Can the Fed Prevent a Surge in Inflation?

Geoffrey Woglom
Professor of Economics (Emeritus)
Amherst College

Rotary Club of Watsonville
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National Economic Education Delegation

- **Vision**
  - One day, the public discussion of policy issues will be grounded in an accurate perception of the underlying economic principles and data.
- **Mission**
  - NEED unites the skills and knowledge of a vast network of professional economists to promote understanding of the economics of policy issues in the United States.
- **NEED Presentations**
  - Are **nonpartisan** and intended to reflect the consensus of the economics profession.

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Who Are We?

- **Honorary Board: 48 members**
  - 2 Fed Chairs: Janet Yellen, Ben Bernanke
  - 1 Secretary of the Treasury: Yellen (D)
  - 6 Chairs Council of Economic Advisers
    - Furman (D), Rosen (R), Bernanke (R), Yellen (D), Tyson (D), Goolsbee (D)
  - 3 Nobel Prize Winners
    - Akerlof, Smith, Maskin
  - 1 Secretary of the Treasury Yellen (D)
- **Delegates: 585+ members**
  - At all levels of academia and some in government service
  - All have a Ph.D. in economics
  - Crowdsource slide decks
  - Give presentations
- **Global Partners: 45 Ph.D. Economists**
  - Aid in slide deck development

Available NEED Topics Include:

- US Economy
- Climate Change
- Economic Inequality
- Economic Mobility
- US Social Policy
- Trade and Globalization
- Trade Wars
- Immigration Economics
- Housing Policy
- Federal Budgets
- Federal Debt
- 2017 Tax Law
- Autonomous Vehicles

Battling Democratic Economists

Treasury Secretary Jane Yellen, 3/14:

To get a sustained high inflation like we had in the 1970s, I absolutely don't expect that. We have had very well anchored inflationary expectations, and a Federal Reserve that's learned how to manage inflation.

Former Treasury Secretary Larry Summers, 3/26:

It may be that a way will be found to bring it under control. But as I look at $3 trillion of stimulus, $2 trillion of savings overhang, …,rates expected by the Federal Reserve to be at zero for three years even in a booming economy, …, and much new fiscal stimulus to come — I'm worried.

Can the Fed prevent an increase in inflation?

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The Fed's Evolving Role in the Macro Economy

- Employment Act of 1946
  1. "Full employment" is an Executive Branch Responsibility.
  2. Council of Economic Advisors.
  3. Economic Report of the President.
- Humphrey Hawkins Act 1978 & the Fed's "Dual" mandate
  - Maximum employment, consistent with
  - "Price stability, " i.e., 2% inflation as measured by the PCE

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Monetary Policy at the Fed

The Federal Reserve System consists of:

- **Board of Governors** (7 members), located in Washington, DC
- **12 regional Fed banks**, located around the U.S.
- **Federal Open Market Committee (FOMC)**, includes the Bd of Govs and presidents of some of the regional Fed banks

Jerome Powell
February 2018

- The FOMC has 8 scheduled meetings a year to set monetary policy.

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Monetary Policy is About Interest Rates (Not the Money Supply)

- **The Minutes of the 3/16/2021 FOMC Meeting mentions:**
  - Money Supply, M1, M2 – 0 times
  - Interest rates – over 20 times
- **Why: The relationship between the money supply and *short-run* macroeconomic variables was never very tight. With the advent of bitcoin and other innovations, it is almost non-existent.**

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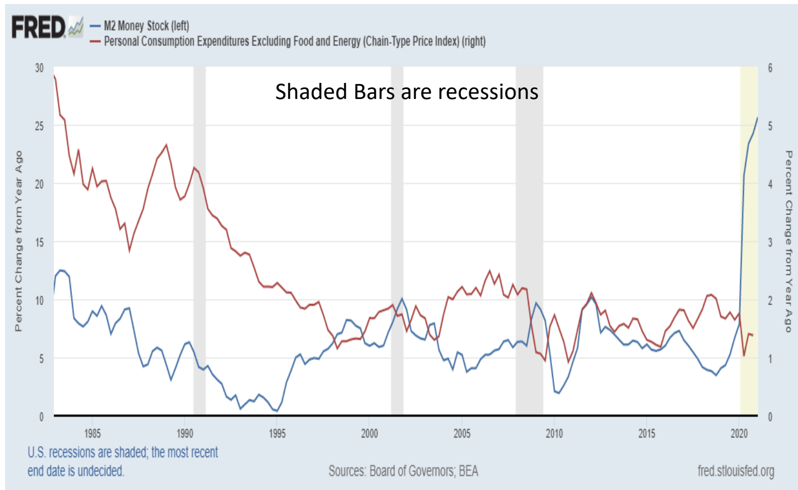
Money Growth and Inflation

