Having gotten it wrong in one direction, the central banks will get it wrong again in the other.

The Cost-*of*-Living Crisis

By Bernard Connolly

The cost-of-living crisis, as it has been labeled, has replaced Covid at the top of the list of domestic political worries in Western countries. But if Covid was an exogenous shock to those countries, inflation, or a good part of it, has not been. In the United States in particular, domestic politics sowed the seeds of inflation. The Georgia run-off Senate election in January 2021 changed everything—and notably the bond market—by giving U.S. President Joe Biden the opportunity to get his hubristic spending plans through Congress. Even the most distinguished (other than to the Nobel Committee) Democratic economist Larry Summers could see, and shouted loudly, that pouring unprecedented fiscal stimulus into an economy in which demand was recovering strongly after the most draconian restrictions were eased, yet supply chains remained disrupted globally, could have only one outcome: a wildly overheated economy and surging inflation. Summers was right, of course, and those politicians and economists who now vilify him are simply showing how right Rose Friedman was when she said that one could almost always predict an economist's analytical views simply by knowing his political affiliation. Summers, by being an exception to that rule, deserves considerable credit.

If Summers deserves credit, the Fed, and central banks more generally, do not. Were political factors to blame? They always are, of course, in the case of the European Central Bank—that goes without saying. In the United States, former Fed Chair Janet Yellen certainly did not enhance her reputation by shutting her eyes, as Treasury Secretary, to the evident truth about her boss's fiscal plans. But what about her successor? Some might wonder if current Fed Chair Jay Powell was constrained in 2021 by a desire to be re-appointed. For sure, his rhetoric,

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and perhaps his supposed "style"—a reluctance to make big moves—changed markedly after his re-nomination.

However, the simplest explanation of the Fed's "hawkish" tilt this year is that in the face of public anger about inflation, it could no longer sustain the ridiculous, wokeish stance that it had formally adopted in August 2020. That still leaves the question of how central banks failed, or refused, to recognize that continuing to pump money into asset markets—even after the threat of Keynesian recession, which had been real in much of 2020, had been dispelled—would produce inflation.

In the case of the Fed, the best answer is that it did not distinguish 2021 from 2009–2013. In 2009–2013, Fed large-scale asset purchases had the effect of mimicking the shadow banking system, whose activities had been greatly diminished by the financial crisis. If the objective was to keep putting off the evil day of deep and prolonged recession that has beckoned ever since the end of the previous millennium, someone, whether the Fed or the shadow banking system, had to create the liquidity required to blow asset price and credit bubbles. Bubbles have the effect of increasing perceived wealth—in, however, an illusory way (cryptocurrencies being the most egregious and socially dangerous current example). In turn, such illusory increases in perceived wealth, with their false promise of future aggregate spending power, meant that the Euler equation, which in circumstances of persistent intertemporal disequilibrium implied a downward expected path of spending relative to the path of expected income—and thus a persistent tendency for negative output gaps to appear and inflation to remain below target—did not result in a reduction in current spending relative to current productive capacity. But by the end of 2020, enormous fiscal transfers, in conditions of restricted ability or need for households to spend during lockdowns, had already produced massive accumulated household savings. Those transfers may well have been unavoidable, for sociopolitical reasons as well as macroeconomic ones. But they created a new illusion of wealth, albeit one dependent on ignoring the debt created by massive budget deficits. That played the role of ensuring that asset price and credit bubbles were not necessary, or, more accurately, were no more necessary than they would have been in the absence of the pandemic—to neuter the downward drag of the Euler equation.

Summers deserves considerable credit.

One can note that had there not been an underlying situation of intertemporal disequilibrium, what fiscal policy should have done was to tighten in 2021 and 2022 to the extent necessary to offset spending out of accumulated savings. Had that happened—had the illusion of wealth produced by fiscal policy not increased aggregate spending—monetary policy would, still supposing that the implicit aim of policy was to continue deferring liquidation, have had to continue blowing asset price and credit bubbles. Monetary policy did in fact continue blowing such bubbles in 2021, but the effect was inflationary as accumulated savings began to be run down and fiscal policy added fuel to the fire rather than dousing it.

