EconoFact Chats: Inflation, the Fed's Response, and the Challenges Ahead

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Michael Klein:

I am Michael Klein, executive editor of EconoFact, a nonpartisan web-based publication of the Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work www.econofact.org.

Michael Klein:

Inflation reached its highest level in four decades over the past two years, but it is coming down. December 2022 saw the sixth straight month in which inflation fell with the consumer price index measure of inflation at 6.5%, down from 7.1% in November, and well below its peak of 9.1% in June. Part of the reason for this is the aggressive response of the Federal Reserve, which raised interest rates at a pace not seen in more than four decades. Four decades ago, the economy was suffering from the very high inflation of the late 1970s.

While the good news is that inflation seems to be coming down, there are concerns that the Fed's actions will cause a recession this year, just as it did in the early 1980s in that dis-inflationary episode. To discuss this policy of disinflation, of bringing down inflation, I'm very pleased to welcome back Professor Dan Sichel of Wellesley College. Before joining Wellesley in 2012, Dan worked for more than 20 years at the Federal Reserve Board. Dan, thanks for joining me once again on the podcast.

Dan Sichel:

Hi Michael, glad to be here. Looking forward to our conversation.

Michael Klein:

Dan, can you give us a brief history of inflation, starting with the experiences in the 1970s, up to the time before the most recent bout of inflation, to give us some context on what's going on now?

Dan Sichel:

Yeah, so that's important to do and to know, to look back at the last time inflation was high. Going back many decades, 1950s, 1960s, inflation was pretty stable, pretty moderate. Then, in the late 1960s, combination of spending for the Vietnam War and social programs started to push inflation up. Then, in the 1970s, a combination of big increases in oil prices, some mismanagement by the Federal Reserve let inflation get really high with the CPI reaching nearly 15% at its peak. That ultimately led to a big response starting in the late 1970s. Paul Volcker was chair of the Federal Reserve. He raised interest rates quite dramatically to slow the economy. As Michael mentioned, there was a deep recession that ensued. Inflation came down in the early '80s, and then over the next couple of decades, the so-called great moderation, inflation gradually drifted lower, remained pretty stable until we got to this period of the pandemic.

Michael Klein:

Dan, you mentioned the great moderation when inflation was very low for a very long time. Was that a situation of good policy, or good luck or some combination of the two?

Dan Sichel:

Economists have spent quite a bit of time studying that period, trying to understand why economic performance was so stable during that time. Really, as you mentioned, could be good luck, could be good policy. Also, could be that the economy was just hit by smaller shocks and there was less bad stuff happening in the world that would've had adverse effects on the economy. Realistically, it's probably some combination of those, but I'd certainly give some of the credit to lessons the Federal Reserve learned about how to conduct monetary policy.

Michael Klein:

These lessons came out of both experience and the theoretical research of economists, right?

Dan Sichel:

Yeah, that's right. There was the experience of, as I mentioned, the late 1970s, early 1980s that highlighted just how damaging high inflation can be and how much American citizens didn't like the high inflation. There also was a lot of academic research at that time that, again, emphasized the benefits of lower and more stable inflation and the importance of good monetary policy in bringing about an outcome like that.

Michael Klein:

The lessons of good monetary policy, one basic lesson was that you don't want to try to start and stop the economy like it was a speedboat. Rather, it's kind of like an oil tanker and it's slow and steady, which means that you want to chart a course that is moderate and you don't want to try to change things in quick response necessarily to the business cycle.

Dan Sichel:

One of the lessons that emerged from the 1970s, late '70s and early '80s, is the importance of having a consistent and steady monetary policy response to inflation. They did raise interest rates quite significantly then and they needed to, but one problem with the response then was that it was very stop and start. Rates went up quite dramatically in the late '70s. They then came down, inflation started going up again, rates went up again. Inflation started to come down, rates went down, and then they went up again. There was this very painful start, stop episode with interest rates, which had pretty devastating effects on the economy.

Michael Klein:

Another lesson from theoretical research, in fact, a Nobel Prize was awarded for this, is that credibility matters. If the central bank is seen as being strongly anti-inflation, that actually makes it easier to bring inflation down.

Dan Sichel:

Yeah, that's right. An important part of economists' understanding of what causes, what generates inflation, is that people's expectations of what's going to happen in the future are an important element in what generates inflation. If people expect inflation to be high in the future, they're going to behave in ways that might very well make inflation high. There's a bit of a self-fulfilling prophecy. If a central bank is credible, and if a central bank says, "we're going to take steps to lower inflation," if the central bank's credible and inflation expectations begin to move down, that will make it easier for inflation to come down. If, on the other hand, financial market participants, regular people, think central bank doesn't know what they're doing, they're saying all this crazy stuff, they say they want to bring inflation down, but we

don't really believe they know how to do that or they're going to do that, then it becomes much more costly and much more difficult to bring inflation down.

