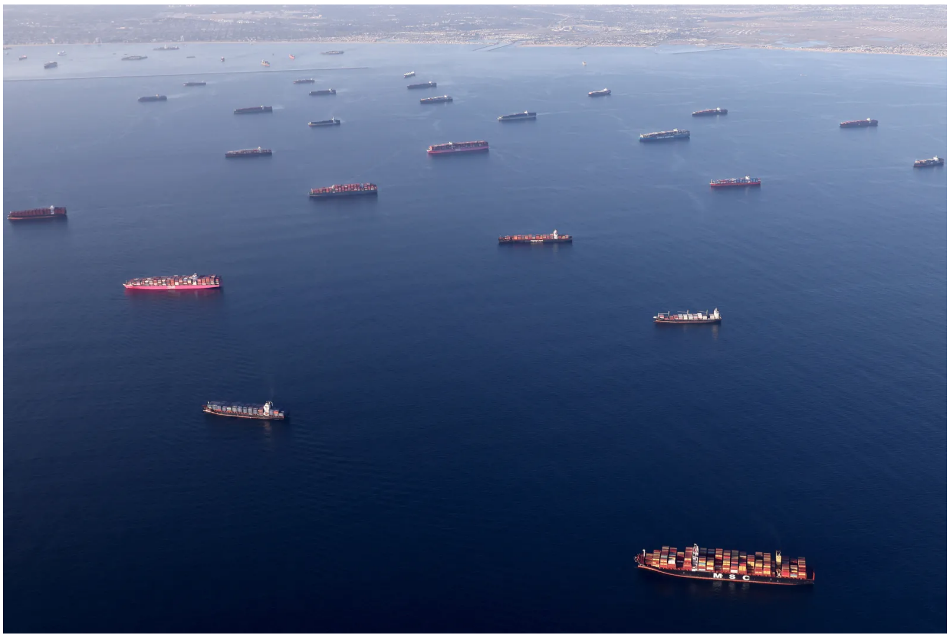
The Age of Inflation

Easy Money, Hard Choices

By Kenneth S. Rogoff **November/December 2022**



Container ships near the port of Los Angeles, September 2021
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Coming on the heels of the pandemic-induced economic slowdown, the inflation crisis of the past two years seemed to catch much of the world by surprise. After three decades in which prices grew slowly across the world's advanced economies, suddenly the United Kingdom, the United States, and the eurozone were contending with near or above double-digit inflation. Prices across many emerging markets and developing economies have risen even faster, for example, with inflation exceeding 80 percent in Turkey and nearing 100 percent in Argentina.

True, the worldwide inflation of the 2020s does not yet rival the worst inflation crises of past decades. In the 1970s, annual price increases in the United States stayed above six percent for ten years, reaching 14 percent in 1980; inflation in Japan and the United Kingdom peaked at over 20 percent. For low- and middle-income countries, the early 1990s were even worse: more than 40 such countries had inflation rates above 40 percent, with some reaching 1,000 percent or more. Still, in 2021 and 2022, the global economy moved in a deeply worrisome direction as governments and policymakers belatedly discovered they were facing runaway price increases amid a war in Ukraine and other large-scale shocks.

Voters do not like inflation or recessions. In an August 2022 Pew Research Center poll, more than three out of four Americans surveyed—77 percent—said that the economy was their number one election issue. Even in September, when prices in the United States had stabilized somewhat, a poll led by Marist College found that inflation continued to be voters' top issue, ahead of both abortion and health care. As with many elections, the 2022 midterms may ultimately hinge on noneconomic issues; nevertheless, the state of the economy has significant predictive power over voter preferences, and politicians know it.

Although much of the debate about the new inflation has focused on politics and world events, just as crucial is the question of central banks' policies and the forces that shape them. For years, many economists have assumed that inflation had been permanently tamed, thanks to the advent of independent central banks. Beginning in the 1990s, central bankers in many countries began setting targets for the level of inflation; a two percent goal became an explicit part of U.S. Federal Reserve Bank policy in 2012. Indeed, well into the COVID-19 pandemic, most regarded a return to the high inflation of the 1970s as implausible. Fearing a pandemic-driven recession, governments and central banks were instead preoccupied with jump-starting their economies; they discounted the inflationary risks posed by combining large-scale spending programs with sustained ultralow interest rates. Few economists saw the dangers of the enormous stimulus packages signed by U.S. Presidents Donald Trump, in December 2020, and Joe Biden, in March 2021, which pumped trillions of dollars into the economy. Nor did they anticipate how long it would take for supply chain problems to sort themselves out after the pandemic or how vulnerable the global economy would be to sustained high inflation in the event of a major geopolitical shock, as happened when Russia invaded Ukraine. Having waited too long to raise interest rates as inflation built up, central banks are scrambling to control it without tipping their economies, and indeed the world, into deep recession.

