[A History of Economic Whac-A-Mole :: Project Syndicate](): [Alan S. Blinderâ€™s]() new book, [A Monetary and Fiscal History of the United States, 1961-2021]()â€¦. There has been neither linear development nor much â€œprogressâ€� in figuring out how to manage modern economies in the interest of macroeconomic stability. Instead, Blinder describes:

> wheels within wheels, spinning endlessly in time and space â€¦ [with] certain themes â€¦ waxing and waning â€¦ monetary versus fiscal â€¦ the intellectual realm â€¦ the world of practical policy making â€¦ the repeated ascendance and descendance of Keynesianismâ€¦

Problems appear and are either solved or not solvedâ€¦. The response sets the stage for a new and different problem to emergeâ€¦. Actions taken in the recent past left the economy more vulnerable in some wayâ€¦. Can inflation be expected to ebb, or does it tend to be highly persistent, with each shift in the rate becoming permanently embedded in the likely future? When Blinder â€œentered graduate school in the fall of 1967 â€¦ empirical evidence virtually screamed out that [it could be expected to ebb] .... Theory and empirics clashed sharply. As Groucho Marx memorably asked, â€˜Who are ya gonna believe, me or your own eyes?â€™ â€� Going with your own eyes was not the right thing to do. As economist [Thomas J. Sargent]() soon showed in a â€œbeautiful five-page paperâ€� that was â€œunderappreciated at the time,â€� much of the theoretical debate â€œwas beside the pointâ€�â€¦. Now, the same problem is back. Do inflation expectations remain well-anchored or not? Is the answer the same as it was in the 1970s? It might well be, or it might not beâ€¦.

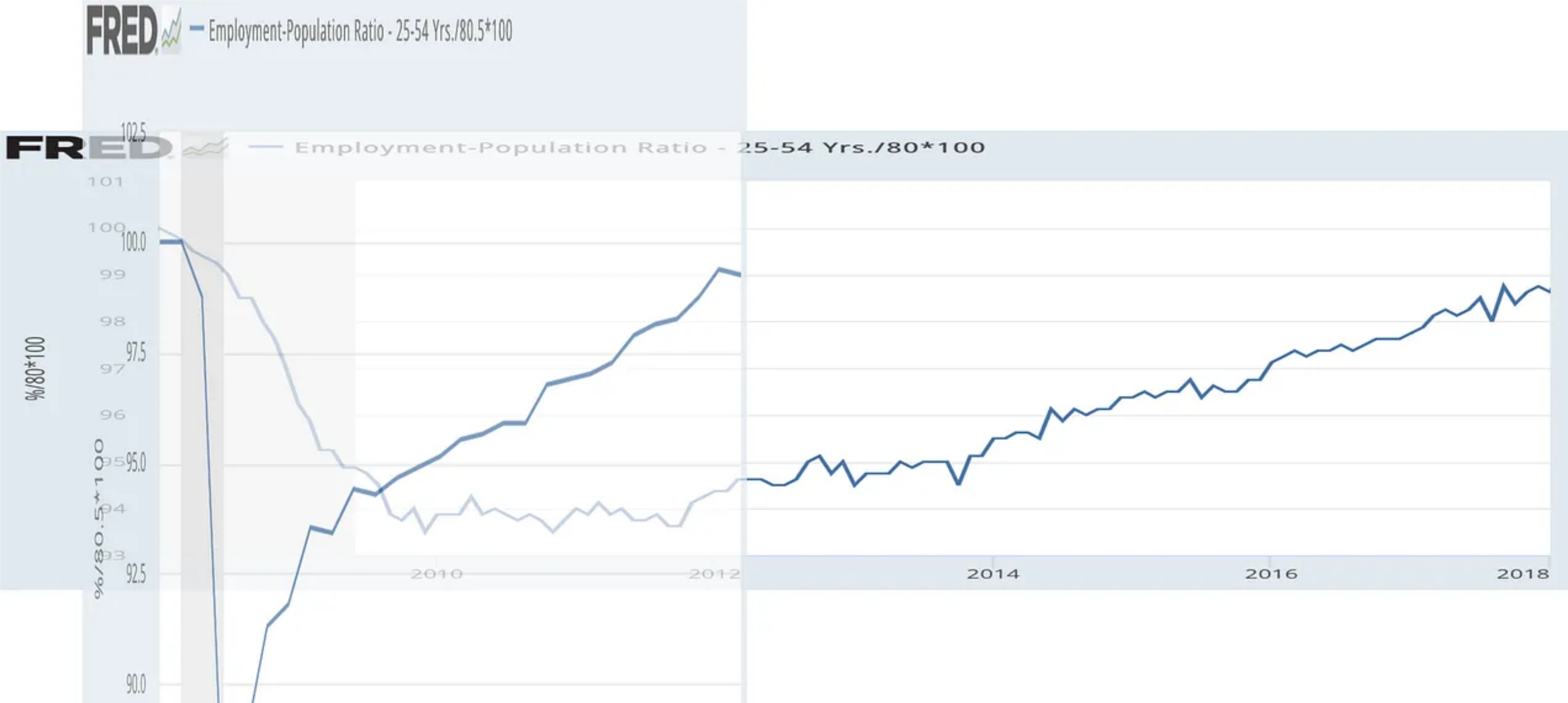
Blinderâ€¦ lets us ride shotgun along the extremely rocky road that US policymakers have traveled in their quest for price stability, full employment, financial resilience, and robust investment. Each episode produced by the Wheel of Fortuna is strikingly and â€“ I believe â€“ almost completely accurately described. Read and absorb Blinderâ€™s account, and you will be qualified to present yourself as a respected elder statesmen who has seen much macroeconomic policymaking up close, and whose advice warrants attentionâ€¦.

While history (correctly handled) can be very useful in helping us understand current situations, theory (at least currently fashionable theory) is notâ€¦. Monetary policymakers who make their decisions on political grounds should count on their reputations being permanently tarnishedâ€¦. Using fiscal policy properly to manage demand and support growth is incredibly complexâ€¦ in ways that are impossible for the political system to comprehend in real timeâ€¦

Two years ago, when the Biden administration-to-be was planning how to try to manage the macroeconomy, it sought to avoid three mistakes.

The first mistake was the trap into which the Obama administration had fallen: failing to prioritize properly and to set up the game board for the rapid return the economy to full employment. The Obama administration had a plan for a first round of recovery measures. It had no plan for what it would do if Republicans and blue-dog Democrats proved obstreperous, and its first round failed to do the entire job. The cost was a lost half-decade of growth, and a further widening of income inequalities. The Biden administration was not going to make that mistake, but would, rather, prefer to make its own different mistakes.

As to the counterfactual, one possibility would be one in which inflation was still below 2%, and in which the labor-market recovery from the Plague Recession of 2020 was as slow as the labor-market recovery from the Great Recession of 2008:



Recovery of prime-age employment from recession, start of recession = 100, Great Recession of 2008 and Plague Recession of 2020

Would that be a better world? ***Should*** the Fed have done that? I really do not think soâ€¦

It is at this point that I do have to admit that the economists I most respect are not doing much better:

> **Emi Nakamura**: *Noah Smith: Interview*: â€˜The recent increase in inflation is much more than historical experience would have predicted (which is about an increase in inflation of 1/3% for every 1% decrease in unemployment)â€¦. Supply shocks are back!â€¦ There has been a historic shift in demand from services to goods: <https://fred.stlouisfed.org/graph/?g=LnYU>â€¦ [and] secular shifts in demand can lead to the same inflationary pressures as supply shocksâ€¦. Thirdâ€¦ a very rapid recovery and a lot of government supportâ€¦. Households have a huge buildup in savings <https://fred.stlouisfed.org/graph/?g=Lo1j>, and spending this down is no doubt contributing to demand. Conceptually, one might expect these demand pressures to be captured by the unemployment rateâ€¦. One thing that hasnâ€™t contributed much to inflation so far is an unhinging of longer run inflation expectationsâ€¦. Market expectations are predicated on what the market expects the Fed to do. There is a self-fulfilling prophecy element in this, as in many things in macroeconomics. So long as the market expects the Fed will do what it takes to contain inflation, we wonâ€™t see much movement in longer run inflation expectations. The Fed is working very hard to preserve this. But we canâ€™t take this for grantedâ€¦
>
> LINK:
>
> Noahpinion
> Interview: Emi Nakamura, macroeconomist
> If you ask any macroeconomist to tell you who the stars of their profession are right now, Emi Nakamuraâ€™s name will surely be at or near the top of the list. In 2019, Nakamura won the John Bates Clark medal, one of econâ€™s two most prestigious awards â€” and one thatâ€¦
> Read more
> a year ago Â· 59 likes Â· 23 comments Â· Noah Smith

One way to put it is this: There has been much discussion of the NAIRU or the â€œnatural rate of unemploymentâ€�â€”the unemployment rate below which you should not try to push the economyâ€”but there has been little discussion of any â€œnatural rate of inflationâ€�â€”the rate of inflation below which you should not try to push the economy. All competent macroeconomists agree that there is a positive natural rate of inflation: we have high costs of nominal wage cuts in terms of the destruction of worker-boss trust, very high costs of bankruptcy workouts, and very very sticky nominal debts. Given those institutional-structural features of the economy, a positive natural rate of inflation to grease the gears of the labor market and of the debt market is an inescapable necessity. But how high is the natural rate of inflation in normal times? And how does it alter in times of supply shocks and of sectoral-rebalancing demand shocks? Not enough economists have spent not enough time on these issues.

My view is that there is noâ€”noneâ€”zeroâ€”case for not accommodating supply and sectoral-rebalancing shocks until they threaten to destabilize long-run inflation expectations. After they threaten to do so, there is a trade-off to be dealt with. Before they threaten to do so, there is not.

The second mistake was falling into the trap of giving too large boost to spending. Rapid and complete recovery would require the acceptance of some inflation: wages, needed to rise in expanding industries to pull workers into them, because the post-plague configuration of the economy would be different than the pre-plague configuration ; bottlenecks would emerge during reopening, and the prices of bottlenecked commodities needed to rise in order to signal the economy that here was a problem of finding substitutes and increasing supply that needed to be crowd, sourced and sold quickly. How much inflation? Nobody could say. But if the re-opening inflation shock was too large, it could easily trigger a Federal Reserve overreaction, which would put us once again back into the semi-depressed or depressed state of secular-stagnatio,n with interest rates at their zero lower, bound and little policy traction to promoe recovery.

The third mistake was that too big a boost to spending would be followed by an insufficient reaction by the Federal Reserve, in which case the economy would fall into a configuration in which inflationary expectations were elevated, which would lead to a stagflation reminiscent of the 1970s.

The metaphor of steering, like Odysseus, between Scylla and Charybdis seems apposite. The first mistake is simply not steering through the strait at all, the second is sailing too close to the hydra monster, Scylla, of seclar stagnation. The third is being dragged into the stagflation whirlpool of Charybdis.

Even a year ago, however, it still seemed that the task was not that difficult. There had been policy and political will to set the oars to work to drive the boat forward at speed. There seemed to be a wide middle path between secular stagnation and staglation. You could argueâ€"we didâ€"about whether staglation was the bigger danger to be avoided, or secular stagnation was. But both risks seemed relatively low, and manageable with a Federal Reserve that understood the situation, and was not prone to panic.

Then, this last February, came Vladimir Putin's invasion of the Ukraine. The safe path narrowedâ€”indeed, the safe path may have disappeared. Then, in June, the Federal Reserve abandoned its forward guidance with a 75 basis-point interest-rate hike, pointing to an unreliable Michigan survey number as justification. It, at least, no longer believed that it understood the situation.

Thus today what worries me even more than that there might be no safe path is that whether or not there is, the Federal Reserve appears to have given up on trying to find it. I no longer hear Federal Reserve officials note that last winter and spring's tightening of monetary and financial conditions has not yet had a chance to materially affect the economy. Janet Yellen once said to me that the FOMC had a strong tendency to overreact to the immediate news flow unless it based its thinking around and had something like the Taylor Rule to serve as a navigational Pole Star. But the world has changed. The Great Moderation economy in which the Taylor Rule made sense is gone. And the Federal Reserve has no replacement to guide its thinking away from immediate news-driven groupthink.

Financial markets, at least, right now appear to be betting that the Federal Reserve is about to make mistake number two: pursuing policies that have too great a chance of returning us to the world of secular stagnation, once again at the zero interest rate lower bound on monetary policy, with the prospect of then triggering another lost half-decade of economic growth, and another upward leap in inequality.

As of the start of February 2022, the five-year five-year forward CPI inflation breakeven rate in the bond market was hanging at 2% per yearâ€”a number corresponding to a PC each chain inflation forecast from 5 to 10 years hence of some 1.6% per year, materially below the Federal Reserveâ€™s 2% target. Thus as of the start of February, I was feeling very good about being on Team Transitory as far as inflation was concernedâ€”or at least on Team The-Fed-Has-Got-This, and Team The-Inflation-Expectations-Anchor-Is-Solid.

The policy discussion surrounding appropriate monetary policy has been greatly hobbled by a lack of attention on the natural rate of inflationâ€”â€the level that would be ground out by the Walrasian system of general equilib- rium equationsâ€¦ [accounting for] structural characteristicsâ€¦ including market imperfections, stochastic variabilityâ€¦ cost of gathering informationâ€¦ [and] of mobility, and so onâ€¦â€ <https://www.aeaweb.org/aer/top20/58.1.1-17.pdf>. Chief, among these structural characteristics is downward nominal wage stickiness: the extreme inadvisability for worker-morale and hence effort-elicitation reasons of a business attempting to continue to employee a worker at a lower nominal wage.

The first-order implication of this is that the natural rate of inflation will almost always be positiveâ€”that, contrary to Milton, Friedman, the long-run Phillips curve is NOT vertical, but, rather that downward nominal wage stickiness requires that the economy have a positive average rate of inflation, in order to grease the wheels of commerce and achieve anything close to an efficient allocation <https://www.brookings.edu/wp-content/uploads/2000/01/2000a_bpea_akerlof.pdf>.

The second-order implication of this is that the natural rate of inflation will be higher in times when there is a good deal of reallocation to be doneâ€”at times when the economy is not in a stable configuration with respect to sectors and industries, but is instead hunting for a new and different cross-sector and cross-industry relative allocation of effort.

At times like now.

So I ran through the qualitative considerations that impact what the natural rate of inflation is likely to be right now for Tristan Bove of *Fortune*.

â€œThe reopening inflation weâ€™ve had has so far been a very good thing,â€ Brad DeLong, a professor at UC Berkeley, told *Fortune*. His comments contradict the more hawkish stance on inflation famously championed by Harvard economist Larry Summers, who worked alongside DeLong in the Department of the Treasury during the Clinton administration.

DeLong argues that there is a major economic shift taking place that people should welcome. It all has to do with our strange but kind of wonderful post-pandemic economy.

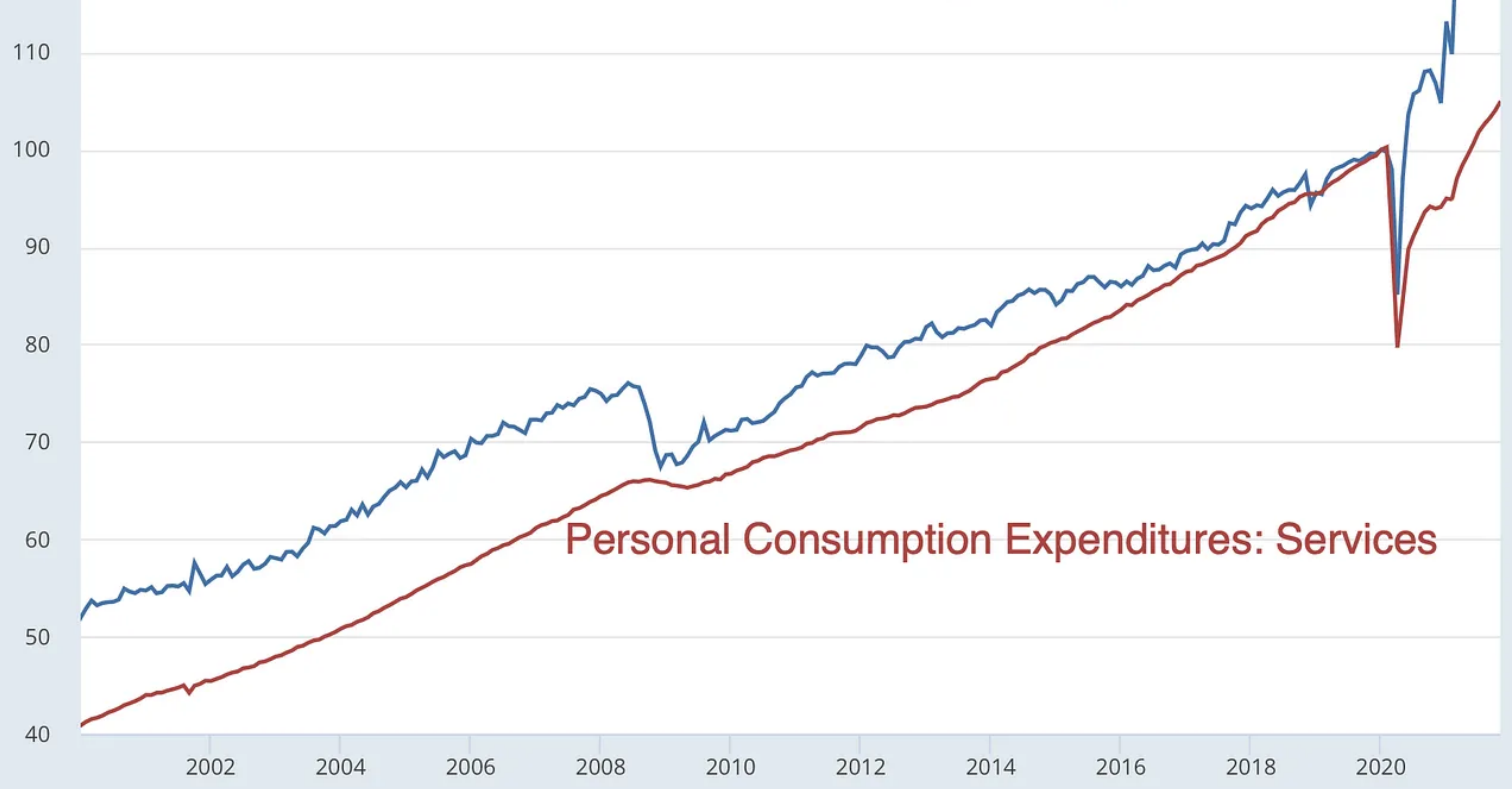
The Zoom world The new economy, DeLong says, is one with more time spent online, fewer jobs requiring in-person interactions, and a substantially higher rate of goods production.Itâ€™s like we have zoomed decades into the future in just a few years.â€œA couple of decades,â€ DeLong said when asked about how many years of economic change have been crunched into just over two: â€œA couple of decades of structural change and social and economic learning about how to be online as a permanent thing.â€â€œFewer in-person workers in retail establishments, a lot more delivery orders, substantially more goods production, and also substantially more information entertainment and production as well,â€ is how DeLong described his vision for the new economy during a separate interview with *Fortune* last week covering his new book, *Slouching towards Utopia*. The meeting took place over Zoom, DeLong noted, proving his point.Inflation in the U.S. is currently serving two functions that could help the economy in the long run, according to DeLong: helping expand new economic sectors poised for big growth, and uncovering and optimizing supply chain snags that have been with us since the beginning of the pandemic.Unemployment is now at its lowest point since before the pandemic, but the full employment we are returning to is not the same as the one we left behind in 2020, DeLong said. â€œWe want to get back to a full employment economy quickly. But itâ€™s a very different full employment economy when we get back there,â€ DeLong said.Moving workers away from industries like retail and hospitality and into expanding sectors needs to come with incentives in the form of higher wages, according to DeLong, which means inflation.â€œIf you want to create economic incentives for people to move into the expanding sectors where we actually need more workers, their wages have to go up,â€ he said. â€œWhen youâ€™re coming out of a big recession, the natural rate of inflation has got to be above the normal 2%,â€ he added. â€œThe rate of inflation that the market really wants to see in order to get production and distribution and transportation into an efficient allocation has to be more than 2%.â€In addition to helping bring the economy into the new era, DeLong sees another benefit of inflation today: it could help resolve crippling supply chain bottlenecks, resorting to the economic adage that high prices are often the best cure for high prices.With supply chain issues contributing to high prices and making people less likely to buy, it could be the impetus behind a revitalization and ultimately a strengthening of industry, according to DeLong, who says inflation is involving more people with figuring out either how to produce more of what we need, or less of what we donâ€™t.â€œThat's the absolutely glorious thing about the market,â€ he said. â€œThat when prices are aligned with social values, it means that you don't just have one brain or a few brains working on the problem. Everyone's brain is working on the problem. And everybody does what they can to solve it in their immediate circumstance.â€But as always, thereâ€™s a catch.