The behavior of inflation over the last 20 years has been a bit of a mystery. But, it has little to do with money growth in the short run.



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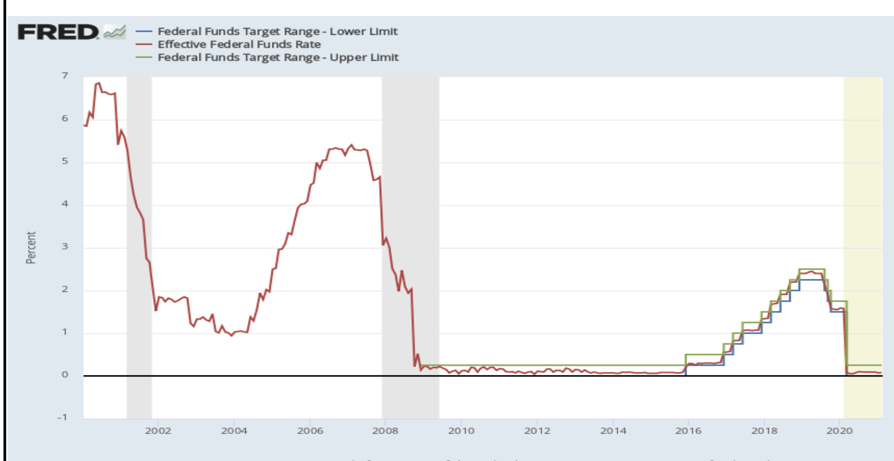
Monetary Policy Is About the Interest Rate



The FOMC does not set an exact number for the Federal funds rate. Instead, it sets an upper (green line) and lower (blue) range. "The Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent…" (4/28/2021)

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Quantitative Easing (QE): A New Tool

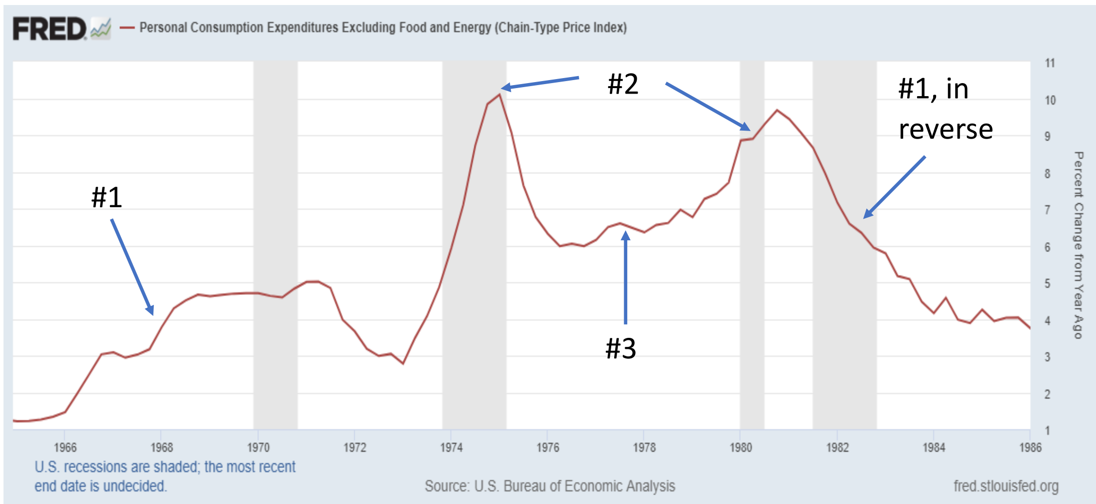
- **The Fed can buy (or sell) long term Treasuries, or risky securities to raise (or lower) bond prices which are inversely related to interest rates.**
- **And, boy did they!**
  - 9/08: Fed holdings of US Treasuries: $0.5 tr; Mortgage-Backed Securities, 0
  - 12/09: US Treasuries, $1.8 tr; MBS, $0.9 tr.
  - 10/14: US Treasuries, $2.5 tr; MBS, $1.7 tr.
  - Between 3/20 and 5/21 US Treasuries +$2.5 tr.; MBS + 0.9 tr.
- **Presently, the Fed is buying $120 billion a month in long-term Treasuries and Mortgage-Backed Securities.**

