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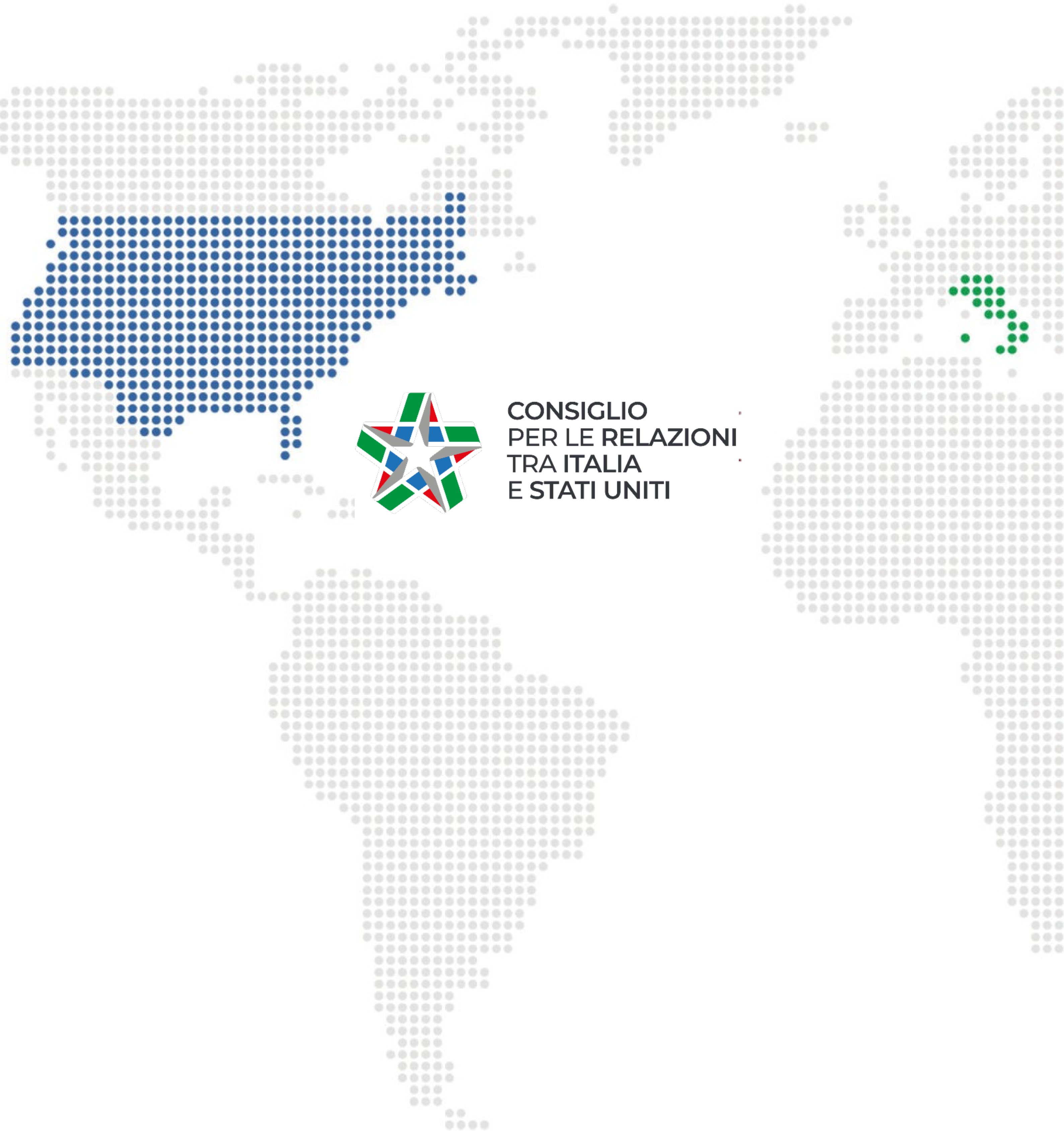

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MONETARY AND INFLATIONARY TRAPS

(Project Syndicate – Nov 23, 2021)

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Having adopted a more flexible policy framework in response to the low-inflation conditions that preceded the COVID-19 crisis, the US Federal Reserve now finds itself confronting an entirely different economic regime. The balance of forces is thus weighing heavily against decisive action to control today's price increases.

CHICAGO – Price increases in the United States are spreading across goods and services, and inflation also can be seen in broad-based business inputs such as transportation, energy, and increasingly labor. How should we expect central bankers to react?

For its part, the US Federal Reserve has emphasized that it will contemplate raising interest rates only after it is done tapering its monthly asset purchases, which will be sometime in July 2022 at the current pace of unwinding. Nonetheless, some members of the Fed's rate-setting Federal Open Market Committee worry that the central bank will have fallen behind the curve by that time, forcing it to raise rates more abruptly, to higher levels, and for longer than anticipated. Hence, Fed Vice Chair Richard Clarida recently indicated that the Fed might consider speeding up the taper (so that it can raise rates sooner) when its members meet again in December.