Stagflation risks The positive outlook for inflation does come with a caveat, DeLong and other economists admit. Expectations that inflation will become entrenched in the economy and stick around might become a self-fulfilling prophecy, which would lead to something even worse for the economy. The word for that is stagflation: the worst-case scenario of slow economic growth combined with high inflation. DeLong says it is still very possible.â€œWorst of all is you get stuck in the stagflation of the 1970s,â€ he said. â€œIf inflation gets entrenched in expectations, it will be a very bad thing.â€The ideal situation, DeLong says, would be a repeat of the recessions that hit the U.S. in the late 1940s and early 1950s, both of which were relatively short before inflation subsided.But a worst-case scenario of stagflation also remains possible, DeLong warned, especially if expectations of inflation become entrenched in the economy.â€œEntrenchedâ€ has been a bogey word for the Fed this year, and a situation it desperately wants to avoid. Entrenched inflation refers to people expecting prices to keep going up, which can lead to inflation staying around much longer than it would otherwise.Should inflation become entrenched during a recession, it would be a â€œvery bad thingâ€ for the economy, DeLong said. Whether this will happen will likely depend on the direction gasoline and energy prices take, which have been highly unpredictable so far this year.â€œWhether or not expectations get entrenched and we get a 1970s problem really depends on the trajectory of energy prices,â€ he said. â€œInflation expectations are always driven by what people see at the pump.â€Top economists and bankersâ€”including Allianz and Gramercyâ€™s chief economic adviser Mohamed El-Erian and Goldman Sachs CEO David Solomonâ€”have warned that inflation is already becoming entrenched and persistent around the world. And the World Bank has issued multiple warnings this year that persistent inflation combined with slow economic growth is leading to a very real risk of stagflation in multiple countries around the world.Also, not every economist shares DeLongâ€™s view that there is much good at all about the current inflation, with many saying it is a much more pressing issue that the government is failing to adequately control. Steve Hanke, an economist at Johns Hopkins University, recently criticized the Fed for â€œincompetence and mismanagementâ€ that has led to inflation, and predicted that the Fed letting the U.S. money supply run short could lead to a â€œwhopperâ€ of a recession next year.DeLongâ€™s old boss Larry Summers has been singing a dire tune on inflation for over a year, warning last year that the Federal Reserve was being too passive about rising prices. At the release of this weekâ€™s CPI report, Summers wrote that the Fed was faced with a â€œserious inflation problem,â€ and cautioned that unemployment will likely have to start ticking upward before inflation recedes significantly.Many economists fear that todayâ€™s high levels of inflation, and the Fedâ€™s commitment to containing it, could trigger a recession as early as next year, although the jury is still out on whether this would constitute a deep or shallow downturn. In a blog post last year, when inflation was already becoming a source of concern, DeLong compared the recovering U.S. economy to a driver suddenly accelerating away. The skid marks left on the asphalt represented inflationâ€”a blemish and a nuisance to be sureâ€”but worth it to get the economy back on track. A year later, inflation can still just represent a temporary skidmark on the road to recovery, he says.

1. **Macro Policy Guiding Principle**: prioritize full employmentâ€”make Sayâ€™s Law true in practice even though it is false in theoryâ€¦
2. **Macro Policy Guiding Principle**: move the economy as fast as possible to what its long-term optimal structural configuration should be
3. **Macro Policy Guiding Principle**: Guiding principles (1) and (2) overrides desirability of *immediate* price stabilityâ€¦
4. We still have lots of room to run before we can say that the post-Volcker Fed has failed to meet its inflation target in an average-outcomes senseâ€¦
5. Time to panic about inflation will be when the bond market gets worried about itâ€”but right now the bond market is very much â€œFed has got thisâ€â€¦
6. Yet the political economy of the thing is overwhelmingly relevant: inflation that gets Biden booted from office would be very badâ€¦
7. Even prolonged inflation may helpâ€”in that there is a lot of structural reform we need to do, and this may help us get it doneâ€¦
8. Hexapodia!

And my immediate first response is to ask the question: In what sense is the Fed supposed to have been "way too slow" in tightening monetary policy? We still are way short of full employment. Some of that is due to childcare and virus-fear bottlenecks. But some of it isnâ€™t. And to the extent that there are important jobs not being done because people canâ€™t afford to make alternative childcare arrangements or fear the virusâ€”well, the inflation that comes from paying people more to see if they will take those jobs is to be welcomed, not fought:

Plus the economy has undergone a great wheel: 6% less relative to trend in personal consumption expenditures on services, and 20% more relative to trend in personal consumption expenditures on goods. Not all of that is going to stick into the post-plague economy, but a good deal of it will. We have an economy in which nominal wages and some nominal prices are really sticky downward. That means that if market prices are to do their job signals of where the value is, prices and wages in industries that need to expand must rise relative to prices and wages in industries that need the contract. With prices and wages in industries that need to contract sticky downward, that means: inflation:



Now it is certainly true that we do not want the inflation now, which we want, and which is an essential part of a rapid restoration of general prosperity, to stick around once we arrive at whatever our new normal is going to be. But I look outside my window now, and I see no new normal.

Thus my immediate second response is to ask the question: Why is it not obvious to nearly everybody questions of inflation control should be postponed until their proper dateâ€”which will be when the plague has fallen to an endemic flu-like illness, and when the economy is back to full employment?

Perhaps I should not be surprised at our world of public discourse about finance and economics that does not seem to have thought much, if at all, about the relationship between macroeconomics and rapid structural change. This is, after all, the same world of public discourse about finance and economics that never managed to absorb Paul Krugman's very important 1998 point call if you find yourself at the zero lower bound on interest rates, that means that your inflation target is too low: <https://www.brookings.edu/wp-content/uploads/2016/07/1998b_bpea_krugman_dominquez_rogoff.pdf>

Brad DeLong: *By Invitation: What Can America Learn From Its Past Bouts of Inflation?*: â€˜In 1947 and 1951 the problem went away by itself. In 1920 the Fed tightened too much, says the economist:

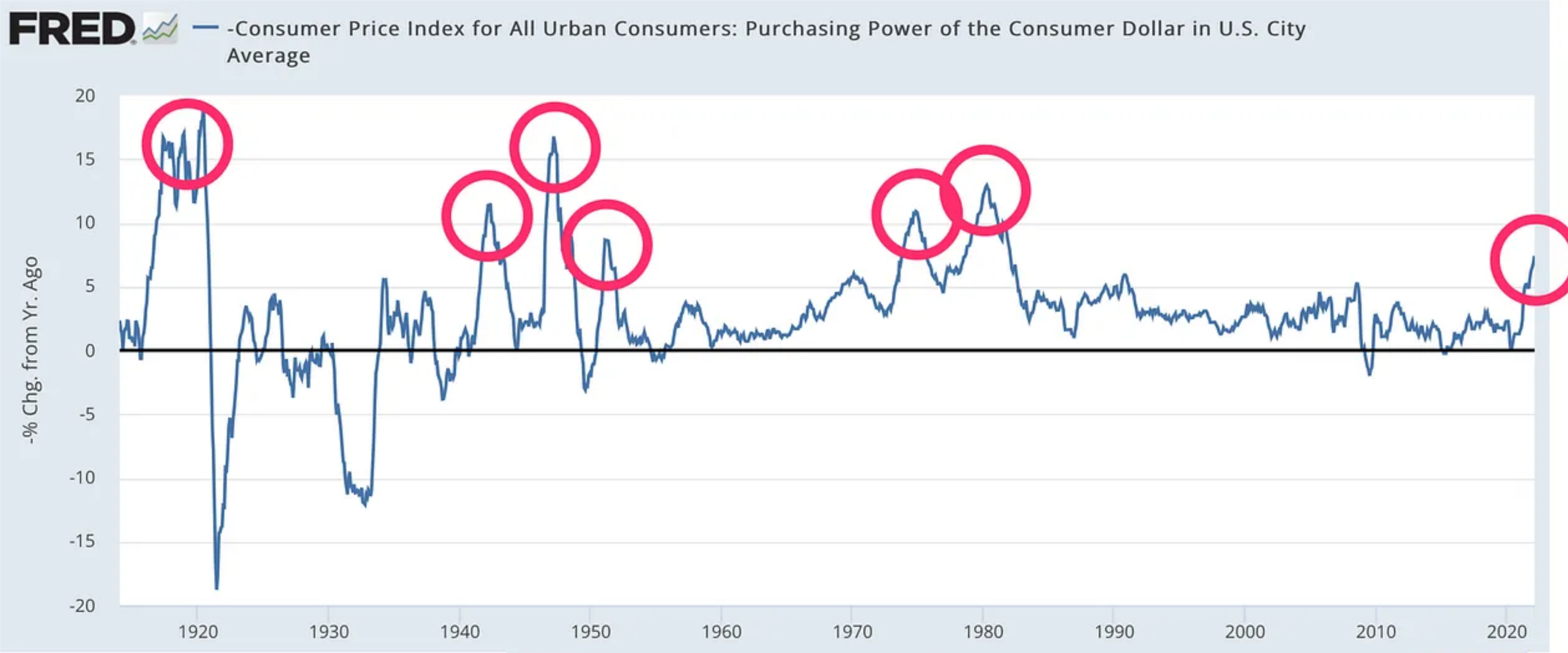
The first and most important thing to recognise about the macroeconomic situation in America is that Jerome Powell and his Federal Open Market Committee (fomc) should be taking victory laps. Two and a half years after the start of the financial crisis in 2007, Americaâ€™s unemployment rate was kissing 10%, the Federal Reserve realised that it was out of firepower and the Obama administration had just thrown away its ability to help by promising to veto spending and tax bills that were insufficiently austere. After that moment it would take six years for Americaâ€™s economy to approach full employment. The impact of deficient employment meant that output was $7trn lower in 2013 than it would have been otherwise. Additional losses stemmed from the investments not made, business models not experimented with and workers not trained during the decade of anaemic recovery.

We have avoided all that this time around. Relative to the Fed presided over by Ben Bernanke between 2006 and 2014, Mr Powellâ€™s team are public benefactors to the residents of America to the tune of $20trn, if you consider that there are more jobs and fewer idle factories now and in the future because of their actions. We have an uptick in inflation partly because the Fedâ€”alongside Congress and the presidencyâ€”responded far more aggressively to the pandemic-induced recession than to the global financial crisis. A world in which the economy recovers so quickly that inflation emerges is better than one in which recovery drags on painfully for years.

America has faced five bouts of inflation in the past century or soâ€”or six, depending on whether you count the 1970s as one or two episodes. The inflation during the second world war, which was tamed by price controls, is not relevant to our situation. That leaves four (or perhaps five) historical parallels which provide lessons in how to deal with the current inflation problem.

First: Six Episodes of U.S. Inflation Above 5%/Year in the 1900s

The top graph is the CPI inflation rate; the bottom graphs are overlapping graphs of the Federal Reserveâ€™s discount rateâ€”the rate at which it lends to banks on reasonable collateral.



Counting 1974 and 1979 as two episodes, there were six times in the twentieth century during which the annual inflation rate got above 5%. One was the World War II inflationâ€”cut off by price controls. Then came the post-WWII structural-rebalancing-and-pent up demand inflation, and then the Korean War structural-rebalancing inflation as the U.S. government wheeled its economy to fight the Cold War. During both the Fed sat byâ€”it was then still focused on keeping the prices of Treasury bonds high. The inflations soon passed away.

Before those came the World War I episode. That episode of inflation was cut off by an increase in the discount rate from 3.75%/year to 7%/year, which not only ended the inflation but enforced deflation: a 20% decline in the price level from its peak. (This decline, I should ask, made the task of restoring the gold standard at anything like pre-World War I nominal parities much more difficult, hence much more pointless.) Milton Friedman and Anna J. Schwartz judged that the rise was â€œnot only too late but also too muchâ€□ <https://archive.org/details/monetaryhistoryo0000frie/page/230/>: the Fed should have moved earlier to prevent excessive bank discounts from inappropriately boosting high-powered money, and at the moment the Fed did move the structure of credit was sufficiently based on a continuation of Fed policy that the Fedâ€™s move generated â€œone of the most rapid declines [in economic activity] on recordâ€□.

If the Federal Reserve had not moved to raise discount rates after World War I, what would have happened? Friedman and Schwartzâ€™s judgment is that an earlier increase of, say, 125 basis points to remove the incentive for banks to engage in excessive discounts would have brought the excessive growth of the high-powered money stock to an end, and stopped the inflation.

Then came the 1970s: The Fed raised interest rates after the Yom Kippur War oil shock to control inflation; then, after inflation peaked, it lowered them to try to restore full employment; then came the year when, as the late Charlie Schultze said, â€œour forecasts of nominal income growth were dead on, but inflation came in 2%-points high and real growth 2%-points lowâ€□; and then came the Volcker disinflation, reversed in September 1982 when they realized that they had bankrupted Mexico, and not resumed as the Fed decided to declare a fall in inflation to the 4-5%/year range as complete victory. That 4-5% target lasted for a decade, followed by the opportunistic disinflation down to and Alan Greenspanâ€™s declaration of the 2%/year inflation targetâ€”a declaration that it is very hard today to argue was appropriate, given the extraordinary amount of time global north economies have spent with interest rates at their zero lower bound since.

What does macroeconomic theory tell us that the Federal Reserve should do now, in the spring of 2022?

Olivier Blanchard writes:

> In early 1975, core inflation was running at 12 percent and the real policy rate was equal to about âˆ’6 percent, a gap of about 17 percent. Today, core inflation is running at 6 percent and the real policy rate is equal to âˆ’6 percent, a gap of 12 percentâ€”smaller than in 1975, but still strikingly largeâ€¦. It then took 8 years, from 1975 to 1983, to reduce inflation to 4 percent, with an increase in the real rate from bottom to peak of close to 1,300 basis points, and a peak increase in the unemployment rate of 600 basis points from the early 1970s. Today is obviously different in many waysâ€¦. [But even so,] it reasonable to think that a 200-basis-point increase in the policy rate, so only 1/6 of the rate increase from 1975 to 1981, will do the job this time when the gap between core inflation and the policy rate is 2/3 of what it was in 1975? And that unemployment will barely budge? I wish I could believe itâ€¦ <https://www.piie.com/blogs/realtime-economic-issues-watch/why-i-worry-about-inflation-interest-rates-and-unemployment>

The suggestion seems to be that we have today 2/3 of the problem we had in 1975, and so the solution would be to do 2/3 as muchâ€”to raise interest rates by 800 basis points, 8% pointsâ€”but then to apply some haircut to that 800 basis-point interest-rate rise because â€œtoday is obviously different in many waysâ€□.

But why does he pick 1975-1983, rather than 1951 or 1948 or 1920? Does economic theory tell him to do so?

Truth be told, there is no economic theory. There is only history, and its events, and analogies we make based on judgments concerning complicated emergent processes we do not understand very well that come out of the millions of interactions that are the economy. Sometimes, it is true, we distill and crystallize the history into something we call theory where little squiggles that look like É£, Î´, Î², Ïƒ, and so on; we then mainline the crystallized product. After mainlining it we can think we know something. But after mainlining crystal meth we experience increased energy, elevated mood, extraordinary confidence, racing thoughts, muscle twitches, and rapid breathing, among other things.

Move cautiously. Be data-dependent. Wait for it to become clearer which, if any, historical analogies are relevant to our situation. And always, always, always remember that in an economy that is near and that we have a good reason to fear will long remain in danger of hitting the zero lower bound on nominal interest rates, premature and excessively aggressive moves that raise interest rates cannot easily be corrected.

The first is the inflation of the first world war, which was brought under control when the newly established Fed raised its discount rate from 3.75% to 4.5% between November 1917 and April 1918, and then again to 7% between October 1919 and June 2020. This triggered a short but very deep recession accompanied by substantial deflation. Milton Friedman later judged that the Fed moved too lateâ€”it should have started raising interest rates a year or more before it didâ€”but that it moved too far when it did move.

The second is the inflation which emerged after the second world war. It peaked at 19.7% in the year to March 1947 as Americaâ€™s economy reoriented itself from its wartime to its post-war structural configuration. Tank factories turned back into car factories. Resources that had been devoted to building factories and equipping them with tools were released to make all the consumer goods that had been rationed during the war. The second world warâ€™s military-industrial complex was dismantled. Prices and wages went up in sectors where demand was high but supply constrained in order to pull resources to where they were wanted. The Fed did nothing. It was focused instead on propping up the value of all the Treasury bonds that had been issued to fight the war. Inflation averaged 8% over the following year and then went negative in 1949, when a minor recession came. Once supply had shifted to match the sectoral pattern of demand, the bottlenecks and the upward price pressure disappeared. Because few expected the inflationary trend to continue, nobody was able to demand a high wage increase or get away with a price increase, as those who paid them shrugged and said â€œitâ€™s just inflationâ€□.

The third bout came in 1951. Inflation peaked at 9.4% in the year to February that year as America geared up to fight the Korean war and, perhaps more important, as it built up its global military capabilities in the early years of the cold war. The military-industrial complex was rebuilt, and rebuilt for a nuclear and aerospace age. Again, the Fed did nothing. And the inflation wave passed. By March 1952 it was below 2%. And recession was avoided until a minor one in late 1953. Again, once supply had shifted to match the sectoral pattern of demand, the bottlenecks and the upward price pressure disappeared. Once again, because few expected the inflationary trend to continue, no one was able to ask for a high wage increase or get away with a price increase.

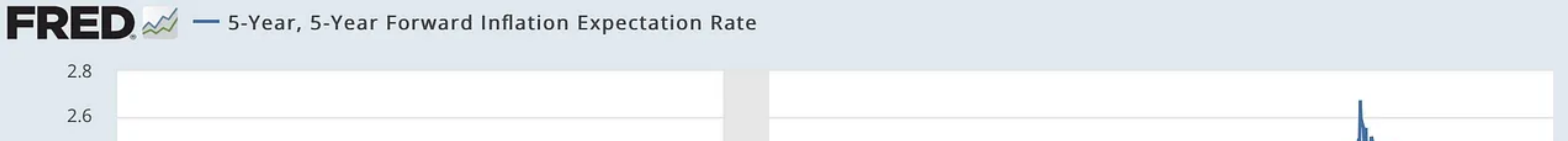
The fourth, or the fourth and fifth, came between 1966 and 1984. Inflation rose from 2% at the start of 1966 to 4.4% on Richard Nixonâ€™s inauguration in January 1969. It then rose and fell throughout the 1970s before soaring to a peak of 12.8% in March 1980. The Fed dithered. Arthur Burns, its chairman from 1970 to 1978, was too interested in maintaining a strong economy while his friend and patron Nixon ran for re-election in 1972. He did not believe that Congress would let him keep interest rates high enough for long enough to cure inflation through monetary policy. It was only when Paul Volcker became chairman that interest rates were raised to a peak of 16.9% in December 1980, and were not lowered below 10% until August 1982.