Causes of Inflation

1. **Excess aggregate demand: total desired spending in excess of the economy's ability to produce, *potential GDP*. (Vietnam inflation)**
2. **Supply Shocks: Increase in the price of a key input. (Oil prices in the 1970s & 80s)**
3. **Expectations of inflation: expected inflation becomes self fulfilling (late 70s inflation persistence)**

It is supposed to work the other way too!

Examples



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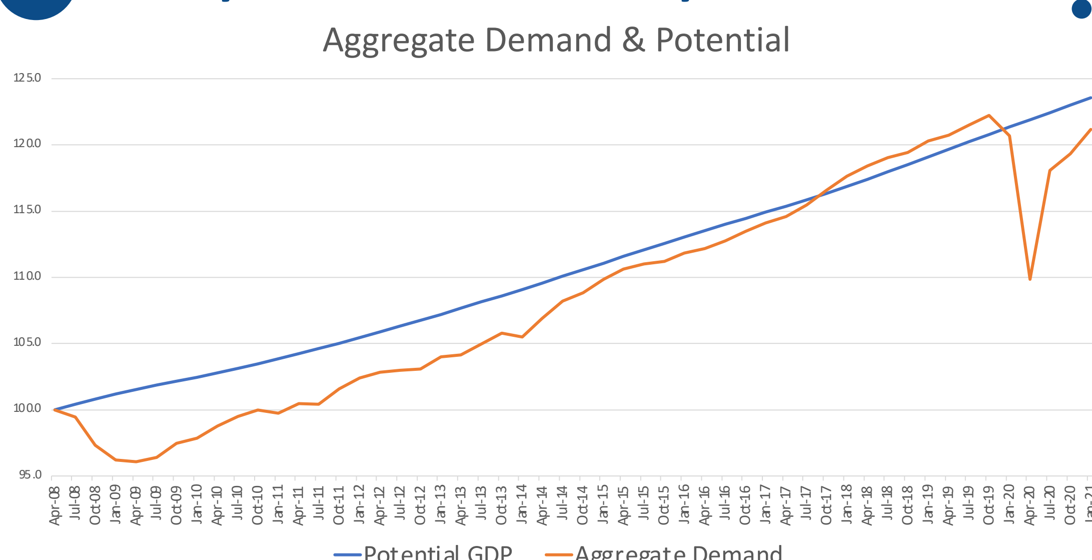
Recent Mysteries: The Stability of Inflation



