

## This Time Is Different...Because We Are

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*Remarks as prepared for delivery.*

It's hard to believe it's been almost two years since COVID-19 hit our shores. And while it's not fully behind us, we've come a long way, especially in the economy. Growth is up. Unemployment is down. And people are getting back to their lives.


But as anyone who has shopped, bought gas, or paid rent lately knows, inflation is high—higher than it has been in nearly four decades.

For some, this is a sign that price stability is at risk. That, absent aggressive action by the Fed, the economy will be propelled into a 1970s-style “Great Inflation.”

Like many of you, I lived through that time. I remember my parents' daily complaints about rising prices and rising bills, and the hours-long waits at gas stations in the hot Missouri sun, stuck to the vinyl seats of our station wagon.

High and rising inflation made life harder. And there was no end in sight.

But the picture today looks different. And so does the Federal Reserve. We have evolved as an institution, and our understanding and tools have evolved as well. I'll spend my time today talking about how this evolution makes us better prepared to meet our dual mandate goals of price stability and full employment, even in these challenging times.



First, I want to remind you that the views I will express today are my own and do not necessarily reflect those of anyone else within the Federal Reserve System.

### Then...

Before I talk about what's different this time, let me talk about what exactly happened during the "Great Inflation." What was it like?

From about the mid-1960s through the early 1980s, American households faced an unrelenting rise in prices. The worst of it came during the 1970s, when the cost of living for the average family more than doubled.<sup>1</sup> The stress in our nation was palpable. Businesses and families lost confidence, and many struggled simply to make ends meet.<sup>2</sup>

People wondered how it had happened.

The answer, of course, is complicated. But I will focus on a few factors that I think are particularly relevant for today's discussion.<sup>3</sup>

The first has to do with fundamental economic changes and our inability back then to measure and understand them in real time.

For example, after decades of rapid postwar GDP growth, led by booming technological advancements and rising labor productivity, U.S. productivity growth had started to slow. This meant that the capacity of the economy to expand without spurring inflation was much more limited than it had been in previous decades.<sup>4</sup>

At the same time, the labor market was changing. Young baby boomers were joining the labor force in large numbers and altering the age composition and the dynamics of the workforce. In particular, they were taking longer to find jobs and churning through more opportunities as they found their preferred path. This behavior, which is completely natural, increased the "steady-


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<sup>1</sup> This pace was three times faster than it had been the previous decade. See consumer price index (CPI). <https://beta.bls.gov/dataViewer/view/timeseries/CUSR0000SA0>

<sup>2</sup> The University of Michigan consumer sentiment index reached its all-time low of 51.7 in May 1980 when CPI inflation over the preceding 12 months had exceeded 14 percent. The most recent preliminary estimate of the sentiment index in February 2022 was 61.7. [www.sca.isr.umich.edu/tables.html](http://www.sca.isr.umich.edu/tables.html)

<sup>3</sup> For an overview of research that seeks to explain the Great Inflation, see Lansing (2000) and Bryan (2013).

<sup>4</sup> Basu and Fernald (2002).



state” rate of unemployment, a benchmark policymakers used to judge how close the economy was to full employment and full capacity.<sup>5</sup>

Looking back, it’s clear that policymakers missed some critical shifts. Without the data, tools, and focus on real-time monitoring, they—and macro forecasters more broadly—expected the economy to behave as it had before, for inflation to fall as the economy and labor force grew.<sup>6</sup> These views, in part, kept the Fed from acting forcefully to offset rising inflation.<sup>7</sup>

But the story doesn’t end there. The Fed’s policy misses were amplified and perpetuated by institutional factors and by its own communication strategy.

Let’s start with institutional factors. At the time, there was a very tight link between price and wage inflation. Many employment contracts included automatic cost-of-living adjustments, or COLAs, which meant that when prices went up, wages soon followed.<sup>8</sup> Firms then passed on these increased labor costs to prices, and so it went, again and again, in a self-perpetuating upward inflation spiral.

When two oil price shocks created even higher inflation, prices and wages grew in near lockstep. And here is where the Fed’s own communication practices exacerbated things.

The Fed and many central banks at the time held the view that transparency and communication were more costly than beneficial. Central bankers actively avoided sharing information, believing that such communications might constrain their ability to nimbly adjust policy, or even dilute its impact.<sup>9,10</sup>

Because of this, the Fed operated largely behind closed doors. The public became aware of Fed policy actions by watching how markets reacted following Federal Open Market Committee (FOMC) meetings. And the main source of information that market participants, households, and businesses had about the Fed’s commitment to price stability was what they could glean from incoming inflation data.

### Figure 1

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<sup>5</sup> Crump et al. (2019).

<sup>6</sup> DeLong (1997) and Taylor (1997).

<sup>7</sup> Clarida, Galí, and Gertler (2000), Orphanides (2003), Primiceri (2006), and Romer and Romer (2013). Political pressures also played a role in the Fed’s decision to keep policy accommodative. See Weise (2012).

<sup>8</sup> Ragan and Bratsberg (2000).