Notwithstanding the growing (but often unspoken) worries at the Fed, central bankers nowadays are reticent to see inflation as a problem. In the past, the current levels of inflation would have prompted them to square their shoulders, look determinedly into the TV cameras, and say, "We hate inflation, and we will kill it" – or words to that effect. But now they are more likely to make excuses for inflation, assuring the public that it will simply go away. Clearly, the prolonged period of low inflation after the 2008 global financial crisis – when the Fed had great difficulty elevating the inflation rate to its 2% target – has had a lasting impression on central bankers' psyches. The obvious danger now is that they could be fighting the last war. Moreover, even if they do not fall into that trap, structural changes within central banks and in the broader policymaking environment will leave central bankers more reluctant to raise interest rates than they were in the past.

To adapt to the pre-pandemic low-inflation environment, the Fed changed its inflation framework so that it would target average inflation over a (still-undefined) period. This meant that it could allow higher inflation for a while without being criticized for falling behind the curve – a potentially useful change at a time when elevating the public's inflation expectations was thought to be the key problem. Gone was the old central-bank adage that if you are eyeball to eyeball with inflation, it is already too late. Instead, the Fed would stare at inflation for a while and act only when it was sure that inflation was here to stay.

Moreover, the new framework places a much greater emphasis on ensuring that employment gains are broad-based and inclusive. Because historically disadvantaged minorities in the US are often the last to be hired, this change implied that the Fed would potentially tolerate a tighter labor market than in the past, and that it would have more flexibility to run the economy hot, which is useful in an environment of weak demand. Yet now the Fed is facing an environment of strong demand coupled with supply-chain disruptions that look unlikely to abate quickly. Ironically, the Fed may have changed its policy framework just as the economic regime itself was changing.

But shouldn't greater flexibility give decision-makers more options? Not necessarily. In the current scenario, Congress has just spent trillions of dollars generating the best economic recovery that money can buy. Imagine the congressional wrath that would follow if the Fed now tanked the economy by hiking interest rates without using the full flexibility of its new framework. Put differently, one of the benefits of a clear inflation-targeting framework is that the central bank has political cover to react quickly to rising inflation. With the changed framework, that is no longer true. As a result, there will almost surely be more inflation for longer; indeed, the new framework was adopted – during what now seems like a very different era – with precisely that outcome in mind.

But it is not just the new framework that limits the effectiveness of the Fed's actions. Anticipating loose monetary-policy and financial conditions for the indefinite future, asset markets have been on a tear, supported by heavy borrowing. Market participants, rightly or wrongly, believe that the Fed has their back and will retreat from a path of rate increases if asset prices fall.

This means that when the Fed does decide to move, it may have to raise rates higher in order to normalize financial conditions, implying a higher risk of an adverse market reaction when market participants finally realize that the Fed means business. Once again, the downside risks of a path of rate hikes, both to the economy and to the Fed's reputation, are considerable.

The original intent in making central banks independent of the government was to ensure that they could reliably combat inflation and not be pressured into either financing the government's fiscal deficit directly or keeping government borrowing costs low by slowing the pace of rate hikes. Yet the Fed now holds $5.6 trillion of government debt, financed by an equal amount of overnight borrowing from commercial banks.

When rates move up, the Fed itself will have to start paying higher rates, reducing the dividend it pays the government and increasing the size of the fiscal deficit. Moreover, US debt is at around 125% of GDP, and a significant portion of it has a short-term maturity, which means that increases in interest rates will quickly start showing up in higher refinancing costs. An issue that the Fed did not have to pay much attention to in the past – the effects of rate hikes on the costs of financing government debt – will now be front and center.

Of course, all developed-country central banks, not just the Fed, face similar forces that push toward restraint on rate hikes. So, the first large central bank that moves may also cause its currency's exchange rate to appreciate significantly, slowing economic growth. This is yet another reason to wait. Why not let someone else move first, and see if they invite market and political wrath?

If the post-2008 scenario repeats, or if China and other emerging markets transmit disinflationary impulses across the global economy, waiting will have been the right decision. Otherwise, the current impediments to central-bank action will mean more and sustained inflation, and a more prolonged fight to control it. Fed Chair Jerome Powell will have a lot to weigh as he begins his second term.

