Fed Chairman Powell's Remarks at Cato Monetary Conference

Ryan Young

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Every year, our friends at the Cato Institute hold a monetary policy conference. This year's conference opened with Cato President Peter Goettler interviewing Federal Reserve Chairman Jerome Powell. Powell made two reassuring headline declarations: One, the Fed will honor its commitment to get inflation under control, no matter what. Two, both parties' decades-long spending binge is unsustainable.

A bit on both of those before turning to other important areas he addressed. Powell had earlier publicly committed the Fed to increasing the federal funds rate in steps through at least the end of this year. The Fed would also begin drawing back the $5 trillion increase it made to its balance sheet during the pandemic. Interest rates and its balance sheet are the Fed's two primary tools for adjusting the money supply, and Powell once again doubled down on getting them back to less inflationary levels.

Powell's remark about the bipartisan spending mess isn't controversial on its own. But in context, it is a not-so-subtle shot across the bow at modern monetary theory (MMT), which argues that the Fed can bail out any level of government spending by creating more money. MMT is not well respected in academia, but it has gained a few adherents on Capitol Hill and in the media. Powell's saying that MMT plays no role in Fed policy decisions should be reassuring to everyone but Congress and President Biden.

The Fed's next Board of Governors' meeting is later this month, and Powell's remarks end any suspense over whether the Fed will continue to increase rates. The only question now is whether the increase will be half a percentage point or three quarters of a percentage point.

Inflation Expectations. Powell believes the public's inflation expectations are important, and is open to tailoring his messaging accordingly. Businesses often sign contracts and make purchasing decisions months or even years in advance. That means they factor in not just today's prices, but what they think prices will be months from now, or even further out. The money supply is king in determining inflation in the long run, but people's expectations also matter.

What Causes Inflation? More concerning is what Powell said about what has caused today's high inflation. He correctly says that the pandemic set it off, and that shrinking output played a role. So far, so good. If the amount of real wealth shrinks in proportion to the amount of money in circulation, inflation happens.

But Powell mistakenly downplayed the importance of the money supply in causing the current inflation. The amount of money in circulation grew by 40 percent during the pandemic, while real output only grew by 4 percent. That imbalance was enough to change the price level by quite a bit. Factor in the lag time needed for that new money to circulate through the economy, and you have just explained the dominant factor in today's inflation—not the only factor, but the biggest factor. The exchange rate between money and real stuff has changed; that's what inflation is. While Powell didn't dismiss the monetary theory of inflation, he thinks other factors are more important.

For example, Powell made the common mistake of confusing prices changes driven by fluctuations in supply and demand with those driven by changes in the money supply. Supply chain problems and unexpected shortages do not affect the amount of dollars in circulation, which means they do not affect inflation. The policies to address supply shocks are different from the ones that affect the money supply, which is why it's important to get that story right.

Tariff relief and repealing the Jones Act will help lower prices of affected goods. The effects would likely be big enough to show up in the most commonly used inflation indexes—Consumer Price Index and Personal Consumption Expenditures—bu they would not affect the monetary inflation rate, which has strictly to do with the money supply.

One way to tell the difference is that tariff relief would lower prices only on the tariffed goods and closely related goods. Money supply adjustments, by contrast, affect the price of every good throughout the economy. Powell did not make this distinction or does not feel it is as important as other factors.

Rules versus Discretion. The most important institution-level debate in monetary policy is whether the Fed should be bound by a set rule or whether officials should have wide discretion. Under a rule, the Fed would react to a change in gross domestic product by adjusting the federal funds rate or its balance sheet by a matching amount set by the rule. There are many possible such rules, ranging from a Taylor rule to nominal gross domestic product, or NGDP, targeting, each with its pros and cons. Powell is aware of this debate, and he says that the Taylor rule, for example, does factor into the Fed's decisions. But ultimately, he argues, the Fed needs discretion to be able to adjust to circumstances.

Most free market economists want to lock the Fed into a rule, especially during crises. The Fed's overreaction to the pandemic is the main cause of today's inflation. Had it been bound by a rule, it would not have been able to grow the money supply by 40 percent in two years, and Congress would have had a more difficult time funding its series of trillion-dollar spending bills. (The recent book *Money and the Rule of Law* by Pete Boettke, Alex Salter, and Daniel Smith is the best explanation of the rules-based approach, for those curious.)

Another argument in favor of a rule that might speak to Powell is that it would keep inflation expectations in check. If people know in advance how the Fed would react to a crisis or a downturn, they will expect inflation to remain stable. This would help avoid a possible self-fulfilling prophecy of runaway inflation.

The Dual Mandate. The other important issue Powell discussed is the Fed's dual mandate. Not only is it tasked with keeping inflation low, it must also work to keep unemployment low. Sometimes these are in tension with each other, and the Fed must use its discretion to choose which of its two missions to prioritize. For example, the Fed's COVID-related money creation was intended to stimulate the economy and keep unemployment low. The tradeoff was higher inflation. The Fed chose to prioritize is unemployment mission. Now, Powell has revered course, and is prioritizing low inflation, even at the price of potentially higher unemployment.

This yo-yo effect creates economic uncertainty, and leaves the Fed vulnerable to political pressure—which is another reason to bind the Fed to a rule and limit its discretion.

Even so, Powell defended the dual mandate against growing calls for the Fed to focus solely on low inflation. But he also argued against calls to give the Fed an even more complicated mission to also use monetary policy to address climate change, equity, income inequality, and other policy goals. If the dual mandate is problematic, imagine if the Fed had a quintuple mandate. An agency can either do one thing reasonably well or several things poorly. Powell apparently prefers to split the difference and have the Fed do just two things, neither particularly well, but not disastrously, either.

When Powell was up for re-nomination for another term as Fed chair, I told an interviewer that we could do a lot worse than Powell, especially considering some of the other possibilities. But we can also do better. Fortunately, so can Powell—as his Cato discussion showed, he is familiar with arguments about the importance of the money supply in inflation, as well as the arguments for limiting Fed officials' discretion and for simplifying the dual mandate.