What can the US government do to control inflation?

American Lyceum Debate 2023–06–08 Th

Announcer: The American Lyceum rebuilds the institution of debate as a cornerstone of our democracy. Once vital and informative, presidential debates have devolved into disrespectful open-mic cage-matches. For the Republic to survive, we the people, must learn to talk to one another again. The Lyceum format is focused on finding solutions, not a binary resolution. Three participants have three minutes to propose three ideas aimed at one problem. The American Lyceum lets us rebuild the foundation of civil society.

Tim Kane: A federal statistical agency recently announced that the average prices facing consumers have gone up by 4.9 percent over the last year. Now, if you look at the long-term inflation index, it's gone up about 20 percent over the last four years. So, we've got a problem. The question in today's Lyceum debate is: What can the U.S government do to control inflation? We've got three excellent speakers. First is PhD Economist and Professor of Economics at George Mason University, Dr. Garrett Jones. Dr. Jones recently authored the book "The Culture Transplant." Two other PhD economists join us: Brad Delong, Professor at Berkeley University and author of The New York Times bestseller "Slouching Towards Utopia," and finally, Dr. John Taylor, a colleague of mine at the Hoover Institution. Dr. Taylor is a Professor of Economics at Stanford University and author of, among many other books, "First Principles."

We'll start with Dr. Jones offering three ideas to tackle this problem.

Garrett Jones: Thank you. So, for the last couple of decades, the Federal Reserve had done a really great job sticking to a two percent inflation target. Even in the wake of the global financial crisis, a lot of people around the world thought that the U.S would end up with some kind of high inflation or some kind of very negative inflation for a while. None of that happened. But when COVID came along, the vast set of stimulus packages, the Fed's unprecedented money supply increases, these things, you know, after a year or two, set off just the kind of inflation that Milton Friedman would have expected. So, what can we do over the next few years to basically reinforce the Fed's commitment to a low and stable inflation rate?

I think there are three things that I think are important. Before I get to those, I have to say the overarching story here has to be that the Fed, as an institution, and the individual members of the Fed need to be openly and personally committed to something like a Taylor rule, to something like a commitment to keeping inflation at two percent, raising rates when they get higher than that, and cutting rates a lot when they get lower than that. So, the Taylor rule, that's some kind of durable commitment to low and stable inflation, is crucial to keeping the school over the longer haul.

So, the first step is really a reiteration of that. My first point is that the Fed should be putting people on the Fed who are overtly, openly committed to a low and stable inflation rate, into something like a Taylor rule. Personnel is policy, we all know that in Washington. And so, having people on the Fed whose research agenda has been focused on fighting inflation, who believe that paying the short-run cost of higher unemployment is worth the benefit of low stable inflation over the longer run, and finding people who are willing to make those political costs, who are willing to take political hits in order to keep that target, that's like commitment is really crucial, and it's hard to find. And we should hire people who are committed to sticking to something like a Taylor rule.

Second, the Fed needs to be more focused on a narrow bailiwick. There's been increasing pressure for mission creep from Capitol Hill over to my right for the Fed to dive into things like environmental and social justice causes and making that part of the Fed's mandate. There's a really good reason to have a division of labor when it comes to economic policymaking and having the Fed stick to financial stability and low, stable inflation as its overwhelming target. That should be made more clear both within the Fed and up here on Capitol Hill. A centralized focus on the inflation target over anything else.

Third, in the very long run, the biggest threat to low inflation rates is bad fiscal policy. The Nobel Laureate Tom Sergeant taught us that persistent inflation is always and everywhere a fiscal phenomenon. We know the entitlement problem has never been fixed and it's not going to go away. So, making sure that some kind of political deal happens between left and right, even political deals that I don't like, that will solve the problem of our looming persistent deficits. That's going to be crucial to helping the Fed maintain its job. A healthy long-term fiscal commitment is crucial to low, stable inflation, and that should be part of the Fed's job depends on Congress doing its job right.

John Taylor: So, Garrett, thanks for your words. You mentioned we need more inflation hawks. On the book, that was the thing I wrote, a more inflation arc. Aren't there pretty much hawks, alright? They're just not doing the right thing. What distinguishes who's hawks and who's not doing the right thing?