Which of these is our current situation most like? In my view, the second and third bouts of inflation, in 1947 and 1951, are the right models. That is because the long-term inflation expectations implicit in the bond market are still trading at their normal â€œin-the-long-run-inflation-will-be-aboutâ€“2.5%â€□ range. Bond traders appear to expect a little extra inflation over the next couple of years, but after that a return to what has become considered normal. Unless workers and managers see more inflation in the future than bond tradersâ€”something that seems unlikely to meâ€”they have no warrant for pushing for high wage increases or thinking that they can get away with price increases ahead of a continuing inflation wave. So there is considerable hope (though hope is not confidence) for a soft landing.

But there are two risks of a hard landing. One thing to fear is that the inflation episode today is like that of 1920. Back then the problem would have passed on its own, but the Fed tightened too much in response. There are no indications of overtightening yet, but then there wouldnâ€™t be: the effects of the roughly two-percentage-point rise in both nominal and inflation-indexed ten-year Treasury rates since December 2021 will not begin to show in the real economic data until 2023.

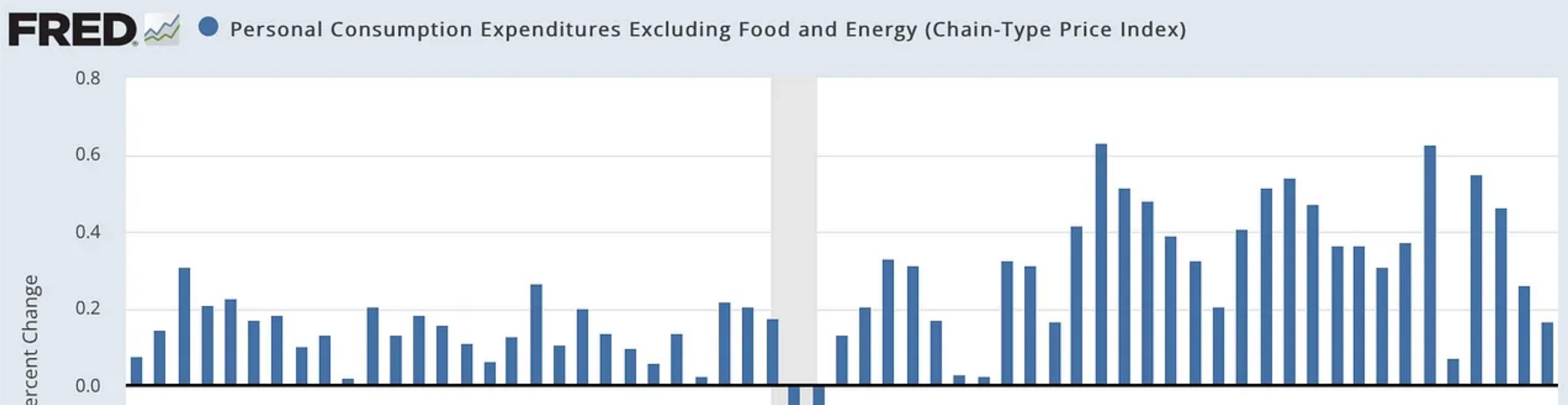
But between the war in Ukraine and uncertain energy markets for the foreseeable future, DeLong admits the outlook is much cloudier now.â€œWe have energy price inflation and food price inflation springing from Russia and its attack on Ukraine. That is greatly complicating the picture and making the situation much more fraught,â€□ he said.

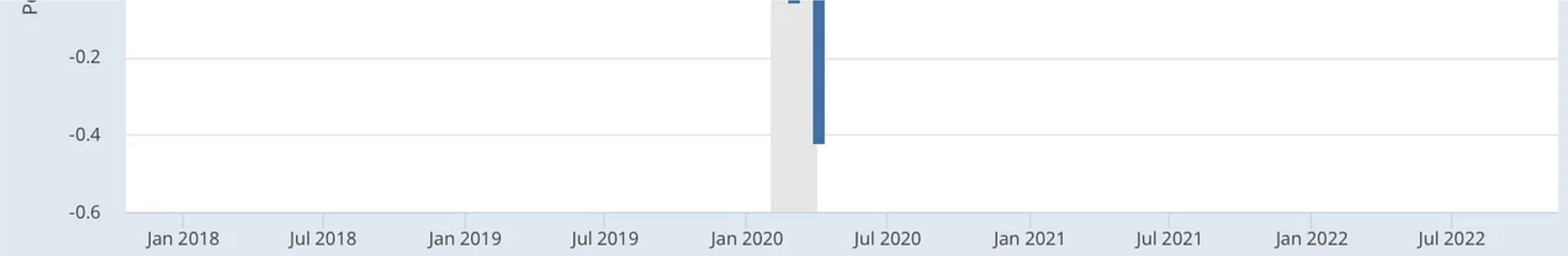
Then, on February 24, the grand prince of Muscovy sent his army to invade and try to conquer Ukraine in a lightning strike. Things did not go as he planned. Energy and grain prices went through the roof, as we contemplated the possibility of a world in which much of Western Europe froze and much of Nigeria and Egypt starved in the winter we are now going through. And the five-year five-year forward CPI inflation breakeven rate rocketed up: from 2% per year to its peak of 2.67% per year on April 21, 2022.



Expectations of annual PCE-chain inflation from five to ten years hence of 2.27% were not a major breaking of bond-trader confidence in the Federal Reserveâ€™s commitment to its target. But if you think the target-zone width is 0.6%-points annualized and thus that the bond market thinks that Fed is or will get on target whenever the five-year five-year forward CPI inflation breakeven rate is between 2% and 2.6% per year, there was reason to worry. As I asked my more hair-on-fire friends back then: Are we now only one more big supply shock away from losing the inflation-expectations anchor?

Perhaps we were.





But we did not get that additional large adverse supply shock. And the monthly PCE-chain inflation number for November released on December 23 was 0.16%, which when multiplied by 12 is less than 2% per year.

One swallow does not make a summer. One data point does not make a trend. Even the rundown from 0.62%â€"7% per yearâ€"in June is not necessarily bankable: after all, we saw rundowns from December 2021 to April 2022 and before that from Auguty 2021 to December 2021.

As I have said, this plague-ridden business cycle is one of the rare times that I do not envy the members of the FOMC. What they decide to do over the next six months will start to affect the real economy of demand, employment, and production starting one year from now, and start to affect the inflation news starting a year and a half from now. Many things good and bad will happen in the next eighteen months. And whatever the Federal Reserve decides to do, it is sure to regret it afterwards.

Will it overdo interest rate increasesâ€"has it already overdone interest rate increasesâ€"and will two years from now see the economy mired once again in secular stagnation, with interest rates at their zero lower bound, and no visible path for a rapid return to full employment? Will the economy attain the soft landing of immaculate disinflation? Will additional supply shocks or political pressures wind us in stagflation, or even in enough of a fear of stagflation that recession comes and is painful and prolonged?

If I were on the FOMC right now, I would hold very tight to two considerations:

1. The Federal Reserve does not have to move slowly. The past six months have demonstrated that there are very few downsides to the swift movement in monetary policy that 75 basis-points increases in interest rates every month and a half deliver. And a 75 basis-point increase at an FOMC meeting is not a speed limit. This suggests: Take advantage of optionality. When the situation is unclear, pauseâ€"and then move fast when the situation becomes clear.

2. In retrospect, Alan Greenspan's decision to set the Federal Reserveâ€™s target inflation rate at 2% per year was very ill-advised. There is an argument that there are substantial benefits from maintaining and strengthening credibility by getting the economy back to the 2% per year target, even if that target is going to be raised in the medium term. But is that really the kind of credibility the Federal Reserve wants to have? It is not clear to me that the Federal Reserve is better off with it. Is it good for markets to think that you will persist in policies when it is clear that circumstances have revealed that they are stupid, and do so just because?

Once again: I do not envy the members of the FOMC this winter.

I disagree pretty strongly with the extremely smart Vince Reinhart here. He says that the past few years have revealed â€œcracksâ€ in how the Federal Reserve makes monetary policy.

But I cannot see any cracks: to date, to me, monetary policy since the plague began has been well-nigh perfect.

Vince Reinhart thinks that the Fed moved â€œlateâ€ and moved â€œfastâ€, as if those are bad things. But in the situation it was optimal to be late, and good to then move fast. Indeed, if I had my druthers and had been running things, I would have moved later and then faster. The optimal monetary policy strategy coming out of the plague was to:

1. delay raising interest rates until inflation was high enough to grease a rapid reopening recovery of and shift in economic activity into its new post-plague full-employment sectoral-balance configuration.

2. delay raising interest rates until there was full confidence that raising interest rates would not send the economy back to the secular-stagnation zero-lower-bound interest rate configuration.

3. then move rapidly to raise interest rates so that expectations of inflation did not become established and entrenched.

4. taking care not to overdue interest rate increases and so generate not a sfot landing but stagflation, quite possibly ending in a return to the secular-stagnation zero-lower-bound interest rate configuration.

It looks to me like the Fed has succeeded 100% at (1)-(3). (4) still hangs in teh balance, but so far so good.

So what re the cracks? What is there to complain about?:

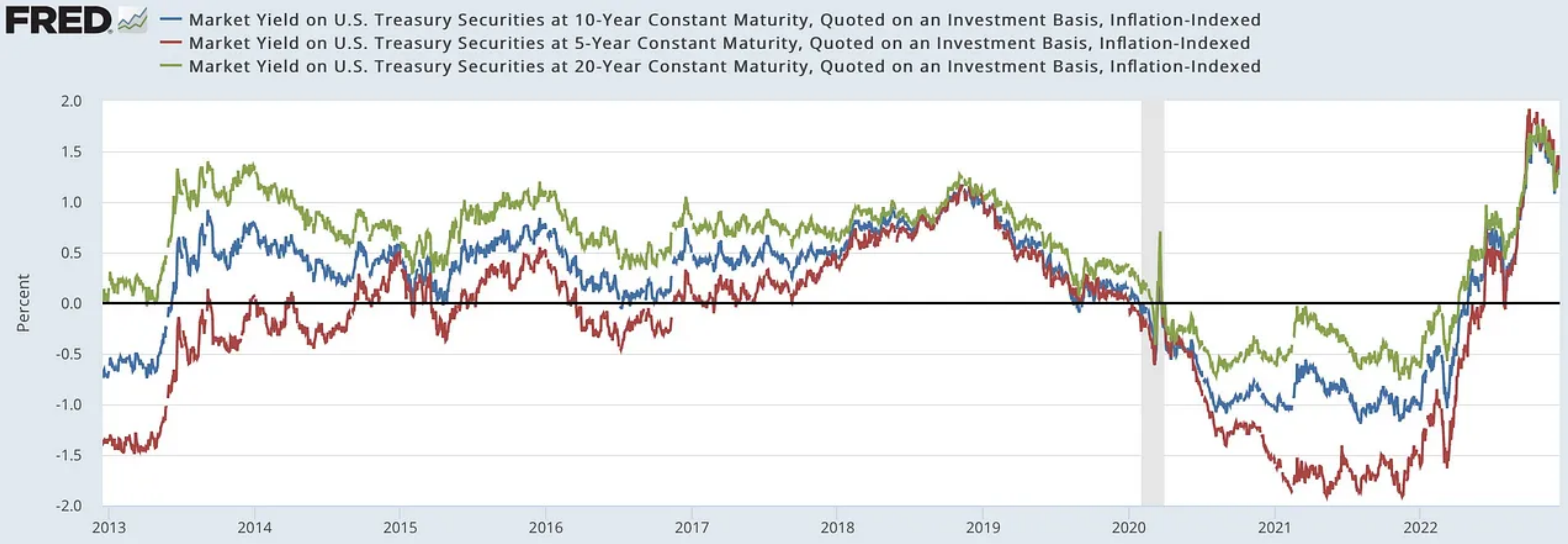
> **Vince Reinhart:** Why Inflation Took Off in 2022â€"and What Happens Next: *The year was a stress test of the Fedâ€™s new framework, and the cracks were apparent*: â€˜The Fed only garners such attention making or correcting a major mistakeâ€"and there was a bit of both this year. Inflation was allowed to hit a 40-year high. Monetary policy had to pivot forcefully to raise the target range for the overnight rate to 4.25% to 4.5% in 2022, including four 0.75-percentage-point installments. True, there were two outside, generational shocksâ€"a global pandemic and a large-scale land war in Europe. However, those shocks were also a stress test of the Fedâ€™s new monetary framework. This test revealed some significant cracksâ€¦. With inflationâ€¦ at a 40-year high this spring, Mr. Powell and his Fed colleagues retired the word â€œtransitoryâ€â€¦. The Fedâ€¦ [brought] the overnight rate to a target range of 4.25% to 4.5% at Wednesdayâ€™s meetingâ€¦. The target range still implies a negative interest rate in real terms, even with an optimistic take on inflation expectations. A negative real interest rate wonâ€™t slow demand growthâ€¦. The challenge here is whether the Fed will be able to defeat inflation completely and regain the confidence of the markets. The jury is out...

Vince is very smart, and very knowledgeable, butâ€¦

(1) The Fed has the confidence of the markets. As of Fridayâ€™s close, the markets are betting that from five to ten years in the future the CPI annual inflation rate will be 2.12%â€"and that is a PCE chain inflation rate of 1.6%-1.7%, below the Federal Reserveâ€™s target:

The jury is not out. The Federal Reserve does not have to regain the confidence of the markets. It has the confidence of the markets. I cannot see how anyone can say otherwise without a theory explaining why the people trading on the markets are not â€œthe marketsâ€. And I do not know what such a theory might be.

(2) The target annualized rate of 4.25%-4.5% for overnight money does not â€œimply a negative interest rate in real termsâ€. The 5-year, 10-year, and 20-year inflation-indexed U.S. Treasury securities are all hanging up there at positive annual real interest rates of 1.1%-1.5%:



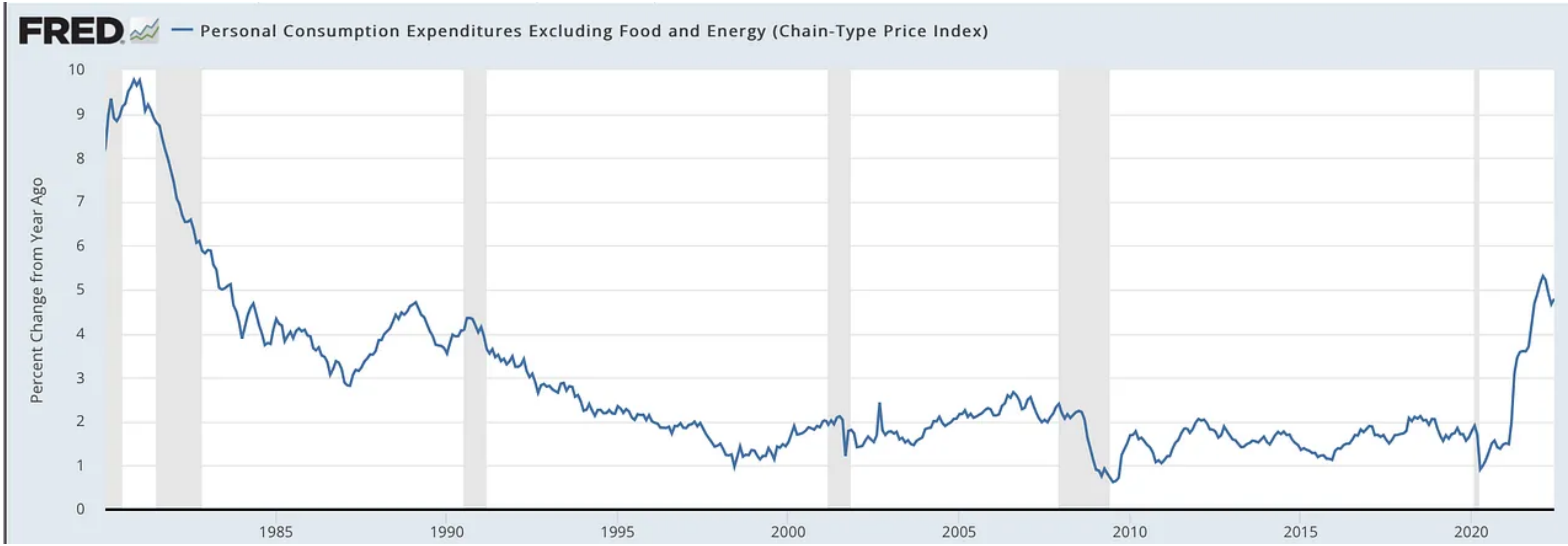
Yes, the current overnight rate is less than the current inflation rate. But those sectors of the economy in which demand is sensitive to real interest ratesâ€”construction and, via the exchange rate, exports and import-competing productsâ€”are governed not by any real overnight rate but by the real longterm interest rate. The claim that â€œa negative real interest rate wonâ€™t slow demand growthâ€□ does not apply, because the relevant interest rate is not negative.

(3) In fact, the claim that â€œa negative real interest rate wonâ€™t slow demand growthâ€□ does not make any sense: a shift from a more negative to a less negative real interest rate would slow demand growth. (But, as I said, we donâ€™t have a negative real interest rate in any relevant sense.)

Well, that was a surprise!

Given that Jay Powell let himself get panicked out of his forward guidance into a much bigger stomping-on-the-brakes because of a preliminary consumer confidence number that vanished as more data came in, will he now allow himself to be guided back to what he was planning to do before he freaked? Or would that be too humiliating?