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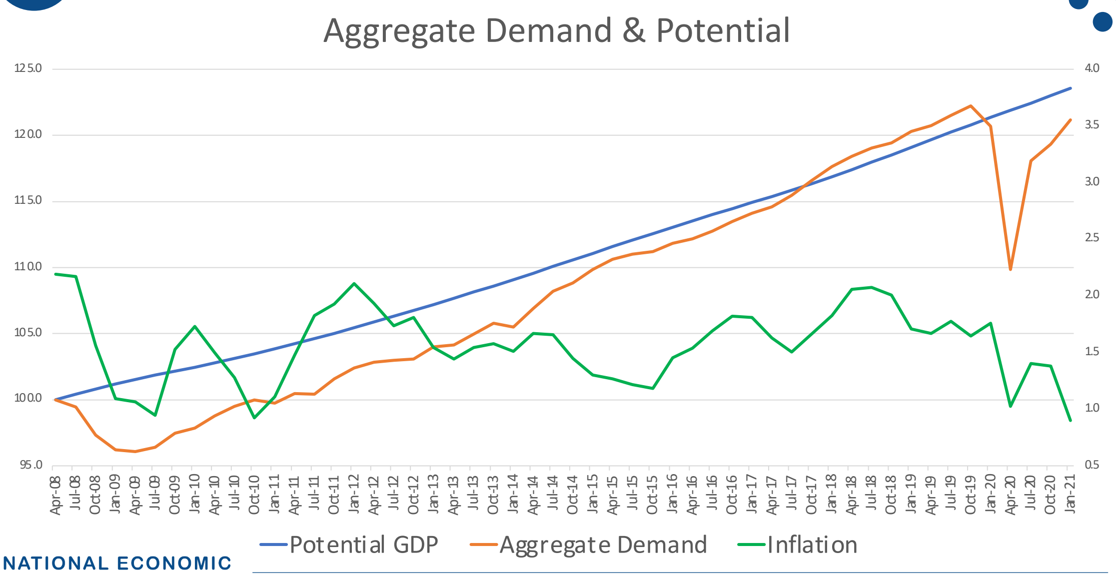
Recent Mysteries: The Stability of Inflation



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Central Banking in One Slide (Prepandemic)

Aggregate demand falls when interest rates rise. Therefore:

1. **When aggregate demand is too high, raise interest rates to prevent rising inflation.**
2. **When aggregate demand is too low, lower interest rates to prevent rising unemployment.**
3. **Communicate clearly and consistently your intention to control inflation; to “anchor” inflationary expectations.**
4. **Pray for no supply shocks.**

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Pre-pandemic problems with Monetary Policy

1. **In aiming for future inflation at 2%, inflation turned out consistently below target.**
2. **Which, among other things, led to very low interest rates.**
   1. Low interest rates mean that the Fed does not have much ammunition (i.e., interest rate cuts) to fight recessions.
   2. Low interest rates encourage speculation in a "search for yield."

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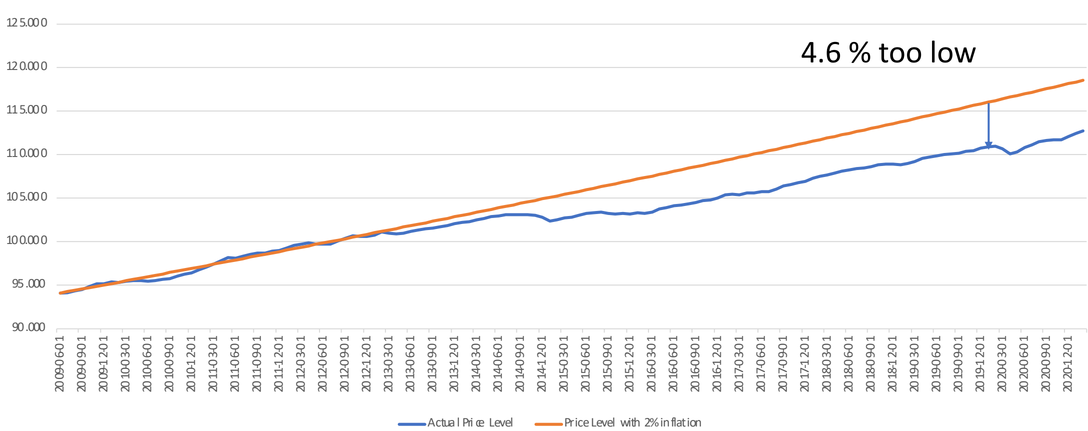
Actual Prices and the Fed's 2% target



