EconoFact Chats: Inflation and The Fed

Jeffrey Fuhrer, Harvard Kennedy School

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Michael Klein
I'm Michael Klein, executive editor of Econofact, a non-partisan, web-based publication of the Fletcher School at Tufts University. At Econofact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein
Inflation was more than 9% in the summer of 2022, the highest rate since 1981. It has since come down to about 6.5%. Lower, but still well above its average over the past decades, and greater than the target rate of 2%. Are we likely to see inflation reaching this target rate anytime soon? Should policy try to reach this target? Will efforts to do so lead to a recession, or can the Federal Reserve engineer a soft landing? To answer these and other questions about what many people view as the most pressing economic problem facing the United States today, I'm very happy to welcome back to Econofact Chats Jeffrey Fuhrer. Jeff served for almost four decades in the Federal Reserve system, first at the Board of Governors in Washington, followed by more than 25 years at the Federal Reserve Bank of Boston, where he served as research director and special advisor to the President of that Federal Reserve Bank. Jeff is also one of the world's leading researchers on inflation dynamics and on monetary policy. Jeff, good to have you back on Econofact chats.

Jeff Fuhrer
Great to be here. Thanks, Michael.

Michael Klein
Jeff, to start off, what tools does the Fed have to combat inflation?

Jeff Fuhrer
Well, Michael, generally the Fed wants to influence an array of financial market conditions and short-term interest rates, long-term interest rates like treasury rates that affect the rates that people borrow for mortgages, cars, and business loans, exchange rates, house prices, and they want to affect those rates so as to slow down or to speed up the economy, employment, and spending, that in turn they hope will affect inflation. Typically, it turns first to controlling short-term interest rates, specifically the Federal Fund's interbank borrowing rate, and that will generally have an impact on all the rates and the asset prices I just mentioned, although it's not a

perfect link.

But since 2008, the Fed has also turned to purchasing long-term treasury and mortgage securities to more directly affect longer-term interest rates, and that's especially important when they've already had to push short-term rates down to zero, but they still want to have lower long-term interest rates.

Michael Klein
This is a so-called quantitative easing policy?

Jeff Fuhrer
That's what it is, exactly.

Michael Klein
The Fed, in fact, has lately been raising interest rates quite aggressively starting last year, right?

Jeff Fuhrer
Yeah, starting last year, the Fed raised interest rates really quite briskly by historical standards to bring inflation down. It went from essentially zero to the current level of a four and a half to four and three-quarters percent interest rates, and it's just an unusually speedy fashion.

Michael Klein
So, Jeff, you said starting last year, but inflation started to spike before that, and some people claim that the Fed was late to the game, that it didn't recognize the problem soon enough.

Jeff Fuhrer
I think it's fair to say that they were late getting started. For a little historical context, it was genuinely hard early on in 2021 to tell how long what they thought were going to be temporary influences on inflation would actually last. But by mid-2021, apart from inflation concerns, the economy was doing quite well, and the rationale for maintaining stimulative monetary policy to support employment and spending was getting pretty thin. At that point, they were still keeping short-term interest rates very, very low, and they were still pursuing quantitative easing, just for the reasons I outlined earlier. I think it would have been wise to raise rates at that point, middle of 2021, so maybe two and a half or three percent, something that's more or less neutral by which I just mean it's not really boosting or restraining the economy. But as for additional increases after that, well, there were a lot of different views on what was causing inflation. Certainly, COVID shutdowns led to a bunch of supply constraints, and I think that the thinking there, and among many economists in the first half of 2021, was that once those temporary supply constraints eased, inflation would come down, and you heard talk about the ‘team transitory’

folks who believed that versus the ‘team permanent’ folks who thought, this might lead to a more permanent increase in inflation. I think by the time we got later into 2021, the notion that inflation would kind of evaporate within a month or two was looking pretty shaky. At the end of 2021, by December, inflation had been above five percent for six months. I still believe that the main factors raising inflation were transitory. I'll put that in quotes, but they were certainly longer lived than I and most other people expected. I think to the question whether they got a late start, had the Fed started raising interest rates to something more neutral by late 2021,
I think that would have put them in a better position for monetary policy that they needed to pursue in 2022.

Michael Klein
Being in a better position maybe would have made it more possible to achieve this ‘soft landing,’ meaning that bringing down inflation without causing the economy to crater, even to weaken too much. I imagine a soft landing is a very hard thing to do, especially when we have the highest inflation rate in 40 years.

