The great inflation of 2022

As prices soar, have the central banks been caught napping?

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THE LORDS OF EASY MONEY
How the Federal Reserve broke the economy
CHRISTOPHER LEONARD
384pp. Simon and Schuster. £20 (US $30).

THE MONEY ILLUSION
Market monetarism, the Great Recession, and the future of monetary policy
SCOTT SUMNER
392pp. University of Chicago Press. £28 (US $35).

Poor People's Campaign rally on Pennsylvania Avenue, Washington D. C., June 18, 2022

THANKS TO THE MASSIVE expansion of financial wealth and the large footprint of the financial news media, central banking has penetrated mainstream consciousness to a degree that was once unimaginable. There is now a healthy public appetite for business books that attempt to demystify central banking, critique central bankers and still entertain.

The Lords of Easy Money: How the Federal Reserve broke the economy by Christopher Leonard is one of the more intriguing recent contributions, offering a lively, populist perspective on institutional culture at the world's most powerful financial institution, the United States Federal Reserve (the Fed). The author's organizing device is to pit the views of a neglected dissenting policymaker, Thomas Hoenig (the president of the Federal Reserve Bank of Kansas City during the financial crisis), against the Fed leadership, particularly Ben Bernanke (2006-14) and Jay Powell (2018-). The subtext is that these men's differing outlooks can be seen as part of a class struggle between the insulated elite and the common person. Prior to taking the reins at the Fed, Bernanke was an influential academic and Powell a successful financier. Both had studied at elite universities and enjoyed stellar early careers before being helicoptered into the top position. Hoenig, by contrast, worked his way up the ranks.

There is little debate that the Fed and other central banks largely did the right thing during the 2008 financial crisis, then twelve years later during the pandemic, at least in the acute early phases. By broadly backstopping the system to prevent asset fire sales and a general meltdown, they shielded the real economy and reduced long-term "scarring". That said, I did not, in the earlier crisis – and still do not – think it made sense to save every major bank, no matter how irresponsible their policies. It would have been better to have put at least one into receivership, which would not only have reduced moral hazard, but given the public a sense that there had been a modicum of social justice for the problems the banks had created. (The case of Lehman Brothers was different: the company did not own a commercial bank and, as Bernanke explained in his testimony to the House Committee on Financial Services, "at that time, neither the Federal Reserve nor any other agency had the authority to provide capital or an unsecured guarantee".) There is a standard procedure for putting a bank into default that essentially siphons the worst loans into a "bad bank" and reconstitutes the rest into a "good bank", protecting depositors but wiping out the bank's equity. Sweden and China did this in the 1990s, quite successfully.

This, in any case, was not Hoenig's beef with his Fed colleagues in the wake of the financial crisis. The much bigger debate concerned what the Fed (and the Bank of England, the European Central Bank and others) did after propping up the banks. First, they pushed very short-term interest rates to zero by offering unlimited cash to banks at this rate. When that proved insufficient to restore growth and tame disinflationary pressures, the Fed engaged in "quantitative easing". This involves offering banks reserves at the central bank – in effect, electronic cash – in exchange for either central government debt ("pure" quantitative easing) or private sector assets ("fiscal" quantitative easing).

Hoenig, along with a significant minority of economists, believed that undertaking quantitative easing on a mass scale would flood the economy with money and lead to inflation and recession. The late Alan Meltzer (1944-2011), a leading monetarist who wrote an influential history of the Fed, was another key proponent of this view. Their reasoning was seductive and its flaw was to be found in something subtle: the fact that, once all short-term interest rates (including very short-term treasury bills) have converged to zero, there isn't a significant difference between electronic cash and short-term government debt. Both are obligations of the central government, since the government owns the central bank. When the Fed issues bank reserves to soak up, say, thirty-year government debt, all that really happens is a shortening of the maturity structure of government debt held by the public. When interest rates are zero (or if bank reserves pay interest), there is virtually no difference between the central government issuing short-term debt or issuing long-term debt and having the central bank immediately issue short-term debt (central bank reserves) to the public to buy it up. One might reasonably think this cannot hold true, because central bank reserves can only be traded in the banking system, while government debt can be held by anyone. But, because many banks are also very active in treasury bill markets, that distinction does not really matter in practice (except for second-order effects due to financial frictions).

