

# Credibility and disinflation

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## Abstract

What the ends of hyperinflations and the Volcker disinflation say about the cost of bringing inflation down, and why credibility is the variable that sets the bill.

Lowering inflation costs output. How much depends on the slope of The Phillips curve and, more than anything else, on whether the public believes the central bank will finish the job. Two bodies of evidence bracket the range.

## The ends of big inflations

Sargent studied the ends of the hyperinflations in Austria, Hungary, Germany and Poland in the early 1920s and found that inflation stopped almost overnight, with far less unemployment than a Phillips-curve calculation would predict (Sargent, 1982). His explanation is that the stabilisations were *regime changes*: a new central bank statute, an end to monetary financing of the deficit, often a foreign loan with conditions. Once the public understood that the regime had changed, expectations reset immediately, and with expectations reset there was no need for a long period of slack.

The argument is the rational-expectations version of the credibility idea: the sacrifice ratio is not a technological constant but a function of how quickly expectations adjust, which is a function of how convincing the change in policy is. Gradual disinflations are expensive precisely because they are not convincing.

## The Volcker disinflation

The United States between 1979 and 1983 is the reference case for a modern disinflation. Inflation fell from about 13 percent to about 4 percent; unemployment rose to 10.8 percent in late 1982; the cumulative output loss was large by any measure. Ball, comparing disinflations across countries and decades, found sacrifice ratios that varied widely, were lower when disinflation was fast, and were lower in economies with more flexible wage contracts (Ball, 1994). The United States in the early 1980s sits near the middle of his range, which is to say that the Volcker disinflation was not cheap.

Goodfriend and King asked why, given that Volcker's commitment was unusually visible. Their answer is that credibility was acquired, not announced: long-term rates and inflation expectations came down only after the Fed had *demonstrated* its willingness to tolerate the 1981–1982 recession, and the delay is what made the episode expensive (Goodfriend & King, 2005). Words alone did not change the regime; sustained action did.

**Theorem 1** (Credibility lowers the sacrifice ratio). *In the expectations-augmented Phillips curve  $\pi_t = \pi_t^e - \alpha(u_t - u^n)$ , a disinflation from  $\pi_0$  to  $\pi^*$  costs cumulative unemployment  $\sum_t (u_t - u^n) = \frac{1}{\alpha} \sum_t (\pi_t^e - \pi_t)$ . If expectations fall to  $\pi^*$  immediately, the cost is zero; if they adjust only as inflation is observed to fall, the cost is  $(\pi_0 - \pi^*)/\alpha$  per period of adjustment lag.*

*Proof.* Rearranging the curve gives  $u_t - u^n = (\pi_t^e - \pi_t)/\alpha$ ; summing over the disinflation gives the expression. Each period in which expectations lag actual inflation by the full distance to the target contributes  $(\pi_0 - \pi^*)/\alpha$ ; with immediate adjustment every term is zero.  $\square$

The proof is a model, not a forecast; its content is the direction. Everything a central bank does to make its target believable, from independence to communication, is a way of shortening the lag in the sum.

## Two lessons for today

- **Fast and credible beats slow and hedged.** The 2022 tightening cycles in the United States and the euro area were unusually fast by historical standards, and the disinflation of 2023–2024 was cheaper than the Volcker template, with unemployment rising little. Anchored expectations, the product of the earlier decades, did the work that slack did in 1982.
- **Credibility is spent as well as earned.** The delay in 2021 was costly not because it produced a large inflation overshoot on its own but because it raised doubts about whether the target would be defended; the fast tightening that followed was partly the price of restoring that belief. The 2021–2023 test returns to this.

The mirror image of a disinflation is the problem of the 2010s: raising inflation *to* the target when expectations have settled below it. Communication and Flexible targeting and its alternatives are the tools central banks reached for.

Ball, L. (1994). What determines the sacrifice ratio? In N. G. Mankiw (Ed.), *Monetary policy* (pp. 155–193). University of Chicago Press.

Goodfriend, M., & King, R. G. (2005). The incredible Volcker disinflation. *Journal of Monetary Economics*, 52(5), 981–1015. <https://doi.org/10.1016/j.jmoneco.2005.07.001>

Sargent, T. J. (1982). The ends of four big inflations. In R. E. Hall (Ed.), *Inflation: Causes and effects* (pp. 41–98). University of Chicago Press.