In the medium term, central banks will have to encourage a resumption of the horrifying secular trend toward ever-lower real long yields and ever-more-inflated asset prices. That trend will continue, with sporadic interruptions, until political conflict sinks capitalism and, with it, democracy.

It is worth asking at this point how money fits into the argument. When a household spends by drawing on its bank account (and thereby correspondingly increases the account of the firm selling the goods or services), there is no change in yields in response to that additional spending if the actions of the central bank are increasing bank accounts in the aggregate, that is, if the central bank is "creating money." In contrast, if households, in order to provide the means of payment required to buy goods or services, must first either sell assets or borrow money, finding buyers for the assets or lenders from whom to borrow must involve a rise in yields unless the central bank is the buyer of the assets: that is, unless the central bank, or the shadow banking system, makes assets as liquid as money. When a central bank buys bonds and (assuming a normally functioning bank multiplier) creates money, it does not increase perceived wealth other than through reducing yields (including credit-risk premiums) and boosting asset prices; if perceived wealth is already, because of fiscal policy, large enough to push aggregate demand above aggregate supply, central bank money creation accommodates excessive private spending. But it remains the case that yields (again including credit-risk premiums) relative to those which would otherwise have obtained—prices, not quantities—are key in assessing the impact, as opposed to the scale, of monetary policy. The quantities that matter are the transfers and spending that make up fiscal "stimulus."

To repeat, fiscal policy should have tightened in 2021 and 2022 to the extent necessary to offset spending out of accumulated savings. But Fed models suggest that household horizons tend, on average (skewed by the presence of many current-income-constrained households whose horizon extends only to the next payday), to be no longer than two to three years. That implies that there is unlikely to be much of a Ricardian equivalence effect. And one should have expected spending out of accumulated savings to be, all else being equal, very substantial in 2021 and 2022, as has been happening, but to be largely exhausted by 2023. Fiscal policy, at least in 2021, added to that private spending rather than offsetting it. But if central banks, having observed inflation high enough to scare them, now tighten monetary policy aggressively and the fiscal impulse also falls away sharply, perceived wealth—already substantially reduced in real terms by increases in the price level—will drop very fast via sliding, indeed potentially crashing, asset prices. That reduction in perceived wealth will add to the squeeze on spending by current-income-constrained households that is being produced by current inflation. One can think of there being a kind of "Hayekian Equivalence" via a reduction in the real value of perceived wealth via inflation, both current and expected in the near future, rather than the Ricardian Equivalence of reductions in perceived wealth via expectations of more-distant future tax increases. Observed collapses in consumer confidence are consistent with such an outcome.

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Some reduction in what used to be called "transitory" elements of inflation may well come, although the Ukraine war and, more significantly, China's zero-Covid fixation may derail that possibility. But that will not be enough, given the present situation of overheating. A recession is absolutely necessary to reduce the rate of inflation to anything like target levels. That is the unfortunate consequence of the fiscal and monetary policies pursued in 2021. Central bank "communication" has already increased the market's rate expectations enough to slam asset prices and confidence. A recession will come. The key question is whether it will come soon enough to avoid a further increase in actual inflation and the risk of unhinging inflation expectations. It is clear that central banks could produce the "right" degree and timing of recession only by luck. More probably, they will overdo it. The experience of 2000 and 2007–2008 suggests that central banks, embarrassed by their failure to prevent an upsurge in inflation (a much more substantial one this time than in the previous two episodes), entranced by the mirage of a "soft landing" and failing to recognize the strength of recessionary, and hence disinflationary, forces, will bring forward and intensify the recession. Having got it wrong in one direction, they are swinging around and will get it wrong in the other direction. Quite soon thereafter, as they are forced to recognize that inflation will be coming down faster than they are now forecasting, they will swing back around yet again, bringing rates back down sharply, no doubt after inventing some "headwind" to justify themselves. That, of course, is a condemnation not just of central banks as institutions but also, more fundamentally, of the hugely harmful canonical academic model that sustains the macroeconomics industry.

In the medium term—which will not in fact be very far away—central banks will have to encourage a resumption of the horrifying secular trend toward ever-lower real long yields and ever-more-inflated asset prices. That trend will continue, with sporadic interruptions, until political conflict sinks capitalism and, with it, democracy. ◆