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This seemingly obscure nuance is important because, once interest rates are zero, further attempts to buy up government debt by issuing short-term bonds are not terribly inflationary. When interest rates on treasuries are zero, "money" and government "debt" start to seem a lot alike. It was this key insight that led John Maynard Keynes, in his *General Theory* (1936), to conclude that government spending is vastly more effective than monetary policy when interest rates collapse to zero, as they did in the US in the Great Depression of the 1930s. Although in recent years central banks have insisted that "money" and government debt are not quite perfect substitutes for one another at the zero interest-rate bound, and that pure quantitative easing policy can still have some effect, the bulk of the academic literature finds the effects to be quite small. Ultimately, the proof is in the pudding: central banks have often failed to bring inflation up to their targets despite gargantuan efforts, as in Japan, which has tried the hardest for the longest.

The real problem with Fed policy in the years after the financial crisis was that it was not inflationary enough, with most central banks struggling to lift inflation to their target (generally 2 per cent). Contrary to Hoenig's view that policy was too loose, it was arguably too tight, and the Fed should have been open to ideas such as raising its inflation target (Paul Krugman's preferred solution) or open-ended negative interest policy (which prevents wholesale cash hoarding, as I explained in *The Curse of Cash*, 2016, but which so far no central bank has tried). My own position during the financial crisis was that moderate inflation (of 4-6 per cent for a few years) would have been a good thing. It would have helped to relieve stress on subprime mortgage holders in the US and on periphery economies in Europe. The Fed's mistake was a failure to create inflation when it was most needed, and an obsession with controlling it when there were bigger problems on the horizon, such as slow growth and rising unemployment. Either way, the notion that the "lords of easy money broke the economy", as per the title of Leonard's book, seems nonsense.

Leonard is aware, of course, that inflation never blew up in real time, as Hoenig had feared, and he can point with much more justification to what is happening today, more than a decade later. Thanks to a mixture of factors, ranging from post-pandemic global supply chain woes to Russia's invasion of Ukraine and, above all, to well-intentioned but catastrophically misguided Biden administration stimulus policies, inflation today in the US exceeds 8 per cent, and it is not going away any time soon. The $1.9 trillion March 2021 package was a particular culprit in this regard, arriving when the economy was already sharply recovering, and it proved too much too late. Unfortunately, the progressives who dominate policy in the Biden administration thought there would be little risk to having the government issue enormous quantities of debt, then letting the central bank soak it up. Their anthem, which goes under the rubric of "modern monetary theory" (MMT), is really just a distilled version of a line many left-leaning academics have long been pushing: that government can vastly expand its debt issuance to pay for social spending without ever having to cut spending or raise taxes, including through inflation.

Leonard's argument is that it was the Fed that was supposed to shut the door on inflation by raising interest rates, and that, had these raises been implemented earlier in 2021, demand would have been tempered by making borrowing more expensive, bringing down asset prices of all types, from equities to housing. Now the Fed is having to play catch-up, most recently with last month's unusually aggressive 0.75 per cent rate hike; and other central banks are following suit. But, while it is true that the Fed held on to zero interest for too long, and particularly from early 2021, the author's contention that Hoenig and his allies were ultimately right is undone by the important detail that the world we are looking at now is more than a decade on from the financial crisis, and circumstances have changed radically thanks to matters such as the pandemic and Ukraine. Very easy monetary policy certainly can lead to high inflation – just look at Argentina or Venezuela – but that does not mean it is wrong in every circumstance. And in the case of our current predicament, a good part of the blame must be laid not at the door of the Fed, but at that of progressives who preferred to engage in epic fiscal spending via the expansion of debt, rather than through raising taxes, and to the substantial number of academics and MMT proponents who supported this view, perhaps lulled to sleep by decades of low inflation.

Despite being wrong in its central economic thesis, *The Lords of Easy Money* is still fascinating and engaging. Where it really shines is in its exploration of how Fed culture attempted to deal with dissent and outside views. Hoenig's willingness to challenge the economic assumptions of the Fed chair and senior staff led to a debate that is, in Leonard's hands, enlightening and entertaining. Unfortunately, the next crisis could be different. Leonard raises important questions about whether groupthink and excessive deference to the chair (Bernanke and later Powell, with Janet Yellen in between) poses bigger risks than politicians and the markets currently appreciate.

