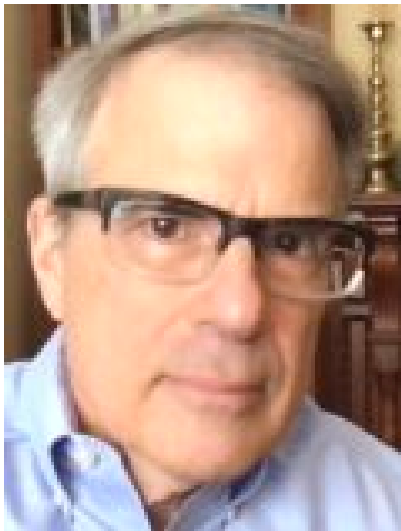

Don't Fight Inflation with Unemployment

By Kerry Pechter Thu, Dec 2, 2021

If our current inflationary trend is caused by kinks in the global supply chain, does it make sense to raise interest rates, knock asset prices down, and put people out of work? The economist Abba Lerner wouldn't think so.



Our most basic assumptions about inflation might be flat wrong.

The great danger for policymakers when confronting inflation, warned economist Abba Lerner in an excellent but almost forgotten book, *Flation (Not INflation of Prices, Not DEflation of Jobs)* (Quadrangle, 1972), is to misdiagnose its cause and prescribe the wrong remedy.

Unfortunately, that's been known to happen.

In the late 1960s, for instance, after military spending on the Vietnam War had begun to overheat the economy, President Nixon prescribed "wage and price controls." Controls didn't work (they never do). Neither did Nixon's fateful decision to end the gold standard in 1971.

Federal Reserve chairman Paul Volcker chose to let the federal funds rate rise to an all-time high of 20% in 1980. For that he is famously credited with ending the inflation of the 1970s. But while Volcker's action did reduce inflation, it also drove the unemployment rate to 10% and plunged the economy into recession.

The more conspicuous causes of inflation in the 1970s were the oil price spikes and shortages, which were triggered by the dollar's loss of value after abandonment of the gold standard. And it may well have been the permanent drop in the price of oil in 1981—not the higher interest rates—that cooled the inflation.

Here's what a 1986 [article](#) from the Brookings Institute said:

"In 1973-74, the real price of crude oil more than tripled. After declining slightly in 1975-78, it doubled again in 1979-80. But the 1979-80 price increase was eroded between 1981 and 1985, as price declined by nearly 40%. Price then collapsed in the first half of 1986, falling

by more than 50%. Within the past five years [since 1981], the real price of oil has fallen from more than a five-fold multiple of its 1970 value to less than a two-fold multiple.” (Brookings Papers on Economic Activity, 2:1986.)

Maybe it's a mistake to remember Chairman Volcker as the person who doused the inflation fire in the early 1980s. Maybe we should remember him as the man who, more like Mrs. O'Leary's cow and the Great Chicago Fire of 1871, sent asset prices down and sparked a 40-year bull market in stocks and bonds.

At the end of September 1981, the 10-year Treasury rate [peaked](#) at 15.84%. In 1982, the S&P 500 Index fell to 312.5, a level it hadn't seen since the middle of 1954—lower than it had been in the 1974 recession. Since prices of existing bonds move in the opposite direction of interest rates, Volcker's actions also drove down the prices of existing bonds and set the table for a decades-long bond rally.

Those were not the worst of times for investors. They were the most opportune time.

Anyone who recognized the exquisite buying opportunity of the early 1980s—when know-nothings like me started getting cold calls from the newly hired army of stockbrokers—was able to get in on the ground floor of a boom. The falling interest rates and rising government spending that followed has kept the boom alive.

If you were smart enough, prosperous enough, or lucky enough to start throwing money into stocks, bonds or a house in the 1980s and 1990s, you're probably well-fixed for retirement. But if you couldn't afford to save much, or if your blue-collar job was effectively doomed by the trade deals with Mexico (1994) and China (2000)—you've probably experienced the bitter end of the growth in “inequality” that belies our immense aggregate wealth.

An increase in unemployment is worse than an increase in inflation, according to Lerner. Mild inflation isn't very dangerous, he wrote. On the contrary, it often accompanies a rise in purchasing power and prosperity. Unemployment, on the other hand, is “the basic sickness” that must be avoided. When policymakers react to inflation by raising interest rates, businesses borrow less, asset prices get marked down, factories cut back production, and people lose their jobs. A wicked cycle begins.

I'm not an economist. Someone else might choose a different set of historical “dots” to connect, and arrive at a completely different explanation for the past 40 years of American economic history. History furnishes us with as many dots as there are stars in the night sky, and we can create any pattern of constellations with them.

I do not buy the popular assumption that the federal government bleeds the private sector for financing, that we must eradicate the national debt and the boomers must die before the US economy can normalize. In this “freshwater” economics view, the federal government is trapped. Keeping rates low will stoke inflation and raising rates will make it too expensive to service the federal debt.

If all that were all true—if the insatiable government snake were in fact consuming the private sector tail—the economy would have collapsed by now. Rather, the evidence suggests that the federal government finances the private sector. If Uncle Sam stopped spending or the Fed raised rates sharply, prices of stocks and bonds would collapse. It was the government that bailed out the private sector in September 2008 and March 2020, not the reverse.

Most people think my view is nonsense. But that’s my story and I’m sticking to it.

Looking to the future, it would be a shame if Fed chairman Jay Powell decided to fight an inflation that is caused by supply chain bottlenecks by raising the fed funds rate. Higher rates won’t unload Chinese container ships any faster, or increase the flow of computer chips from Taiwan.

I’m not against higher rates. Near-retirees would probably enjoy more savings options—and life insurers would not be so constrained—in a world where the 10-year Treasury bond yielded 3% per year and A-rated corporate bonds a bit more. But restoring a “Goldilocks” rate environment without a painful mark-down in fixed income and equity prices—and without higher unemployment—will be difficult.

© 2021 RIJ Publishing LLC. All rights reserved.