Inflation Is Down, but It Wasn't 'Transitory'

By William L. Silber

Inflation has come down without yet causing a recession, leading Nobel Prize-winning economist Joseph Stiglitz to claim victory. "More than two years after economists divided into opposing camps over the nature of the post-pandemic inflation, we now know which side was right," he wrote recently. "Disinflation has confirmed that the earlier price increases were 'transitory,' driven largely by supply disruptions and sectoral shifts in demand." Mr. Stiglitz dismissed the role the Federal Reserve played in inflation's recent decline.

It's too early to declare inflation dead. But even if it is, that wouldn't mean it was transitory. It's a mistake to overlook the importance of the Fed's monetary restraint in offsetting expansionary pandemic policies. A tight monetary policy can reduce inflation without causing a recession, according to the rational expectations theory—the concept that people make decisions based on all the information available to them, including how policymakers behave.

Nobel Prize-winning economists Robert Lucas and Thomas Sargent helped develop this theory. Mr. Sargent showed that hyperinflation in Austria, Germany, Hungary and Poland after World War I disappeared almost overnight when those governments exercised fiscal restraint that encouraged credible anti-inflationary policies.

The Federal Reserve's monetary restraint was crucial in slowing the rise of prices.

The decline in inflation during 2023 can be explained in a similar way. The Fed's tightening in the beginning of 2022 gave consumers, savers and investors a credible signal that it wouldn't tolerate inflation. The Fed said it would raise interest rates as high as necessary to reduce upward price pressures and then made good on its word.

This evidently persuaded companies to restrain price increases, lest they lose business. In November 2022, as the Fed's tightening continued, the Journal reported that big U.S. retailers—Walmart, Target, and Amazon—told their suppliers they would no longer pay high prices, asked for discounts and in some cases canceled orders. The cutback in inflationary prices by retailers encouraged customers to continue shopping. This prevented the decline in economic activity that most economists had expected.

But there is a difference between today's disinflation and the post-World War I experience. The Fed's credibility this time didn't come from a fundamental shift toward budgetary balance as it did then but from 40 years of successful inflation targeting by the central bank. That matters. The U.S. is running a fiscal deficit of 6% of gross domestic product, an unprecedented number for a fully employed peacetime economy.

Going forward, the credibility of the Fed's commitment to raise rates as high as necessary may crumble under political pressure from Congress to cap government interest costs. Lawmakers should use the opportunity provided by the Fed's recent success to restore budgetary balance. If they don't, the decline in inflation will be transitory.

Mr. Silber is the author of "Volcker: The Triumph of Persistence" and "The Power of Nothing to Lose: The Hail Mary Effect in Politics, War and Business."