Low Inflation in the United States

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Inflation has fallen to a 50-year low

Percent Change in CPI and Core CPI

Note: Percent change is the change over the previous twelve months. The data shown in the figure spans the period from January 1946 to September 2015.
Source: Department of Labor, Bureau of Labor Statistics
Why has inflation fallen? A Phillips curve perspective

- A simple accelerationist Phillips curve

\[ \pi(t) = \pi(t - 1) - \kappa [U(t) - U^*(t)] + e(t) \]

Note: Core inflation is measured by the percent change in the annual average of the CPI from its level in the previous year.
Source: Department of Labor, Bureau of Labor Statistics and author’s calculations.
Factors limiting disinflation #1: Anchored inflation expectations

Note: Inflation in the previous year is measured by the percent change in the annual average of the CPI from the level in the previous year. Inflation expectations (1-year ahead) are measured by the one-year expected inflation in GDP prices for the 1976-1995 period, as reported in the first-quarter Survey of Professional Forecasters. For the 1996-2014 period, inflation expectations are measured by the one-year expected inflation in the CPI from the Survey of Professional Forecasters.

Factors limiting disinflation #2: Flatter slope or limited slack

• The Phillips curve appears to have flattened
  – A consequence of low and stable inflation? (e.g., Ball, Mankiw, and Romer, ‘88 or Kiley, ‘00)
  – Downward nominal wage rigidity (Daly and Hobijn, 2014)
• The financial crisis may have raised costs, despite high unemployment (Gilchrist et al, ‘15)
• The natural rate of unemployment may have risen
  – Elevated long-term unemployment (Ball and Mazumder, ‘10)
  – Shift in Beveridge curve
• Recent work and experience casts doubt on a rise in the natural rate (Kiley, ‘15; Figura and Ratner, ‘15)
• Erceg and Levin (‘14) – unemployment understates slack
Policy implications

• Low inflation and low equilibrium real interest rate imply that effective lower bound on nominal interest rates may bind more frequently

• Flat Phillips curve implies that pursuing a high pressure economy has a lower inflation cost
  – But it also implies a higher unemployment cost to lower inflation if inflation gets high
  – And the Lucas critique lurks in the background