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How Covid threatens the left's win at the Fed

Critics of easy money policies say the central bank's new pro-worker pivot stoked price spikes and made the central bank late to fighting them.

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Progressives two years ago won a big battle by getting the Federal Reserve to ease up on inflation. Now, the staying power of that hard-fought victory is in doubt.

The Fed pledged in the depths of the pandemic not to raise interest rates until prices rose more rapidly — a bid to increase employment as much as possible. That policy shift followed a years-long campaign by activists and Democratic lawmakers to convince the central bank that it should worry less about inflation and help more Americans share in the nation's prosperity by keeping rates low.

But now that fractured supply chains and trillions of dollars in federal Covid aid are boosting inflation to rates not seen since the 1980s, critics of easy money policies say the central bank's new pro-worker pivot stoked price spikes and made the central bank late to fighting them. Fed officials have shifted from prioritizing widespread employment to fretting about labor shortages, and progressives are left to worry whether the central bank might react differently next time.

The new policy "virtually guaranteed that the Fed would be behind the inflation curve," said Sen. Pat Toomey (Pa.), the top Republican on the Senate Banking Committee. "It's time for a new framework."

It's the latest chapter in a long-running, often-partisan tussle between those who believe the Fed should focus more on preventing inflation by keeping spending and wages in check, and those who think some inflation is a worthy trade-off for a booming job market. At stake is the momentum gained by many on the left, who successfully argued that the Fed overestimated the danger of inflation in the wake of the 2008 financial crisis.

Progressive economists, worker advocates and other Fed observers fiercely defend the merits of the Fed's job-promoting approach, and warn of serious consequences for

disadvantaged Americans if the central bank reverts to its old ways of preventing unemployment from getting below a certain threshold and crimping growth too early.

“Because we had a much quicker recovery than in previous downturns, the scarring for workers was less,” said William Spriggs, a professor at Howard University and chief economist at the AFL-CIO. The percentage of Black workers who were employed “didn’t accelerate until late 2021,” he pointed out.

The Fed’s new policy was born out of lessons from the Great Recession. Former Fed Chair Janet Yellen allowed rates to stay low for years after the downturn to boost employment, despite dire warnings from many economists and Republicans in Congress that she would foment runaway inflation. That inflation never came, and the data suggested the Fed could have even been more cautious, with inflation still muted and wages growing only modestly when it began hiking rates.

Against that backdrop, activist groups like the Fed Up Campaign lambasted the central bank for holding back job gains for workers.

Eventually, Fed Chair Jerome Powell, a Republican elevated to central bank head by former President Donald Trump, admitted the Fed could have been gentler in raising borrowing costs. Prominent Democrats like Sens. Sherrod Brown (D-Ohio) and Elizabeth Warren (D-Mass.) urged the Fed to work to close racial employment gaps.

In August 2020, the Fed put the finishing touches on its new policy stance, where it would allow inflation to rise a bit higher before clamping down and pursue “broad and inclusive” employment.

But the policy was designed for an economy that doesn’t resemble the pandemic-era world. When unemployment stood at 3.5 percent before the pandemic, inflation was still hovering below its 2 percent target — a goal chosen because the Fed believed it would keep interest rates low enough to make room for growth but high enough so that prices wouldn’t go up unsustainably.

The policy was supposed to manifest a world in which inflation increased based on healthy economic factors — plentiful jobs, bolstered by economic growth, that pushes up wages as well as prices.

These days, the central bank doesn’t talk much about its hailed approach.

“The framework was intended to solve a certain problem,” said Bill Nelson, chief economist at the Bank Policy Institute and a former top Fed staffer. “Now that interest rates are above zero, it isn’t really that relevant.”

Top Fed officials have publicly acknowledged that the central bank likely should have acted sooner to begin tamping down surging prices, which have risen more than 8 percent over the past year. That’s in no small part because it saw inflation as caused by supply problems in key sectors, which it expected to begin subsiding much sooner.

But the central bank held off on raising interest rates even as it grew more wary that price spikes had begun broadening out across the economy in October and November, citing a focus on bringing back previously employed workers who had left the labor force during Covid. But inflation kept accelerating, and the Fed sped up its timeline to begin making borrowing more expensive.

"The inflation that we got was not at all the inflation we were looking for or talking about," Powell told reporters in December. "It was to do with, you know, strong monetary policy and fiscal stimulus into an economy that was recovering rapidly, and in which there were these supply-side barriers."

"And the way we've approached it is really nothing to do with our [new] framework," he added.

Since late last year, labor force participation has increased notably, though not yet to pre-pandemic levels, and the unemployment rate has dropped to 3.6 percent, suggesting the Fed did help heal the job market further.

"They have succeeded on the labor market side," said Skanda Amarnath, executive director of worker advocacy group Employ America, adding: "The counterfactual in which the inflation eruption was to be avoided seems actually pretty hard to imagine." He pointed to price spikes, for example, in Europe.

Still, Fed officials worry that they've overdone it, with job openings exceeding available workers. Former New York Fed President Bill Dudley argued recently that he was never comfortable with the notion that the Fed would wait until the labor market was contributing to inflation before it even began to raise rates.

That pledge "by definition was going to make them very late at some point," he said at an event hosted by the Shadow Open Market Committee.

"If the Fed reins in inflation in a timely way, all it's doing is slowing the growth in spending," said George Selgin, a senior fellow at the Cato Institute. "That would not have necessarily prevented the employment level from continuing to go down."

And now, the longer-term benefit of the Fed's initial patience isn't guaranteed. Unemployment is low and vacancies are plentiful, giving low-income workers more freedom to change jobs and get higher pay. But wages still haven't been keeping pace with inflation, which many economists say means the labor market isn't really yet a major factor in price surges.

"There's a disconnect between the micro and the macro," said Nela Richardson, chief economist at payroll processing firm ADP. "The micro says, 'I'm not getting paid enough. My wages are declining fast.' The macro says, 'you're getting paid too much, and you may eventually contribute to inflation.'"

Now, workers could face collateral damage as the Fed continues hiking rates.

“Their position in January 2020 was, we can keep rates lower for longer without stoking inflation,” Richardson said. “Two years later, they are commencing a campaign that will focus on demand destruction in order to tamp down the very wage gains and the very communities that they sought to help.”

“The Fed’s landscape has really shifted,” she added. “Maybe the next step for the Fed is a more agile framework.”