In addition to suffering the consequences of myopic economic thinking, central banks have also been buffeted by dramatic political and economic changes. The 2020s are shaping up to be the most difficult era in central banking since the

1970s, when the global economy was contending with both the Arab oil embargo and the collapse of the postwar Bretton Woods system of fixed exchange rates. Today, large-scale global shocks such as war, pandemic, and drought seem to be coming one after another or even at the same time. Meanwhile, the forces of globalization that for much of the past 20 years have helped sustain long-term growth have instead turned into headwinds, both because China is rapidly aging and because of growing geopolitical frictions between China and the United States. None of these changes is good for productivity and growth, but they are all contributing to higher inflation now and will into the future.

By their nature, supply shocks are difficult for central banks to address. In the case of a simple demand shock—too much stimulus, for example—central banks can use interest rates to stabilize both growth and inflation. With supply shocks, however, central banks must weigh difficult tradeoffs between bringing down inflation and the costs to businesses and workers of lower growth and higher unemployment. Even if central banks are prepared to raise interest rates as needed to tackle inflation, they have far less independence than they did two decades ago. The 2008 financial crisis weakened central banks' political legitimacy by undermining the idea that their policies ultimately work to the benefit of all; many people lost their homes and their jobs in the worst economic downturn since the Great Depression. As central banks today deliberate how far to tamp down on demand, they have to consider whether they are willing to risk causing yet another deep recession. If during a recession the government's social safety net is inadequate, doesn't the central bank need to take that into account? Those who dismiss such concerns as external to monetary policy have not been reading central bankers' speeches over the past decade.

Amid an unending series of supply shocks, central banks may also be confronting a long-term shift that neither policymakers nor financial markets have yet taken into account. Although many of the immediate drivers of the extraordinary rise in prices in 2021 and 2022 will eventually dissipate, the era of perpetual ultralow inflation will not come back anytime soon. Instead, thanks to a host of factors including deglobalization, rising political pressures, and ongoing supply shocks such as the green energy transition, the world may very well be entering an extended period in which elevated and volatile inflation is likely to be persistent, not in the double digits but significantly above two percent. Most central bankers insist that they can make no bigger mistake than allowing high inflation to linger so long that it starts pushing expectations of long-term inflation by any noticeable amount, and it is probably fair to say that the majority of Wall Street economists buy that argument. But they may be facing more painful choices over the next decade, and certainly in the immediate future. The social and political implications of a central-bank-induced deep downturn—coming after the two worst recessions since the Great Depression (2008 and 2020)—are profound.

PASSING THE BUCKS

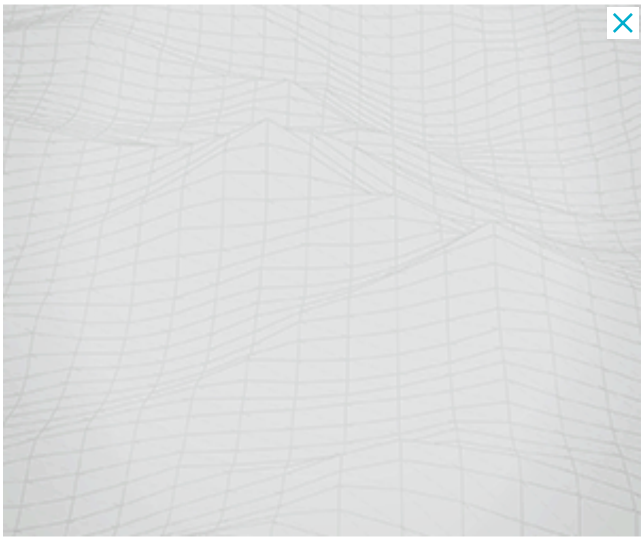
Ever since U.S. monthly inflation began to rise sharply in the spring of 2021, Washington has been divided between those who blame it on excessive stimulus spending by the Biden administration and those who maintain that it is mostly caused by global factors beyond Washington's control. Neither argument is terribly convincing. The stimulus view is clearly overblown: countries across the world today have been experiencing high inflation, despite vast differences in the extent to which they stimulated their economies. Although their stimulus packages were considerably smaller, the United Kingdom and the eurozone have had even higher inflation than the United States, with Australia, Canada, and New Zealand only slightly lower. Some have also pointed to the Biden administration's clampdown on fossil fuel pipelines and exploration as a contributor to inflation, though the main effects on production and output probably lie in the future.