THE FED MUST THINK CREATIVELY AGAIN
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Supposedly transitory one-off price adjustments in the United States have become pervasive, and a major inflation shock is now at hand. But despite the flashing warning signs, the Federal Reserve remains wedded to a monetary-policy strategy born of the low-inflation past

NEW HAVEN – The transitory inflation debate in the United States is over. The upsurge in US inflation has turned into something far worse than the Federal Reserve expected. Perpetually optimistic financial markets are taking this largely in stride. The Fed is widely presumed to have both the wisdom and the firepower to keep underlying inflation in check. That remains to be seen.

For its part, the Fed counsels patience. It is so convinced that its bad forecast will eventually turn out to be correct that it is content to wait. No surprise there: The Fed telegraphed such a response with the "average inflation targeting" framework that it adopted in the summer of 2020. In doing so, the Fed indicated that it was prepared to forgive above-target inflation to compensate for years of below-target inflation. Little did it know what it was getting into.

In theory, average inflation targeting seemed to make sense – an elegant arithmetic consistency of undershoots balanced by overshoots. In practice, it was flawed from the start. It was an inherently backward-looking approach, heavily conditioned by a long experience with slow growth and low inflation. The Fed believed, as did many, that the pandemic shock of early 2020 was cut from the same cloth as the 2008-09 global financial crisis, underscoring the possibility of yet another anemic, disinflationary recovery that could push already-low inflation dangerously toward deflation.

Just like Japan. Ever since the dot-com bubble burst in 2000, Fed policymakers have worried about a Japan-like endgame for a crisis-prone US economy – lost decades of economic stagnation coupled with persistent deflation. Those concerns are understandable if a crisis hits when inflation is already dangerously close to zero. But by fixating on the risks of a Japanese-style deflation, the Fed all but ignored the possibility of a major upside inflation surprise.

And that is exactly what has happened. Thanks to an explosive post-lockdown rebound in aggregate demand, which the Fed itself played a key role in fueling, already-stressed global supply chains quickly snapped. From food, semiconductors, and energy to shipping, homes, and wages, today's multiplicity of price and cost pressures are far too numerous to count. Transitory one-off price adjustments became pervasive, and a major inflation shock is now at hand.

But there is an added complication – the Fed's belief in the magical powers of its balance sheet. Like average inflation targeting, quantitative easing was also born of recent crises. Ben Bernanke, first as Fed governor, then as chair, led the charge in cataloging the endless list of unconventional policy options that a fiat monetary system has at its disposal when the nominal policy rate nears the zero bound.

Bernanke first couched this in terms of a thought exercise in 2002, stressing the Fed's unlimited capacity for liquidity injections via asset purchases should deflationary risks mount. But when reality came close to the hypothetical in 2009, Bernanke's script became an action plan – as it did once again in the depths of the COVID-19 shock of 2020. While out of basis points at the zero bound, the ever-creative Fed was never out of ammunition.

The challenge comes with normalization – restoring monetary policy to pre-crisis settings. And for both the conventional benchmark policy interest rate and the unconventional balance sheet, the Fed has yet to figure this out.

The Fed faces two complications in policy normalization. First, unwinding ultra-accommodative monetary policies is a delicate operation that raises the possibility of corrections in asset markets and in the asset-dependent real economy. Second, there is confusion over the timeframe of normalization – how long it takes to return policy to its pre-crisis settings. That is because, until now, there has never been an urgency to normalize. The persistence of low, and often below-target, inflation would give an inflation-targeting central bank plenty of leeway to feel its way gradually, step by step, down the road to normalization.

Think again. Now the Fed must normalize in the face of an inflation shock. This calls into question the glacial process envisioned in a low-inflation normalization scenario. The Fed has failed to make this important distinction. It has telegraphed a mechanistic unwinding of the two-step approach it used in the depths of the crisis. The Fed views normalization simply as a reverse operation – reining in its balance sheet first and then hiking the policy rate.

While that sequencing might be appropriate in a low-inflation environment, an inflation shock makes it unworkable. The preferred first step, balance-sheet adjustments, is likely to have only a limited impact on the real economy and inflation. Balance-sheet transmission channels, running through long-term interest rates and lagged wealth effects from adjustments in asset prices, are highly circuitous, at best. The Fed needs to reassess its mechanistic approach to policy sequencing.

With inflationary pressures now going from transitory to pervasive, the policy rate should be the first line of defense, not the final shoe to drop. In real (inflation-adjusted) terms, the federal funds rate, currently at -6%, is deeper in negative territory than it was at the lows of the mid-1970s (-5% in February 1975), when monetary-policy blunders set the stage for the Great Inflation. Today's Fed is woefully behind the curve.

My advice to the Federal Open Market Committee: It is time to up the ante on creative thinking. With inflation surging, stop defending a bad forecast, and forget about tinkering with the balance sheet. Get on with the heavy lifting of raising interest rates before it is too late. Independent central bankers can well afford to ignore the predictable political backlash. I only wish the rest of us could do the same.