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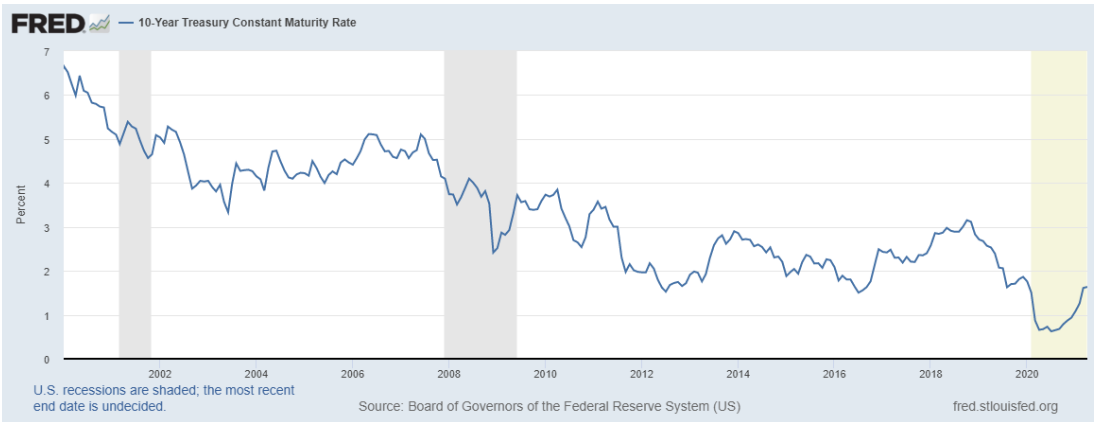
Interest Rates are Too Low



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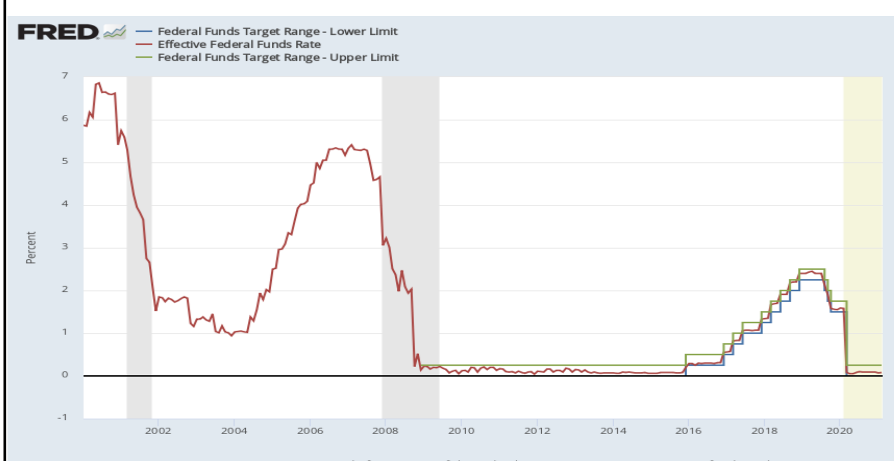
Low on Ammo



In the Great recession, the Fed cut interest rates by 5 percentage points and it still wasn't enough.

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Innovations under Powell

- Abandon "normalizing the balance sheet"
- Put more emphasis on the maximum employment goal.
- Conduct monetary policy to achieve average, realized inflation of 2 % (instead of targeting 2 % for the *forecast* of future inflation).
- Explicitly tolerate inflation in excess of 2%.

This is in contrast to Ben Bernanke and Janet Yellen who both wanted to normalize the balance sheet and who adamantly refused to raise the inflation target during the Great Recession

FOMC Policy Statement 4/28/2021

The Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time.

But Fiscal Stimulus Raises Aggregate Demand!

And, there has been a lot of it:

1. **Roughly $4 trillion in 2020 much of which was saved and may be spent this year.**
2. **American Rescue Plan, $1.9 trillion.**

Proposed:

3. **American Jobs Plan and American Family Plan $4 trillion over 8 years, financed with tax increases spread over 15 years.**

The America Economy is $22 trillion.