Yet blaming inflation mostly on Russian President Vladimir Putin's war in Ukraine, Chinese President Xi Jinping's war on COVID-19, or post-pandemic supply chain breakdowns is also wrong. For one thing, prices were already ramping up in the United States in 2021, long before Putin invaded Ukraine. And inflation initially manifested itself in different countries in very different ways. In much of the world, higher food and energy costs were the main driving factors, but in the United States, the most pronounced price increases came in rents, vehicles, clothing, and recreation. At this point, second- and third-round effects are working their way through the economy, and price increases are radiating even more broadly across many sectors.

Many economists think the real cause of the inflation crisis was the Federal Reserve.

Many economists think the real culprit was the Federal Reserve, which did not begin hiking interest rates until March 2022, at which point inflation had been rising sharply for a year. That delay was a huge mistake, although more easily seen as such in hindsight, knowing that the worst effects of the pandemic could have quickly been brought under control. And the root of the mistake lies not just with the Fed and its staff but also with a broad consensus within the economics profession, which had become heavily wedded to the view that, most of the time, it is far better to have too much macroeconomic stimulus—high deficits, very low interest rates—than too little.

Almost no one has questioned the massive spending programs implemented around the world in the early stages of the pandemic. The point of having governments preserve fiscal capacity is precisely so they have the resources to take large-scale actions to protect the vulnerable in the event of a deep recession or catastrophe. The issue is when to stop. Inevitably, stimulus spending is political, and those who promote large rescue packages are often also motivated by the opportunity to expand social programs whose approval in Congress might in ordinary times be impossible. This is one reason why there tends to be far less talk about reducing stimulus once a crisis is over.



As a candidate, Biden pledged that he would expand government spending if elected, partly with the aim of facilitating the post-COVID economic recovery but mainly to share the benefits of growth more equally and to put significant resources into the national response to climate change. As a lame-duck president, Trump attempted to frustrate his winning opponent's ambitions by passing his own $900 billion COVID-19 relief package in December 2020, even though the economy was already rebounding strongly. Just three months later, although the economy was continuing to recover, Democrats under Biden passed a new $1.9 trillion stimulus package, with a number of prominent economists, including *New York Times* columnist and Nobel laureate Paul Krugman, cheering them on. Krugman and others argued that the package would enhance the recovery and provide insurance against another wave of the pandemic and that it carried minimal risks of igniting inflation.

LET THEM SPEND

Already in early 2021, there were reasons to question the prevailing wisdom about the Biden stimulus. Most notably, Harvard economist and former U.S. Treasury Secretary Lawrence Summers began warning that the bill being contemplated could lead to inflation. Although serious inflation had not occurred in decades, Summers had a simple and compelling insight. Throwing trillions of dollars into an economy with severe supply constraints and only a modest demand shortage had to be inflationary. If too many people are trying to buy cars at the same time and have the cash to do so, car prices will rise.

A key element of Summers's logic was that the stimulus-fueled consumption binge would not be satisfied by foreign suppliers, including China. Normally, when U.S. consumers go on a spending spree, the U.S. trade deficit supplies at least a partial outlet from internal price pressures: if U.S. demand exceeds U.S. production, Americans can still buy from abroad. But in the spring of 2021, with the U.S. economy emerging from the pandemic faster than most and with global supply lines in even greater disarray than domestic U.S. supply lines, the availability of foreign goods was limited. Although economists have differed over the precise figure, a reasonable guess is that excess demand accounted for as much as half the cumulative rise in prices in the United States immediately after the pandemic.

Federal Reserve Board Chair Jerome Powell, Washington, D.C., July 2022
Elizabeth Frantz / Reuters

Faced with this vast gap between demand and available supply, the Fed could have stepped in and taken action. The Fed cannot change how the government chooses to allocate stimulus funds or negate any inefficiencies it might entail. But it does have a powerful instrument to prevent excess demand from creating high inflation, namely the short-term interest rate, which it effectively controls. By raising interest rates, the Fed makes it more expensive to borrow money, which in turn lowers the price of all long-term assets, from equities to art. The most important example of this phenomenon is the housing market, which is by far the largest component of most Americans' personal wealth. Higher mortgage rates make it more expensive to buy houses, which ultimately pushes down home values. The resulting fall in wealth reduces consumption. More generally, higher interest rates discourage borrowing and encourage savings, damping consumer demand. Higher interest rates also cause firms to reevaluate long-term investment projects, directly and indirectly lowering their demand for workers.