Michael Klein:

With this framing, let's turn to the present situation. We had the great moderation, as you mentioned, when inflation was very low for a very long time. What changed to bring us to the present high inflation situation?

Dan Sichel:

Well, it ended up really being a perfect storm. The pandemic hit, there was a significant withdrawal of people from working. People were locked down. People were home, a lot of layoffs, a very large drop in the number of people working. That, of course, reduces the economy's productive capacity. We suddenly had all of these supply chain problems, partly related to withdrawal of people from working, also related to trade issues and getting goods across the ocean because of all the lockdowns from COVID. We had this big reduction in the economy's supply.

At the same time, there were very generous fiscal programs that were boosting demand and creating additional income that people were spending as they were locked down at home doing all the things that we all did when we were locked down at home. Then, the third key element is that about a year ago, the war in Ukraine, the Russian invasion of Ukraine and the war, which had very adverse effects on markets for energy and for food, pushing those prices up. Really, those three things together ended up creating a perfect storm, pushing inflation much higher.

Michael Klein:

Dan, after the financial crisis that began in 2008, the Fed ran very loose monetary policies. They kept interest rates low, and some people have been forecasting high inflation for more than 10 years because of these policies. Is today's inflation a case of the chickens coming home to roost, or is it more like a stopped watch is right two times a day?

Dan Sichel:

Going back to that pretty famous forecast that a number of economists made, that in the aftermath of financial crisis, there'd be a surge in inflation, really more like the stopped watch being right. Really, they were just using the wrong model for thinking about inflation, and so they were using kind of an outmoded monetarist model that the Fed has been easy, created a lot of money, and that's going to generate a lot of inflation. But, of course, the mechanism by which an increase in the money supply creates inflation is that that increase in the money supply generates greater demand, makes people want to buy more stuff. That is absolutely not what the circumstances were in 2008 and 2009. People were hunkered down, banks were hunkered down. Banks weren't lending, people weren't buying things, and so that increase in the money supply, of course, wasn't going to, and didn't generate a high inflation. Very different situation in the pandemic.

Michael Klein:

Recently the Fed has been very aggressive in flagging inflation, although initially this wasn't the case. I guess that reflected the view that inflation was thought to be temporarily high because of the supply disruptions coming from COVID. Was a pivot to a more aggressive monetary policy due to the fact that inflation didn't come down in response to these more dovish responses?

Dan Sichel:

Yeah, I think that's basically right. The Fed, I think, was late to the party on raising rates to slow the economy, to keep inflation in check. I think they were focusing on the supply chain disruptions and the labor market disruptions, and I think quite reasonably expected that those would unwind and that then inflation would come down. There was a big debate at the time with team transitory, team permanent, team transitory being those who thought the pickup and inflation would be transitory, team permanent being those who thought it would be more persistent. I think the thing that they missed, and many macroeconomists missed, and I put myself in the same category, is just how disruptive the reductions in supply, both through labor markets and the supply chain, things were, and just how much the fiscal policies are going to boost demand. Then, we ended up in this situation where demand had outrun supply and that was leading to this very persistent inflation. Then, of course, ultimately the Fed did do this pivot and this past year very quickly raise interest rates to slow the economy and bring that inflation back down.

Michael Klein:

Yeah, I admit that I too thought... I guess I was a member of team transitory as well, and we were buffeted about by events somewhat. But now there's a lot of debate on whether after being too slow out of the blocks the Fed is overreacting. What's the concern about the Fed's most recent policies?

Dan Sichel:

The concern is that a big increase in interest rates could slow the economy quite significantly, and that could lead to a recession. Indeed, if one looks at the history, in past decades when the Federal Reserve has raised interest rates, specifically with the intention of slowing the economy to bring inflation down, most of the times they've done that, it has led to a recession. Getting this exactly right, achieving the so-called 'soft landing,' as it's called, in which the economy slows just enough to bring inflation down, but not enough to cause a recession is really difficult. A little bit like, I think, landing an airplane at night on a rocking aircraft carrier when all the radar and all the lights have gone out. It's a really hard thing to do. Given that, there's certainly concern that the Fed's efforts to reduce inflation could lead to a recession.

