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THE DOG THAT DIDN'T BARK: HAS INFLATION BEEN MUZZLED OR WAS IT JUST SLEEPING?

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Key Points

- During the Great Recession, inflation barely moved despite the large shocks—the inflation dog didn't bark because:
  - Inflation expectations remain anchored to central bank targets.
  - Resistance to nominal wage cuts and other rigidities mean that increases in cyclical unemployment have put limited downward pressure on inflation.
- With long-term inflation expectations firmly anchored, inflation is also likely to remain stable as the recovery strengthens—the dog has been muzzled and is unlikely to bark. Therefore, fears about high inflation should not prevent monetary authorities from pursuing highly accommodative monetary policy.
  - Any temporary overstimulation of the economy—perhaps stemming from misperception about the size of output gaps—is likely to have only small effects on inflation.
  - Preserving central bank independence is key to anchoring inflation expectations and, thus, inflation: Don't take off the muzzle.

Inflation has been remarkably quiet of late. While previous recessions were usually associated with marked declines in inflation, the Great Recession barely made a dent (Figure 3.1). Some have inferred that the failure of inflation to fall is evidence that output gaps are small and that the large increases in unemployment are mostly structural. Thus, they fear, the monetary stimulus already in train may reduce unemployment, but only at the cost of overheating and a strong increase in inflation. Others have argued that the stability of inflation reflects the success of inflation-targeting central banks in anchoring inflation expectations and, thus, inflation.

This chapter finds that inflation expectations have remained strongly anchored to inflation targets during the Great Recession and the sluggish recovery. Long-term inflation expectations in advanced economies remain close to targets despite wide variation in actual inflation rates. Even in Japan, expectations remain close to the 1 percent target announced in February 2012 despite a prolonged period of deflation. Furthermore, coincident with greater central bank credibility, this anchoring is found to have increased over time.

As the average level of inflation has declined, the responsiveness of inflation to changes in cyclical unemployment has become more muted. Figure 3.5 shows the cross-country means of inflation and cyclical unemployment at quarterly frequencies since 1975, with fitted regression lines during several periods. Broadly speaking, inflation was high in the late 1970s and early 1980s, when the relationship between inflation and unemployment appears relatively steep; it was more muted between 1985 and 1994, when many economies experienced disinflation as central banks started establishing the current targeting regimes; and it was particularly flat after 1995, a period of stable inflation around 2 percent. This finding is confirmed by the more involved econometric modeling reported in the paper.

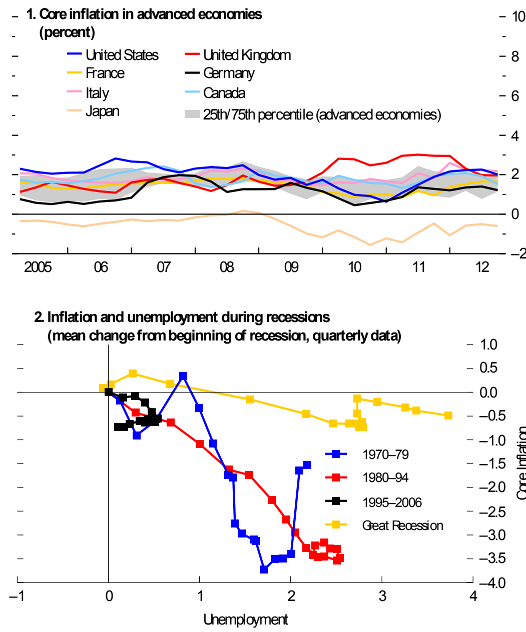
With long-term inflation expectations firmly anchored, fears about high inflation should not prevent monetary authorities from pursuing highly accommodative monetary policy. Indeed the combination of a relatively flat Phillips curve and strongly anchored inflation expectations implies that any temporary overstimulation of the economy—perhaps stemming from misperception about the size of output gaps—is likely to have only small effects on inflation.

Preserving central bank independence is key to anchoring inflation expectations and, thus, inflation. The U.S. and German experiences in the 1970s serve as an important reminder about the inflation risks arising from political pressure and limited central bank independence. Although a flatter Phillips curve can mitigate the inflationary effects of expansion, history clearly demonstrates the risks when political considerations start influencing monetary policy decisions.

Moderate inflation could induce complacency—and complacency would be a mistake. Low consumer price inflation does not necessarily equate with a lack of economic imbalances, and on-target inflation does not necessarily indicate that there is no economic slack. In the 2000s, low inflation coexisted with rampant asset price inflation in a number of countries; today, close-to -target inflation is coexisting with high unemployment.

Figure 3.1. The Behavior of Inflation Has Changed

Despite large rises in unemployment during the Great Recession, inflation has been remarkably stable in almost all advanced economies. This is different from the recessions in the 1970s and 1980s, when inflation fell much more when unemployment rose.

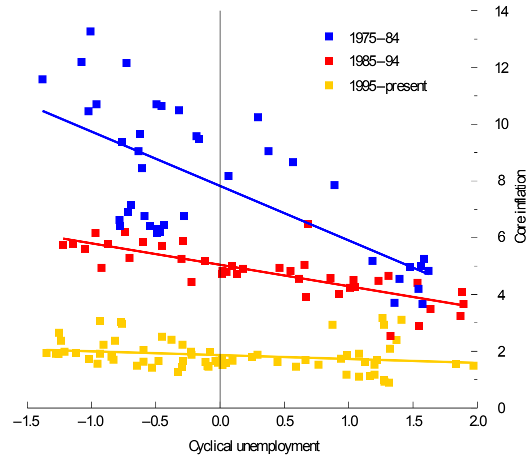


Sources: Organization for Economic Cooperation and Development; and IMF staff calculations.

Figure 3.5. Inflation and Cyclical Unemployment

(Percent; average across advanced economies)

From its peak in the 1970s, the average level of inflation has fallen as a result of central banks' successful disinflationary policies. What is also noticeable is that the relationship between cyclical unemployment and inflation appears to have moderated as the level has fallen.



Sources: Organization for Economic Cooperation and Development; and IMF staff calculations.
Note: Each dot represents the average across advanced economies of inflation and cyclical unemployment in one quarter.