<sup>9</sup> Cukierman and Meltzer (1986) and Bernanke (2007a). Bernanke noted, “Since 1975, the Federal Reserve has presented testimony twice each year to the Congress on the conduct of monetary policy.” So there was at least some communication to the public about policy back then. Before the 1990s, however, inflation targets, FOMC statements, and other communications were not publicly shared as they are now.

<sup>10</sup> In the June 2003 FOMC meeting, then-Chair Alan Greenspan advised participants to be “very vague” in response to questions about the conduct of monetary policy. See Federal Open Market Committee (2003).



## Inflation: actual vs. expectations



The result was predictable.

And you can see it in this figure. The green and blue lines show two measures of actual inflation and the red line shows inflation expectations.

Clearly, the more inflation rose, the more consumers and businesses expected it to rise. As inflation moved up, so did inflation expectations.<sup>11</sup> These expectations of future inflation were then built into wage and price contracts.


Before long, inflation dynamics and future inflation were deeply intertwined with inflation psychology. And with the Fed offering little guidance or reassurance that it would do something about it, the situation snowballed.

It wasn't until the Fed implemented a series of steep interest rate hikes that inflation finally started to recede.

### ...Now

Now inflation is high again and many are concerned that we could soon be facing another long and painful period, followed by another long and painful correction.

<sup>11</sup> Cogley and Sbordone (2008) and Lansing (2009).



But that’s not what I see. Let me explain.

You’ve heard many, including me, talk about how inflation itself is different this time. It’s been pushed up by pandemic-related imbalances between policy-supported demand, which has remained robust, and COVID-disrupted supply, which has been slow to recover. Both of these factors should recede as the pandemic weakens its grip.

And the economy is also different. There are weaker links between wage and price inflation, greater global price competition, and a number of longer-term structural factors, including an aging population, that will continue to exert downward pressure on growth and inflation once the pandemic is behind us.<sup>12</sup>

But these are not the differences that matter most. The main reason I’m confident we are not heading for another 1970s-style Great Inflation is that the Federal Reserve is different. And I’m not referring to the people of the Fed, who clearly have changed, but to the practices and beliefs, which have changed even more.

One major evolution that separates today’s Federal Reserve from the Fed of 50 years ago is a deep understanding that inflation expectations influence future inflation.<sup>13</sup> If people expect inflation to persist, then it does.<sup>14</sup>

This understanding led the Fed, and economists more broadly, to a critical insight: in order to manage actual inflation, policymakers also have to manage inflation psychology.<sup>15</sup> The Fed has to enlist the help of households, businesses, and market participants in the job of fighting inflation, by communicating with them about its commitment to price stability and its plan to achieve it.

Acting on this insight required a radical transformation. The Fed had to break open its “black box” of decision-making and embrace transparency.

Figure 2

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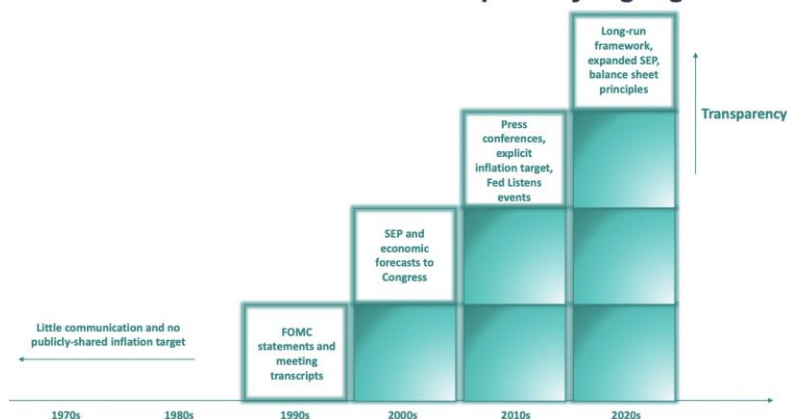
<sup>12</sup> Eichengreen (2015), Gordon (2015), and Laubach and Williams (2016).

<sup>13</sup> Orphanides and Williams (2005) and Bernanke (2007b).

<sup>14</sup> Gürkaynak, Levin, and Swanson (2010).

<sup>15</sup> In October 1979, at the height of the Great Inflation, Fed Chair Paul Volcker (1979) famously observed, “Inflation feeds in part on itself, so part of the job of returning to a more stable and more productive economy must be to break the grip of inflationary expectations.”

## Timeline: Federal Reserve's transparency highlights



Source: Board of Governors of the Federal Reserve System

To understand the magnitude of this transformation, you have to recall that, for most of its history, the Fed was uncommunicative.

The first step in its communications “revolution” came in 1994, when the Fed began releasing post-FOMC meeting statements (see Figure 2).<sup>16</sup> In the mid-2000s, the Fed went further, publishing the Summary of Economic Projections to provide the public with information about the expected path of the economy and interest rates. In 2012, the Fed announced its first explicit inflation target, 2 percent.<sup>17</sup> And in 2020, we introduced a new monetary policy framework, which outlined principles for managing our inflation and employment mandates in a variety of economic conditions.<sup>18</sup>

As the figure illustrates, the Fed went from being mostly silent to explicitly and intentionally transparent.

