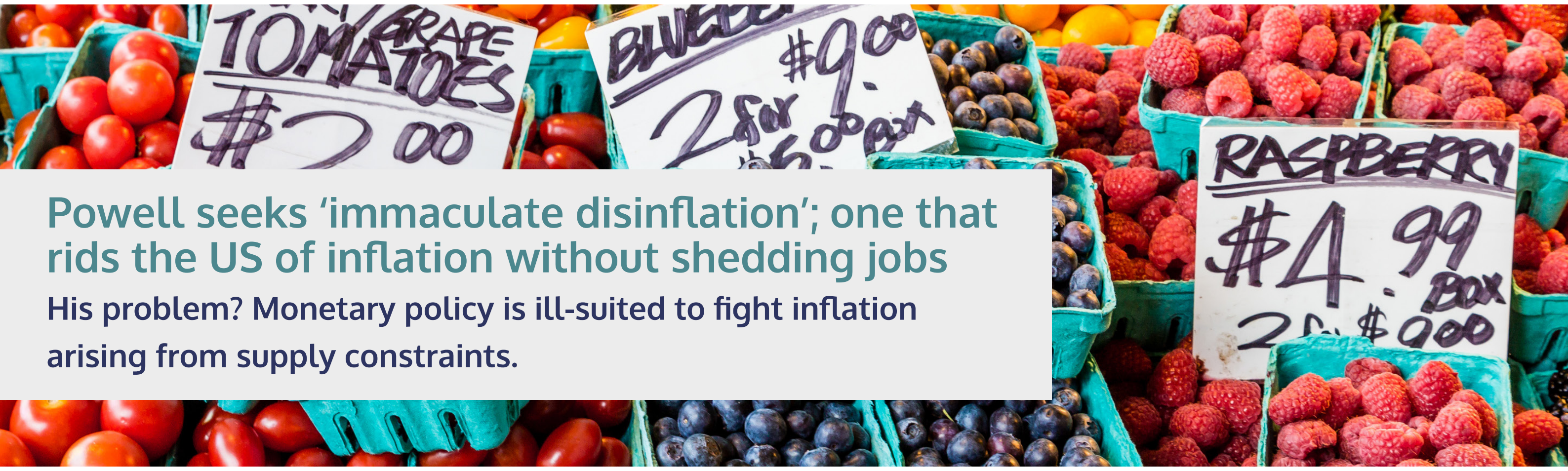

Powell seeks 'immaculate disinflation'; one that rids the US of inflation without shedding jobs

His problem? Monetary policy is ill-suited to fight inflation arising from supply constraints.

Federal Reserve Chair Jerome Powell appeared on March 3 before the Senate Banking Committee and vowed the US central bank would quell inflation running at four-decade highs. "We are going to use our tools," he said. Then came a pointed question. Would the Fed be prepared to harm the economy to tame inflation?

To show his intent to smother inflation that has surged to 8.5% (12 months to March), Powell answered "yes" by invoking the last Fed chief to induce a recession to rein in price rises. The Jimmy Carter-appointed Paul Volcker, who was Fed chair from 1979 to 1987, raised the key rate so much – to 20% in 1981 – he triggered two recessions; a fleeting one in 1980 and the slump of 1981-1982 when the jobless rate peaked at a then-post-Depression high of 10.8%.[1] "I knew Paul Volcker," Powell said. "I think he was one of the great public servants of the era."[2]

Volcker was probably the most hated.[3] As the economy slumped, the Fed was subject to protests that still rate the greatest in its history. In-debt farmers on tractors besieged Fed headquarters while car dealers sent coffins full of unsold car keys.[4] Volcker was assigned bodyguards,[5] especially as a man angry at high rates and armed with a sawed-off shotgun burst into Fed HQ.[6]

While Volcker was scorned by industry, the public and politicians (but not the media – why Ronald Reagan reappointed Volcker in 1983), historians have been kind. "Volcker was Jimmy Carter's gift to Reagan," one Reagan biographer wrote. Volcker "squeezed the inflationary expectations out of the economy and put it on the path to solid growth".[7]

Powell says he can achieve the same feat without the Volcker recession(s). He'd better. Though Volcker was on the Fed leadership team from 1975, he bore little responsibility for how inflation was running at 13% when he became Fed chair. (It peaked at 14.8% in early 1980.) Powell, however, is to blame for much of today's inflation for two reasons.