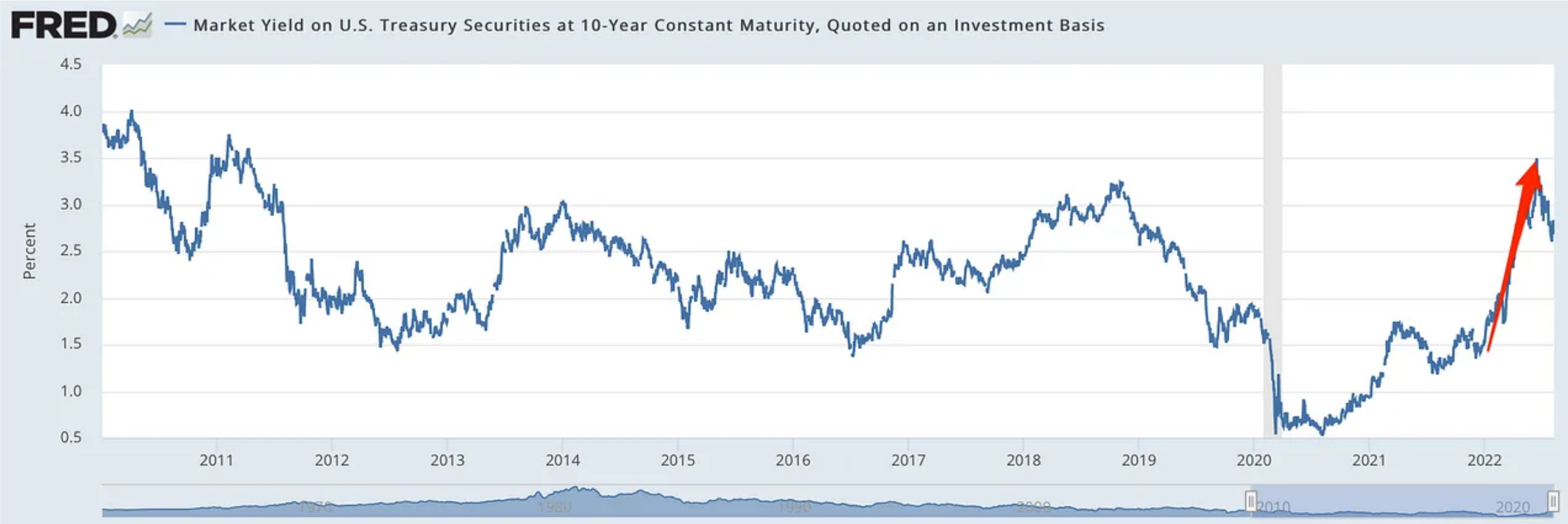
What he should, of course, be watchingâ€”and what he ***says*** he is watchingâ€”is core PCE:



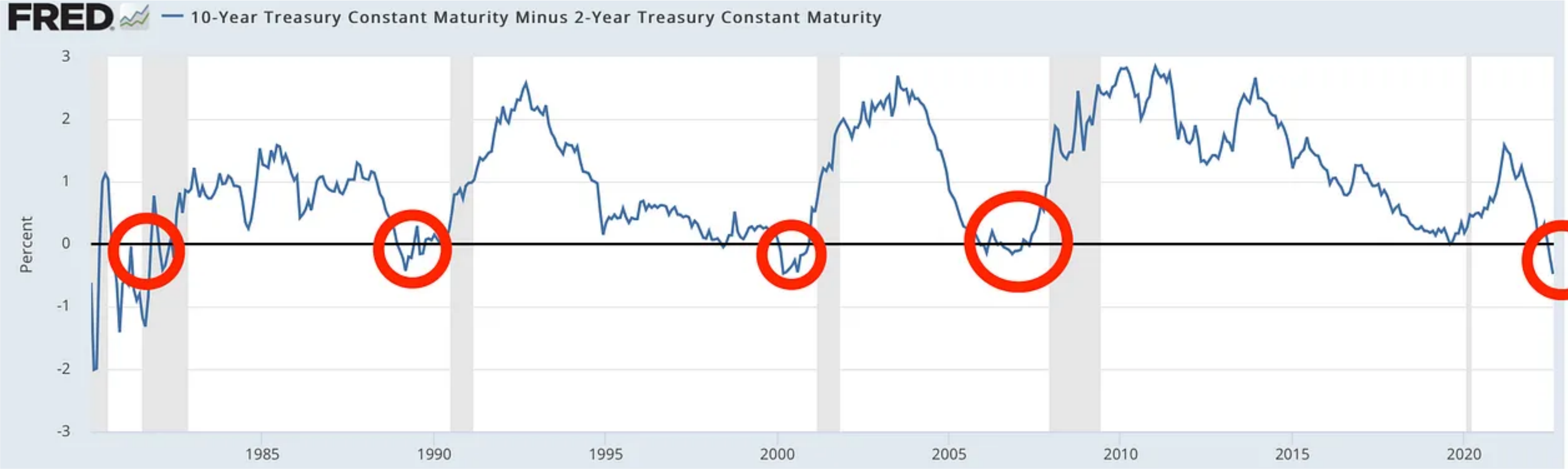
which now stands 2%-points below where it would be had the Federal Reserve actually hit its 2%/year inflation target since the Great Recession began. And he should also be watching the 5/5 forward inflation breakeven

which shows no signs of inflationary psychology.

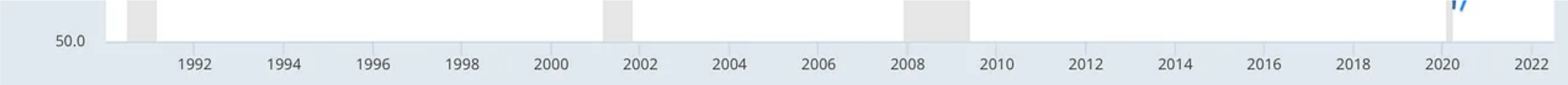
Add in a remarkable tightening of financial conditions from January-May, which will put substantial drag on the economy next year as its effects hit exports and construction:



And the reliable recession indicator that is yield-curve inversion.



So tell me: What is the argument for the Federal Reserve not standing pat, and seeing what the policies it has already undertaken will do to the economy?



Greenspan made his reputation by cutting-shortâ€”over the objections of other Fed governorsâ€”his interest rate increases in the mid-1990s, and so triggering the high productivity-growth late 1990s of the dot-com boom. Bernanke thought he had done all that he ought to in the early 2010s and presided over a flatlining depression-condition employment level half-decade, followed by continued anÃ¦mic recovery. Powell ought to be thinking about how to manage the situation so that he will be able to take a rapid-return-to-full-employment victory lap.

Key Insights:

1. Yes, it is possible to talk about everything in an hourâ€¦
2. We are not very far apart on what the Fed is doing and should be doingâ€”there is only a 100 basis-point disagreementâ€¦
3. Miles would be 100% right about the proper stance of monetary policy if he were in control of the Fedâ€¦
4. Miles is not in control of the Fedâ€¦
5. Thus Brad thinks that asymmetric risks strongly militate for pausing for six months, and then moving rapidlyâ€¦
6. Smart people need to think much more about how to increase loveâ€¦
7. Remember Robot Tarktil!
8. Noah Smithâ€™s mother is a good friend of â€œMurderbotâ€ author Martha Wellsâ€¦
9. Hexapodia!

Iâ€™m going to have GPT3 make this into an oil painting, what youâ€™re describing here about marriage. Let me pull out one piece of that because I think itâ€™s important, both for that period, for the inflation that comes, and also for eventually, in this conversation, thinking about where we might be going. I think when people hear about social democracy, theyâ€™re very familiar with the social-insurance side of it. It has health care and maybe pre-K and education and so on.

But you mentioned the way the government is involved in decision making. And thereâ€™s often, in this period, this sort of tripartite bargaining structure by which decisions are made â€”

Brad Delong

in business, in labor â€”

Ezra Klein

â€” with government and labor â€”

Brad Delong

â€” big government â€”

Ezra Klein

And business. Tell me a bit about that, both what that was and then how maybe it set the stage for some of the inflation of the â€˜70s.

Brad Delong

Well, consider that the federal government, in the 1960s, was spending something like 7 percent of national income on its own account in investment. And a lot of that was military â€”

Ezra Klein

What does that mean?

Brad Delong

â€” a lot of that was outer space. A bunch was civilian, things that are not providing direct services to people and things that are not buying goods that then provide direct, immediate services to people, things that are very much aimed at building capacity for the future. And thatâ€™s 7 percent not counting government expenditures on education.

Well, now, maybe itâ€™s a quarter of that as a share of national income â€” that the idea of the government was looking toward the future and was spending an awful lot of money trying to build infrastructure, science, technology, capabilities to produce things.

We saw the apex of this during World War II when the government built a huge number of factories that it then gave away to the private sector afterwards on the grounds that the government didnâ€™t think it was terribly competent to run them. That was a major commitment the government made during the social-democratic era that it has not made in the neoliberal era, where the view has been that the private sector is much better positioned to figure out what we should be investing in.

And in the United States, other countries did significantly more, France and Japan most especially, in terms of combining business with government and focusing where the investments of the society would be going, and boosting their magnitude.

Ezra Klein

So tell me a bit about labor in that period because I think people, even in this period, are familiar with the idea that government and business might collaborate quite closely. But labor is much weaker today. But what was it then?

Brad Delong

It was a mass production. It was a mass-production economy, rather than today our global value-chain economy, which means an awful lot of people on assembly lines and elsewhere, doing fairly-routine and very similar jobs, which made it extremely easy to organize them and for them to believe they have one common voice, which means theyâ€™re highly likely to vote for a union to represent them because theyâ€™re confident the union leaders will think like they do.

And theyâ€™re very much aware of their numerical strength in the country, so much so that say, periodically, G.M. and Ford executives would come to the president of the United Auto Workers, Walter Reuther, and saying, why donâ€™t you come on over here and run the company since as much about the auto business and more about the work force than we do?

And that extremely strong labor-side voice is something that is almost entirely absent at least from our elite discussions. The New York Times used to have several dedicated labor reporters. Then they had only one, I think, Steven Greenhouse, the idea that itâ€™s simply not there as an interest group, as an estate in society, to hark back to earlier forms of political organization.

And in large part, itâ€™s not there. Laws did a great deal of it. Greater business confidence did a great deal of it, both aspects of the neoliberal turn. But it also reflects the changing underlying technologies, the fact that if I were Friedrich Engels, I would say, hey, wow, this global value-chain economy really is a different mode of production than the mass-production assembly-line economy that we saw in the 1960s.

Ezra Klein

Before we get too deep into the way inflation rose in the â€˜60s and â€˜70s. I just want to talk about what it is. What is inflation? What do you tell your students?

Brad Delong

The standard view is inflation is too much money chasing too few goods. I donâ€™t think thatâ€™s really right. Itâ€™s too much spending chasing too few goods. Itâ€™s that people have expectations about what prices are going to be. And they assume that, on average, prices are going to be pretty stable in normal times.

And so people have their incomes. People have their wealth. People decide how much to save, how much to spend. And you have this flow of spending that enters the economy, and it meets the flow of production.

And so people have their incomes. People have their wealth. People decide how much to save, how much to spend. And you have this flow of spending that enters the economy, and it meets the flow of production.

And when the flow of spending is less than the flow of production, you get huge amounts of inventory accumulation followed by businesses pressing the big, red button and firing people, you get a depression. When thereâ€™s higher demand than there is, that can be produced, you get empty shelves. You get long lines. You get T.S.M.C. and GlobalFoundries saying youâ€™re going to have to wait an extra six months to get this particular chip.

And then you also get substantial price rises as people say, well, this thingâ€™s in really short supply. Why donâ€™t I cut the line and offer to pay more for it? Or people say, I donâ€™t have very many of these. If I keep my prices the same, Iâ€™ll sell out of them by noon. Iâ€™m going to raise my prices today.

So inflation is when people show up wanting to buy things, expecting to buy things, and find that the economy has tricked them, that it disappoints their expectations because youâ€™re unable to buy what you wanted to buy at the prices you expected to buy. And so at the end of the week, you find that $50 that you were planning to have just isnâ€™t there because you spent it on gas because the gas price reached $6 a gallon.

Ezra Klein

When I ask an economist what inflation is, I tend to get that more-or-less mechanical-sounding answer â€” too much money, too few goods, too much spending, too few goods. And then I scratch and I start to get very hazy ideas about psychology and beliefs and expectations about the future. So if itâ€™s just too much money and too few goods or too much spending and too few goods, where does the idea of peopleâ€™s ideas come in? How does inflation become an almost cognitive dimension of the economy?

Brad Delong

Well, there are two ways. The first is John Maynard Keynesâ€™s observation back in 1919, that inflation is a betrayal of social trust at an extraordinary level. When you have a depression, maybe one in 20 people loses their job and they have a really lousy time.

Maybe other people are scared that they donâ€™t dare quit. But for the people who those people are working for, the fact that someone isnâ€™t quitting and is more eager to please you is a plus. And a depression affects only a few people.

Inflation, pretty much everyone feels, wait a minute, this is not how the system is supposed to work. I had my budget. I had my expectations. All of a sudden, everyone is cheating me. Everyone is charging for things more than they are worth.

I donâ€™t know about you, but I have given up going to countries with overvalued exchange rates because I get there and everything is incredibly expensive. And I really feel cheated.

By contrast, when my now wife and I went to Britain â€” I think it was the summer of 1984 or the previous time, when the pound sterling was at its lowest value, was in fact, close to kissing a dollar to a pound, it seemed like everything in Britain was one third off, that everyone was offering me extraordinary bargains.

And the effect on my psychology was immense. It was such a happy time, in large part because I did not have this underlying feeling that people were kind of cheating me. So thatâ€™s what inflation means on a psychological level.

There also is the question about what determines the rate of inflation. And there, the willingness of people to raise their prices or to demand higher wages very much depends on what they expect other people to be doing at the same time.

And so that means that if there is a general expectation that inflation is going to be 7 percent next year, lots of people are going to go into things thinking, my wages should go up by or I should be able to raise my prices by about 7 percent per year and that fact will do an awful lot to determine what the rate of inflation is because this is one of these economic equilibria in which there is a little bit of the fundamentals but thereâ€™s a lot of just things are what people expect things to be.

Ezra Klein

I want to hold on that first insight, the John Maynard Keynes insight, that inflation is a destroyer of social trust. I want to read you another John Maynard Keynes quote about inflation. He says, â€œThere is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction and does it in a manner which not one man in a million is able to diagnose.â€

Tell me about that last piece, that thereâ€™s something uniquely destructive about an economic affliction that seems to have very little logic and very little diagnosability.

Brad Delong

On the one hand, this is Keynes as establishment upper-class twit with an underlying belief that society holds together only if people think it is just and fair and rational, even though that it isnâ€™t.

And to all of a sudden have an inflation, to all of a sudden have people who have substantial amounts of immediate market power because what theyâ€™re selling is in short supply able to extract huge amounts of wealth from everybody else, that makes it very clear that the race is not to the swift, that instead, luck, time, and chance rule everything and that the distribution of income and wealth, the order of society, is just some random arrangement based on how lucky you are and how unscrupulous you are and that is not the kind of thing on which you can build a society with enough trust to actually run a productive, modern economy.

[MUSIC PLAYING]

Ezra Klein

So then I want to talk about how the inflation of the â€˜60s and â€˜70s actually happens. In the story you tell, what we think of as the inflation of the â€˜70s really begins in the late â€˜60s with President Lyndon Johnson. Tell me a bit of that narrative. What are the economic forces here that are at play?

Brad Delong

All right. The Democratic administrations of the 1960s are very interested in running a high-pressure economy and hope that they can get full employment. And maybe the price will be that inflation, on average, will be 3 percent rather than 1 percent or 2 percent or maybe 4 percent at most, but that itâ€™s worth doing because you get more people at work, businesses are willing to invest a lot more in training people, the African American unemployment rate goes down by 2 percentage points for every one percentage point the overall unemployment rate goes down and so forth.

And so thereâ€™s some liking by the administration for a high-pressure economy collides with Lyndon Johnsonâ€™s belief that he must wage the Vietnam War or be subject to political attacks by soft on communism from the Republicans, but also that he does not dare raise taxes in order to cool off the economy as the Vietnam War rolls forward.

And so when Richard Nixon enters office in 1969, he has an inflation problem. Inflation is around 4 percent or 5 percent or so. His economic advisers tell him that well, what you really need to do is you need to let the Federal Reserve raise interest rates a lot and to significantly cut back on the federal deficit. And so let unemployment go up by 1 percent, 2 percent, 3 percent.

Nixon says, OK. But as time passes and as he looks forward to 1972 and his re-election and he remembers 1960, when he and his friend, Arthur Burns, had gone to Dwight Eisenhower and said, hey, it looks like there might be a recession at the end of 1960. Itâ€™s very important that the economy be strong on Election Day. And here I am, your vice president. I have carried your water for eight years. Iâ€™ve done loyal service. You owe this to me to help me out and to push policy.

And Eisenhower blows him off. Nixon loses extremely narrowly. Nixon remembers when, by 1972, Arthur Burns is not only Nixonâ€™s friend but is also installed as the chairman of the Federal Reserve Board. And so Nixonâ€™s ideas about how you need to cool off the economy a bit go out the window as the important thing is to have a strong economy in November 1972, and in fact, to reduce inflation as you try to get a strong economy, to impose wage and price controls with the idea that these will be temporary and that they wonâ€™t distort the market economy too much and you can take them off once the thing has passed â€” which does not work all that well.

Ezra Klein

Let me hold you on that because why? I think wage and price controls seem very intuitive to people when you hear about inflation. Look, if the problem is that we are rising prices too fast and in turn, weâ€™re rising wages too fast and weâ€™re getting into a feedback loop between the two, just tell everybody to stop. But economists really donâ€™t like these. Why?

Brad Delong

Well you set yourself a huge administrative problem if you try to say, we are going to construct a bureaucracy to tell you not to raise wages and prices. And if you actually want to, you have to go to some board and make an argument for it. Then you have to say that we canâ€™t get this particular product. We canâ€™t find anyone to work unless we raise their wages.

You start degrading the ability of the market economy to actually do its job, like right now. Right now we have two kinds of inflation going on. One is an underlying 5 percent inflation, jump up of inflation from 2 percent to 5 percent, as a result of reopening the economy after the plague. And the other is the Vladimir Putin oil-and-grain Europe is likely to freeze this winter and Nigeria and Egypt may starve.

The first of these, weâ€™re coming out of a plague. We need to get people back to work. And we also need to get people back to work in a very different configuration than we had back in 2019. Lots of technological learning about things you can do remotely and things you canâ€™t since then. Weâ€™re reopening with an economy with much more goods production, with many fewer in-person sales, and with more deliverators and more website designers and data-center operators.

And if you want to get people back not just into jobs, but into the right jobs for the future, you really have to offer the people moving into those sectors higher wages so they find it advantageous to go. And you really canâ€™t cut anyoneâ€™s wages. If you tell someone weâ€™re going to pay you less than we paid you last year, itâ€™s such a major psychological insult that theyâ€™re unlikely to work hard for you or indeed to work at all if you do that.

Wages in expanding sectors have to rise. Wages in contracting sectors stay the same. Youâ€™ve got to get some inflation in order to make this reopening happen rapidly and smoothly. Plus the bottlenecks. You have a bottleneck. You have something in short supply. As Friedrich von Hayek would say and did say, the whole point of a market system is that it means that decisions are not made by some clueless central planner or by someone mindlessly following a bureaucratic rule book that only covers a third of the cases. But instead, decisions are made by people on the spot who have the information.

We need to crowdsource solutions to all the bottlenecks and supply-chain difficulties that have emerged as weâ€™ve reopened. And the way to do that is to offer people money if they figure out, had a way to provide more of, say, this particular type of lumber right now and to provide people with incentives to economize if we donâ€™t really need this but can use something else.

So Friedrich von Hayek would say that yes, coming out of a plague, if you want to come out of it rapidly, get back to full employment rapidly, not repeat the lost decade of the 2010s, youâ€™re going to have some inflation.

Ezra Klein

So back to the â€˜70s.

Brad Delong

Yes?

Ezra Klein

So Nixon has relatively-high inflation.

Brad Delong

Yep.

Ezra Klein

He has a Fed chair. We understand Fed chairs to be relatively independent.

Brad Delong

Not then.

Ezra Klein

Why does Arthur Burns not just do what we think should be done now and hike interest rates up until inflation goes away?

Brad Delong

Well, Arthur Burns is a Republican. And Arthur Burns is one of Nixonâ€™s best friends. And Republican Fed chairs, thereâ€™s a tradition of them hewing a little closer to the Republican Party line that in fact, they should.

Do you remember the days when Alan Greenspan was saying, no, no, if you look carefully I did not actually endorse â€”

Ezra Klein

I do remember those days.

Brad Delong

â€” George W. Bushâ€™s 2001 and 2003 tax cuts. I did not endorse them.

Ezra Klein

You had to look very carefully.

