To Make the Economy Better, Let’s Not Make It Worse

By Kerry Pechter *Thu, Apr 14, 2022*

Raising interest rates, driving down asset prices, and sparking layoffs can't be the best way to neutralize a petroleum-driven inflation. But higher rates could make real returns on bonds positive for investors.

Inflation is the obsession du jour, so on Tuesday I spent my lunch hour listening to economists discuss the “I” word in a live panel discussion broadcast on Twitter. Their main concern: That the Fed’s response to inflation might cause a recession.

The Bipartisan Policy Center (BPC) in Washington sponsored the one-hour colloquy. Its expert guests included Justin Wolfers, an economist at the University of Michigan, Diane Swonk, chief economist at Grant Thornton, and Xan Fishman, director of Energy Policy and Carbon Management at the BPC. Shai Akabas, the BPC’s Director of Economic Policy, moderated.

The broadcast coincided with this week’s release of the March 2022 Consumer Price Index (CPI) report. As you’ve probably read, the annualized “headline” inflation rate, which includes groceries and gasoline, was a fairly shocking 8.5%, with a 1.2% rise in March alone.

The “core” inflation rate, which excludes the cost of food and energy prices, was 6.5% year over year. It rose a mere 30 basis points in March. The near 50% increase in gasoline prices over the past year, and its effect on the cost of transporting food, presumably accounted for at least part the 2% gap between the headline and core inflation rates. But let’s not presume.

Irony is the currency of journalism, and the BPC’s Akabas initiated the conversation by invoking one. The general public appears to have interpreted the steady tattoo of news about inflation as an indicator that the US economy is sick, he has noticed. “Inflation is on everyone’s mind. People think the economy must be losing jobs, and that things must be bad overall,” he said.

But they’re getting it backwards, he added. Higher inflation is symptomatic of a strong economy—as measured by today's low unemployment rates. People are working and spending. Job openings are going unfilled because so many people have jobs. The economy, therefore, is so good that it's bad. To make it better, we must make it worse.

The experts discussed possible causes of the high inflation rate, and tried to weight them. Among the culprits:

- **High oil and gas prices.** The price of oil rose 32% over the past year, the panelists agreed. The average price of gasoline in the US was $2.86 per gallon in March 2021 and $4.10 in March 2022, for a 43% rise. Xan Fishman said that China's latest COVID-related lockdown could slow its economy enough to weaken its appetite for petroleum, thus removing some of the demand-driven upward pressure on oil prices.
- **Russia's invasion of Ukraine.** "Whats happening in Ukraine is not a fundamental underlying pressure" driving inflation, Wolfers said. "Russia won't reinvade Ukraine." He expects no further Russia-related energy shocks. They noted that gasoline prices tend to stay elevated even after oil prices decline; they didn't explain why.
- **Congress' big stimulus bill, passed last summer.** Policymakers "had two choices," Wolfers said. "A, they could under-do a stimulus or B, they could over-do a stimulus." He said he would have recommended Path B "in a heartbeat," but he might not have released so much of it in so short a time. "We could have made those investments more slowly and it would have worked just as well," he said. Swonk agreed: "I'd rather we do too much than not enough."
- **Release of pent-up consumer demand.** Swonk said she has seen "hotel room prices going up from suppressed levels a year ago." At airports, she said, the number of people passing through Transportation Security Administration check points has recovered almost to 2019 levels. Some restaurants remain closed because they lack adequate staff, not customers.
- '**Shelter' inflation**. This is more a symptom than a cause, but with inflation there's not necessarily a difference between the two; hence its ambiguity. Swonk noted the "surge in rents," which tend to lag surges in home prices by about a year. "Even after some of the steam comes off overall inflation numbers, we probably won't see an abatement in shelter costs," she said.

Neither economist suggested any danger of "runaway" inflation. Neither invoked high government spending, high budget deficits or high long-term federal debt as possible sources of inflation. All of those factors were true during the Great Moderation, when headline inflation was regarded as sublimely low.

So what should the Fed do? No one seems to recommend Milton Friedman's advice anymore, which was to reduce the money supply; it's almost impossible to measure the "money supply."

"The right answer is for the Fed to move closer to a 'neutral' interest rate, but that's still some distance from where we are," said Wolfers. [The neutral rate is the mythical Goldilocks rate at which the economy is neither shrinking or growing.] "Right now, the Fed is raising the nominal rate just to keep up with inflation. It's not tightening, it's just becoming less expansionary."

As for the likelihood of a recession, Wolfers was less pessimistic than Swonk. "I've been surprised by the frequency of the use of the word 'recession' lately," he said. "It puzzles the heck out of me. We're creating 400,000 jobs a month. The economy is going gangbusters. So I don't know where the recession talk is coming from."

But Swonk worries that aggressive anti-inflation tactics by the Fed could tip the US economy from too hot to too cold by early 2023—especially if the Fed simultaneously raises the Fed Funds Rate and sells a bunch of the mortgage back securities (MBS) that it bought during past crises as a way to put a floor under falling bond prices. That purchasing process was known as *quantitative easing*; its reverse is called *quantitative tightening*. (Selling the MBS will increase their supply, putting downward pressure on their prices and, ipso facto, upward pressure on their yields.)

"The Fed would like to get the Fed funds rate to 2%," said Swonk. (The Fed funds rate is the rate that banks pay to borrow reserves from each other. It was 2.43% in April 2019, after having been close to zero from December 2008 to December 2015.)

"But then there's the economic quagmire of the Fed's balance sheet." She noted that *quantitative tightening*—a term-of-art for the sale of financial assets that are on the Fed's balance sheet—"can amplify the effects of rate hikes in ways not necessarily well known. I'm afraid that the monetary policy could cause a recession or even a contraction in growth by the end of this year."

No one mentioned the potential impact of rising interest rates on the stock market. Rising rates trigger instant mark-downs in the market prices of bonds. But the effect on stocks isn't as direct. The stock market seems more like a JENGA tower: after an indeterminable series of quarter-point rate hikes, it will collapse. Nor did they mention that higher rates could make investments in new bonds more attractive for savers (and insurance companies).

During the past 20 years, neither Fed chairs Alan Greenspan, Ben Bernanke, Janet Yellen or Jay Powell figured out a way to raise interests rates from zero back to neutral without triggering some kind of economic calamity. Some fresh thinking may be required. Raising interest rates, driving down asset prices, and sparking layoffs can’t be the best way to neutralize a petroleum-driven inflation.

Note: My understanding is that the Fed doesn’t exactly “raise” rates. Instead, the Federal Open Market Committee, through its purchases and sales of bonds, reduces its “accommodation” of the banks’ demand for reserves–which banks need in order to cover the checks written by their customers. Banks then have to compete a little harder for Fed Funds, which they accomplish by bidding up the Fed Funds Rate.

Accommodation can become too much of a good thing. “Current US monetary policy is set at peak accommodation, which is putting upward pressure on inflation,” said St. Louis Fed President Jim Bullard in a recent **statement**. In his opinion, “This situation calls for rapid withdrawal of policy accommodation in order to preserve the best chance for a long and durable expansion.”