But before it decided on a series of rate hikes, the Fed had to be confident that high inflation was a serious risk. Despite Summers's towering stature, his views made him an outlier. Although a few respected economists, including former IMF Chief Economist Olivier Blanchard, agreed with his warnings, Wall Street and most academics discounted them. After all, inflation had not risen above four percent for several decades, and many of the progressives that dominated Biden's economic team believed that the inflation effects of their stimulus would be minor. What right did the Fed have to push back on a signature policy of an administration that had come to office promising to help ordinary Americans and that had the support of many progressive economists? Had the Fed started hiking interest rates in spring 2021 and had a recession then occurred for any reason—such as a bad turn in the COVID-19 pandemic—the Fed would have been subject to withering criticism and could potentially have compromised its future independence. Given these considerations, it was hardly surprising that the Fed was hesitant to act.

Yet the Fed delayed taking action even after it became clear that inflation was rising. By the fall of 2021—six months after the Biden stimulus—the economy was rapidly heating up, yet the Fed left interest rates untouched. It is hard to escape the fact that Jerome Powell's term as Fed chair was set to expire at the end of the year and Biden had not yet announced his reappointment. If Powell had chosen to initiate a cycle of interest-rate hikes, it is entirely possible, indeed likely, that Biden would have replaced him with a different chair, perhaps Lael Brainard. A well-respected economist and prominent former treasury official in the Obama administration, Brainard was viewed by financial markets as more dovish on interest rates, more willing to risk inflation to sustain growth. In the event, the Fed held back on raising rates, and Biden eventually reappointed Powell. Only then, with Powell comfortably in his new term, did the Fed finally raise interest rates in the spring of 2022. If the administration had wanted the Fed to raise interest rates sooner, as some later argued it did, the right move would have been to reappoint Powell in the summer of

2021, giving him a clear mandate to act as the Fed saw fit.

MAGICAL MONETARY THINKING

Amid these pressures from Washington, the Fed was also influenced by an increasingly dominant strand of Keynesian economic theory that argued that there was considerable scope for using macroeconomic stimulus more aggressively. Long before the start of the pandemic, many economists had concluded that it was possible to significantly increase government spending (and/or lower taxes) without having to raise interest rates and without causing inflation. After nearly a decade of ultralow interest rates and low inflation, some thought that upward price pressures could be avoided even if the entire spending increase was financed by "printing money"—having the central bank pump money into the economy by buying up government debt. "Modern monetary theory" is perhaps the best known version of this approach, although more moderate versions had already become mainstream.

One prominent idea was that running the economy "hot," through high government spending and ultralow interest rates, could be an effective tool for reducing inequality. As low-wage workers were brought into the labor force, they would gain skills that would translate into higher lifetime earnings. Strong temporary stimulus could thus result in permanent gains, or so many assumed. Support for this approach was not limited to left-leaning policymakers. Trump's economic team often touted the effect of the strong, tax-cut-driven economy on incomes for low-wage workers and minorities.

By 2019, when the Fed gathered policy perspectives from leading academics as part of a review of its fundamental monetary framework,

monetary stimulus, even after interest rates had been taken to zero. Within the profession, there were growing concerns about "lowflation"—inflation well below two percent—a fear that became a major reason for the Fed's inaction two years later. Along with many academic economists, the Fed concluded that rapid price increases were no longer a serious concern, since it could always raise interest rates to quell them, forgetting the difficulty of getting the timing right and the political challenges that might ensue. In August 2020, the Fed announced the results of its policy review, making clear that it would no longer act preemptively to fight inflation just because labor markets were getting tight but would wait until the economy showed clear signs that inflation was actually taking root.

In 2020, the Fed made clear that it would no longer act preemptively to fight inflation.

Despite its concerns about lowflation, however, the Fed failed to embrace one innovation that might have helped in the subsequent crisis: negative-interest-rate policy. That is, it could have allowed very-short-term interest rates to go below zero in order to push up inflation expectations and longer-term interest rates in a deflationary economy. It may seem counterintuitive that such a tool could help deal with inflation as well. But if the Fed in 2021 had had such a "bazooka" in its arsenal, to paraphrase former Treasury Secretary Hank Paulson, it could have been more proactive in raising interest rates, knowing that if it overshot, it could cut them as much as needed without running into the dreaded "zero bound."

