Monetary and Inflationary Traps

By Raghuram Rajan

CHICAGO – Price increases in the United States are spreading across goods and services, and inflation also can be seen in broad-based business inputs such as transportation, energy, and increasingly labor. How should we expect central bankers to react?

For its part, the US Federal Reserve has emphasized that it will contemplate raising interest rates only after it is done tapering its monthly asset purchases, which will be sometime in July 2022 at the current pace of unwinding. Nonetheless, some members of the Fed’s rate-setting Federal Open Market Committee worry that the central bank will have fallen behind the curve by that time, forcing it to raise rates more abruptly, to higher levels, and for longer than anticipated. Hence, Fed Vice Chair Richard Clarida recently indicated that the Fed might consider speeding up the taper (so that it can raise rates sooner) when its members meet again in December.

Notwithstanding the growing (but often unspoken) worries at the Fed, central bankers nowadays are reticent to see inflation as a problem. In the past, the current levels of inflation would have prompted them to square their shoulders, look determinedly into the TV cameras, and say, “We hate inflation, and we will kill it” – or words to that effect. But now they are more likely to make excuses for inflation, assuring the public that it will simply go away.

Clearly, the prolonged period of low inflation after the 2008 global financial crisis – when the Fed had great difficulty elevating the inflation rate to its 2% target – has had a lasting impression on central bankers’ psyches. The obvious danger now is that they could be fighting the last war. Moreover, even if they do not fall into that trap, structural changes within central banks and in the broader policymaking environment will leave central bankers more reluctant to raise interest rates than they were in the past.

To adapt to the pre-pandemic low-inflation environment, the Fed changed its inflation framework so that it would target average inflation over a (still-undefined) period. This meant that it could allow higher inflation for a while without being criticized for falling behind the curve – a potentially useful change at a time when elevating the public’s inflation expectations was thought to be the key problem. Gone was the old central-bank adage that if you are eyeball to eyeball with inflation, it is already too late. Instead, the Fed would stare at inflation for a while and act only when it was sure that inflation was here to stay.

Moreover, the new framework places a much greater emphasis on ensuring that employment gains are broad-based and inclusive. Because historically disadvantaged minorities in the US are often the last to be hired, this change implied that the Fed would potentially tolerate a tighter labor market than in the past, and that it would have more flexibility to run the economy hot, which is useful in an environment of weak demand. Yet now the Fed is facing an environment of strong demand coupled with supply-chain disruptions that look unlikely to abate quickly. Ironically, the Fed may have changed its policy framework just as the economic regime itself was changing.
But shouldn’t greater flexibility give decision-makers more options? Not necessarily. In the current scenario, Congress has just spent trillions of dollars generating the best economic recovery that money can buy. Imagine the congressional wrath that would follow if the Fed now tanked the economy by hiking interest rates without using the full flexibility of its new framework. Put differently, one of the benefits of a clear inflation-targeting framework is that the central bank has political cover to react quickly to rising inflation. With the changed framework, that is no longer true. As a result, there will almost surely be more inflation for longer; indeed, the new framework was adopted – during what now seems like a very different era – with precisely that outcome in mind.

But it is not just the new framework that limits the effectiveness of the Fed’s actions. Anticipating loose monetary-policy and financial conditions for the indefinite future, asset markets have been on a tear, supported by heavy borrowing. Market participants, rightly or wrongly, believe that the Fed has their back and will retreat from a path of rate increases if asset prices fall.

This means that when the Fed does decide to move, it may have to raise rates higher in order to normalize financial conditions, implying a higher risk of an adverse market reaction when market participants finally realize that the Fed means business. Once again, the downside risks, both to the economy and to the Fed’s reputation, of a path of rate hikes are considerable.

The original intent in making central banks independent of the government was to ensure that they could reliably combat inflation and not be pressured into either financing the government’s fiscal deficit directly or into keeping government borrowing costs low by slowing the pace of rate hikes. Yet the Fed now holds $5.6 trillion of government debt, financed by an equal amount of overnight borrowing from commercial banks.

When rates move up, the Fed itself will have to start paying higher rates, reducing the dividend it pays the government and increasing the size of the fiscal deficit. Moreover, US debt is at around 125% of GDP, and a significant portion of it has a short-term maturity, which means that increases in interest rates will quickly start showing up in higher refinancing costs. An issue that the Fed did not have to pay much attention to in the past – the effects of rate hikes on the costs of financing government debt – will now be front and center.

Of course, all industrial country central banks, not just the Fed, face similar forces that push toward restraint on rate hikes. So the first large central bank that moves may also see its exchange rate appreciate significantly, slowing its growth. This is yet another reason to wait. Why not let someone else move first, and see if they invite market and political wrath?

If the post-2008 scenario repeats, or if China and other emerging markets send disinflationary impulses across the global economy, waiting will have been the right decision. Otherwise, the present impediments to central bank action will mean more, and sustained, inflation, and a more prolonged fight to control it. Chairman Powell will have a lot to weigh as he begins his second term.