Garrett Jones: Yeah, that's a totally fair question, right? Like, there are hawks on paper and then there are hawks in practice. I guess in the political role, people call those chicken dogs, right? So, you're right, and I have a soft spot, for instance, for the old conservative Central Banker story that part of the way you get credible inflation fighters in the Fed is you appoint some people who place at least substantial weight on the view that monetary policy just doesn't matter that much. This is why it was great when we had Charles Placer on the Fed, the person who coined the term real business cycles. It's…we as outsiders can only preach so much, right? So, at some point, we have to take the White House view, the personnel is policy, and appoint people with long-standing reputations as being hawkish because once we put them there, they're there. The two of you can do evangelization from the outside that might change the minds. The rest of us have to just vote for the right people for the job.

Brad Delong: I mean, Garrett, you see in the past few years a bunch of uncertainty and fluctuations in medium and long-term inflation expectations in the market, you know, which I don't see at all. You know, I see a very surprising burst of inflation, an order of magnitude larger than the Federal Reserve or indeed many other commentators were expecting, coming out of the plague depression. But throughout all of that, the long-term gaps between Treasury tips and phenomenal Treasury rates remain pretty constant and remain consistent with long-run CPI inflation of two and a half percent or less. And so, I've taken great confidence that there actually hasn't been a lot of fluctuation in medium-term and long-term inflation expectations over the past three years. But you're clearly seeing something different than I am.

Garrett Jones: You're exactly right. I think that's actually the best counterpoint, right? Is that the financial markets that are trying to guess the long run and the medium run are guessing that the Fed's going to get its job right and is going to do its job right. And my hunch Looking at how they turned out, the market turned out to not apparently see the inflation that we just experienced over the last year and a half or so. What I've concluded out of it, and this takes us outside of normal economics, I confess, is that the market has a sense that the Fed's going to do it, but they just don't know how the Fed's going to do it, right? So even though a lot of these actions in between seem quite inconsistent with getting out to two percent over the long run, they're basically leaving it to the Fed to figure it out. And I think, in a way, our discussion is part of this. They have a sense, the market has, the market is nervous. You see market commentators talking about this, saying that they're wondering whether the Fed is totally committed to two percent. And those verbal comments now seem like they could be foreshadowing a market price response later. So, getting institutions better, and by whatever means necessary, is going to be part of the process of getting us back to that two percent. I think the market thinks it's going to happen; it's just that they don't know how it's going to happen.

Brad Delong: Well, for my view, the Fed should keep doing what it has been doing.

That medium-term inflation expectations, at least all the bond market registers of them, have been and continue to be nailed to what they need to be for the Fed to hit its two percent inflation target without undue unemployment in the medium term. And I find it very hard to think of a scenario in which, you know, the bond market is less pessimistic about future inflation than other people whose views matter in terms of forming this thing we call inflation expectations in our model. You know, that is, the penalties of the bond market for guessing that inflation will be lower than it'll be are very steep, and the other benefits from guessing inflation will be higher are quite small. So you'd expect the bond market to be the canary in the coal mine, and if there were any inflation threatening you, anywhere the expectations cycle, you'd think the bond market canary would drop dead first. And without expectations of inflation, it's very hard to see how any inflationary spiral gets accomplished, and how anything can happen other than things returning to the Federal Reserve's target, you know, in the medium term, unless the Fed keeps goosing the economy with an unwarranted stimulus year after year after year, which I don't think the current FOMC is in the business of doing.

As to Monday morning quarterbacking for what's happened since the start of the plague, well, I think if the Fed moved earlier to tighten, you know, we would not have had as rapid and complete a recovery from the plague depression. And so, America would be poorer, and, you know, the markets, Von Hayek, and crowdsourcing solutions to problems of production would be much less effective at boosting economic growth. Um, so, the inflation we've seen over the past year and a half, while alarming and unexpected, looking back at it as it seems to pass into the rearview mirror, it looks to me a lot like what happens when you rejoin the highway at speed. You leave a bunch of rubber on the road, but leaving rubber on the road is better than getting onto the highway and then getting rear-ended.

For my third point, let me shift, and because I'm profoundly disappointed, not in the Fed, but rather in our Congressional leadership over the past couple of months, that Schumer, McConnell, McCarthy, and Jeffries should be providing much more backup to Janet Yellen and Jay Powell as they try to wrestle with financial stability issues. You know, the Congress grabbed a bunch of power to deal with financial stability back from the Federal Reserve and the Treasury with Dodd-Frank. And part of that grabbing it back means that they then have a responsibility to actually exercise the powers that they have accumulated, even if doing so is going to expose them to political bricks flung from one side or the other.

Garrett Jones: So, my question, Brad, is which things do you wish Congress were doing differently, and on a concrete level, is this a policy problem or just a one-off issue in your view? I think that's the most important question I can ask, and I'm just going to stick with that one.