Michael Klein:

Well, let's hope that Captain Powell does a good job of this.

Dan Sichel:

Absolutely.

Michael Klein:

Thinking back about Captain Volcker, Paul Volcker who led the disinflation in the early 1980s, what are the similarities, and maybe some differences, between the high inflation in the late 1970s and the current situation? What does that say about the policies to reduce inflation now as compared to the so-called Volcker disinflation that began in October 1979?

Dan Sichel:

Yeah, people often look back to that episode because that was the last time inflation was really high in the US. The obvious similarity is high inflation, Federal Reserve aggressively raising interest rates to slow the economy and bring that inflation down. There are some important differences, and these differences are part of why there's such a debate amongst economists about whether the situation will be a replay of that leading to a recession or whether that elusive soft landing might materialize.

A number of important differences, one is inflation was starting from a much higher level than it is now. As shocking as people found the high inflation over the last year, it was much higher, nearly 15% at one point back in that earlier period. Also, the inflation had been high for a while, and so that very important point about inflation expectations likely played a bigger role. With inflation having been high for a while, that probably meant that it was more difficult to bring inflation expectations down and so therefore more difficult to bring inflation down. The other thing I'd point to, the last thing, would be I think now the Federal Reserve has more credibility than it did then. There's more transparency, more of an understanding of what the Federal Reserve does, and I think the hope would be that Captain Powell will wisely use that credibility and maybe will achieve that soft landing.

Michael Klein:

Even with this better understanding of dis-inflationary policies and the different situation that we're starting out with, as you just described, there is a concern that bringing down inflation will cause pain, something that Chairman Powell himself has acknowledged. Economists talk about the 'sacrifice ratio.' It's a rather grim name. Can you explain what that is?

Dan Sichel:

Yeah. The sacrifice ratio is a term that economists use to describe how much either lost output is necessary or how much of a rise in the unemployment rate is necessary to bring inflation down by one percentage point. For example, if the sacrifice ratio in a particular time and country and place were one, then, say the unemployment rate would have to go up by one percentage point to bring inflation down by one percentage point. If the sacrifice ratio were two, that would be more painful. That would mean we'd have to sacrifice two percentage points of an increase in the unemployment rate to bring inflation down by one percentage point.

Michael Klein:

You said in a particular time and place and country. Are estimates of the sacrifice ratio constant, or do they vary over time or across countries? And if that's the case, what are some of the factors that make the sacrifice ratio vary across time or across countries?

Dan Sichel:

It's definitely not constant. If one looks within an individual country, you'd see variation over time. If you look across countries, you'd see variation across countries. Also, different economists have used different approaches to estimating just what the sacrifice ratio is. Depending on what statistical techniques you use to estimate the sacrifice ratio, you can get different numbers as well. It makes this analysis complicated. A number of factors I think could explain some of these differences. The degree of credibility the central bank has would be one. The degree of flexibility in wages and prices, and how do product markets, how do labor market works, what are the underlying institutions, could be another. The past pattern of inflation could be another. With a period of extended low inflation, that could generate forces leading to a different sacrifice ratio than you might expect in a country or a time when inflation had been running high for quite some time.

Michael Klein:

When you were at the Fed, you actually estimated sacrifice ratios, right?

Dan Sichel:

I did. Definitely something that the Federal Reserve then would've been interested in and now. Yes, I did do some of that when I was at the Federal Reserve.

Michael Klein:

When you reported this, did you sort of dress like an undertaker, all in black and very solemn and everything?

Dan Sichel:

Well, people at the Fed do that every day, so it wouldn't have been any different on that day than any other day.

Michael Klein:

I guess people at the Fed aren't known for their sartorial excesses, are they? There's a reason for that as well.

Dan Sichel:

Yeah, there you go.

Michael Klein:

There's a political aspect to disinflation as well, of course. There are predictions, for example, that voters in the recent midterm election would be responding to high inflation and this would cause a red wave, although that doesn't seem to have been the case. Then, there are concerns that if there's a disinflation now and it leads to a weakness in the economy, that weakness could have political ramifications as well. When you worked at the Fed, was pressure brought to bear on you by elected officials? If so, how did the Fed respond to this?

Dan Sichel:

In recent decades, for the most part, presidential administrations have been very careful to respect the Federal Reserve's independence. In my time in Washington, I worked both in the Federal Reserve, and for a period in the Clinton administration, so saw that from both sides. The traditional approach has been for administrations to be very hands-off and understand that we have an independent central bank in the United States, and they will do their analysis. That was different during the Trump administration, when President Trump frequently criticized the Fed and offered advice on where interest rates should be set.

