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What the Fed should do next on inflation

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The debate over U.S. monetary policy is in a new phase. There is no longer any question that the Fed allowed itself to fall way behind the curve in the second half of 2021 and early 2022, calling its credibility into question. It is equally clear that, as its critics urged, the Fed has since moved aggressively to contain inflation by raising rates and quantitatively tightening. After these steps, along with the president's releases from the Strategic Petroleum Reserve and some good luck, the Fed has regained its credibility as an inflation fighter.

Unfortunately, all major reductions in inflation in the past 70 years have been associated with recessions. It should come as no surprise that many economists, including me, expect a recession to begin in 2023. Historical experience as encapsulated in the proposition known as the Sahm Rule demonstrates that whenever U.S. unemployment rises by more than half a percent within a year, it goes on to rise by 2 percent. So, if recession comes it is very likely to lift unemployment to the 6 percent range.

What should the Fed do next? The choices from here get harder, not easier, as both the risk of a severe recession and enduring inflation make policymaking more challenging. Chair Jerome H. Powell was right in his Dec. 14 news conference to emphasize that there is no basis for confident economic prediction.

Some of the most stridently made arguments are also the silliest. Doves are wrong to argue that the Fed should obviously pause in raising rates since inflation expectations are low. Hawks who suggest the Fed must keep raising rates until they substantially exceed past inflation neglect the fact that inflation is coming down - much less the possibility that the economy could face a Wile E. Coyote moment in 2023, in which demand collapses.

This could occur as small and medium businesses hit a wall of high-interest refinancing, as markets suddenly focus on what a recession would do to corporate profits, as consumers' covidera savings are depleted, or as businesses that have been clinging to their workforces realize they're no longer necessary. Alternatively, oil prices could spike or geopolitical risks could increase. In all these scenarios, policymakers will wish that monetary policy was not highly contractionary.

The Fed is seeking to balance the risk of stagflation caused by entrenched inflation expectations with the risk of dangerous downturn. It is being supported by the administration, which is doing an exemplary job of respecting the Fed's independence. My instinct is that the Fed's approach of stepping more gingerly as the situation becomes more problematic is appropriate.

It is very unlikely that we will have a recession so severe as to drive the underlying inflation rate below the 2 percent target. Hence, overshooting on inflation reduction is not the primary risk, and the Fed is right to emphasize its inflation objective going forward.

This judgment is supported by another consideration. There has been a transitory element in inflation's recent deterioration caused by bottlenecks in sectors such as used cars. As these bottlenecks ease, and prices return to normal, there will be a transitory deflationary impact hitting the statistics. This must not be confused with enduring resolution of the inflation problem.

Wage inflation is now running at 5 percent or more, and labor markets remain exceptionally tight. Until wage inflation declines significantly or we get clear evidence of a productivity acceleration, there is no basis for assuming that any low rates of inflation observed will be sustained if monetary policy is eased.

Some suggest that a 2 percent inflation target is not appropriate in current circumstances, especially given the costs of meeting it. Powell was right, in my view, to firmly reject this idea. I doubted at the time that setting a numerical target for inflation was a good idea, but now is not the time to switch course. A shift now even to a 3 percent target, let alone a higher one, would set the stage for a stagflationary decade. The 3 percent target would devolve to a floor, as policy eases, with the economy turning down and 3 percent in sight.

A year ago, the policy imperative was altering a monetary policy that was way behind the curve. Today, the greatest low-hanging fruit for policy improvement lies in steps that the rest of the government outside the Fed can undertake. These include tariff reductions, measures to accelerate permitting for energy projects urged by Sen. Joe Manchin III (D-W.VA.), measures to contain health-care and college tuition costs, and procurement practices focused on buying at minimum cost.

Fiscal policy will need to respond if and when recession comes. There will not be room for massive, across-theboard efforts. But now is the time to put in place carefully targeted measures to refund child tax credits, strengthen unemployment insurance and be ready to pull forward federal spending on maintenance and replacement cycles to periods when overall demand is soft.

It is a tribute to the 2010 Dodd-frank financial regulations that so much monetary tightening has taken place with so little market trauma. But regulators need to be alert to issues of liquidity in a number of markets and to the very substantial divergences that have opened in recent months between public market valuations and the value at which many assets are being carried on private balance sheets. They also need to be conscious of the possibility that well intentioned regulatory safeguards will interfere with liquidity in key markets.

The rest of the world will suffer greatly if the United States does not control inflation and rates ultimately rise far above current levels, as occurred in the early 1980s. Even recent increases in rates and the dollar along with geopolitical dislocations are creating serious problems for many developing countries. The United States should be leading global efforts to resolve sovereign debt problems more quickly and to catalyze much higher lending levels from the International Monetary Fund and World Bank.

Managing inflation and the risk of recession in a way that ensures a soft landing is likely not possible. But managing these risks with maximum care is profoundly important as a foundation for the long-term investment policies that will drive the inclusive prosperity that almost all Americans desire.