Jeff Fuhrer
It's really hard to know when the economy has softened just enough, but not too much. Got kind of a Goldilocks growth rate, enough to pull inflation back to two percent, but not so much as to cause a significant recession. You probably know, probably many of the listeners know that the record on predicting recessions is abysmal. Nobody does it well consistently. Once in a while, you get a stopped clock who's always predicting a recession, and obviously once in a while, they're right. But it's so hard to know when the economy is going to soften just enough. I'd say that a year ago, the bigger risk was that monetary policy might indeed not do enough to contain inflation. But today, I think the risk of a hard landing has risen substantially, and that's largely due to tighter Fed policy. It's up to the Fed, of course, to manage that risk by setting policy that contains inflation but doesn't get too restricted.

Michael Klein
There's that famous quote by Milton Friedman that “monetary policy operates with long and variable lags,” which I guess is just a statement of our ignorance of how monetary policy operates, and how long it takes and how big a shock you need in monetary policy to bring down inflation. Is that correct?

Jeff Fuhrer
Yeah, I think that's fair. And I think the long lags we're pretty sure about, but as you say, the uncertainty is captured and his use of the word variable. We don't know exactly how long it takes. We know that if the Fed says it's tightening and the markets believe them, then fairly quickly, the effects on financial market conditions that I alluded to earlier will show up. They'll anticipate it's going to happen, and they'll price that into long term interest rates and stock prices

and so on. But exactly how long it takes to work through the full chain of effects to inflation, that's a tough thing, and that is part of what makes it difficult to tailor a soft landing as opposed to a hard one.

Michael Klein
There's also the metaphor that the economy is more like an oil tanker than a speedboat, that you can only move it very slowly and you have to start well in advance, and you don't know how long it will take. It's not something that can turn on a dime.

Jeff Fuhrer
And I think that's absolutely right. I think the years of experience and economists' research on this would validate that idea. And that's one of the reasons I say that it would have been better for them to have tightened earlier, get to something like neutral, instead of having to move very quickly in a short period of time, knowing that the exact timing of their effects is a little difficult to gauge. So they've moved quickly and they did move quickly in 2022. My estimation is that's had very little effect on inflation so far. When it will have an effect on inflation and how much, tough to gauge, but it would have been easier if they started the process a bit earlier, gauged where the economy and inflation were going, and then they could probably move forward in a somewhat more gradual fashion.

Michael Klein
Jeff, you worked in the Federal Reserve system for decades. Do you have any guesses about their reticence to raise interest rates earlier?

Jeff Fuhrer
Well, I think part of that was due to a concern about upsetting an economy that they hoped was really only temporarily perturbed by inflation. Up to 2020, they had had great patience letting the economy expand. And one of the reasons was that they saw the effects of that patience, of a long period of low interest rates in a long, strong economy. The effects on low-income and minority communities were really good. Communities that had struggled for decades were doing better and they were hesitant to just slow things down because they know that those are the communities that suffer first when the economy slows down. So I think they were hopeful that inflation really was transitory, and they didn't want to lose some of the gains they'd made on employment, especially among low-income and minority communities in earlier years.

Michael Klein
And in fact, you have a very nice EconoFact memo on that shift in policy, and the evidence that a somewhat hotter economy helps minority and low-income communities more.

Jeff Fuhrer
Yeah, and not just my memo. I think earlier, the Chair and the members of the FOMC, partly through listening to those communities during their Fed Listens tours, really took that to heart and said, well, back then, when there was no concern about higher inflation, it was definitely a time to probe a bit, to allow the economy to expand more and let those communities derive the benefits of an economy that was strong, a labor market that was strong for a long time.

Michael Klein
Jeff, in your decades at the Fed, I know you spent a lot of time trying to understand contemporaneously what was going on in the economy by looking at the data and looking at, in fact, a very wide range of data. What's your sense of where the economy is at now?

Jeff Fuhrer
You know, I think apart from inflation, the economy is doing well. Employment is certainly strong. Every report we've seen right up to the most recent says employment is continuing to grow quite broadly across many sectors. I think consumer demand looked a little bit fragile at the end of last year. There's some retail sales reports that made us take notice. But then at the beginning of the year, it seems to have rebounded pretty nicely. The sector that is weak is housing and that's really as expected because one of the consequences of the tightening is higher mortgage rates. And so we definitely see weaker housing that starts and permits construction. All that stuff has slowed down. Pace of sales has slowed down. But I think overall, the economy is in pretty good shape as of right now. The question is what any additional rate increases or maybe the lagging effect of previous rate increases will have to soften both consumer and housing demand.