The first is Powell loosened the Fed's inflation guidelines. The Fed in 2020 scrapped a 2% inflation ceiling that had been in place unofficially then since 2012 officially for two decades in favour of an average target of 2%. The change means the Fed will let inflation exceed 2% "for some time" if it has undershot that figure. The move signalled the Fed would refrain from taking pre-emptive steps against inflation. It makes inflationary expectations prone to leaps.[8]

Powell's other error – one he admits to[9] – was to misdiagnose today's inflation as fleeting.[10] Even though inflation has topped 5% since mid-last year by when unemployment had fallen below 6%, the Fed left untouched a record low US cash rate and persisted with its asset purchases until March this year. The Fed was even purchasing mortgage-backed securities when home prices, which eventually feed into inflation gauges, were soaring at a 20% clip.[11]

Powell's major fightback against inflation kicked off on March 16 when the Fed raised the cash rate by 25 basis points to a range of 0.25% to 0.5%. Powell's other anti-inflation tool is to shrink the Fed's US$8.9 trillion balance sheets swollen by quantitative easing. Such asset sales would boost longer-term bond yields. Powell's third weapon is to talk tough, as he did on March 21 when he said the Fed would raise the key rate "by more than 25 basis points at a meeting or meetings" to beat inflation.[12]

On the day the Fed raised the cash rate, Fed policy-setting board member 'projections' showed they expect to authorise another 11 rate increases of 25 basis points by the end of 2023 that would lift the key rate to 2.8%. Such an outcome would mean the key rate would be below the Fed's inflation projections until the end of 2023.[13] The Fed thus thinks it can douse inflation with negative real rates while the economy will "flourish" in Powell's words[14] and unemployment stays at generational lows. The jobless rate stood at 3.8% in February.

Such thinking contradicts how the Fed's economic models assume a trade-off between inflation and employment. Michael Feroli, chief US economist at J.P.Morgan, ridiculed the Fed's forecasts as "magical, immaculate disinflation".[15]

The models on which the Fed bases policy decisions are Keynesian-based ones[16] where policymakers seek to manipulate demand to influence inflation, employment and economic growth.[17] Powell's biggest problem is the US economy is not just overheating due to excessive demand (due to fiscal and monetary stimulus). The economy is suffering from 'supply shocks' beyond the reach of monetary policy that fan inflation while denting growth.

Count these shudders. Russia's attack on Ukraine has boosted energy, food and metal prices and reduced consumer spending on other items. The West's sanctions against Russia will hasten

the reversal of the globalisation that exploited cheap foreign labour to reduce the cost of goods. China's recent lockdown is just the latest to constrain the output of 'the world's factory' and elsewhere. The pandemic-inspired 'reshoring' of production since 2020 has caused shortages. Lockdown populations, deprived of services but flush with fiscal stimulus, bought goods in such quantities that ports, ships, trains and trucks couldn't cope. Populations detained at home boosted demand for technology so much a shortage of microchips is hobbling the production of many goods. A shift to renewable energy is causing 'greenflation', the term for when the supply of fossil fuels falls but demand doesn't. Pandemic-inspired resignations and the decline of working-age populations tied to falling birth rates are pushing up wages (by 6% in the US).[18]

Powell's best hope is the supply shocks ease and inflation recedes without the Fed needing to raise rates. This is the "soft landing" of the Fed projections that Powell says the Fed pulled off in 1965, 1984 and 1994.[19] Next best, Powell might permit moderate inflation and hope to avoid a cost-of-living blowout that would result in stagflation. An option if inflation persists? Powell might have to crush the economy. Ultimately, a credible Fed chair must mimic Volcker.