Brad Delong

I simply fuzzed my testimony before Congress so that every Republican could claim I had endorsed them. And then I stayed silent. And Alan thought heâ€™d preserved his technocratic purity by doing so. Those on the other side begged to differ and think he acted relatively badly.

To some degree, Burns acted badly in 1972. To some degree, Burns went as far as he could in terms of pressuring the Nixon administration to do something in order to fight inflation. Paul Volcker reports conversations with Burns on funding flights to Europe and so forth in meetings and Burns would rant about how more had to be done.

To some degree, Burns thought he would not be allowed to, that if he were to raise interest rates, then Congress would come and would take the Fedâ€™s powers away, that he could only preserve his independence by not using it.

Ezra Klein

This is interesting to me. And you spent some time on this in the book because I think we look back and see Arthur Burns is primarily, simply a politicized actor. But the Fed chair who comes after him, whose name I and everybody else forget, also does not hike interest rates very high and for the same reason â€” thereâ€™s a few â€” that the people will not stand for, the politicians will not stand for some random person, running the Fed, crashing the economy because thatâ€™s how they think inflation should come down.

Brad Delong

Yes.

Ezra Klein

And in a way, that seems actually quite logical, that thereâ€™s been quite a shift post Volcker in what we think it is â€” what we will morally expect the Feds are doing.

Brad Delong

Especially because the Fedâ€™s interest-rate weapon is one with â€” its extremely narrowly targeted. itâ€™s targeted at home builders. Itâ€™s targeted at exporters.

Ezra Klein

Your friend, Larry Summers, gets so mad at me when I say the interest-rate weapon is weird. He really does not like it when I criticize the interest-rate weapon.

Brad Delong

It is weird. It may be the only weapon we have and is powerful. But it hits exporters, it hits import-competing businesses, and it hits construction. With overwhelming force, it also hits anyone whoâ€™s bankrupted or who relies on someone who goes bankrupt because they were over leveraged, when the interest rates go up.

But itâ€™s not a broad-based tool to cool off the economy in general. Itâ€™s a tool to put a bullâ€™s-eye on a few sectors, whomp them with a brick, and then hope that whomping then spreads more-or-less smoothly and rapidly to the rest of the economy. Itâ€™s something you really would rather get out of some other way if you could figure out how to.

Ezra Klein

So inflation in this period is not that high, though, under Johnson, under Nixon â€”

Brad Delong

Itâ€™s 5 percent.

Ezra Klein

Itâ€™s 5 percent, 6 percent â€”

Brad Delong

No â€”

Ezra Klein

Somewhere in that range?

Brad Delong

5 percent to 7 percent, yes.

Ezra Klein

So what happens that shifts from 5 percent to the really big spikes we begin to see, to the stagflation era?

Brad Delong

The 1973 Yom Kippur War. The U.S. provides a lot of emergency resupply to Israel during this war. And the Saudis get pissed and say, we are going to impose an oil embargo on the United States and the Netherlands. And oil prices immediately spike â€” and spike by a lot.

And so the Organization of Arab Petroleum Exporting Countries â€” I got this wrong in the book and Iâ€™ve been swamped by energy economists on it. I said OPEC. Itâ€™s actually OAPEC, is the organization â€” says, hey, wait a minute. We now have a lot of pricing power over the global oil market. We donâ€™t have to accept $3 a barrel as the oil price, which was what it had been set at before. Weâ€™re going to raise it to $10 and weâ€™re going to keep it there.

And so you have the entry of the House of Saud on the geopolitical scale as a mighty and fearsome thing that has to be dealt with. And then you have U.S. and European economies that immediately must start to cope with the fact that all of a sudden, this one, key, industrial input into the civilization is all of the sudden three times expensive as it used to be, which means a huge amount of energy-intensive manufactures and other things are no longer profitable.

And a lot of businesses have to turn and immediately change their plans to figure out how can we reconfigure ourselves to be more energy efficient. And also, everyone faces gasoline prices that have suddenly gone up by a lot. This works its way through the system as inflation as all of a sudden, the price of one key input is $10 rather than $3.

And it also brings on a recession because a whole bunch of money that was flowing through the spending system is now being diverted overseas and is being put into the Saudi coffers. And theyâ€™re not immediately spending it on U.S. exports in order to rebalance the economy immediately.

So 1973 to 1975 sees both the deepest recession since World War II and an explosion of inflation to 10 percent, followed by a reduction of inflation down to maybe 5 percent of 6 percent come 1976, at which point Jimmy Carter gets into office by saying Gerald Ford has mismanaged the economy. Look at sum of the inflation and the unemployment rate. Look at this, quote, â€œmisery indexâ€□ as his economic adviser Art Okun had constructed.

The Carter administration then says, well, unemployment is high. Weâ€™re just coming out of a recession. Weâ€™re going to not step on the gas. But weâ€™re going to let the economy grow because even though inflationâ€™s 6 percent, unemployment is problem one.

And then there came the year whenâ€” as Carterâ€™s chief economist Charlie Schultze once told me, our forecasts of total nominal G.D.P., nominal national income, were accurate. But inflation came in 2 percent high and real growth came in 2 percent low because productivity growth had fallen off the cliff because people were no longer concentrating on making their businesses more efficient with respect to labor, but instead with more efficient with respect to energy.

And then comes the Iranian Revolution and the cutoff of Iranâ€™s oil supplies. And the Saudis take advantage again. And all of a sudden, the price of oil is $30 a gallon. Inflation is more than 10 percent. Paul Volcker replaces G. William Miller as Fed Chair.

And Paul Volcker says, weâ€™ve gotten ourselves into a situation in which people donâ€™t just expect inflation next year to be what it was last year. People expect inflation next year to be what it was last year plus a bit more. Iâ€™ve got to fix this and I got to fix this by hitting the economy on the head with a brick and keep hitting until people understand that no, if they insist on raising their prices, theyâ€™ll have no demand for their products.

And it works. Worst recession of the post World War II era, with its peak in 1982 when the unemployment rate hit 11 percent. And I graduated from college, looked around at the job market, and decided, Iâ€™m not going to leave the university and hence, did not.

And then in the middle 1980s, inflation settles back to something like 4 percent, which would have been viewed as a horrible thing back in the late 1960s, as evidence that things were going badly. But by then, everyone says, yay, weâ€™ve had a victory over inflation. Weâ€™re not going to talk about it anymore.

Ezra Klein

Paul Volcker is such a crucial figure here.

Brad Delong

Yes.

Ezra Klein

But you described him in the book as something of an accidental Fed chairman. So how do you get this guy, who is willing to go much further than the recent ventures are, thinks the political system will support that â€”

Brad Delong

Well, heâ€™s not a financier. Heâ€™s a financial civil servant. He rises up through the bureaucracy. He is Under Secretary of the Treasury for Monetary Affairs during the Nixon administration.

And so he goes from Under Secretary of Monetary Affairs to then being chosen as president of the Federal Reserve Bank of New York, which has this strange, semi-medieval position in the Federal Reserve System in that itâ€™s just one of 12 regional banks but then it isnâ€™t. And it has a special role on the open-market desk and so forth.

Paul Volcker is sitting there. And Jimmy Carter has a snit and decides he has to fire his treasury secretary, Mike Blumenthal. Carterâ€™s political advisers say, well, you canâ€™t just fire the treasury secretary and say weâ€™ll choose another one next week. That would show an administration that is bureaucratically inept and in chaos. You have to have a person to fill in.

So Carter says, well, how about G. William Miller. I like him a lot. Heâ€™s my Fed Chair. Letâ€™s bring G. William Miller over as Treasury Secretary. And they say yes. And so the press release is prepared. And then they come and they say, well, wait a minute. Canâ€™t just move the Fed chair over and say weâ€™re going to name a replacement next week. That would indicate an administration that was bureaucratically inept and in chaos. You have to have a replacement for the Fed chair.

And well, whoâ€™s the obvious person? Well, either the number two or number three at the Fed, depending on how it is, is this guy, Paul Volcker, who is definitely nonpartisan and in fact, somewhat of a Democrat. OK, weâ€™ll name Volcker.

Charlie Schultze again asked Carterâ€™s domestic policy adviser, Stu Eizenstat, if anyone had done any research into what Paul Volckerâ€™s views about monetary policy should be and as I understand it, did not get an answer. And so Paul Volcker winds up as Carterâ€™s choice for Federal Reserve chair, at which he says that Arthur Burns was worried that we had to curb our actions in order to keep our independence. If there was ever a time when independence needed to be used it was now. And so I am going to be independent.

Ezra Klein

Itâ€™s easy to see Paul Volcker as this guy history turned on. But something you point out in the book is that you have a bunch of other countries dealing with fairly high levels of inflation at the time, Germany, France, Japan, the U.K. But they keep it more under control than we do. Or they disinflate earlier than we do without the drastic shock therapy that Volcker applies in the U.S. Why is that? Why did we need to do more?

Brad Delong

It was easier to do earlier, when the problem was smaller. And when Japan and Germany get off the train, they got off the train significantly earlier when the problem is smaller. I think that people who ask â€” people who criticize Volcker have a problem in saying what else could have been done given the situation at that moment.

And the most they will say is that he hung on to the high interest rate policy too long. I mean, he bankrupted Mexico, among other things. But then thereâ€™s the question of what happens if you relax the high interest-rate policy too early as in fact, G. William Miller had and then you find not just that the problem is back, but that all of the unemployment that youâ€™ve inflicted on the construction and export industries has been to no good at all â€” that criticizing Volcker for holding on to the policy too long is, I think, unfair. And criticizing Volcker for undertaking the policy at all requires that you have an alternative.

And we left these social Democrats say, well, this is actually the time to have used wage and price controls, or this was the time to have imposed surtaxes on businesses that raise their prices, or this was the time to have actually gone to the unions and struck a bargain that is, you, unions, agree to freeze your wages for the next three years in order to say that you can cooperate with the general macroeconomic requirements of the country. And in return, we push for, and we, in fact, get through pension reform, expanded welfare state, this and that, a lot of things that are good for Union members in general.

Whether that grand bargain could have been made or not, it was not tried. Whether the unions would have bought for it, we do not know. And Volcker could not have made that. Only Carter and the Unified Democratic Congressional Caucuses could have made that. And in the late 1970s, Democratic Congressional Caucuses did not like Carter very much. And he did not like them. And he, being a Georgia guy, did not like unions at all.

Ezra Klein

So tell me about the political consequences of the inflation crisis in the aftermath. How exactly does it get weaponized against social democracy and government in general?

Brad Delong

Well, first, that the social-democratic governments are clearly, clearly incompetent. They do not understand the situation and they cannot deliver, that what theyâ€™ve delivered is stagflation, the worst of high inflation and high unemployment, that the [INAUDIBLE] the misery index was bad when Gerald Ford was running for re-election. Look at this thing now.

Second, and behind that, the idea that inflation is the result of a society that is permissive, that social democracy will inevitably hand out more tickets to things than there are actually seats on the roller coaster. And this is endemic in it because it simply cannot say no, especially not to the organized interest groups, big labor, those parts of big business that have gotten in bed with it, welfare-rights organizations, minorities and so forth that think they have a claim on it.

And so in order to have stable prices, in order to have a functioning society, we need to get back to the unpermissive view that you get only what you pay for and that you pay for only what you can earn so that social democracy, that the New Deal order was in the end going to pretend that more could be produced than could be â€” as, in fact, right-wing economist Jacob Viner had written of the emerging New Deal order in John Maynard Keynes. Itâ€™s going to work only as long as the printing press can stay ahead of the business agents of the labor unions, in terms of their wage demands. And it will work for a while but then it will fell apart.

Add to that all the other things, the reasons that people did not like social democracy very much. And Paul Krugman is, I think, pretty certain that it was the inflation that actually pushed the system off the cliff, that it would have hung on without it and you would not have had the neoliberal turn. Iâ€™m less sure.

Ezra Klein

I want to now read a quote of yours to you from the book because I think this puts a nice point on what begins to happen in the 1970s. You write that, â€œpeople do not just seek to have good things materially. They like to pretend that there is a logic to the distribution of the good things and especially its distribution to them in particular, that their prosperity has some rational and deserved basis. Inflation, even the moderate inflation of the 1970s, stripped the mask away.â€□

Tell me how inflation changed the moral narrative of the economy as we turn from the social-democracy era to the neoliberal era. When you say it stripped the mask away, what did it strip away exactly?

Brad Delong

What it stripped away was precisely the idea that the social democratic, the New Deal order, had gotten it broadly right, that people were working hard and they were getting their incomes and that people who had been unlucky in the sense of not being in places where huge amounts of wealth was made honestly and honorably were getting substantial amounts of support and everyone had their right to their Social Security, to their Medicare, to their unemployment benefits if they were unlucky, to all the things that were theirs as citizens.

unemployment benefits if they were unlucky, to all the things that were theirs as citizens.

But that by and large, the system made considerable sense in that yes, there were some cases in which inheritance played a big role, but that by and large it was a meritocracy in which those who exerted themselves could rise and in which there was a fair amount of luck involved and chance and fortune and who your friends are, but that was secondary to the idea that people were by and large getting what they deserved.

And with inflation coming, with you having to wait for hours in line for gasoline, as Jimmy Carter and company bollocks up the adjustment to the oil-price increase, with unions that are strong, able to use their power to get substantial cost-of-living increases written into their contracts and to get a catch up from past inflation increases when it came by surprise, it becomes clearer or appears clearer that if you do not have big labor or big business or big government looking after you personally, you are a person of relatively little account and the system is working against you.

Ezra Klein

It also seems to me â€" I want to try this as an idea on you â€" that thereâ€™s something about inflation that also erodes confidence in those and really any institutions. I wouldnâ€™t, I think, be able to prove this to you. But I have a theory that recessions and depressions are crises. And people often turn to experts and to authorities when there is a crisis.

But inflation is a kind of disorder. Itâ€™s a derangement of the system. And people tend to turn on experts and authorities when the system becomes deranged, when it isnâ€™t working the way the experts and the authorities told them it would.

Brad Delong

I would say that there are similar reactions to both, that when a crisis comes, you turn to somebody who has an answer or an explanation. But you also are extremely likely to vote the bastards out who mismanaged the system this way.

And so there are then desperate attempts by everyone to say someone else mismanaged the system, which I think, reached its apex in what we saw in 2007 to 2010, the American Enterprise Institute and Heritage Foundation and other guys who said, well, we have this Great Recession because the government forced banks to lend for mortgages to poor, black people, something with absolutely no empirical content whatsoever but that serves as a distraction that hits a mental fault line in a great deal of the potential audience for that.

It goes both ways. But it definitely is the case that all you had to say in the late 1970s was that if the government was competent and understood the economy, we would not be having this inflation.

[MUSIC PLAYING]

Ezra Klein

I want to go back to the too many tickets for the roller coaster. You get part of that in terms of the critique, the government gives too much to too many undeserving people. Deservingness is a big part of this politics. Thereâ€™s also the issue, though, of, to be blunt, worker power.

In that period, itâ€™s the unions putting wage increases into contracts. You get wage-price spirals. And thereâ€™s some truth to that, arguably, in terms of how inflation works. But the other thing that you hear today is something similar. Now we donâ€™t have a strong unions. You donâ€™t have the same kinds of contracts. But what you do have is, I think, this fake trend of quiet quitting, which is really a TikTok idea but with no real evidence behind it.

But you see a lot of managers writing op eds about it. There is this feeling that everybody got lazy during the pandemic. They wouldnâ€™t work. They wouldnâ€™t work for reasonable wages and that one part of the neoliberal turn is actually a turn against worker power, worker power as instantiated in unions, worker power as instantiated in the moral willingness of workers to work, their work ethic. And you see that today too. Could you talk a bit about that side of it?

Brad Delong

Well, the idea is that taxes will be lower on the rich so that the job creators will be incentivized to do their proper entrepreneurial thing and create jobs, rather than spend money on lawyers in order to figure out how to evade taxes, that the social-democratic New Deal order had created a world in which the returns to working hard were too low.

And so as a result, the productivity trend that had been extremely nice up until 1973, had then fallen off a cliff after 1973. And this was that we have finally done too much to punish hard work and enterprise. And so we need to get back to, as Deng Xiaoping said, to get rich is glorious. And we need to massively lower taxes on the rich in order to make that so.

Conversely, itâ€™s that the non rich have it much too easy, that you can find a union job and then feather bed your way through and the Union will represent you if they try to fire you and the boss has virtually no control over anything and that if you do get fired, well, then unemployment insurance is there for a while. And thereâ€™s all this social welfare stuff that supports you.

In its most racist versions, itâ€™s this is why all these Black people are having kids out of wedlock. Itâ€™s because that then they get the A.F.D.C. payments which allow them to live and party, never mind that they have a one-year-old.

Ezra Klein

Tough on the partying, I can tell you.

Brad Delong

Yes, lots and lots of partying with a one-year-old. And so that a much greater degree of income inequality than we had in the largely middle-class, at least for white guys, social-democratic and New Deal societies of the â€˜60s and 1970s was, in fact, strongly desirable.

And maybe the desirableness of it was regrettable in that people really needed to be incentivized to work hard properly, which required the rich be richer and the poor be poorer. And this is, alas, just the way things are in this fallen, sublunary sphere, where we cannot say, from each according to his ability, to each according to his need, and still have a functioning society.

And on the other side, you get into, well, the income inequality is actually a feature rather than a bug, that itâ€™s very important that society recognize industry effort and achievement. And if everyoneâ€™s income is more or less equal, the fact that you are then giving out some people prizes for being industrious and organized and achieving, that really isnâ€™t sufficient.

Thatâ€™s a fake reward when actually, the productive and successful deserve very real rewards. And money, in the form â€" and the social power over other people that money brings is a very important part of that.

Ezra Klein

I think thereâ€™s a tendency to look at the effect economics has on politics as somewhat mechanical, that if you deliver good macroeconomic outcomes, you get rewarded, if you deliver bad macroeconomic outcomes, you get punished. But thereâ€™s also a dimension where I think economics is understood and economic outcomes are understood and they end up influencing politics morally. There has to be a story people tell about the economy that they believe.

And so whether inflation is the reason for the neoliberal era, whether itâ€™s a reason for the neoliberal era, one thing that happens here is that it is â€" from what I hear in your story and it seems persuasive to me â€" is that itâ€™s a major cause of a desire for a new story.

It makes the old story look bad, that we were wrong about what would come of that kind of moral suasion. And it creates this context for a new one that Reagan tells, that Thatcher tells, that others tell. And how would you describe the moral story of the neoliberal era? Youâ€™re describing what they thought didnâ€™t work about the last one. What is the moral story of the neoliberal era?

Brad Delong

Well, at least the plan for the neoliberal era was that you do indeed make income inequality significantly greater and you thus re incentivize both the rich, job creators and also re incentivize the great mass of the workers. And you also properly punish the slackers and the moochers as well.

In addition to widening income inequality, you take aim at the social-insurance state which has been vastly and completely corrupted by rent seeking, interest groups that have figured out how to make their way to Capitol Hill and then get a large amount of benefits channeled to them via all the things that government does that they have no rightful claim to, and that the war on rent seeking is a very important thing that neoliberals can do but that nobody else is willing to do, especially not social Democrats, which did not work out, I think, the way that neoliberals hoped.

There also is that the social-democratic world had become vastly over bureaucratized. You trust bureaucrats to write rules and regulations but then you turn everyone into a software bot, essentially, that is following a rule book that has only one third of the cases properly covered, that what you really need is entrepreneurship and enterprise. You need to push power out to the people informationally and also power to act.