Michael Klein
You're no longer in the Federal Reserve system, Jeff. Do you think the economists who are at the Fed have a similar view to what you've just voiced?

Jeff Fuhrer
I think it's likely that they have a pretty similar view of current and near term prospects. Of course, you know, they are all over the data. They know as much about it as anybody in the world. So I think they do have a similar view of where the economy is. The tougher thing is knowing how best to set policy under those conditions. And that's a matter of judgment. As you know, as recently as last week, Fed officials were continuing to signal that there are likely to be more increases to come. And given some of the strength both in inflation and some of the real economy numbers that they saw, whereas earlier they thought they might peak out a little above five, it's possible they're going higher than that–five, six percent range. That's getting pretty high.

Michael Klein
How much further do you think interest rates need to rise?

Jeff Fuhrer
Yeah, I don't want to claim I know this with metaphysical certainty, but my judgment is that they don't need to increase rates any further. As we discussed a few minutes ago, they are now or at least will be very shortly in a restrictive posture. Monetary policy interest rates will be set at a position where they're going to be restraining the economy somewhat significantly. So mildly restrictive monetary policy seems okay to me, but pushing interest rates even further up and becoming more restrictive, I think there's important risks.

Michael Klein
Jeff, let's get a little nerdy for a minute here. Standard macroeconomic analysis focuses on what are called real interest rates rather than nominal interest rates. That is adjusting the interest rate that people are paying for the fact that the money paid back in the future is worth less because of inflation. The real interest rate is a nominal interest rate, the rate we read about in the newspapers or that we sign on to for loans, minus the expected inflation rate. But the difficulty here is that word ‘expected.’ We as economists don't know what people's expectations of inflation are. But suppose people expect inflation to stay around five percent over the next year, then a one-year loan at seven percent represents a real interest rate of about two percent. Jeff, is the real interest rate the relevant rate? And if so, what does that say about how restrictive or expansionary Fed policy is now?

Jeff Fuhrer
So I heard a famous guy some years back say that the real rate of interest is the rate you really pay.

Michael Klein
That would have been Vice President George H. W. Bush in a debate before the 1984 election.

Jeff Fuhrer
That's the guy all right. But no, I think you're right. Obviously, thinking about real rates as nominal interest rates adjusted for inflation is the right benchmark for monetary policy. And so maintaining a negative real interest rate that is a nominal rate of interest that's noticeably below the current and the expected rate of inflation, well, that provides a really significant inducement to borrow. Who wouldn't want to borrow now and pay back in cheaper dollars later? But that, of course, is going to spur spending and employment that depends in part on how cheap it is to borrow. That doesn't make sense for an economy that's otherwise functioning quite well and that notably features an elevated rate of inflation. So back to the question of how to calibrate monetary policy, where are we with respect to real rates now? Well, from my eye, inflation

appears to be declining. And most forecasters have it coming in somewhere in the neighborhood of 3% later this year. And if that's right, what that means is that nominal rates will be about 2 percentage points above inflation or more in the middle of this year or so, and that's getting pretty restrictive. So that's why I think the risks have tilted back towards a monetary policy that's too restrictive rather than too accommodative.

Michael Klein
Some people say that all of economics boils down to demand and supply. So that isn't really quite true, but it is true in some ways for inflation. Some people say that the current high inflation rate is due to a very high level of demand, and this is evidenced by the continually low unemployment rate. And other people say that we're still feeling the effects of the supply disruptions that began with COVID, and then were continued by the war in Ukraine. What's your view of the balance of demand versus supply in what's going on with inflation these days, Jeff?

Jeff Fuhrer
Well, I think it's right to point to the balance of demand and supply. There's something like that going on in the macro economy with respect to inflation. But I think to say today that most of inflation comes from unsustainably high demand, just doesn't really square with the facts. Inflation today is mostly about a host of supply restrictions related first to the after effects of the pandemic here, then to the war in Ukraine and the effects that had on agricultural prices and energy prices, and then more recently to the pandemic responses. So why do I say it's not demand? Well, think back to late 2019, even the beginning of 2020. We had a very similar level of strong demand at that point prior to the pandemic. You may recall that you referenced the unemployment rate. It was also about 3.5% then too, so very strong demand. But at that time, the challenge that the Fed faced was that it wasn't able to raise inflation up to its 2% target. It had been chronically below 2%. So that's to say that even in the face of strong demand, there was no sign that that demand was going to cause inflation to break out, especially then when, as best we can tell, supply conditions were pretty normal. So what that means to me is that once the multitude of supply factors sort themselves out, and many already are, from autos to some of building materials to airfares, once they sort themselves out, our economy will be quite capable of absorbing that level of strong demand without any significant inflation. To be fair to the other side, could we be a bit rich on the demand side? Many people pointed to the last round of fiscal stimulus as adding more demand than we needed. That may well be. But monetary policy at its current setting, which as I say is mildly restrictive, should bring that economy back nicely in line with longer-run supply. I would just add one other point of comparison. About mid-2008, you may remember, or you may not, but it's the fact that inflation rose in mid-2008 to above 5% on a 12-month basis. It was above 7% for three months in a row because oil prices jumped up to around $140 a barrel. There were folks in the Fed at that time who said that even though that was clearly a supply, and we hoped, it turned out it was, a short-term curtailment of oil supply, short-term rise in inflation, some of the Fed argued you had to stave that off by raising interest rates.