Admittedly, for negative-interest-rate policy to be fully effective, a number of legal, institutional, and tax changes would have to be implemented, and the Fed would need the cooperation of the Treasury and Congress. The most important single challenge is how to prevent significantly negative rates—say minus two percent or lower—from causing investors to switch from bank accounts and Treasury bills to paper currency, which has a zero interest rate. So far, even Japan and Europe, which have tiptoed into negative rates, have avoided this issue, but there are two solutions that would prevent arbitrage into paper currency. One involves establishing an exchange rate between paper currency and central bank reserves (which are digital) that depreciates over time just enough to offset the fact that, storage and insurance costs aside, paper currency might otherwise look good in a negative-interest-rate world. The other, of course, is to eliminate paper currency entirely, while ensuring that free basic banking services were available to all, either by introducing a central bank digital currency or by requiring banks to offer free basic accounts to unbanked individuals (as, say, Japan does). Between these two alternatives, it is likely possible to implement negative rates as low as perhaps minus three percent, simply by phasing out large denomination notes (hundreds and fifties) and taking other regulatory steps to make large-scale currency hoarding, in the billions of dollars, impractical.

In the event, the adoption of negative-interest-rate policy was deliberately taken off the table in the Fed's 2019 review out of fear of political repercussions, although if used effectively, it would help power the economy out of a deep recession. (Indeed, greater short-term stimulus would actually push up longer-term rates because of higher growth and inflation expectations.) When the Fed next reconsiders its policy framework, one hopes that it will consider what legal and institutional changes might be necessary to allow it to use such tools.

In short, the Fed's failure to respond to inflation in 2021 illustrates how much central bank independence is often affected by both political and intellectual undercurrents—particularly during elections but also when the government in power is subject to populist pressures. But it also shows that in today's environment, the Fed needs to expand its toolkit for stimulating the economy in a severe downturn if it wants to strengthen its resolve to fight inflation when the economy overheats.

UNMOVING TARGET

One of the recurring questions about the 2021–22 inflation has been whether the current trajectory resembles the Great Inflation of the 1970s. How bad can it get? Central bankers insist they will never allow the kind of complicity and complacency in economic management that characterized that era. At the start of the 1970s, the chair of the Fed at the time, Arthur Burns, recklessly expanded the money supply in what many viewed as an effort to help President Richard Nixon get reelected. Then, in 1978, Burns was succeeded by G. William Miller, who was so focused on printing money to keep short-term interest rates low that he failed to recognize that expectations of rising inflation were driving up long-term interest rates as lenders demanded higher payments to keep up with inflation. Under

Miller, inflation in the United States rose to double digits.

Only with the appointment of Paul Volcker, who succeeded Miller after a year and a half, did the Fed begin to conquer the problem. Volcker is remembered for having raised the Fed's short-term policy rate above 19 percent, eventually bringing down inflation from its peak of 14 percent in 1980. Far less noted, however, is that the Volcker Fed initially held back, worried that causing a recession would affect the 1980 presidential election; instead, it allowed inflation to rise initially, possibly causing the later recession to be even larger. By 1982, the Volcker Fed had brought annual inflation down to the three to 4.5 percent range, where it remained until Alan Greenspan took over as Fed chair in 1987. Notably, although Greenspan is famous for having masterfully steered the economy while lowering inflation even further, it took the Fed a while to get it to two percent. Measured by the Consumer Price Index, annual inflation rose during Greenspan's first few years, reaching more than five percent before falling decisively in the mid-1990s. True, it was arguably a much more difficult task back then when high inflation expectations were deeply ingrained. In the current crisis, so far, inflation expectations have risen relatively modestly, though central bankers remain concerned that they might rise much more.

At the time of the Great Inflation, central banks also faced very different challenges. The breakup of the Bretton Woods fixed exchange rate system in the early 1970s removed any remaining link between currency and gold. Yet the United States was among only a few countries that had independent central banks for which maintaining stable prices was an important part of their mandate. Over time, this mandate has proven invaluable as a counterweight to political pressures to hold down interest-rate increases, pressures that central bankers again find themselves fighting today; politicians more often push central bankers to take it easy on interest-rate hikes than beg for more, especially in the year before an election.