Obama stimulus was less than 6% of GDP

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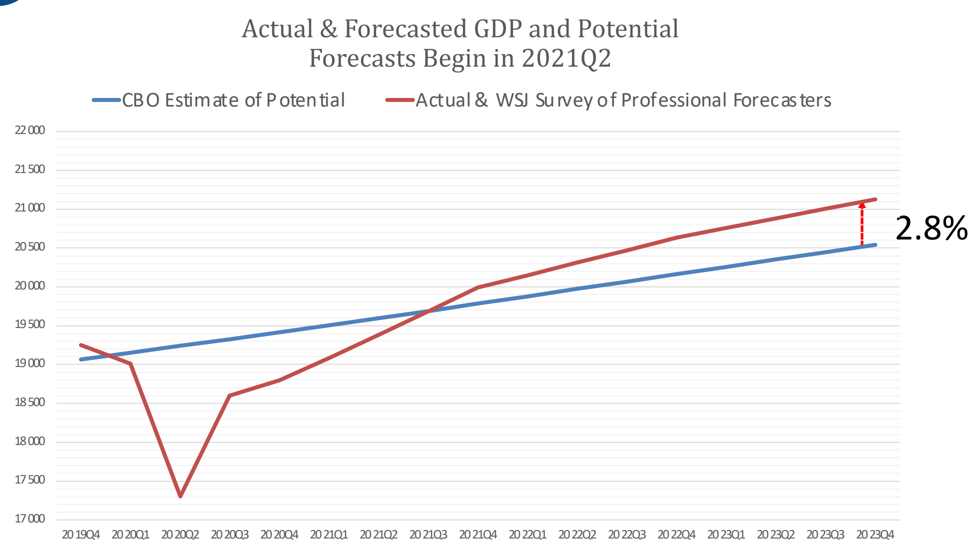
Forecasts of the Recovery



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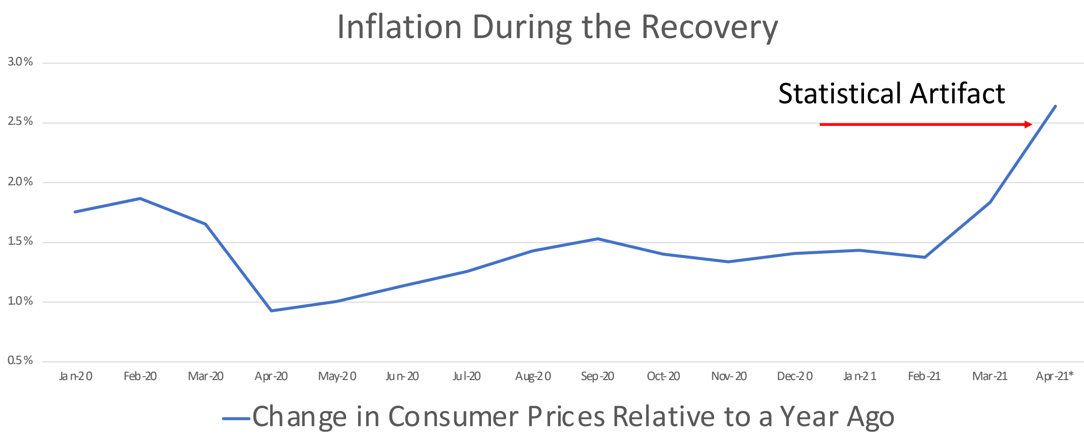
Inflation Has Been Stable so Far



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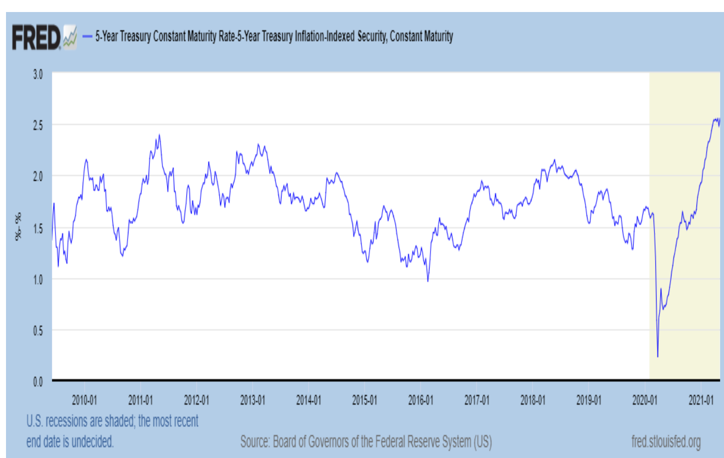
Financial Markets Expectations of Inflation over the next 5 years

The graph shows the difference between the interest rate on 5-year Treasuries and 5-year inflation protected Treasuries (TIPs).