In a sense, Leonard's perspective is part of a wider populist push after the financial crisis to argue that the technocratic elites had it all wrong and should be purged. This view is dangerous: it is precisely because of its technocratic excellence that the Fed managed the crisis so effectively, if imperfectly. And it is precisely the power of technocracy that we see on display in Scott Sumner's excellent new book, *The Money Illusion*.

This thoughtful and broad-ranging critique of the post-financial crisis consensus on macroeconomic policy is worth reading for anyone interested in monetary policy, even if you don't buy into the "market monetarism" (of which more later) championed by the author. Sumner is unafraid to challenge the academic consensus: in his earlier book on the Great Depression (*The Midas Paradox*, 2015), he argued that bad policy-making at every turn made things far worse in the late 1920s and early 1930s than they had to be. In *The Money Illusion*, much like Leonard in *The Lords of Easy Money*, he explores monetary policy decision-making during the 2008-09 financial crisis and its aftermath – but with more focus on the economics and less on the personalities. Some may wonder why anyone today would write (or read) a book raking over the financial crisis, when the world has moved on to dealing with the pandemic, war in Europe and how to manage economic policy in an era of wild political see-saws. In fact, Sumner's book is of great significance to our current crises, and his challenge to conventional wisdom is bracing.

As I have previously argued, central-bank policy rules that focus excessively on inflation targets can be wildly off in a deep crisis, causing central banks to react too slowly and cautiously to prevent the economy from sinking into low demand and deflation. Of course, in a really deep crisis, a huge fiscal policy response is essential, but the contemporary view that monetary policy should play a secondary supporting role reflects a profound lack of imagination. And Sumner fully appreciates this. A key element of his preferred framework is market monetarism, which advocates for central banks to target "nominal GDP", which is basically national income without adjustment for inflation. Compared to targeting, say, 2 per cent inflation, nominal GDP targeting would let inflation go up when output seems to be collapsing. If – and this is a critical point – the public has high confidence in the central bank's ability to let prices rise when output softens, this measure provides an automatic incentive to shift consumption and investment into the present and away from the future. This behaviour will have the effect of pushing up demand, which will result in some inflation but soften the blow to employment and output. The potential efficacy of nominal GDP targeting can be illustrated in a wide class of Keynesian models, first laid out by James Meade in 1977 and a few years later by James Tobin, both Nobel laureates.

The alert reader will notice that Sumner's recipe is 180 degrees opposite to that of Hoenig. In Sumner's view (and mine), the inflation that results from very easy monetary policy in a financial crisis is not a flaw of nominal GDP targeting, but a desirable feature. It's not that a fiscal response is unimportant: it's that monetary policy can have a big impact in relieving the burden on fiscal policy, as well as on both public and private debtors, particularly during a slow post-financial crisis recovery. This would certainly have been desirable back in 2008-09. Importantly, in normal recessions, even deep ones, the advantage of monetary policy as a first line of defence is that it can be reasonably technocratic. By contrast, politics are baked into fiscal policy, making it hard to get the timing, and balance, right; fiscal policy is reliant on horse-trading and other external factors.

One might argue that the massive response to the pandemic proves that political obstacles can be conquered. And this seems fair – until we realize that a pandemic recession is hardly a typical one. A pandemic is akin to a natural disaster, making political consensus far easier to reach. At the same time it hits the economy very unevenly, making targeted fiscal policy far more effective than scattershot monetary policy. Pandemics are different from ordinary recessions in other ways, too. As the economy recovers, the initially dominant demand shock fades and the economy is left facing a huge supply shock. For example, if China continues to follow its radical zero-Covid policy into sustained recession, global supply chains will seize up even more than they have already. If the global economy is supply-constrained, pumping in too much more demand is only going to create inflation. It is clear that policy-makers spent too long fighting the last war, during which, it is now commonly agreed, the fiscal stimulus was withdrawn too quickly.