Brad Delong: Well, right now, I would settle for a letter from the four leaders saying that they understand that the financial system, after 15 years of extremely low-interest rates, has got itself wedged into a situation in which it is awash in liquidity. And that a much larger share of bank deposits than anyone had ever imagined is above the insurer FDIC insurance cap. And that Congress understands that this needs to be rapidly addressed through legislation.

And just that piece of paper for Jay Powell and Janet Yellen to wave around, you know, as they say, “We are, in our actions, now using whatever emergency powers we still possess to try to run in front of where the Congress is going,” would, I think, give them much more authority to figure out just what to do with First Republic right now and whether there will be other strange and weirdly things that cause the possibility, but not the certainty, of some kind of systemic risk coming from these second-tier, not quite too big to fail but big enough to be unpleasant if they do fail banks.

John Taylor: Brad, you mentioned the Fed did not get behind the curve. When I looked at the 25 basis points when the rate should be five, it was a year like that. Don’t you think that’s a bit of a problem, getting behind the curve?

Brad Delong: If not for the zero lower bound on interest rates, I would agree with you. You know, but we do have an effective zero lower bound on the nominal interest rates the Fed can push its overnight and three-month treasury bills to. And that creates this strange and weird optimal control asymmetry, right? In which when you’re coming out of a depression, when interest rates are extremely low, at the zero lower bound, if you move late, you can move fast and catch up. Well, if you move early and push the economy back to a situation in which the neutral rate is at or below the zero lower bound, you then cannot recover from a mistake. So, the fact that there’s one kind of mistake that takes you over the cliff while the other kind of mistake leaves you on solid ground means you really should move late and fast, right? That the Taylor rule needs to have an extra optionality term in it, in which you lag behind where you would be without the zero lower bound for a while, but then when you’re confident that returning to the zero lower bound is almost out of the question, you then move fast, which is, I think, what they have done.

John Taylor: So, first of all, I think it’s pretty evident that in 2022, the Fed got behind. I mean, a half a percent with the rate, and we should have been three or four or five percent or whatever, and it was quite a span of time. They moved aggressively, but I think that’s the first problem to look at: why did this happen? It’s unusual to have an inflation

But I think that’s the first problem to look at. Why did this happen? It’s unusual to have an inflation rate of 10% and the funds rate at a half a percent. So, that’s the first thing that we did have a problem. We needed to make it up.

The second thing I would mention, Tim, is it's a global issue. It's not just the Fed. The ECB seems to be behind. We're going to have the former Governor of the Bank of Japan speak next week. He's there behind. Inflation is roaring in Latin America. So, we have a general problem now about this, and I think that's something that needs to be addressed. Perhaps we need to think about this more generally. It's not the Brad Garrett mentioned the Taylor rule. That's one way to do it, but that would eliminate some of the problems that we have had. So, that brings us to my third point.

Do we need to have something more systematic? It wasn't that long ago that the Fed used to write down what rule they're thinking about and deal with it that way. So, I think now may be the time because we have a little bit before that behind. I'll let this watch is really like that maybe it did that much damage. I think it did. It's that others said for banks get behind too. 27 banks tend to follow each other. They worry about the exchange rates. Or we've seen that they haven't shared many times. That may be what's happened if you're up in Latin America. I think the thing is now, if we maybe take advantage of the situation that we have been in, there's time. We're not in a recession yet. It's time to make the adjustments now, and that's what I think we should be doing.

So, let me finish up. I see there, your number one. There, maybe we can see it. This also suggests to me the Fed, Guppy line, the big tone. Other central banks are also behind. Everyone but that big town. So, this is a time where we can stipulate some kind of rare, some kind of process, some kind of procedure so we can evaluate systematically what central banks or central bankers thank you.

Brad Delong: The difference between me and you is that you say the Fed moved late, and I agree the Fed moved late and fast, but I do think moving late and fast is optimal. You know, given the asymmetry and the constraint imposed by the zero lower bound on interest rates. And I don't see, I do not see any significant damage that was done to the economy by moving late and fast. I see rather a benefit in terms of a more rapid reapproach to full employment and getting the von Hayekian crowdsourcing resource allocation form of the market back in gear in a serious way long before it would have happened otherwise. I do see potential damage in the crypto grift bubble we saw in 2022, which redistributed an awful lot of money and burned a huge amount of electricity. But aside from the crypto bubble of 2022, what is the damage you see to the economy coming from the Fed's moving late, given that medium and long-term inflation expectations seem to be nailed where they should be, at least according to bond market measures?

