the historical episodes included 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.
- The subtext is that one has to back off of the rational expectations assumption to discuss how a policymaker could be earning credibility.
  - Financial markets would have to be learning about the intentions of the policymaker, as opposed to knowing those intentions with certainty under rational expectations.

Learning and credibility

- A literature subsequent to Sargent (1981, 1982) investigated credible disinflations in models.
    - Credibility: Ireland (JMCB, 1997, "Stopping Inflations, Big and Small"), Goodfriend and King (2005), Sargent (2022), Bonomo and Carvalho (JMCB, 2010), Walsh (working paper presented at BOJ, May 2022, "Inflation Surges and Monetary Policy").
    - Learning: Barnett and Ellison (JMCB, 2013), Cogley, Matthes and Sbordone (JME, 2015), Nunes (MD, 2009), Schaling and Hoeberichts (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 (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.
- This point is stressed especially by 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 European Monetary Union, 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, Sargent emphasized the monetary-fiscal mix, not just the credibility of the central bank.

THE MONETARY-FISCAL MIX TODAY

- The COVID-19 pandemic induced large-scale deficit spending combined with accommodative monetary policy, including a policy rate near zero along with large-scale asset purchases.
- 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 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?

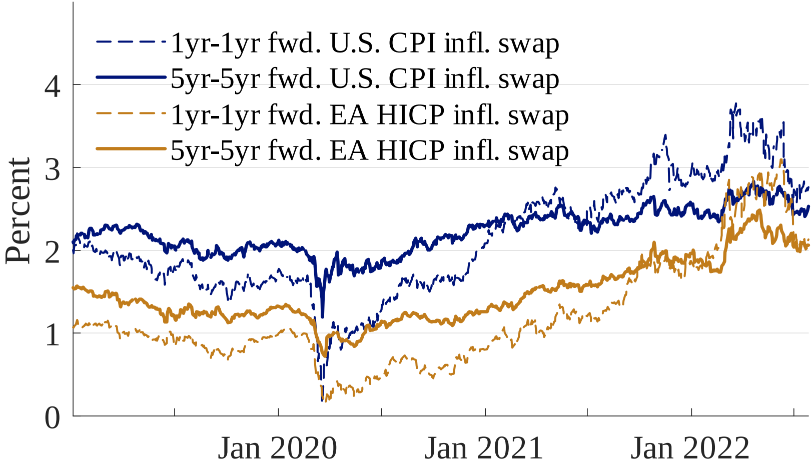
Disinflation today

- The regime shift back to the pre-pandemic 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.
- Is there a similar narrative for the EA?

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, medium- and longer-term inflation expectations currently tend to be lower than shorter-term inflation expectations, suggesting markets presently expect inflation to come under control in the quarters and years ahead.

Medium- and long-term inflation expectations lower than short-term expectations



Source: Barclays. Last observation: July 27, 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	High	Poincaré: costless disinflation; soft landing	Erosion of credibility
of Fed credibility	Low	Volcker: costly disinflation	1970s: High and variable inflation & volatile real economy

Conclusion

- Current inflation in the U.S. and the EA 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 ("soft landings") 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 compared with their 1970s counterparts, suggesting that a soft landing is feasible in the U.S. and the EA if the post-pandemic regime shift is executed well.

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