You see, I think the apex of this in the 1984 Apple computer Macintosh launch commercial, which is very much about how a Macintosh will enable you to move into the neoliberal era with control over your information rather than being simply a mindless cog working for a large, bureaucratic organization who has to bow to its every dictate. Instead, you can use your Macintosh computer to be a knowledge worker, be an independent knowledge worker.

And add to those, there also is a very strong sense that if people had to buckle down and work, if the social-insurance state was not there and was not so lavish, well, you wouldnâ€™t have people in Australia claiming unemployment insurance and then going on monthlong surfing vacations.

You wouldnâ€™t kind of get all this permissiveness. You wouldnâ€™t get the decline of the nuclear family. Mothers wouldnâ€™t think that they had an option to leave husbands and accept various forms of A.F.D.C. and other benefits and would actually return to their proper place in the patriarchal household.

A very, very, very large tangle of Gordian knot, of all kinds of ideas about how the right ordering of the world was to accept that the market economy was a very powerful thing and that the market economy did what it did for reasons and that the right attitude toward it was that the market giveth, the market taketh away, blessed be the name of the market.

Ezra Klein

I think you, like many, including me, think that the neoliberal era ends in the aftermath of the financial crisis.

Brad Delong

Well it ought to have ended in the aftermath, yes.

Ezra Klein

Maybe itâ€™s not clear what comes after it. But it is not, certainly, unquestioned. And I think people are trying to understand what will come next. But why? Within the context of these moral logics, what is the financial crisis do that breaks that story?

Brad Delong

As of 2006, you could say, well, Reagan had a rough decade. But economic growth is rapid. Income is more unequal. So if you see that as a feature rather than a bug, youâ€™re kind of happy. And then come 2007, it becomes very plain that the neoliberal policymakers had forgotten everything the New Deal knew about financial regulation.

And then it becomes clear in 2010 that the neoliberal order has forgotten everything the New Deal new about how, in a depression, you then want to get everyone back to work and not think that the problem has been solved when the banks have been saved and recapitalized if unemployment is still at 10 percent. And that was a big shock to the view that the neoliberal politicians and technocrats actually knew what they were doing.

Ezra Klein

So weâ€™ve had, then, in the past decade and change, two truly major economic financial shocks. So we have the financial crisis and all the follows from it. Then we have the pandemic, moving into the inflation rate that weâ€™re in now.

Brad Delong

And we may also have China hitting the middle-income trap and the return of major, conventional war with its subconsequent oil shock and killer robots stalking the skies above Ukraine, yes.

Ezra Klein

Well, thereâ€™s a lot going on, much of it bad. But I want to hold on those two economic shocks because I do think, to what youâ€™re saying, the financial crisis discredits this idea and in particular, discredits the idea that the rich know what theyâ€™re doing. The rich caused the financial crisis to a very high degree. The bankers, the financiers, they are theyâ€™re the villains of that particular morality story.

And then inflation comes. Inflation comes in the context when it feels like a turn is moving â€" is going back to the social-democratic policy making, a much more active government, industrial policy, being very, very worried about repeating the 2009-2010 mistake of under stimulating in a crisis. But here comes inflation to pound, in America at least, the Democrats.

Somebody who has spent a lot of time thinking about the joints of economic history, these times when old regimes die and new ones are born, what are your intuitions about the stories that could survive or emerge from this moment? Or at least what stories do you see people trying to tell?

Brad Delong

Yeah, so I think that this is a moment of danger. And because of who has happened to be in power in the United States right now, itâ€™s a moment of danger for any attempt done to see Biden as any kind of social-democratic revival.

Conversely, in Britain, it looks to be the death knell of the Conservative Party as we know it because itâ€™s been in charge during this and has had not only these problems, but all of its other self-inflicted problems as well, which are mighty, that itâ€™s throw the bastards out as a reaction to the inflation that weâ€™re currently having.

And I confess that if you want to say that weâ€™re conceptualizing ourselves as having a choice between neoliberalism on the one hand and the return to social democracy on the other, and various third, fourth, fifth and sixth ways, this is a bad thing for social democracy.

The third, fourth, and fifth and sixth ways that appear to have political valence right now appear to be very unpleasant things for the most part, things much, much worse than neoliberalism, things even worse than right neoliberalism, I would say, in my left neoliberal hat and that thatâ€™s quite disturbing.

But I would also say that look, you couldnâ€™t run a gunpowder empire in 1650 like you ran a feudal regime in 1000. And you couldnâ€™t run a steam-power society in 1870 like you ran a gunpowder empire in 1650. Similarly, the mass-production economy that supported the New Deal order was a very different animal than the semi-globalized economy or the global value-chain economy of the neoliberal order.

And we are now moving into what Iâ€™m thinking of as an info-biotech economy right now. And so the forces of production foundations are very different. And any kind of political or political-social bargain built on top of them, if you try to recreate one that was built in the past on an earlier set of forces-of-production foundations, itâ€™s highly unlikely to work. Itâ€™s highly unlikely to work at all.

Ezra Klein

Well, now, let me ask you a reverse of that question because the reason I wanted to have this conversation this way is that the 1970s are operating as the principal historical analog for the time weâ€™re in. Chairman Jay Powell talks often about Paul Volcker. Everybody debating monetary policy talks about the 1970s.

What are the wrong lessons to take from the inflation and the monetary policy of the â€˜70s and â€˜80s for today? And what are the right ones in your view?

Brad Delong

Well, the wrong lesson to take is that obviously, weâ€™re in the position Paul Volcker found himself in 1979, with inflation expectations extremely strongly entrenched in the economy, both in terms of what people were expecting to happen and also in terms of things that had been built into the multiyear contracting structure of businesses and union workers, that Paul Volcker had to raise unemployment rates high enough that unions would go to companies and say, I know we have a 6 percent wage increase for next year built into our contract but can we give that back to you in return for you doing fewer layoffs here in this recession?

We are not in that position at all. You look at the long-run bond-market inflation expectation gauges that I prefer to look at, and they are all blinking that the bond market expects inflation to be lower than the Fedâ€™s target in five years rather than above.

And bond-market traders expectations â€" they arenâ€™t what people are counting on happening and what people real people are counting on happening â€" is much more attuned to whatâ€™s happening to the gasoline prices that they see at the pump, that being the principal thing that people see that impacts them that fluctuates widely and that people do indeed take as gauges of inflation.

But the analogies between the late 1970s are still, I think, weaker than analogies with the 1947 demobilization after World War II when we had inflation as the civilian economy opened up and then the reverse of that, in 1951, when we mobilized for the Korean War and the permanent Cold War and once again, had an inflation wave as the bottlenecks emerged in the national security sector, that Iâ€™d say the odds are still 60 percent that weâ€™re repeating those and only 40 percent that itâ€™s something somewhat or more analogous to the 1970s.

Of course, Vladimir Putin and company and the House of Saud could change that.

WE HAVE a very nice reframing of the current mindset of the Federal Reserve by the extremely smart Robert Armstrong and Ethan Wu of the *Financial Times:*

The Federal Reserve currently anticipates that their medium-run inflation target can be restored with an increase in interest rates of only 250 basis points over the next three years.

The first thing to say is thatâ€"if the Federal Reserve is correctâ€"that low a level of interest rates at their peak means that we will once again hit the zero lower bound on interest rates if and win another negative demand shock hits the economy. That means, above all, that the long-run inflation target is too low to maintain macroeconomic balance. The Federal Reserve should already have thought about this and take an action to raise the inflation target.

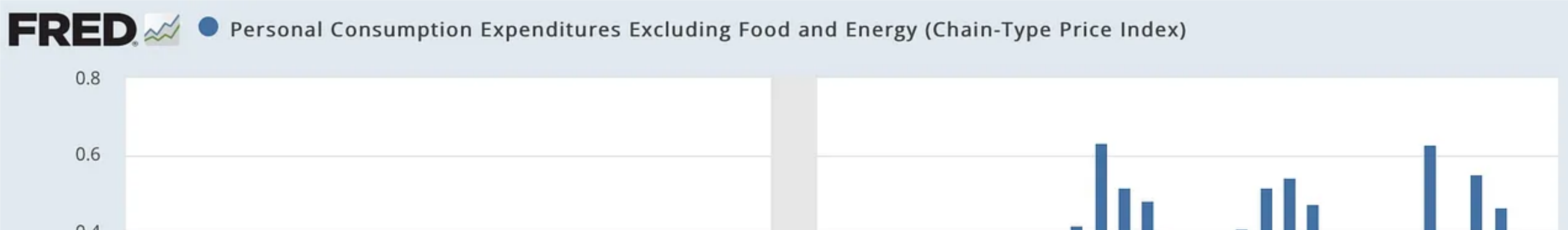
The second thing to say is that the overwhelming bulk of the inflation we are right now seeing must be transitory if such a small increase in interest rates will be sufficient to return the economy to its 2 1/2% per year long-run inflation target. This is, as I say over and over again, not a 1970s like inflationary spiralâ€"not melting the engineâ€"but rather leaving rubber on the road as you rejoin the highway traffic at speed. Rejoining the highway traffic at speed is a good thing to do. Leaving rubber on the road is a necessary consequence of doing that. Itâ€™s stupid to complain about it.

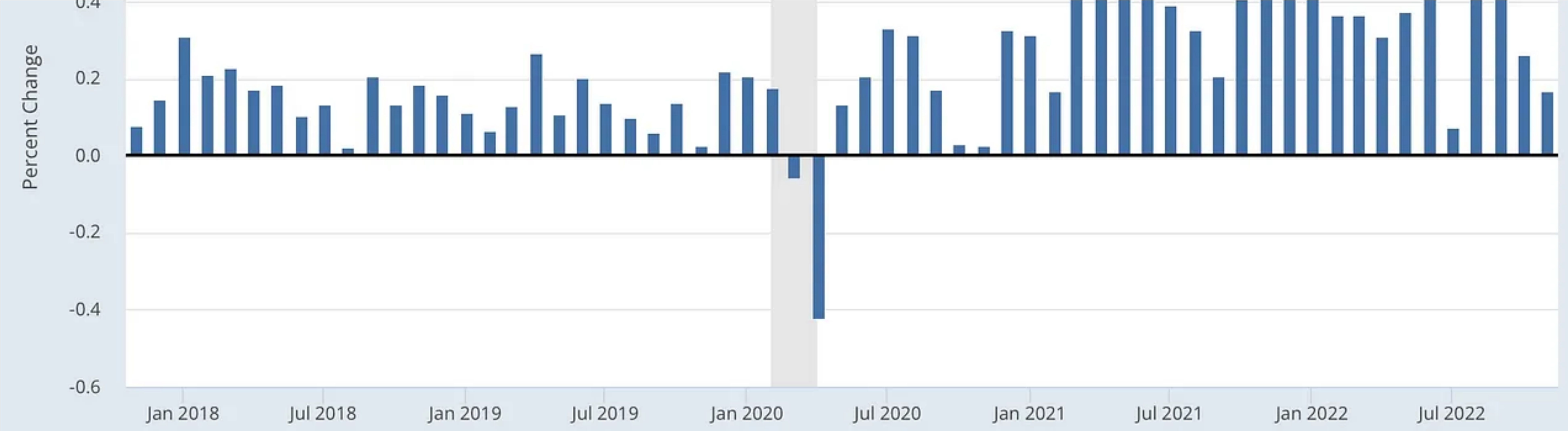
The third thing to say is that restoring an economy to full employment while undertaking a massive structural shift in an economy with sticky downward wages (and some prices) has always, in our experience, been accompanied by a transitory burst of inflation. You have to incentivize movement into the sectors that need to expand by creating price differentials vis-a-vis the contracting sectors. And with their wages (and some of their prices) downward-sticky, that is a transitory burst of inflation. It is the post World War II demobilization and the Korean war era mobilization from the Cold War that should serve as are examples, if indeed there are any examples that are relevant. Those who look at the US post-Korean War experience and try to generalize from that are, I think, barking up the wrong tree:

> **Robert Armstrong & Ethan Wu**: *The Fed Still Thinks Inflation Is Transitory*: â€˜The most surprising thing in the Fedâ€™s sedate December meeting was the newsâ€¦ that monetary policy committee members project three interest rate increases next year, rather than the two that consensus had called for. Even this spooked no oneâ€¦. The Fed is acknowledging short rates will need to rise somewhat to hedge against persistent inflation. That is evident in the 2022 and 2023 dots. But the median forecast for rates in 2024 nudged up only a bit, from 1.75 percent to just over 2 percent. The longer-run dots have stayed the sameâ€¦. The committee thinks, with a high level of unanimity, that a short raising cycle, topping out at 2.5 percent, will ensure that inflation is transitoryâ€¦. Above target inflation will last about a year. Everybody, say it together now: ***transitory!*** The Fed retired the word, but it still thinks the same wayâ€¦. The bond market wholeheartedly agrees with the Fedâ€™s attitudeâ€¦
>
> LINK: <https://www.ft.com/content/024e4598-61cf-4871-89dc-0626d71a8c96>

Share

Dean Baker: â€˜Pretty damn good PCE numbers. Health care services index rose just 0.16 percent. With rent coming down sharply (we know this from private indexes of marketed units) sure looks like the Fed's job is doneâ€¦




Percent Change
0.2
0.0
-0.2
-0.4
-0.6
Jan 2018
Jul 2018
Jan 2019
Jul 2019
Jan 2020
Jul 2020
Jan 2021
Jul 2021
Jan 2022
Jul 2022


FRED
5-Year, 5-Year Forward Inflation Expectation Rate
Percent
2.8
2.6
2.4
2.2
2.0
1.8
1.6
1.4
1.2

Some respected economists are talking as if the US economy is in serious inflationary trouble. But the current uptick in price growth is highly likely to be a largely benign consequence of the post-pandemic recovery.

BERKELEY â€“ In the past three years, technological advances have provided about one percentage point of warranted US real wage growth each year â€“ admittedly, only half the rate of earlier times, but still something. Yet, real wages are currently 4% below their warranted value from adding on the underlying fundamental productivity trend to the pre-pandemic real wage Employment Cost Index (ECI) level. Does that sound like a â€œhigh-pressureâ€□ labor market to you?

Those who believe that the US labor market is in some sense â€œtightâ€□ point out that the ECI increased by 3.7% in the year to September â€“ well above its 3% annual growth rate in the pre-pandemic years of former US President Donald Trumpâ€™s administration. But, because US consumer prices have increased by 5.4% over the past year, the ECI-basis real wage has fallen by 1.7% in that period. In a high-pressure economy with a tight labor market, workers would have enough bargaining power to obtain real wage increases.

Nowcasting is extremely difficult, and hazardous. But the â€œnowâ€□ that I see today is the one I forecasted two to three quarters ago. Yes, the recovering US economy, like a driver who suddenly accelerates, is leaving inflationary skid marks on the asphalt. But, as I argued in May, these should not concern us, because â€œburning rubber to rejoin highway traffic is not the same thing as overheating the engine.â€□

The US is not currently in a situation where too much money is chasing too few goods, which would result in a surfeit of demand for labor and likely trigger an inflationary spiral. This is despite the fact that the ongoing COVID-19 pandemic and its associated disruptions continue to cause a substantial undersupply of labor.

Today, the US economyâ€™s overall employment-to-population ratio is three percentage points below what we used to regard as its full-employment level. The ratios for women, African-Americans, and workers without a college degree are, respectively, five, 4.5, and four percentage points below this level.

Yet, economists whom I respect talk as if the economy is in serious inflationary trouble. Jason Furman, a former chairman of President Barack Obamaâ€™s Council of Economic Advisers, thinks â€œthe original sin was an oversized American Rescue Plan,â€□ the $1.9 trillion recovery package that President Joe Biden signed into law in March. In Furmanâ€™s view, it would have been better to have less aggressive policy measures and thus a slower employment and growth recovery this year, because Bidenâ€™s plan â€œcontributed to higher output but also higher prices.â€□ And according to the same New York Times report, former US Treasury Secretary Larry Summers thinks that â€œinflation now risks spiraling out of control.â€□

The inflation worriers then argue that the COVID-19 crisis has permanently damaged the supply side of the economy by causing a lot of early retirements, as well as lasting disruption to the lean-and-mean supply chains on which a good deal of productivity and prosperity had depended. Perhaps. But similar arguments in the early 2010s, in the aftermath of the 2008 global financial crisis, aimed to justify policies that did not put the pedal to the metal and attempt rapidly to re-employ so-called â€œzero-marginal-productâ€□ workers. One consequence of this timidity was the election of Trump, whose rise was fueled by the rage of those who thought â€œelitesâ€□ cared more about immigrants and minorities than they did about blue-collar workers whose economic opportunities had never recovered to pre-2008 levels.

Lastly, some claim that, regardless of whether or not the labor market is tight, inflation â€“ whether driven by supply-side or demand-side factors â€“ is high and salient enough that firms and households will swiftly incorporate it into their expectations. Thus, the inflationary snake has to be scotched now, while it is small, before it grows and devours everything of value.

But so far, rising inflation has not been incorporated into any of the â€œstickyâ€□ prices in the economy, according to the measure constructed by the Atlanta Federal Reserve. True, the financial marketâ€™s current 30-year breakeven inflation rate, at 2.35%, is more than half a percentage point above where it settled in the second half of the 2010s. But todayâ€™s rate is similar to that in the first half of the decade, and slightly below the level that would be consistent with the US Federal Reserveâ€™s inflation target of 2% per year.

The current uptick in US inflation is highly likely to be simply rubber on the road, resulting from the post-pandemic recovery. There is no sign that inflation expectations have become de-anchored. The labor market is still weak enough that workers are unable to demand substantial increases in real wages. Financial markets are blasÃ© about the possibility of rising inflation. And a substantial fiscal contraction is already in train.

Given these facts, why would anybody argue that the â€œoriginal sinâ€□ was the â€œoversized American Rescue Plan,â€□ and that tightening monetary policy starting right now is the proper way to expiate it? I, for one, simply cannot follow their logic.

Brad DeLong: When the Fed Stops Trying: First, it was committed not to fall into the same trap as President Barack Obamaâ€™s administration in 2009, when it failed to set clear priorities and look more than one move ahead. While Obama and his advisers had a plan for the first round of recovery measures following the 2008 financial crisis, they did not have a strategy for what to do when congressional Republicans and â€œblue-dogâ€□ (pro-austerity) Democrats mobilized against them. When that first round proved insufficient for delivering a robust recovery, the stage was set for a lost half-decade of tepid growth and widening income inequalities.

Second, the Biden administrationâ€™s policy planners were wary of providing too large a boost to spending. But they also knew that achieving a rapid and complete recovery would mean accepting some level of inflation. Because the post-pandemic economy would be configured differently than the economy that had preceded it, wages would have to rise in the newly expanding industries to attract the necessary supply of workers. Without clear price signals, workers would not have gone where they needed to go for the recovery to stay on track.

Similarly, it was inevitable that bottlenecks would emerge during an economic reopening, and prices of bottlenecked commodities duly rose. Again, such signals were necessary to show where the problems lay. Higher prices naturally create incentives for substitutions and other solutions.

Just how much inflation would there be? Nobody could say, but Bidenâ€™s team knew that if the reopening inflation shock was too large, it could easily trigger an overreaction from the US Federal Reserve. That, eventually, would put America back in a semi-depressed or depressed state of secular stagnation, with little policy traction to respond to the next crisis or to promote a recovery.

The third hazard to be avoided was that spending would rise by too much and the Fedâ€™s reaction would be too restrained. In this scenario, inflationary expectations would become elevated or unanchored, and the economy would end up in 1970s-style stagflation.

The situation was thus analogous to Odysseus sailing between Scylla (a multi-headed monster) and Charybdis (a massive whirlpool). The Biden administration could either not try to navigate the strait at all (the first mistake), or it could try its luck with Scylla (secular stagnation) and Charybdis (stagflation).