This difference should be an ***overestimate*** of inflation expected inflation over the next 5 years

WSJ forecasters see a temporary increase but only in 2021. Consumer expectations of inflation over the next 3 years have increased by 0.5%



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So, What's the Problem?

If the Fed sees an uptick in inflation, can't they raise interest rates?

- **Economic Problems**
  1. Aggregate demand has tremendous inertia, it could take years for a rise in interest rates to slow demand. Particularly, given the Fed's new stance on tolerating inflation.
  2. Significant danger of "overshooting." What would a substantial rise in interest rates do to stock prices; financial stability?
- **Political Economic Problem**
  1. Would the Fed raise rates with the 2022 elections pending?
  2. A substantial rise in rates would make our deficit and debt problems much worse.

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Thank you!

What Do You Think?

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Geoffrey Woglom
grwoglom@amherst.edu

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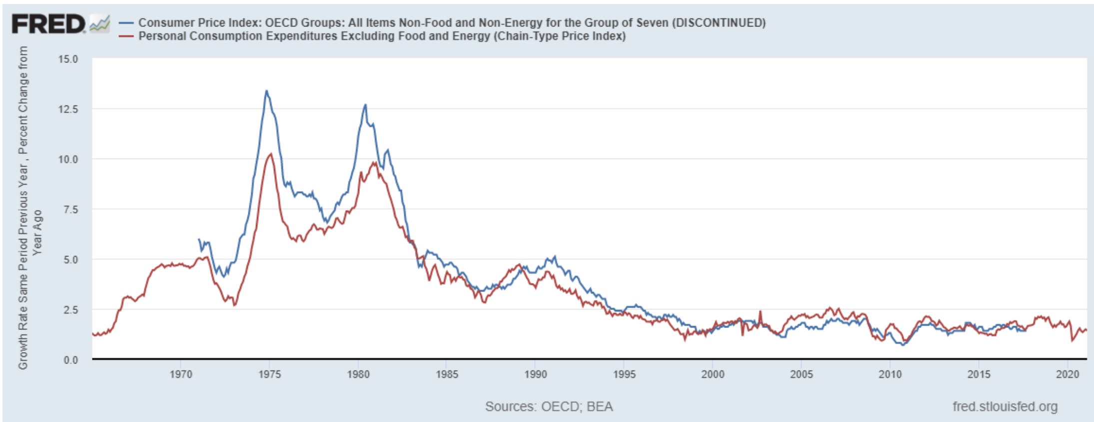
The Great Moderation: Inflation



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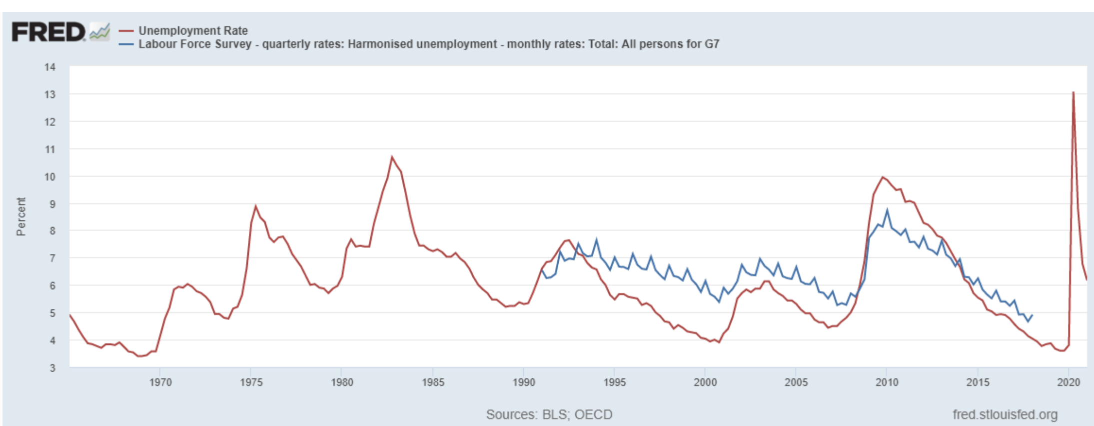
The Great Moderation: Unemployment



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