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Powell Should Remain Cautious To Avoid Even More Economic Turmoil

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Last week the New York Times NYT published an opinion piece by AEI's Michael Strain titled "Powell Needs to Cool the Economy Now to Avoid Recession Later." Reasonable people can disagree over such things and, well, we disagree.

Strain wants the Fed to get more aggressive "immediately," and that is opposite the approach that I've been promoting for months. Aggressively tightening right now ignores that supply problems are a primary driver of the recent CPI surge. Tighter monetary policy in the face of those supply shocks means that people will have even less funds to purchase even scarcer goods.

That's a recipe for disaster, but Strain makes no mention of this problem.

Yes, a good case can be made that the Fed should start *signaling* that it will soon tighten. And I've even made the case that the Fed should *mildly* tighten in late 2021 or early 2022 *provided that* nominal GDP (NGDP) stays on its current path. (It is basically back to its pre-pandemic trend now and seems to be increasing.)

But assuming the Fed can aggressively tighten now without causing major economic problems, resulting in nothing more than staving off some future recession, gives the Fed much too much credit. This idea harkens back to the days when federal bureaucrats naively believed that they could "fine tune" the economy to achieve permanently high employment, stable prices, higher productivity, and better living standards. (Some people might be holding on to that dream, but the rest of us are living in reality.)

Given that poor fiscal and regulatory policies are undeniably increasing inflationary pressures (and contributing to people staying out of the labor force), Strain's proposal amounts to calling for dueling economic policies at the federal level. Against a backdrop of Congress and the administration implementing harmful policies that cause specific prices to rise, he wants the Fed to use tight monetary policy so that the overall price level falls.

The folly in this approach is evident in multiple segments of the economy, including housing. For instance, Strain wants the Fed to stop purchasing Fannie/Freddie mortgage-backed securities,

a very sensible idea that would relieve at least some price pressure in the "white-hot housing market." But even if the Fed did stop buying those securities, the price pressures would move in the opposite direction as those from the Biden administration's policy to double a punitive sales tax on U.S. buyers of Canadian lumber.

Besides, if history is any guide, it is wishful thinking to assume that the Fed can precisely offset the recent CPI surge, much less closely counteract price increases in specific categories of goods, such as lumber, beef, and poultry. (Don't forget that the Fed spent the last two decades consistently *undershooting* its inflation target, even when there wasn't any sort of economic turmoil.)

There are also at least three big-picture problems that Strain's policy recommendation shares with academic economics:

- It credits the Fed with keeping interest rates low, thereby "running the economy so hot."
- It calls for the Fed to weigh price stability against maximum employment.
- It assumes that the Fed *should* pursue price stability.

First, Fed officials cannot simply make interest rates whatever they desire them to be. In fact, it should be uncontroversial that the Fed cannot even maintain any (for example) federal funds rate it desires, especially at a level inconsistent with the underlying equilibrium (natural) federal funds rate. If, for instance, the Fed tries to maintain an unnaturally high federal funds rate (a rate above the natural rate), it will lead to excessively tight monetary policy. All else constant, lending, overall spending, and the price level, will fall, and the drop in the demand for credit will lead to a lower federal funds rate.

Second, even though the Fed has a congressional mandate that requires it to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates," it largely pays lip service to the employment portion of the directive because it has to. Officially, the Fed acknowledges that "the maximum level of employment is largely determined by nonmonetary factors that affect the structure and dynamics of the labor market."

Finally, despite its mandate to promote price stability, it would be far better if the Fed targeted total nominal spending growth *instead* of inflation, thus striving to maintain a neutral monetary policy. In the face of supply-driven changes in the economy, an inflation-targeting central bank always pushes against the natural market forces that drive price changes.

- When there is a positive supply shock, such as an increase in productivity, prices should fall, thus allowing people to enjoy the benefits of more goods for sale at lower prices. This kind of deflation is not the enemy, and a growing economy does not automatically result in rising prices. Yet, the inflation-targeting central bank tries to raise prices.

- In the face of a negative supply shock, such as a major slowdown in trade, prices should rise as goods and services become scarcer. These price increases signal to businesses to supply more goods and services. Tighter monetary policy might lower the overall rate of inflation, but it will not result in more plentiful goods and services. It might even lead to more severe shortages. Yet, the inflation-targeting central bank tries to lower prices.

Sound economic policy requires that any obstacles driving specific prices higher should be addressed directly. Sound monetary policy dictates that the Fed should tolerate a higher price level *provided* that the rate of inflation does not continue to climb and push NGDP too far. In the current economy, that policy prescription equates to (1) making sure that NGDP does not get too far above its pre-pandemic trend; and, (2) removing the policy barriers that are exacerbating the COVID-19 supply shocks, including restrictive labor, immigration, and trade policies.

Strain is right that "Mr. Powell faces a very different economy now than he did when he assumed leadership of the Fed in 2018." There is, therefore, good reason to believe that tightening or loosening monetary policy to stabilize prices—the same basic policy prescription that we've heard for the last half century—might not be the right approach.