John Taylor: So, I think the main damage is the credibility. The Fed has maintained somewhat close to two percent for a long time. They let it get as high as 10%. They're bringing it down and not all the way back to two. That's for sure. And there's debate about why they need to go a little bit Further to get it back to two, so I think the whole credibility of the Fed is up for grabs. There's debate amongst members who debate about who should be reappointed. I think the zero bound is not really the issue. I think maybe I'm wishful thinking, but I don't think so. We have a two percent inflation target. That's where we should aim for. So, I think taking the rate negative is not really the key. The key is to stay with the policy. Maybe it should be higher than two. I don't think so, but two is also universal. That goes back to what I'm saying about the international aspect too. It's very common in many countries at this point. So, we did take that into account too. This is a global issue.

Garrett Jones: Yeah, I think the point that Brad made that's important is that it does look like this was a pretty fortunate inflation in a sense. All that extra stimulus created a lot of jobs and reduced a lot of uncertainty about the labor market. A lot of people, a couple years ago, were really wondering what would happen to labor markets after the COVID recession. And if there's one thing we've learned over the last two years, it's that wow, labor markets can just find a lot of workers. Much more than I would have predicted. Also, I have to say that the big surprise inflation managed to expropriate a lot of wealth from bondholders and give that wealth back to the American taxpayer. That solved one small part of our long-run fiscal problem. So, you know, one-off events are something that are outside of our normal rational expectation story. In this case, it looks like it gave us a learning experience.

Second, I think I want to point to John's idea. I would love for him to flesh out this idea. Do we need something like a G20 or G7 level conference of central bankers to systematize a rule, a credibility to inflation, a state-contingent rule for inflation? This seems like a moment where one could actually get a broad spectrum of central bankers to get together and come to some kind of agreement, the likes of which we've never seen before, and create a focal point for rich country monetary policy for decades to come.

Brad Delong: The inflation since 2021, we all expected that there would be some bottlenecks and some places in which prices rose as the economy reopened. And it turned out that where people were and what people were doing were in scarce supply relative to the demands of the market. But the amount of inflation and the duration came as a huge surprise to me and to a very large number of people. And we're still trying to process what this really means.

One thing does seem clear to me, right? That the relative price movements associated with the inflation, the responses of wages to labor shortages and prices to bottlenecks, we have seen since the start of 2001, are strongly, strongly positive.

Some that they are necessary if the market economy is to do its Von Hayekian crowdsourcing solutions to resource allocation jobs. And they are also great in that for the first time in this millennium, except for the last two of the Trump years, 2018 and 2019, for the first time we have an economy that is actually working for male blue-collar Americans. In the sense that they can see that they have opportunity to move to better jobs and the prospect of getting higher wages in the jobs in which they are. And those are wonderful things to have, even if they are accompanied by this unpleasant inflation, which makes everyone think the government's breaking its social contract by which you're supposed to By which you're supposed to go to the store and be able to buy the things you want to buy at the prices you expect. You know, plus the supply shocks of Putin's attack on Ukraine, though those have deranged the global economy substantially.

But the associated inflation that accompanies those relative price movements would have been strongly negative if it had fed through to elevated expectations of medium-term inflation in the future. Such elevated expectations would bring with them a temporary rise in the natural rate of unemployment and be a substantial loss. But I think there are no signs of any such shift in medium-term inflation expectations, and so, at least exposed, there are no net downsides and very powerful upsides to the policy the Federal Reserve has followed, although we can argue about the degree to which they were either quite smart or very, very lucky.

But so far, looking into the past and looking into the future and what the market expects, it really looks like Jay Powell and Company have got this so far. No guarantees.

John Taylor: Well, first of all, I don't think this burst of inflation is a surprise. It's just what we would predict from having rates so different from what lessons have taught us from the past. So let's chalk that up to the kind of mistake that you'd expect. We don't know the reasons. It could be the reappointment issues. It could be sensitivity to what's going to happen. It could be perceptions. It's a difficult thing.

The second thing I would mention is I think Brad's right to bring in the international stuff, in the Ukraine, in Russia, and stuff that complicates things in a way that I think we need to be aware of. I don't think it's as much of a problem yet, but it could be. And then the third thing, as Garrett asked, should there be some multilateral process here? I think there is something to be said for that. The Fed is a very important Central Bank, the BoJ, the ECB, etc., but we need to have more people involved in this discussion. And I think the evidence that we've seen recently in the last couple of years is where inflation has picked up, but it's not back to 2%. Maybe if we raise it or something like that. But this is the time to think a little bit about why did it happen, to have a discussion on the Senator backs, maybe do the G20, maybe do the

G7, whatever happens to be. But I think it's important to get that going.

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