The Federal Reserve Board building, Washington, D.C., June 2022
Sarah Silbiger / Reuters

Still, the current inflation crisis and its predecessor have some remarkable similarities. Above all, both eras were catalyzed by new kinds of supply shocks. The OPEC oil embargo of 1973–74 was the biggest shock the global economy had seen since World War II, and Russia's invasion of Ukraine has likewise shaken the foundations of the global economic system, hugely exacerbating problems in global supply chains, which were already frayed by the pandemic. And in both episodes, Keynesian-oriented stimulus policies were in high fashion among academic economists and policy commentators, with supply-side economics all but forgotten.

Central bankers today seem confident when they say they know how to bring inflation back to two percent, but they are less convincing when they insist that they will not rest until inflation returns to that target. They must realize that pushing up interest rates risks creating a deep recession. And central bankers know that a deep recession is going to fall particularly hard on low-income people, the young, and workers from historically disadvantaged groups. These are precisely the groups that the Fed, in its new policy framework, expressly aims to help. In light of recent events, the Fed will need to reconsider this shift in emphasis, but helping disadvantaged groups will certainly remain a priority.

Some economists argue that central banks should never have formed a consensus around a two percent inflation target in the first place and that a three or even four percent target would be better. According to this view, by building higher expected inflation into interest rates, central banks would have more room to cut rates in a crisis. It is a complex debate with many nuances; in essence, raising the target rate could provide an alternative to negative-interest-rate policy. For central bankers, the drawback of such a move is that having sworn up and down that they are absolutely committed to a long-run inflation target of two percent, any change—particularly from a position of weakness—might undercut their credibility, suggesting that the target could be pushed even higher in the future. For this reason, if the economy stabilizes at a higher rate of inflation for several years, central bankers are likely to say that although they are tolerating moderately higher inflation for the moment, they still intend to return to two percent in the future and will look for opportune ways to smoothly achieve it without causing a prolonged downturn. There are other drawbacks to having permanently higher inflation—wages and prices will eventually adjust more often, making monetary policy less powerful—and in a severe recession the extra room to cut rates might still not be enough.

THE PRICE OF STABILITY

For all their complaints about inflation, one wonders how prepared voters are for yet another deep recession. The Fed is surely concerned about such an outcome. Another risk is that long-term real interest rates—that is, inflation-adjusted rates, which collapsed after the 2008 financial crisis—could continue moving back up toward the very long-term trend, which tilts down at about 1.6 percent per century, but nothing like the nearly three percent drop that occurred just a few years after the financial crisis. This would make it more expensive for governments to borrow money and put more pressure on central banks to keep interest rates low and devalue government debt through inflation. Indeed, the changes in the political and economic landscape have become so profound that it seems unlikely for the foreseeable future that the Fed will choose to bring inflation down to prepandemic levels and keep it there.

Monetary policy has a big effect on politics; the economic cycle is a strong predictor of elections almost everywhere in the world. But as the current crisis has made clear, politics also affects monetary policy. The European Central Bank was doing cartwheels to explain why it had to keep buying large quantities of debt from countries on Europe's periphery, most notably from Italy. It originally marketed this policy as necessary for fighting deflation, but it has now rebranded the program while raising interest rates to fight inflation. The real reason for the policy, of course, has always been to demonstrate the commitment of northern eurozone countries to backstopping southern eurozone government debt, a profoundly political goal. In the United Kingdom, Liz Truss, who became prime minister in September 2022, has openly advocated reining in the Bank of England, just at the moment when her fiscal policies are likely to place upward pressure on long-term inflation.

The economist Milton Friedman once opined that inflation is always and everywhere a monetary phenomenon. That is, of course, a polemic overstatement. As the world is now witnessing, many factors affect inflation, including government spending stimulus and global supply shocks. It is true that central banks can bend long-term inflation rates to their will if they are patient enough and independent enough. But it is unclear how far they can go if the global economy continues to suffer seismic shocks. One upside of this episode of high inflation is that it may increasingly force politicians to once again recognize that low and stable inflation cannot be taken for granted and that central banks must be allowed the freedom and focus necessary to achieve their core mandate. Central bankers, for their part, should be more open to using new tools such as unrestricted negative-interest-rate policy to fight severe recessions, tools that could provide crucial help in resisting political pressures to hold rates down in an overheating economy. Whether or not the Fed manages to engineer a "soft landing" in the current crisis, the challenges it will face in the coming decade are likely to be considerably more difficult than what it confronted in the pre-pandemic world.

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