Journeying safely to the other side seemed eminently achievable as recently as a year ago, when there was both the policy and the political will to set the oars to work to drive the boat forward at the right speed. There even seemed to be a wide middle path between secular stagnation and stagflation. While many argued over which danger was worse, both risks seemed relatively low, and thus manageable with a Fed that understood the situation and was not prone to panic.

Then came February 24, 2022, when Russian President Vladimir Putin ordered his invasion of Ukraine. The safe path appeared to narrow. By June, the Fed had abandoned its forward guidance and replaced an anticipated 50-basis-point interest-rate hike with a 75-point hike, citing an unreliable figure from the University of Michigan inflation-expectations survey to justify the move. At this point, the Fed no longer believed that it understood the situation.

Today, it is unclear whether there is still a safe path between Scylla and Charybdis. But following two more 75-bps hikes in July and September, I worry that the Fed has given up on even trying to find it. Instead, like Odysseus, it has intentionally started to hew toward Scylla (secular stagnation), viewing it as the lesser of two evils. One no longer hears Fed officials cautioning that last winter and springâ€™s tightening has yet to ramify fully throughout the economy. Instead, the Fed has signaled another 1.25-bpsâ€™ worth of hikes to come before the end of this year.

US Secretary of the Treasury and former Fed Chair Janet Yellen once told me that the Fedâ€™s rate-setting Federal Open Market Committee will tend to overreact to the immediate news cycle unless it bases its thinking on some transparent formula like the Taylor Rule. But while the Taylor Rule made sense during the Great Moderation, the days of persistently low and stable inflation are gone, and the Fed has no replacement framework to elevate its thinking above the news-driven groupthink.

Not without reason, financial markets seem to be betting that the Fed is about to make mistake number two: pursuing policies that will likely drag the US back toward secular stagnation. If past is prologue, we eventually will return to a scenario in which monetary policy is stuck at the zero lower bound. The economy may suffer another lost half-decade of growth, and socially and politically destabilizing inequalities will become even more pronounced.

Optimal control. You have an objective: to get inflation back into its target range over the medium termâ€”five to ten years from nowâ€”and to do so while doing the least damage to other objectives like employment and growth. If your best forecast is that your current policy path gets you there, you maintain your currency policy path. If your best forecast is that your current policy path does ***not*** get you there, you take the cheapest and most effective step to move the future needle. If the bond-market 5-year 5-year forward inflation breakeven is not the best forecast, what is the best forecast? Indeed, given that inflation is an expectational phenomenon in all our standard modelsâ€”inflation will be what it is expected to be plus policy-change and economic-shock termsâ€”it is very hard to see how the bond-market 5-year 5-year forward inflation breakeven could not be the best forecast. And if our standard models are not the best models, what are the best models?

Thus I look at this, and I think those who claim inflation is â€œout of controlâ€□ are doing their audiences and their selves no good serviceâ€¦

Me over at Project Syndicate:

With commentators offering increasingly dismal warnings about the inflation situation in the United States, one might think that the US Federal Reserve has failed completely at its primary task. But the bond market is telling a different story, and there is no reason to think that it is driven by doves.

BERKELEY â€“ As of Friday, May 6, the bond market expected US consumer price inflation to average 2.5% between five and ten years from now. That is the rate of inflation needed to equalize returns on inflation-indexed and non-indexed US Treasury securities. And given that CPI inflation has been running higher than the rate associated with the implicit price deflator for personal consumption expenditures, I count that 2.5% five-year, five-year-forward rate as hitting the US Federal Reserveâ€™s 2% price-deflator inflation target.

What, then, would it take to get the economy back to the Fedâ€™s targeted inflation rate? Since the five-year breakeven rate at the close of May 6 was 3.22%, the implicit expectation is that inflation will run a cumulative total of 3.6 percentage points above the Fedâ€™s target over the next five years. If it does not cause the economyâ€™s inflation anchor to vanish, a deviation of that size would be an exceedingly small price to pay for the rapid recovery from the pandemic-induced recession. If the recovery delivers the structural economic transformation that we need, the higher inflation that we have experienced will have been well worth it.

Accordingly, it seems to me that the Fed should be taking a victory lap. It has done precisely what it is supposed to do, by enabling Americaâ€™s sticky-price, sticky-wage, sticky-debt economy to return rapidly not just to full employment but to the right version of full employment â€“ the one that has workers working in sectors making products for which there is real, fundamental demand â€“ after a shock. And it has done so without disrupting confidence in the monetary system and its stability.

So why does the very sharp [Kenneth Rogoff]() of Harvard University [argue]() that â€œthings are way out of controlâ€□? If you have been diverted from your desired trajectory, and you then find yourself on a path where you can expect to return to it, I would think the only way to describe the situation is as a case of being â€œin control.â€□

Rogoff makes clear that there is â€œa lot of uncertainty,â€□ and that he is â€œnot going to say I know exactly what needs to be done.â€□ But his observation that inflation is â€œway out of controlâ€□ makes sense only to the extent that he is willing to declare the bond market and its implicit expectations to be wrong. Only then could the expected evolution of Fed policy lead to inflation significantly higher than 3.22% over the next five years, and to average inflation significantly above 2.5% 5-10 years hence.

Sure, that could happen. The economy is a surprising place, and our models and forecasts are ultimately just poorly informed guesses. The Fed might have to change course substantially. It might have to send the US economy into a substantial recession with significantly higher-than-expected interest rates to return inflation to its target over the five- to ten-year medium run.

For Rogoffâ€™s own implied forecast to come to pass, workers and bosses would have to reach wage bargains that assume inflation well above 3.2% for the next five years and well above 2.5% for the five years after that. Moreover, those inflationary wage bargains would have to be locked in place through contracts and institutional arrangements that would make it hard to revise them downward should they turn out to have exaggerated actual inflation. For workers and bosses to do that, they would have to be pretty confident that bond traders are irrationally Panglossian â€“ that they are inflation doves despite the evidence to the contrary.

Is there any reason to think that bond traders are irrational Panglossian inflation doves? Are there any reasons to think that workers and bosses now believe that bond traders are irrational Panglossian inflation doves?

I see none.

In our modern economy, an outbreak of inflation is a peculiar expectations-driven process. It requires a vicious circle in which expectations of high inflation drive actions that then validate those expectations â€“ with higher wages leading to higher consumer prices that in turn lead to demands for higher wages, ad infinitum. For this to happen, the expectation of high inflation has to come from somewhere, and as of now, it is not in evidence.

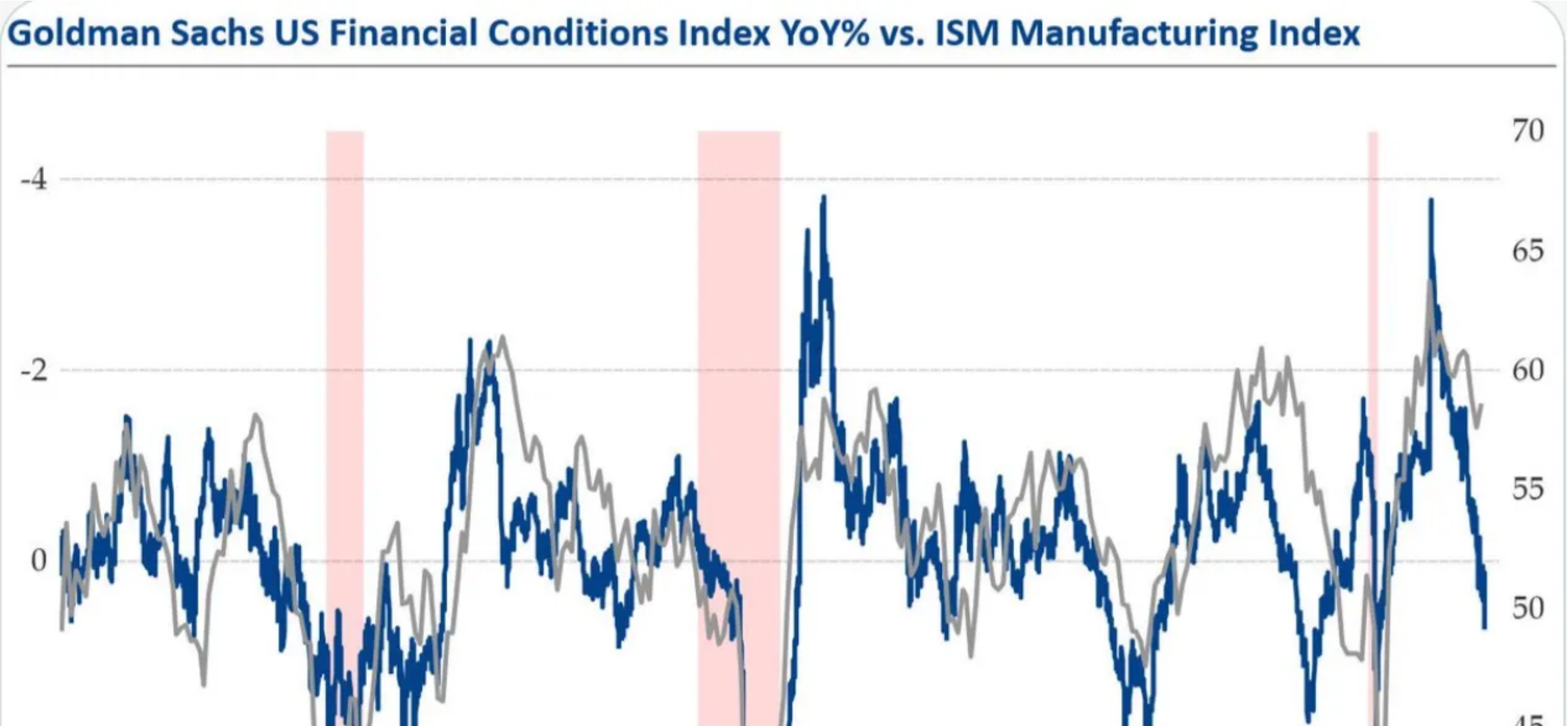
Yes, additional adverse supply shocks could lie in our future. The COVID-19 virus still has the potential to mutate and confront us with dangerous, disruptive new strains. Further disruptions could emanate from a widening of Russian President Vladimir Putinâ€™s war on Ukraine or from an economically catastrophic interaction of new virus variants and Chinaâ€™s zero-COVID policy. These kinds of developments could push inflation out of control.

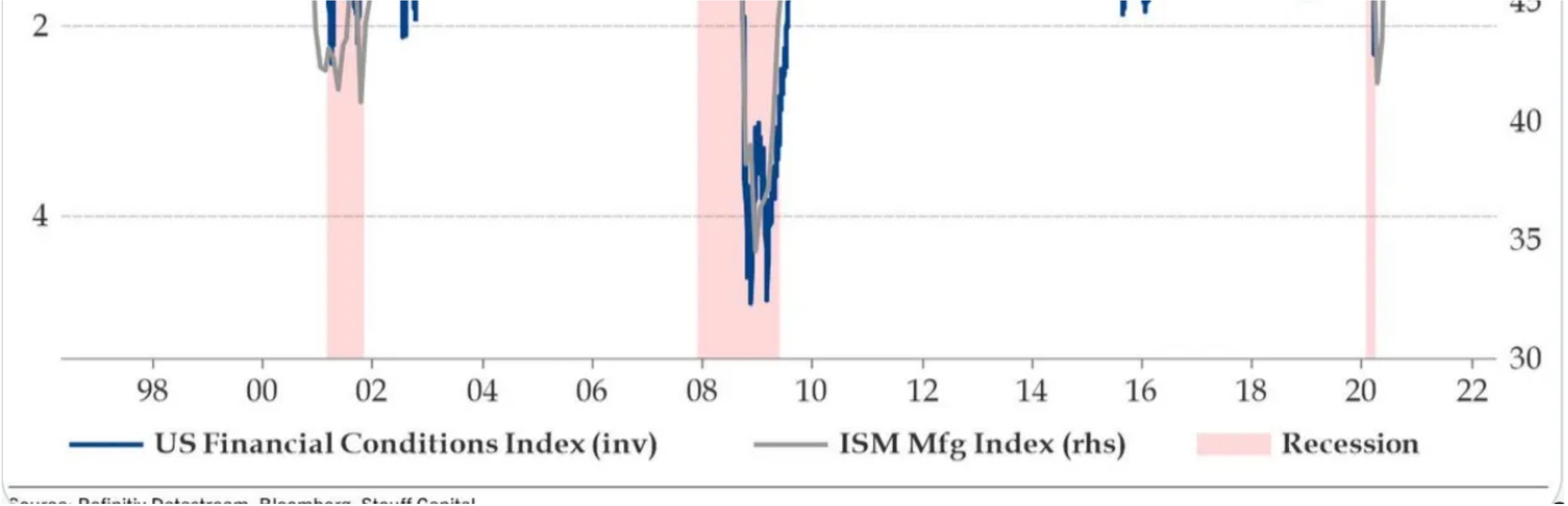
But the fact that such risks exist does not mean we should live as if they have already come to pass, and thus ignore the world as it currently is.

LINK: <https://www.project-syndicate.org/commentary/bond-market-medium-term-inflation-currently-on-target-by-j-bradford-delong-2022-05>

First: No, the Fed Is Not (Far) Behind the Curve!

Here is a reason I do not think that the Fed is (far) behind the curve:





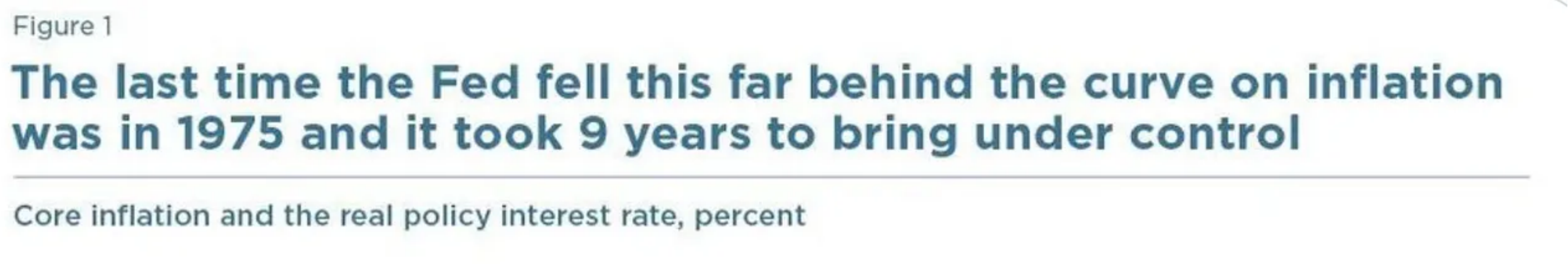
It seems highly likely that at least the manufacturing part of the economy will slow markedly over the next 1 1/2 years, no?

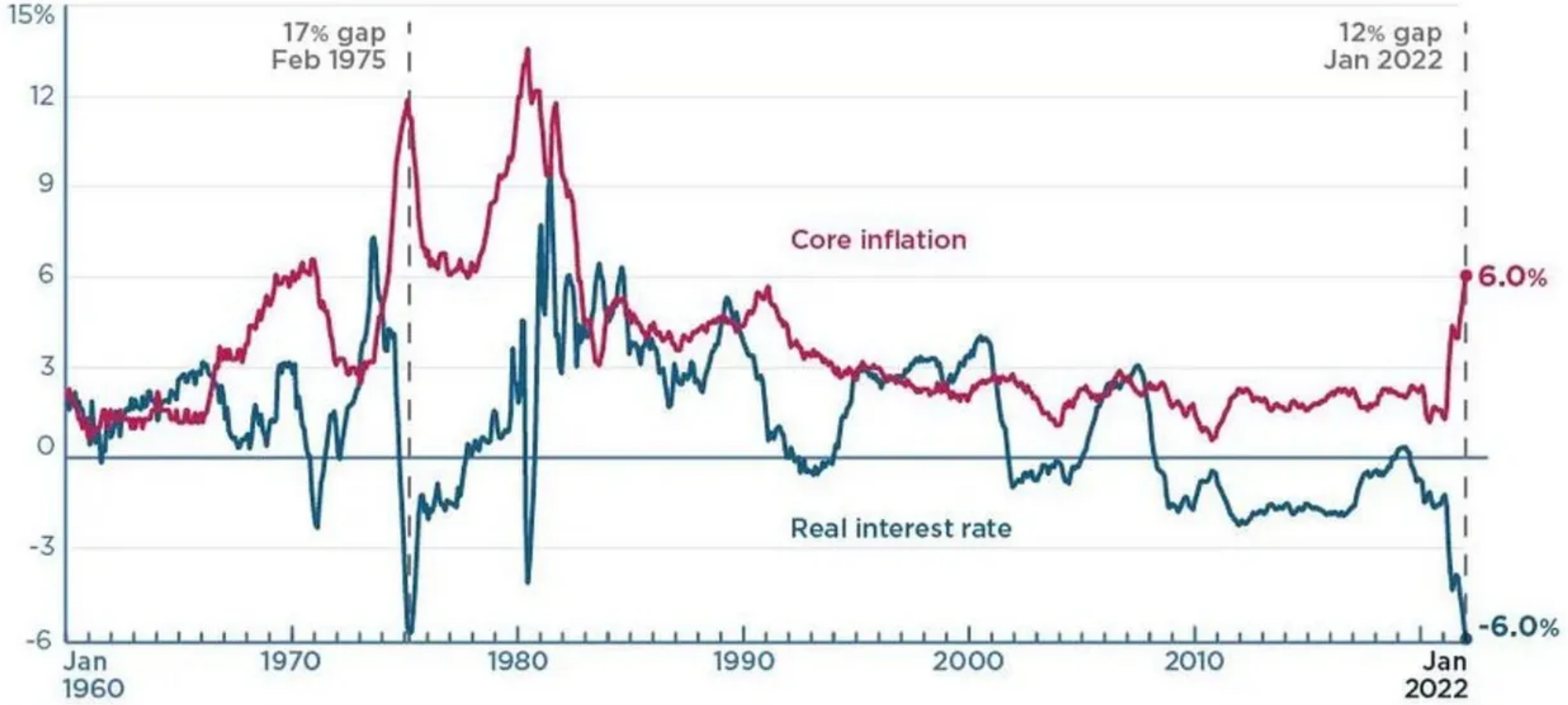
And that is with what the Fed has already done (and is expected to do). Would one want more slowing than the FC index tells us is already baking in the cake? If you think so, why?

Yes, bottlenecks, oil shocks, wheat shocks, and China-lockdowns will do what they will do to inflation in the short run.

But over the medium and the long run, the bond market is still quite happy with the outlook as far as inflation is concerned, at least if you believe the information in TIPS:

So then why now do we have the extremely sharp Olivier Blanchard, commenting on Reifschneider and Wilcox <https://www.piie.com/publications/policy-briefs/case-cautiously-optimistic-outlook-us-inflation>, writing <https://www.piie.com/blogs/realtime-economic-issues-watch/why-i-worry-about-inflation-interest-rates-and-unemployment>:





PIIE

Note: Core inflation is consumer price index inflation excluding food and energy. The real policy interest rate is the federal funds interest rate minus core inflation over the previous 12 months.