Inside the Fed. I think decisions are made really, I would say, without regard to the political implications, to the extent that people can do that. That being said, everyone at the Fed is certainly aware of the political implications of decisions that they make, but I think they work really hard to make the decisions based on the facts, the evidence, the models, the data, and not on who's in the White House, and what political party, and all the rest.

Michael Klein:

Now, there is this famous example purportedly of Nixon leaning on Arthur Burns, who was then the chairman of the Fed, in advance of the 1972 election, right?

Dan Sichel:

Yes, absolutely, and until Trump, that really would've been the last time that's widely understood where a presidential administration put pressure on the Federal Reserve. I think looking back at that, from the vantage point of decades later, that's seen as a very bad development, very bad set of things that happened. I think partly because of that and the high inflation that ensued, many economists, many policymakers, many politicians came to the view that the economy will perform better if central banks are

relatively independent. There was an increasing understanding that the political branches of the government should lay off the independent central bank.

Michael Klein:

In fact, that independence is part of the structure. For example, the Fed Chairman is not reappointed in an election year, but in two years after to remove, to the extent possible, political considerations.

Dan Sichel:

That's right, and some other ways that in the US institutional arrangements enshrine that independence are that governors are appointed for lengthy terms. 14 year terms, if they serve a full term, and can't be removed like a cabinet secretary can, the term of [inaudible] being 'at the pleasure of the president.' It really only can be removed for cause, meaning they do some terrible thing, so they serve long terms. It's not quite like a lifetime appointment on the Supreme Court, but they are long terms, which are meant to insulate them from the ups and downs of political pressures. The Fed's budget, also in contrast to other parts of the government, is not a result of a congressional appropriations. The Fed generates a lot of income in the course of its operations, and they set their own budget by holding back a small slice of that income, and then turning the rest over to the treasury. They are not every year going to Congress asking for money, and that also creates a significant amount of independence.

Michael Klein:

With that income, I remember the Fed had the best cafeteria of all the different government agencies in Washington, perhaps behind the IMF or the World Bank, but well above what I saw when I was at Treasury.

Dan Sichel:

When I was there, it did have a very nice cafeteria, although during the time I was there, the subsidy that was provided to the cafeteria went away.

Michael Klein:

Well, things are tough all around, Dan.

Dan Sichel:

Just saying, a little inflation prices and the cafeteria went up.

Michael Klein:

Dan, as a longtime Fed economist, how would you grade its recent performance? How do you see it acting moving forward, given the easing of inflation over the past half year? Of course, this is very hard to do in this kind of an environment, but what are your impressions?

Dan Sichel:

Number one, as I mentioned before, I think the Fed was late to the party in raising rates and in understanding just how persistent this higher inflation was going to be. Again, they weren't out there on their own. That's where a large fraction of macroeconomists were at the time. Again, I'd put myself in that group as well. I think once they realized that, over the past year, they've done a tremendously good job at aggressively raising rates, communicating to the public why they're doing that, what their goals are, what the intention is. Quite appropriate that they did this major recalibration of rates, pushing interest rates up,

again, with the intent of slowing the economy, bringing demand down into balance, more into balance with supply. Maybe not such a good grade for the initial bit, very good grade for the last year or so.

Going forward, the interesting question is, is the Fed going to do what they say they're going to do, and what policymakers indicate, which is probably raise rates a couple, maybe three more times, and keep rates at that high level through the rest of the year? Or, as financial markets seem to expect, begin lowering rates, the so-called great pivot, somewhere in the middle of the year. Of course, in the end, it all depends on the data. It's data dependent, depending on what happens with the inflation numbers and what happens with the economy will determine what the Fed's policy is. It's really the data that matters and is going to drive this. That being said, given my best guess of how those data are going to unfold, I think financial markets are going to be surprised by the Fed's persistence in keeping rates elevated, because I think the Fed is pretty determined to bring inflation down. They're going to keep rates elevated until they see very clear evidence that inflation is close back down to its 2% target, or on a path that is going to get there reasonably soon.

Michael Klein:

Well, given your metaphor of landing a plane on an aircraft carrier in stormy seas, it's going to be a challenge, but I hope that they bring this about for the sake of the country. Dan, thanks very much for joining me today and for providing your insights based on both your experience at the Fed and your own research. I really appreciate it.

Dan Sichel:

Yeah. Thanks, Michael. Very happy to do it, and I share your hope that the soft landing does come to pass.

Michael Klein:

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