That would have been a really bad idea. That was a temporary surge in supply, and it worked itself out by the end of 2008. Thank goodness the Fed didn't tighten monetary policy in response to a supply-driven inflation surge. Now, this one, of course, has lasted longer, but my estimation is still it is mostly about supply. Those are two important lessons, I think, to draw.

Michael Klein
What about rising wages? Is that going to contribute to ongoing inflation, maybe even a wage-price spiral, where higher wages drive prices higher, which leads to even higher wages and so on?

Jeff Fuhrer
I think that happened in the 1970s. I don't think that's the case today. What's happening with wages is that they are following inflation. They're not causing inflation. On average, wage gains since the beginning of the pandemic have not matched price gains, so they've lost ground relative to inflation over the past three years. So, I think it's hard to say that wages are what's pushing inflation up. Rather, workers and businesses are looking at the prevailing rate of inflation, and workers are saying, well, could I at least get enough of a wage increase to match inflation, so I don't lose ground in terms of purchasing power? Well, they haven't, but they have been able to get some wage increases. That's only fair. But they're not what's pushing inflation up today.

Michael Klein
Another concern that we hear about is that if people expect higher inflation, this itself could contribute to inflation rising, not just through wages, but also by companies setting prices higher. Does there seem to be evidence that expectations are driving higher inflation these days?

Jeff Fuhrer
I think it's broadly true that there's a link from expectations to inflation. If people generally came to expect qualitatively higher inflation, even though inflation to date has been caused by these temporary supply factors, that could turn an otherwise temporary inflation bout into something much more persistent. I think economists tend to take that linkage from expectations to inflation a little bit too literally and too precisely. I think the link is more about prevailing norms than about smaller, modest changes in expectations, which in any event are difficult to measure.
So yeah, if the norms for expected inflation were to shift from something low around 2%, to something noticeably higher like 4% or 5%, well, that could really be a problem. I just don't see any evidence to date that the prevailing norm for inflation has changed, a qualitative change in the way people think about the inflation landscape. To that point, measures of longer-term inflation expectations, let's say 5 or 10 years, have remained quite stable, which suggests that people in the financial markets, consumers, those people believe inflation is going to be transitory, not that there's a qualitative change in the inflation regime. So I don't think

expectations or norms, as I'm putting them, as yet, are likely to turn this into a more worrisome inflation episode.

Michael Klein
So to conclude, Jeff, the tenor of your remarks seem to be that you're worried more about the Fed being too aggressive, than not aggressive enough. What's the likely outcome if the Fed continues to be in your estimation too aggressive and gets it wrong?

Jeff Fuhrer
Well, I think the obvious concern is that if they are too aggressive, they will cause a recession. And that recession will cause significant damage. And I would be remiss if I didn't point out right now that the first to suffer in such a recession will be low income, and disproportionately, families of color. And of course, those same families suffer when prices of necessities are on the rise. But in the scenario I just sketched, that problem is already in the process of getting better. Inflation's coming down, some prices are reversing. But a recession will, for sure, cause millions to lose their jobs. And I think unnecessarily, because I don't see that that recession would be required to contain inflation. But it would certainly be an economic hit and have longer lasting repercussions, especially for families who constantly live in a state of economic fragility.

Michael Klein
Well, Jeff, let's all hope that the Fed gets it right. And we recognize it's a difficult thing to do. But people like yourself who are devoted public servants, who are very smart, and work very hard at their job, that'll help the Fed, in fact, get it right. So thank you for joining me once again EconoFact Chats, Jeff.

Jeff Fuhrer
It's been a pleasure talking with you, Michael.

Michael Klein
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