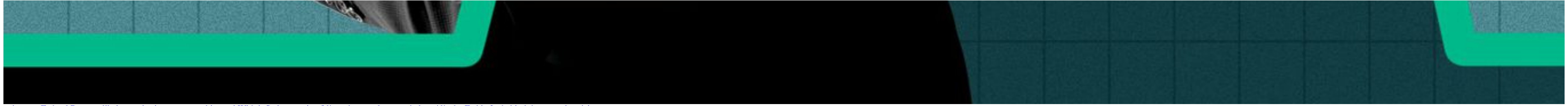
Sources: US Bureau of Labor Statistics and Board of Governors of the Federal Reserve System, retrieved from Federal Reserve Bank of St. Louis (FRED).

?

Moreover, he is far from alone:

- **Neil Irwin:** â€œWhen did the Fed start getting behind the curve? I think it was one year ago this week. Between December '20 and March '21 meetingsâ€¦â€□ <

Neil Irwin @Neil_Irwin
When did the Fed start getting behind the curve? I think it was one year ago this week. Between December '20 and March '21 meetings, $2.8t in pandemic stimulus passed, vaccine rollout got underwayâ€"yet fed funds rate forecast didn't budge.

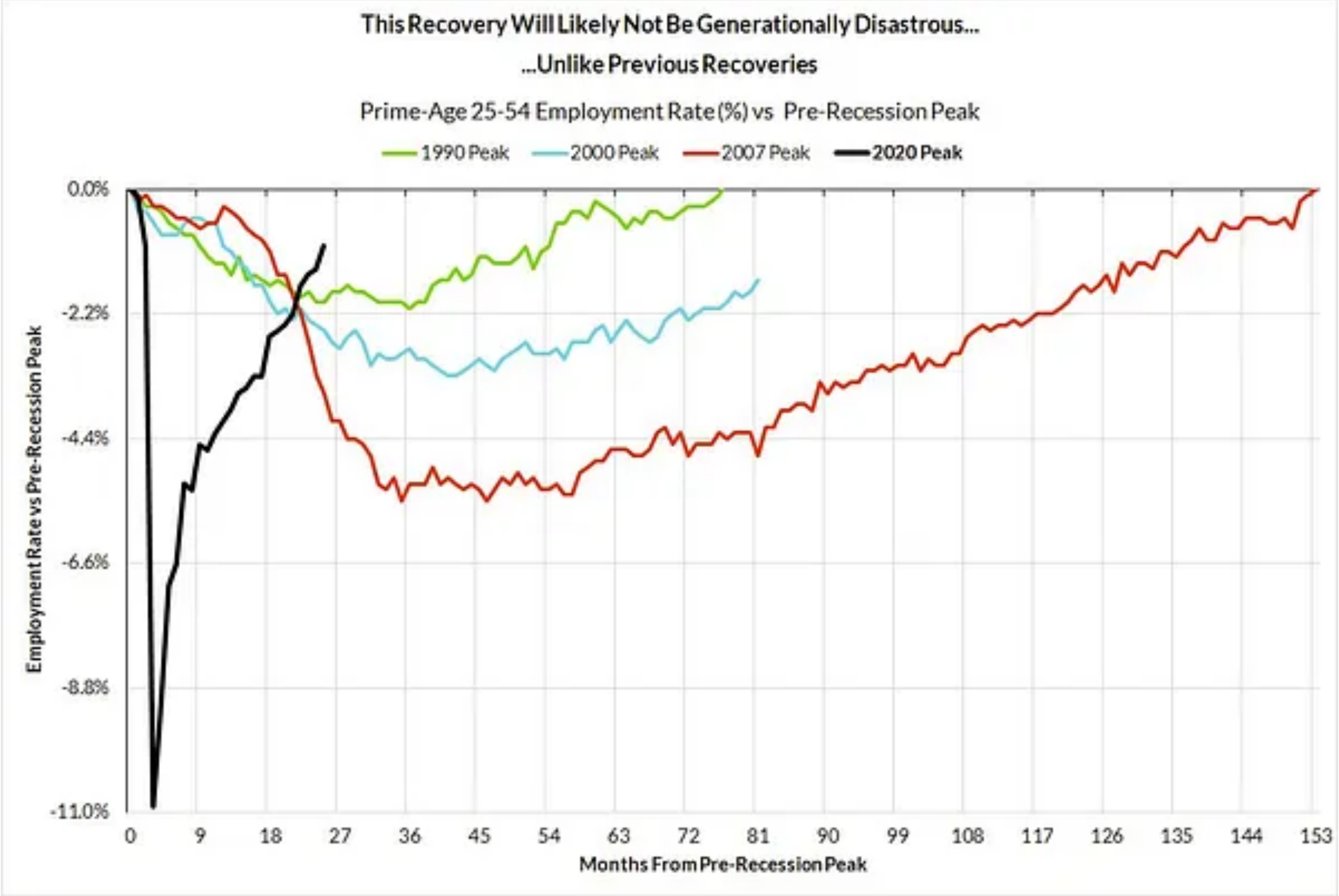


[axios.comFederal Reserve likely to raise interest rates this weekWith inflation nearing 8%, and unemployment below 4%, the Fed is far behind the curve in raising rates.](#)
[1:37 PM â˘™ Mar 14, 2022](#)

[35Likes9Retweets](#)

- >;
- **Irving Swisher**: â€œConsensus is that the Fed has fallen behind the curveâ€¦â€□ <

[Skanda Amarnath (Neoliberal Sellout) @IrvingSwisher](#)
[Consensus is that the Fed is behind the curve, while the Fed itself seems to have fallen short of laying out what they really meant by "broad and inclusive" with respect to maximum employment. But we should take stock of what has been a historic labor market recovery.](#)



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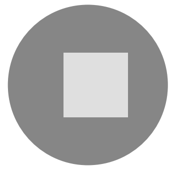
[18Likes2Retweets](#)

- >;
- **Squawk Box**: â€œâ€˜We are behind the curve. We have to moveâ€™ , says Former Dallas Fed President Richard Fisherâ€¦â€□ <

[Squawk Box @SquawkCNBC](#)
["We are behind the curve. We have to move," says Former Dallas Fed President Richard Fisher. "So, yes I'd be advocating to begin the process. Reverse the gears."](#)



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[37Likes12Retweets](#)

- > (never mind that Fisher made precisely zero correct calls his entire time at the Fed);
- **Mohamed El-Erian**: â€œThe US Federal Reserve, the worldâ€™s most powerful central bank, is already dealing with self-inflicted damage to its inflation-fighting credibility. With that comes the likelihood of de-anchored inflationary expectationsâ€¦â€□ <https://www.ft.com/content/db9e3706-84dd-47bc-a943-90d7dfef6abe>;
- **Eric Rosenbaum**: â€œFed 'behind the curve' on inflation, says former Obama economist Jason Furmanâ€¦â€□ <https://www.msn.com/en-us/money/markets/fed-behind-the-curve-on-inflation-says-former-obama-economist-jason-furman/ar-AAQybLT>.

â€œSelf-inflicted damage to [the Fedâ€™s] inflation-fighting credibilityâ€¦â€□:

â€œSelf-inflicted damage to [the Fedâ€™s] inflation-fighting credibilityâ€¦â€:

I simply do not see this â€œself-inflicted damage to [the Fedâ€™ s] inflation-fighting credibilityâ€¦â€

Now maybe there is an argument did the people treating in the bond market are weirdos, disconnected from the inflation expectations embedded in the actors in the economyâ€"those whose beliefs and expectations really matter because they drive decisions. Maybe there is an argument that we need to fear not bond-market vigilantes, but rather other actors and agents. Maybe it is their expectations of inflation have become substantially de-anchored already. Maybe they are already taking steps that will produce a persistent inertial inflationary spiral.

But who are they?

What are their expectations?

How are their expectations now being translated into actions?

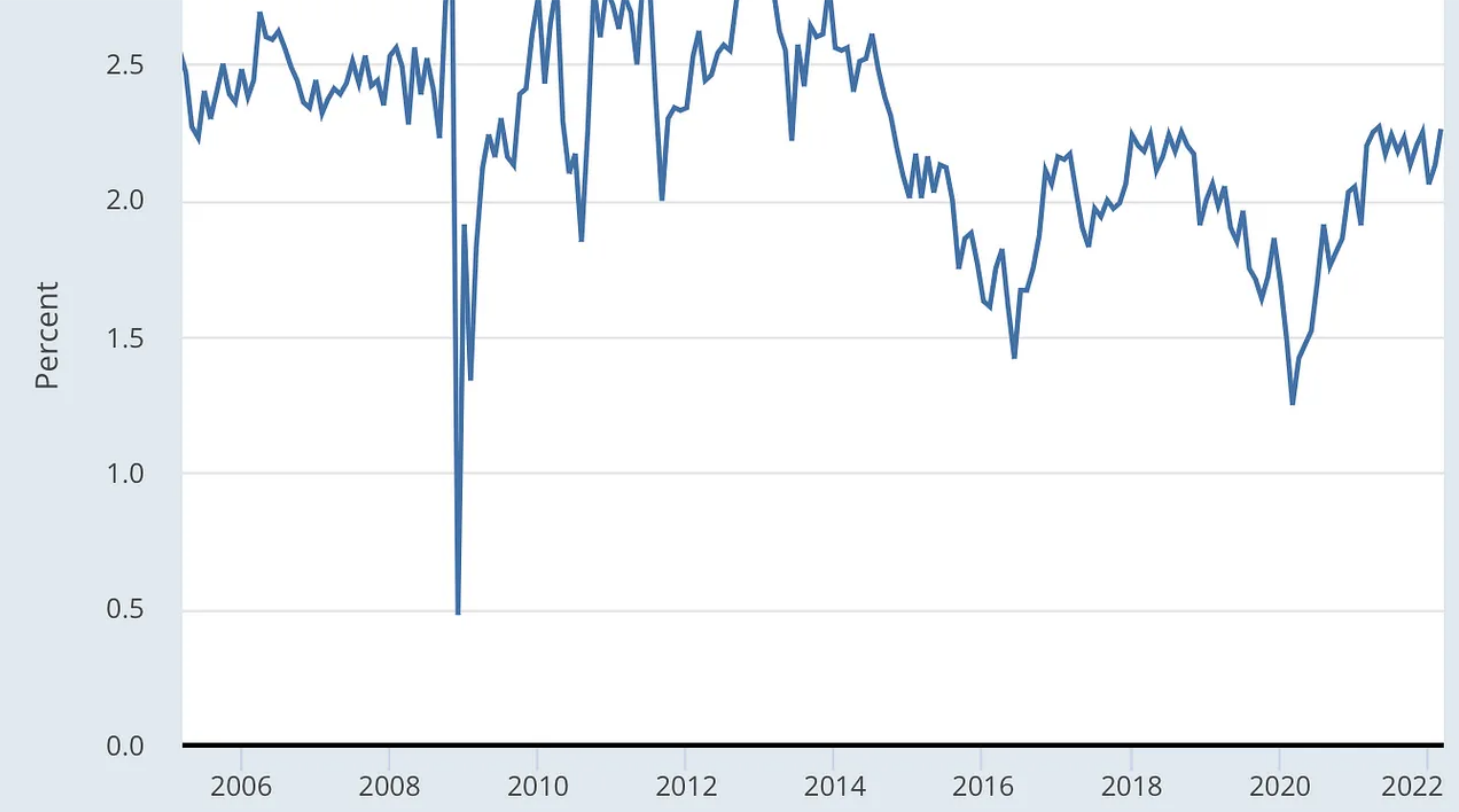
And how are those actions not easily reversible?

I have not seen any of those arguments made.

Blanchard writes, apropos of the 200 basis-point increase in the Federal Funds rate we expect to see over the next two years:

> Is it reasonable to think that a 200-basis-point increase in the policy rate, so only 1/6 of the rate increase from 1975 to 1981, will do the job this time when the gap between core inflation and the policy rate is 2/3 of what it was in 1975? And that unemployment will barely budge? I wish I could believe itâ€¦

But why is the rate increase from 1975-1981 relevant? We have a target: inflation from five to ten years out. We have an instrument: the current level and planned forward path for the Fed Funds rate. We have a reading on whether we are on a glide path to the targetâ€"the bond marketâ€™ s 5-year, 5-year forward expected inflation rate. That reading says we are.



Is there a better reading available as to whether we are on the glide path?

If so, what is it?

I believe that there is not. So why is the conclusion not: â€œPolicy is appropriate. The Fed is not behind the curveâ€? This is, to me, a very genuine mystery.

Blanchard writes:

> There are good reasons, however, to think that the Phillips curve will, as it has done many times in the past, shift, and that the landing will be harder than Reifschneider and Wilcox conclude. Part of the inflation will indeed go away on its own, but the Fed may have to increase interest rates by more than 200 basis points to get back to its targetâ€¦

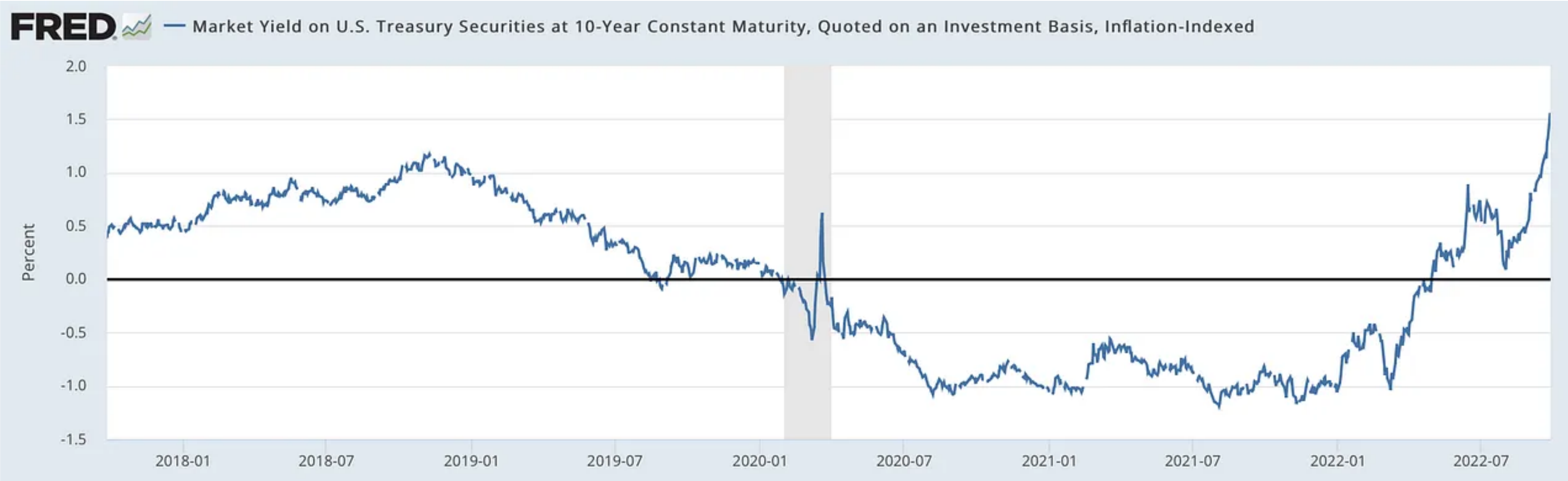
Indeed. The Fed may have to raise interest rates by more than 200 basis points. The Phillips Curve may well shift. And when there is evidence that the Fed is indeed behind the curve and not on an appropriate glide path, it will be time for the Fed to use forward guidance that it has changed its policy plans to shape expectations.

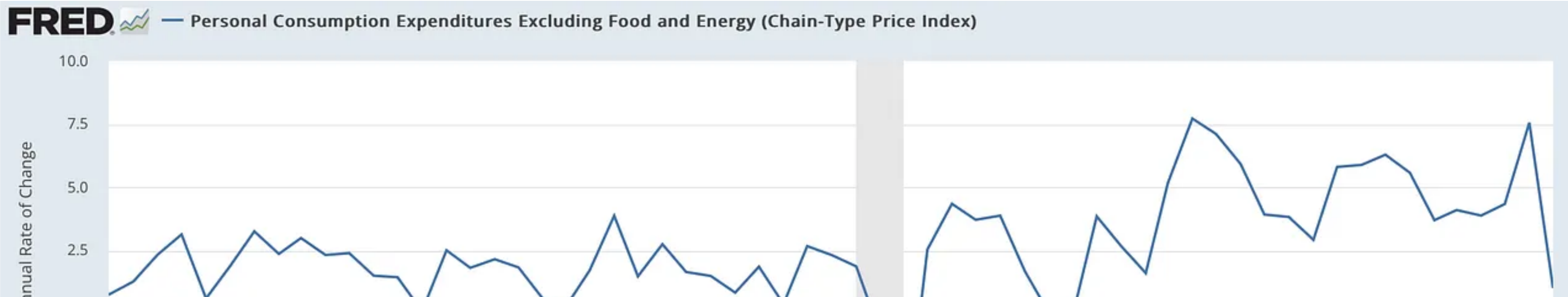
But why is today that day?

Especially since errors in not raising interest rates quickly enough are errors from which we can recover, but at and near the zero lower boundâ€"which we areâ€"errors in raising rates too quickly are errors from which we cannot reasonably recover.

FIRST: There Are Now 250-Basis Points of Long-Term Monetary Tightening That Have Not Yet Hit the Economy

As of now, nobody knowsâ€"especially not the Federal Reserveâ€"whether the very substantial monetary tightening that the Federal Reserve has induced over the past nine months is too little, too much, or just right:





The one thing that is clear is that we do not have a bond-market expectations problem:

There are thus two and only two credible positions right now:

- The Fed needs to pause, and see what its policy moves over the past nine months have doneâ€"which means waiting until after the turn of the year to move again.
- We remain just one supply shock away from a de-anchoring of inflation expectations, and so the Fed needs to keep talking very tough.

My view is that the bond market will tell us when it is time for additional tightening: the Fed should pause unless and until the 5-year/5-year-forward inflation breakeven crosses 2.5% heading upwards.

(Yes, there are problems in a fully rational-expectations world of conditioning policy on market variables that are primarily expectations of what that policy will be. But is there any reason to think that we are in such a world?)

1.
2.

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1.
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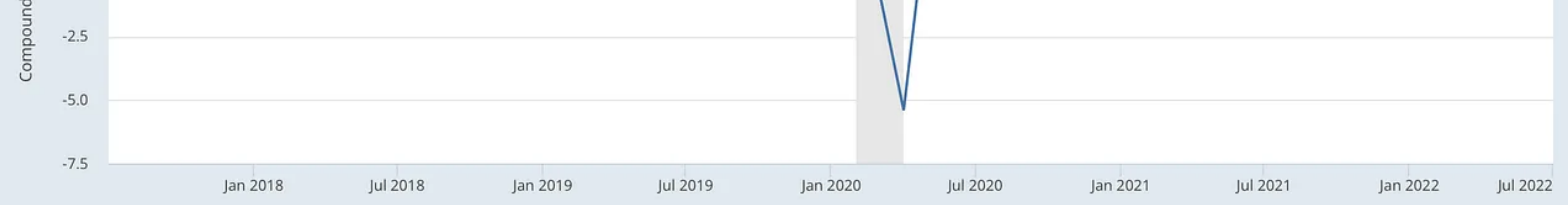

The one thing that is clear is that we do not have a bond-market expectations problem:

There are thus two and only two credible positions right now:

- The Fed needs to pause, and see what its policy moves over the past nine months have doneâ€"which means waiting until after the turn of the year to move again.
- We remain just one supply shock away from a de-anchoring of inflation expectations, and so the Fed needs to keep talking very tough.

My view is that the bond market will tell us when it is time for additional tightening: the Fed should pause unless and until the 5-year/5-year-forward inflation breakeven crosses 2.5% heading upwards.

(Yes, there are problems in a fully rational-expectations world of conditioning policy on market variables that are primarily expectations of what that policy will be. But is there any reason to think that we are in such a world?)

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