BY KARTIK ATHREYA

Following Through

While 2022 isn't over yet, it seems a safe bet that inflation will be one of this year's defining stories. Inflation measures have hit levels not seen in four decades. Nostalgia for the 1980s may be riding high, as evidenced by the success of *Top Gun: Maverick* at the box office, but the inflation of the early part of that era is not something we are eager to reexperience.

As I discussed in my last column, the Fed is taking steps to bring inflation back down to its 2 percent long-run target. This includes decisively raising its policy rates and letting the balance sheet shrink as well. (See "The Fed Is Shrinking Its Balance Sheet. What Does That Mean?" p. 4.) The Federal Open Market Committee has repeatedly stressed its commitment to stable prices and made clear that it has both the tools and the will to meet that commitment.

So far, market participants have confidence that the Fed will get inflation under control. One indicator of this is the five-year TIPS/Treasury Breakeven Rate, which provides a market-based measure of what investors believe inflation will be in the next five years. It has been trending down toward the Fed's 2 percent target since the Fed began tightening in the spring.

Still, actual inflation remains well above where the Fed would like it to be, so it is not surprising that some have questioned whether the central bank will make good on its pledge. After all, the Fed was always committed to keeping inflation low and stable, yet high inflation has now occurred. One could justifiably ask what we've learned and why the Fed should be trusted to get things right now.

I don't think anyone would dispute that monetary policymakers have had to navigate a challenging environment since the pandemic began. Economic data is noisy, lagged, and often contradictory even in the best of times. These issues become even more relevant in an environment of huge, unanticipated shocks, such as (what we hope is) a once-in-a-century pandemic and a war in Europe. But even bad luck can erode a central bank's credibility. With each unanswered shock, it becomes harder to convince the public that we are serious about price stability.

The issue can be viewed as one of making clear "who we are not." Namely, that the public should not perceive us as prone to reneging on promises, lest we no longer be believed. In the wake of inflation, the trick is to ensure such beliefs are not unduly entertained. Yet how to do this is not obvious. Simply taking tough actions right now, while heuristically appealing, does not transmit an unambiguous signal. While inflation is high, unemployment is extremely low — it's an easy call to tighten right now. So, time will tell if we are believed.

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Still, the challenge the Fed faces now is not quite the same one it faced the last time inflation was this high. In the 1980s, the central bank not only had to deal with high inflation, it also had to reestablish the credibility it had lost in the previous decade. Like today, the 1970s were marked by several unanticipated inflationary shocks, including the energy crises in 1973 and 1979. But the Fed compounded the inflationary pressures from these events by failing to follow through with the right policy. It tightened policy to address inflation — only to reverse course as the economy weakened, resulting in a stop-and-go monetary policy regime that, via the outcomes it produced, diminished the public's trust in the Fed's commitment to price stability. The lesson from that era is that it is not enough to communicate the right policy. Central banks are expected to follow through, something that may be tested when things get tough.

Happily, in 2022, the Fed isn't starting from scratch when it comes to its credibility. As I noted, there is substantial evidence that markets and households both believe that the Fed will bring inflation back down. Additionally, the Fed now has an explicit 2 percent inflation target to help anchor those expectations, something it lacked in the 1970s. Lastly, the Fed is much more open and transparent about policy than it was four decades ago. Fed officials have clearly communicated their plan to tackle inflation and regularly update the public on their view of the economy as new data come in.

These are all reasons for some optimism, but they don't diminish the importance of following through. Fed Chair Jerome Powell has stressed that monetary policy is a blunt instrument and using it to bring down inflation could entail some short-term pain. This risk, though, must be compared with outcomes that would confront the Fed and the economy were clear action not forthcoming. Following through on its commitment to restoring price stability, even in the face of some pain, will help ensure the Fed doesn't end up in a position where it must rebuild its credibility entirely. History suggests that is a much more painful process. **EF**

Kartik Athreya is executive vice president and director of research at the Federal Reserve Bank of Richmond.