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The Use and Abuse of Inflation History

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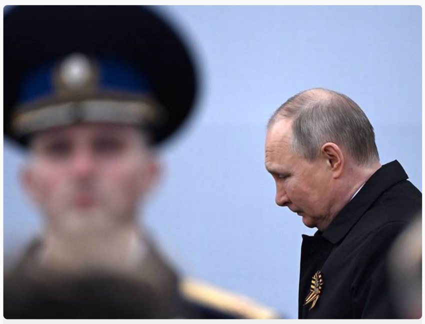
For months, many macroeconomic observers have been likening Federal Reserve Chair Jerome Powell's unenviable position to that of Fed Chair Paul Volcker in the early 1980s. But the differences between the two eras are greater than the similarities – and all of them make Powell's job relatively easier.

PRINCETON – George Santayana famously observed that, "Those who cannot remember the past are condemned to repeat it." But allow me to offer a corollary: Those who *mis*remember the past may be led into error by misreading history.



Case in point: Many observers of the US Federal Reserve's current policy predicament – which is similar to the predicament facing other central banks around the world – have drawn parallels to the problems that Chair Paul Volcker and the Fed faced in the early 1980s. The implication (if you buy the parallel) is that bringing inflation to heel will require much higher interest rates, a lot of pain, and probably a deep recession.

To be sure, parallels do exist. US inflation over the last 18 months or so has been the highest since the Volcker era. The public has been greatly distressed by rising prices, as it was back then, making inflation the number one economic problem. And, as in the 1970s and early 1980s, the economy has been buffeted by a series of adverse supply shocks to food and energy prices. But comparing current Fed Chair Jerome Powell's task to Volcker's reveals that the differences are greater than the similarities – and all of them make Powell's job relatively easier.

Let's start with an obvious but much-ignored fact. Today's inflation problem in the US is relatively recent, dating only from the spring of 2021. In February 2021, the 12-month CPI inflation rate was still a mere 1.7%, but by that May it had reached 5%. In contrast, when Volcker took the reins at the Fed in August 1979, the US had already experienced nearly 15 years of high inflation. As he settled into his new office, the headline inflation rate was a stunning 11.8%, having been above 5% since April 1973 and over 8% since September 1978. High inflation had become deeply ingrained in Americans' business plans and popular psychology. Surveys showed that people expected 8-10% inflation to persist for years.

That brings us to the second big difference. Inflation expectations today are remarkably well contained. In fact, they are nearly consistent with the Fed's 2% inflation target for the Personal Consumption Expenditures Price Index (PCE). Of course, expected inflation is higher than 2% in the near term, because people can see that inflation is running higher right now. But over a five- or ten-year horizon, the numbers cluster in the 2-3% range.

This matters a lot, because inflation expectations tend to become embedded in wage settlements, interest rates, and household and business plans. Once they rise to high levels, as they had for Volcker in 1979, it can be hard to bring them down. At least for now, Powell doesn't face that problem.

Third, consider the different macroeconomic conditions under which Powell and Volcker embarked on their disinflation campaigns. In August 1979, at the start of Volcker's tenure, the US unemployment rate was 6%. That wasn't so bad, perhaps; but by May 1980, after the short but sharp recession of 1980, it was up to 7.5%.

The Fed under Powell came late to the fight against inflation, for which it has been justifiably criticized. But when it finally started raising interest rates, in March 2022, the unemployment rate was at a historic low of 3.6%, and recent rates of payroll job creation were above 500,000 per month. To put that last number in perspective, the number of new jobs needed to hold the unemployment rate steady is probably around 75,000-100,000 per month. That means the US had a tight and booming labor market in March 2022 – and still does.

It also means that tightening monetary policy today can drive monthly job creation rates all the way down to the 0-100,000 range, and the unemployment rate up to 4.5% or so, without causing terrible hardship. If the Fed can achieve that outcome (which will, admittedly, require both skill and luck), observers will declare that Powell and his colleagues have achieved an economic soft landing. Volcker was afforded no such luxury.

Finally, we must mention the most glaring difference of all. The Volcker disinflation effort chopped nine or ten points off the peak CPI inflation rate (depending on whether you measure it by core or headline inflation), whereas Powell's Fed is focused on core PCE inflation, which peaked at 5.4% last February-March. Today's Fed wants to drive that number down to 2% – a drop of "only" 3.4 percentage points. That's no trivial task, but it's a much lighter lift than the Volcker Fed had. Furthermore, today's Fed is already getting some help from the supply side, as disruptions to supply chains ease.

For all these and other reasons, Volcker and his colleagues never gave a moment's thought to engineering a soft landing. It simply was not in the realm of the possible. Powell and his colleagues are dreaming about a soft landing every night.

This commentary is drawn from the author's new book, A Monetary and Fiscal History of the United States, 1961-2021*(Princeton University Press, 2022).*

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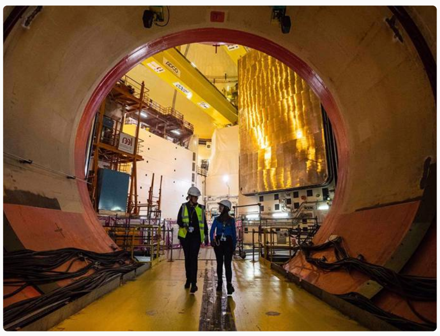

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