Sumner's argument that the Fed should have targeted nominal GDP going into the financial crisis misses one critical element. If output is falling, the Fed needs to create more inflation, but how can it achieve this once it has taken short-term policy rates to zero and "money printing" becomes, as I have shown, akin to shortening the maturity structure of government debt? During the Great Depression, President Franklin D. Roosevelt managed to create inflation by reducing gold backing for the dollar, which effectively depreciated the currency. The UK did the same in 1931. But in the modern system there is no gold anchor to jettison. Instead, Sumner floats ideas such as higher inflation targets and negative interest rates, but he does not view them as necessary, and, in any event, the version of negative rates that he considers is a limited one that fails to prevent wholesale paper currency hoarding by pension funds, insurance companies and financial firms, which no central bank has tried and which would be necessary to truly make negative policy effective. (As I explained in *The Curse of Cash*, it is extremely straightforward to shield 99 per cent of people from negative rates, and the idea that bank profitability has to suffer is a red herring.)

For all its searing critiques of mainstream thinking, *The Money Illusion* is by no means a diatribe. Sumner offers numerous examples of occasions when he believes mainstream thinkers got it right, while at the same time calling out various overblown claims. For example, during the years after 2008-09, the UK never did have the disastrous "double dip" recession widely vaunted by many liberal economists (including the chief economist of the International Monetary Fund). Nor did the US ever tip into a true depression, even if leading left-leaning economists such as Krugman continued to insist otherwise.

In addition to the policies Sumner critiques, there are other ways in which the financial crisis response fell short. In particular, US policy-makers were too hesitant to find creative ways to write down subprime loans, and those in Europe were far too reluctant to write down unsustainable debts in the European periphery. In some ways the pandemic response corrected these mistakes through debt moratoria or, in Europe, the next generation EU programmes, which were akin to a massive debt write-down, even if not labelled as such for political reasons. And, of course, with sweeping interventions into financial markets, most of the main advanced-economy central banks effectively subsidized high-risk borrowers. It is curious that the current academic literature continues to focus so heavily on fiscal policy in the pandemic and not the myriad other policies that supported the economy.

> **"The biggest bubble of the past forty years is the collapse of interest rates**

So, as inflation continues to skyrocket in the main advanced economies, should they take nominal GDP targeting more seriously? Although I believe there are better ideas – especially rethinking how to better implement negative interest rates – nominal GDP targeting merits serious discussion. But it might be wise to make an effort to raise economic literacy first. While the public loosely understands what inflation is – even if most people quite reasonably attach more importance to food and gas prices than the CPI index does – almost nobody understands what nominal GDP is and why it matters. On top of that, GDP is poorly measured. Revisions of 1 per cent or more are reasonably common. Another problem is that, under a regime of nominal GDP targeting, there would be enormous pressure on the Fed to make optimistic growth predictions, which would end up adding to inflation if unrealized. (I first made this point in a paper of 1985, "The Optimal Degree of Commitment to an Intermediate Monetary Target", which introduced the idea of central bank independence as a way to stabilize long-term inflationary expectations.)

Sumner's book has all sorts of philosophical insights that will be interesting to anyone trying to understand markets and macroeconomics. One bogeyman he confronts is bubbles. Many market observers see speculative bubbles everywhere. Sumner, by contrast, argues that there is typically some rational factor behind the "bubble", and the fact that the casual (or academic) observer isn't easily detecting it is not a reason to dismiss signals from market prices. After all, the biggest bubble of the past forty years, if you want to call it that, is the collapse of interest rates, particularly "real" interest rates (the interest rate adjusted to remove the effects of inflation). Low real interest rates make virtually any kind of long-lived real asset seem more valuable, from housing to art to stocks to cryptocurrency. Now that interest rates are on the rise, asset prices are tanking across the board. Does this confirm that everything was a bubble that is now popping? Well, only if you are sure that interest rates before were too low and that they are now becoming more "normal", a topic about which there is great debate. Indeed, the decline in inflation-adjusted interest rates over the past few decades, and especially since the financial crisis, has been the single most important phenomenon in macroeconomics. Right now markets seem to believe that after a few years things will go back to something like the new post-crisis normal of very low real interest rates. But if interest rates were to revert to the longer-term trend, then there would need to be many adjustments to come, especially for governments that have been borrowing with abandon in the belief – often egged on by liberal academics – that rates will never rise significantly.

It is to the credit of both Christopher Leonard and Scott Sumner that they are prepared to challenge the smug consensus. And in their own ways, both of their new publications are valuable contributions. Arcane books about central banking may not seem important in quiet times when inflation is tame and markets are soaring. But with the UK and US now both at high risk of entering a period of "stagflation" (high inflation plus low growth), these debates suddenly start to become highly relevant. ■