The effects of these efforts can be seen in the data.


With greater transparency came more stable inflation expectations, which, since the late 1990s, have remained well anchored around 2 percent through spikes or drops in the inflation rate.<sup>19</sup>

<sup>16</sup> Revolution was the term then-Vice Chair Janet Yellen used to describe the evolution of communication at the Federal Reserve. See Yellen (2012).

<sup>17</sup> See <https://www.federalreserve.gov/newsevents/pressreleases/monetary20120125c.htm>

<sup>18</sup> See <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200827a.htm>

<sup>19</sup> Williams (2006), Bernanke (2007b), and Jørgensen and Lansing (2022).



Even today, with inflation at a 40-year high, long-run inflation expectations of businesses have remained quite stable.<sup>20</sup> And financial market expectations have also been well anchored, as evidenced by long-term interest rates staying low despite the current inflation shock.

This tells us that businesses and markets are listening. They're hearing the Fed's communications and believe that we will act on our commitments.

In practice, greater transparency, better communication, and the era of well-anchored inflation expectations built Fed credibility. And this credibility provides an important insurance. It makes the economy more resilient and less vulnerable to painful periods like the one we experienced in the 1970s.<sup>21</sup> And it gives all economic agents, not just the Fed, a role to play in helping the economy smooth through inflation and other shocks, making it more resilient to whatever changes are on the horizon.

Most importantly, greater transparency and a strong commitment to achieving our goals assures Americans that periods of high inflation or unemployment will not last forever; that there is an end in sight.

### Focused and Aware

But transparency is not a destination, it's a practice. And it requires ongoing communication if we are to keep the credibility that we so value.

In that spirit, let me tell you about how I see the economy today and the policy adjustments that will be needed to move us to a sustainable path.

Let's start with the economy. By almost any measure, it is doing well. GDP growth, consumer spending, and business investment are all up, and the labor market continues to post solid job gains, low unemployment, and strong wage growth. Importantly, labor market gains have been broad based, occurring for a wide range of groups, including those who are traditionally disadvantaged—African Americans, Hispanics, and people with less than a college education.


Of course, as everyone knows, inflation is too high, and inflation pressures have begun to spread outside of sectors most directly affected by pandemic-related disruptions.<sup>22</sup> Most

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<sup>20</sup> See Survey of Professional Forecasters. <https://www.philadelphiafed.org/surveys-and-data/real-time-data-research/survey-of-professional-forecasters>

<sup>21</sup> Indeed, former Fed Chair Ben Bernanke (2003) observed that during the Great Inflation, “the Fed’s loss of credibility significantly increased the cost of achieving disinflation.”

<sup>22</sup> Lansing, Oliveira, and Shapiro (2022).



strikingly, average Americans, like my parents five decades ago, are worrying about rising prices and rising bills.

This means it is time to move away from the extraordinary support that the Fed has been providing during the pandemic and bring monetary policy in line with the challenges of today. Absent any significant negative surprises, I see our next meeting, in March, as the appropriate time to begin this adjustment.

The timing and magnitude of future funds rate and balance sheet adjustments will depend on how the economy and the data evolve. And this will depend on how well we transition from pandemic to endemic; how much and how quickly supply chains recover; how rapidly workers sidelined by health, family care, or other COVID-related barriers return to the labor force; and how quickly the fiscal boost that aided spending in 2020 and 2021 fades. We will closely watch all of these developments and let the data determine the appropriate path of policy.

As we adjust policy and move into a post-pandemic world, we will also have to keep in mind that many of the challenges that existed pre-pandemic will likely still be with us. Notable for policy are slower global growth, less monetary and fiscal policy space, and the associated downward pressure on inflation.<sup>23</sup>

Against this backdrop, the next few years will require focused awareness; focus on bringing inflation back down to levels consistent with price stability and delivering a labor market that works for everyone; and awareness, of the uncertainty that lies ahead and the challenges that are surely before us.

### **Different Never Rests**

That for me is the main lesson of the Great Inflation. It's not really about the Fed. It's not even really about economics.

It's about humility.

It's about knowing that ours is an economy in transition. And that none of us knows for sure what the new future holds.

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<sup>23</sup> Fernald and Li (2019) and Elsby, Hobijn, and Sahin (2013). These and other developments help explain the steady decline in the neutral policy rate, which over the past 30 years has been more prone to reaching the zero lower bound. See Mertens and Williams (2021).





We need to move forward with confidence—in our policy, in our tools, and in the credibility the Fed has built. But we also have to remember that evolution isn't static. And to meet the needs of a constantly changing economy, we have to be constantly changing.

Today's Federal Reserve looks different than it did 50 years ago. And I expect that it will look different again in 50 more.


And that will be a good thing. It will mean the evolution continued. And that next time will also be different.

Thank you.



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