To be sure, some excess demand the Fed can stifle is boosting US inflation. But how to remove surplus demand without strangling an economy recovering from the covid-19 blows? Hard to calibrate. How much demand would need to be eliminated to tame inflation boosted by supply constraints? Too much. The soft landings Powell cited aren't much solace because in these cases the Fed stopped inflation accelerating, rather than hauled it in.[20] The US economy could enter a downturn irrespective of what the Fed does, if events were to so turn (due to, say, Russian cyberattacks, a sovereign debt crisis in the eurozone or the developing world or covid-22). In an era of record debt and bloated asset markets, Powell need not raise the US cash rate to the level Volcker did to slow economic growth.[21]

But Powell surely needs to do more than the Fed projections suggest. In the balance between aiming for price stability and full employment, the Fed seeking to hold its authority and independence will eventually need to prioritise fighting inflation to keep the trust that Volcker earned against much hostility.

SIDELINED CENTRAL BANKERS

Charles Goodhart (born 1936) is a UK economist who has split much of his career between the Bank of England and the London School of Economics.[22] Last year, Goodhart predicted that by 2021 higher inflation would become entrenched. Why? Low birth rates and the consequential decline in working-age populations are ending the era of cheap labour and affordable goods. A future of faster inflation (3% to 4% compared with 1.5%) beckons. In the meantime, Goodhart predicted labour shortages, fiscal stimulus and the post-pandemic recovery meant inflation would hit "between 5% and 10% in 2021 – and stay high."[23] Which is what's happened in the eurozone (inflation at 5.9%), the UK (6.2%) and the US.

Goodhart, co-author of The great demographic reversal book released in 2020, is correct that the labour pool in many countries (from China to Germany) is shrinking as the world heads towards its first voluntary depopulation. Whether such a wage-boosting shift is driving today's inflation is arguable. What is clearer is that monetary policy is largely powerless to tackle such inflation, short of a Volcker-destroy-the-economy setting that no one wishes to seek.

Same goes for greenflation. Global efforts to curb the use of fossil fuels, such as Biden's decisions to halt fracking on federal land and block a key oil pipeline from Canada to the US, have helped propel benchmark oil and gas prices. Central banks struggle to ease greenflationary pressures without inducing a downturn that, among other harm, could slow the investment in renewables they seek to promote.

The end of the second great era of globalisation will probably be dated to when the pandemic struck in 2020. Shortages of emergency goods prompted governments to order home the manufacturing of essential medicines and supplies. Lockdowns, especially those in China, that interrupted the production of everything from microchips to car parts motivated firms to rejig supply lines. Russia's invasion of Ukraine in February only further prioritised national security and self-reliance over economic efficiency. The sanctions imposed on Russia, the strictest ever inflicted on a large economy, are inspiring Moscow to seek revenge (the closing of a key oil pipeline and demands European countries pay in rubles for gas), which further boosts energy prices.[24] The sanctions could come with unintended blows for the global economy and, longer term, might encourage autocracies to become less reliant on the US-led financial order. What can monetary policy do to help alleviate inflationary pressures as ties between blocs fade? Not much. Higher interest rates could even be harmful if they slow investment that could relieve shortages.

Wars usually cause inflation because production is interrupted, transport is disrupted, resources are diverted, young workers are deployed to the military and many are killed and maimed, civilians are killed and become refugees as they flee battlegrounds, and capital goods are destroyed.[25] The OECD in March said the war in Ukraine is likely to lop more than 1 percentage point from global economic growth this year while lifting world inflation by 2.5 percentage points.[26] (Late 2021, the OECD predicted the global economy would expand by 4.5% this year while consumer prices would rise by 4.2%.) Successful peace talks would dampen inflation pressure far more than any action central bankers could take.

China's latest lockdown has only added to policymaker angst about hampered supply. How can central banks tackle inflation stemming from health restrictions without damaging the economy? They can't.

In a world where supply constraints are driving up prices, central banks must choose between inflation and growth (especially in the absence of politically led appropriate solutions to supply-side inflation such as using fiscal policy instruments (taxes and transfers), microeconomic reforms, industry policy, trade policy and diplomacy (in the case of the Ukraine war, and a better health response in the case of China and covid-19). Two big differences between Volcker's world and that of today are the mammoth increase in debt (government, corporate and household) and the financialisation of the global economy that means asset markets hold larger sway over the economy. The marginal impact of each increase in interest rates is greater, especially if asset prices are stretched.

In any Powell blitz against inflation, the cash rate won't have to increase as much as some people might think to trigger a Volcker-like bludgeoning of the economy.

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