The Fed is Raising Interest Rates to Make up For Its Own Inaction

George Selgin

June 15th, 2022

"Natura non facit saltus"—"Nature never leaps." That was the motto the great Victorian economist Alfred Marshall chose for the frontispiece of his *Principles of Economics*.

Until recently, "the Fed never leaps" might have been our central bank's motto. With rare exceptions, when it raised interest rates, it did so in baby steps of 25 basis points, or a quarter of one percentage point. But in May the Federal Reserve hiked rates *50* basis points for the first time since 2000, and it just raised them again, by *75* basis points—a move not seen since 1994.

Why the big leap? Of course, the immediate cause is inflation, which has done some leaping of its own. After spending most of a decade below the Fed's two percent target, it shot up last spring, and has been rising ever since. During the last 12 months, the Consumer Price Index rose by a whopping 8.6 percent—something not seen since 1981. Hence the Fed's own, exceptional move.

But pointing to high inflation begs the questions: How did the Fed let it get so high? And why is it slamming on the brakes now, at the risk of giving the U.S. economy a severe case of whiplash, when it might have started pumping them months ago?

Some blame "Quantitative Easing"—the large-scale security purchases the Fed started making when COVID-19 broke out. All told, those purchases added about $1.6 trillion to banks' cash reserves—an amount, some pundits say, that was bound to make bank lending and prices skyrocket once things got better.

Once upon a time, that story would have made sense. But things changed in October 2008, when the Fed started paying interest on bank reserves. Now, to keep banks from

lending too much, the Fed just has to pay them more. So we're left asking why the Fed didn't start raising rates sooner.

It messed-up for three reasons. The first was the Fed's official misuse of "forward guidance"—their statements about the likely future course of Fed policy. Used properly, such guidance can assure the public that the Fed plans to do what it takes to keep policy on target. But the wrong sort of forward guidance can trap the Fed in its own promises, forcing it to choose between breaking its seeming commitment and keeping inflation on target.

That's just the trap the Fed found itself in last year. After COVID-19 broke out, Fed officials started saying that they didn't expect it to raise rates until 2023 or 2024. That "guidance" may well have played a part in Fed officials' decision to put-off their first post-COVID rate hike until this March. That's *ten full months* after inflation breached five percent—a rate that had Richard Nixon freezing prices and wages for the first time since World War II.

The second cause was the Fed's new strategy for controlling inflation. Chagrined by persistent below-target inflation, and chastened by complaints that its previous, premature rate hikes led to unnecessary unemployment, in August 2020 Fed officials opted for a new approach.

Whereas their old strategy had the Fed hiking rates whenever inflation rose above target, no matter how low it had been in the past, under the new scheme, called "flexible average inflation targeting" (FAIT), it would let inflation rise above its long-run target long enough to make up for previous undershooting.

But if FAIT was good at keeping the Fed from overtightening, it proved just as good at keeping it from tightening enough. The problem was the vagueness of the new strategy. Fed officials never said just how far back they'd look in deciding how much "making up" they meant to do. Nor did they say how long they'd take to get inflation back on target. This lack of clarity made it all too easy for them to put off rate hikes, despite high inflation numbers, while still claiming to be on course. Worse still, it meant that Fed officials themselves could never be sure whether they were on course or not.

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The third source of trouble was output or supply "shocks." Broadly speaking, prices can go up either because people are spending too much—"demand side" inflation—or because goods have gotten more scarce—"supply-side" inflation.

It makes sense for the Fed to overlook or "see through" supply-side inflation: when goods get scarcer because of lockdowns, war, sanctions, or any other supply setback, higher prices just reflect that sad reality. If the Fed kept prices down by tightening credit, it

would only add insult to injury by matching the unavoidable scarcity of goods with an avoidable scarcity of means for paying for them.

Demand-side inflation, in contrast, is the Fed's fault. Instead of meaning that goods have gotten more scarce, it just means that money is too abundant.

The fact that a substantial part of the recent inflation has been of the supply-side sort seems obvious. But how much? Fed officials tried to gauge it by looking at the "core" inflation rate—a rate that leaves out food and energy prices, which are especially subject to supply shocks. Because core inflation ran somewhere between one and 1.5 percentage points below "headline" inflation, Fed officials took that as an indication of the extent to which inflation was "transient," meaning that it would go away without any help from them.

But "core" inflation is a poor indicator of demand-side inflation. All prices are subject to both supply-side and demand-side influences, so picking out a few that are *generally* most subject to the last is hardly a reliable way to know just how rapidly the demand for goods is growing. That kind of demand can be tracked directly by looking at nominal Gross Domestic Product (NGDP)—a direct measure of the total amount spent on U.S. output.

Had Fed officials kept their eyes on NGDP, as some economists have been urging them to do for years, they'd have had every reason to start hiking rates modestly late last year. And we'd all be a little less jumpy now.

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