

SUPPLY & DEMAND

Does the Fed's Monetary Policy Threaten Inflation? (Contains Spoilers)

By JOHN H. COCHRANE | March 9, 2021 6:30 AM



(Willard/Getty Images)

The central bank is headed back to the Seventies — a rerun that no one should want.



D OES the Fed's monetary policy threaten inflation? By conventional measures, yes. But those

conventional measures have failed in the past. I believe that the short-run danger is less than it appears, but the long-run danger is larger.

If one reads Fed statements through conventional glasses, monetary policy seems to have been reset to the 1960s, and we know how that worked out.

 **Top Articles**

[READ MORE](#)

For example, in a [March 2 speech](#), Fed governor Lael Brainard states that

the new framework calls for monetary policy to seek to eliminate shortfalls of employment from its maximum level, in contrast to the previous approach that called for policy to minimize deviations when employment is too high as well as too low.

(I don't intend to pick on Brainard. This is just a recent speech that explains clearly and concisely things that many Fed governors have said, and appear in official policy statements.)

Indeed, this represents a dramatic repudiation of the macroeconomics consensus since the early 1970s. In the 1960s, the then-dominant Keynesian paradigm regarded any shortfall of output or employment, relative to a line connecting peaks, as a deficiency of aggregate demand, remediable by fiscal or monetary stimulus. The goal of macroeconomic policy should be to fill up the valleys.

MORE IN INFLATION

- **Erdogan's Love Affair with Islamic Finance**
 - **Putting the Grift in ESG**
 - **What the Fed Really Said**
-

In the 1970s we discovered that economies could run too hot as well as too cold. Much as a healthy housing market has some empty houses for sale and people moving, a healthy job market has some people between jobs or looking for better jobs, and others taking

time off to study, or to tend to families or other pursuits.

Most deeply, macroeconomists realized in the 1970s that the long-run level of employment (i.e., the labor-force-participation rate) and long-term wage and economic growth are the job of structural, microeconomic efficiency, not outcomes that printing more money can solve.

Macroeconomics since the 1970s has thought of monetary and fiscal policy as aiming to reduce economic volatility. The Fed is going back to the 1960s filling-valleys view.

Brainard adds that the “long-standing presumption” that “accommodation should be reduced” when the economy is running at full steam “may curtail progress for racial and ethnic groups that have faced systemic challenges in the labor force.” So “appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time.”

Just how long? Well, “Maximum employment is a broad-based and inclusive goal assessed by a wide range of indicators.” And the Fed now believes that there is a “low

sensitivity of inflation to resource utilization,” meaning that it can run the economy really hot for a long time without causing inflation, or that a little bit of extra inflation will do a lot of good.

This is as 1964 as *A Hard Day's Night*.

Economics textbooks draw the static Phillips Curve relating inflation and unemployment, and deride the conventional wisdom of the time that the Fed could permanently lower unemployment by tolerating a little more inflation. Push on it, and the Phillips curve shifts to more inflation and unemployment, as it did in the 1970s. Today's Fed is even more radical, though. While it has traditionally understood that its power is limited to guiding the overall economy, the Fed has now taken on inequality and social justice. Climate change is next. Another bit of hard-won 1970s wisdom was that with one tool, monetary policy could control one thing well — or, it could name ten goals, but with one tool, hit each one badly.

We also learned in the 1970s that clear goals are important to monetary policy. Using a “wide range of indicators” along with this word salad of a “strategy” is license to pick the number you want to justify whatever you

want to do at the time.

When inflation does pick up, you can tell how the Fed will process the news. Brainard on inflation:

Inflation is likely to temporarily rise above 2 percent. . . . Transitory inflationary pressures are possible if there is a surge of demand that outstrips supply in certain sectors. . . . Any inflationary bottlenecks would likely be transitory. . . . A burst of transitory inflation seems more probable than a durable shift above target in the inflation trend and an unmooring of inflation expectations to the upside.

The Fed said much of the same in the 1970s. Transitory factors. Bottlenecks. Oil prices.

If you add it up, it is hard not to see here the policy package of the late 1960s and early 1970s: deliberately running the economy hot in a vain attempt to raise employment permanently; a plan to let inflation run above target before doing anything about it; excuses for inflation when it comes; and a smorgasbord of numbers and goals to

cherry-pick from. I have heard strong denials from friends at the Fed. But dear friends, from the outside it's sure hard to see what's different.

Brainard, like other Fed officials, speaks of “anchored” inflation expectations. Anchored by what? Are expectations an anchor, or a balloon in a temporarily windless sky? Given the number of words coming out of the Fed on this long-run strategy, perhaps they believe inflation expectations are anchored by great speeches. So did their predecessors in the 1970s, culminating in President Ford's ludicrous Whip Inflation Now (“WIN”) buttons.

Anchoring is important. If people do not expect inflation to continue, when they eventually see some of it, they treat it as a transitory blip and do not build inflation into the prices they charge or are willing to pay, the wages they offer or demand, and the prices of assets they buy and sell. Once people expect inflation in the future, we have inflation now.

There is only one “anchoring” that makes sense: anchoring by actions. People must

believe that if inflation got out of hand, the Fed would quickly do what it takes to bring it back. If that means reliving the awful recessions of 1980–1982, people must believe the Fed would do it. Today, anchored expectations depend on fiscal policy as well. People must believe that if inflation were to break out, the federal government would swiftly retrench, stop spreading money around like fertilizer, and put its house in order with a tax and entitlement reform.

Indeed, Brainard writes, “If, in the future, inflation rises immoderately or persistently above target, and there is evidence that longer-term inflation expectations are moving above our longer-run goal, I would not hesitate to act and believe we have the tools to carefully guide inflation down to target.” It matters that people believe this, even if the actions cause immense short-term pain. Do people still believe the Fed has that will? Do people believe that the Treasury Department and Congress have the parallel will to take fiscal steps to contain inflation if it should come?

Does the Fed really have the tools to do it? I am doubtful. For ten years, interest rates were zero. (Interest rates were either too

high or too low, depending on your view of things, but stuck at zero in any case.) For ten years, the Fed ran massive quantitative easing after quantitative easing. Inflation just sailed along slightly below 2 percent. This episode suggests the Fed has a lot less power than it thinks. But that is also a cheery view, as if the Fed's interest-rate and bond-purchase tools are relatively powerless, then not much of what the Fed is doing will cause inflation either. In the current economy, fiscal policy and fiscal anchoring seem the greater danger to inflation than even the monetary mistakes of the 1970s.

If you would like to subscribe to our daily commentary on business, finance, and economics, The Capital Note, please follow the link [here](#). If you would like to subscribe to The Capital Letter, a summary of the week on Capital Matters — and some additional commentary — please follow the link [here](#). Both are free.

JOHN H. COCHRANE is the Rose-Marie and Jack Anderson senior fellow at the **HOOVER INSTITUTION** at Stanford University. He is also an adjunct scholar of the Cato Institute, among many affiliations. He authors the “grumpy economist” blog. All opinions are his own, and not necessarily those of the Hoover Institution or Stanford University.

AROUND THE WEB



California Drivers with No DUI's Are Getting a Big Pay Day in March

SMART LIFESTYLE TRENDS



California: Say Bye To Expensive Solar Panels If You Live Near Palo Alto