View from the Beltway

The Case for Humility

By Owen Ullmann

The experts grapple with understanding inflation.

When he ran the Federal Reserve during his legendary career, Alan Greenspan used to joke that he found economic models to be of great use to him as he contemplated the Fed's interest rate policies. Not, mind you, to predict where the economy was headed, but to look backwards and explain how it got where it is. The problem with models, he would chuckle, is that they are good predictors until some unanticipated trend comes along to make the models outdated in forecasting the future—and something unexpected always comes along.

Greenspan's contempt for models seems particularly appropriate today as some of the brightest economists on the planet engage in a high-stakes debate about the future trajectory of inflation in the United States.

The hand-wringing inflation-phobic camp is led by such luminaries as former U.S. Treasury Secretary Larry Summers and, to a lesser extent, former International Monetary Fund chief economist Olivier Blanchard. They have warned that the United States is headed toward an inflation explosion unseen in half a century because the Biden Administration is pouring trillions of dollars of fuel on top of an already blazing economy, as Jerome "Jay" Powell's Fed is helping to spread the fire around the world with ultra-low interest rates and an unabated bond-buying spree.

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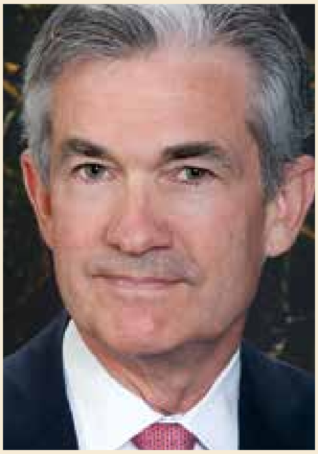
By 2022, according to this view, an inflationary spiral will be well underway, forcing interest rates to jump, the dollar to drop, and the stock and bond markets to swoon. Early evidence they cite as of mid-June included red-hot economic growth in the second quarter and soaring price increases for homes, used cars, food products, and commodities, from lumber to oil—all contributing to

Owen Ullmann is TIE*'s executive editor and author of* Empathy Economics: The Remarkable Career of Janet Yellen *(Public Affairs, forthcoming in 2022).*



On the One Hand…

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Jerome Powell, *Chair, Federal Reserve Board of Governors*

the highest increases in the consumer price index in more than a decade.

On the other side is a not-to-worry coalition led by Powell and U.S. Treasury Secretary Janet Yellen. They contend that inflation likely will rise in 2021 to as much as 3 or 3.5 percent, but then drop back into the 2 percent range in subsequent years. They base their projections on the belief that the Covid-19 pandemic which shut down the U.S. economy for several months in 2020 created price spikes because of temporary supply shortages, but supply and demand will return to balance once the economy returns to normal supply-and-demand patterns as the pandemic wanes.

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Yes, they acknowledge, there is huge pent-up demand and $2 trillion in consumer savings itching to go on a buying spree, but that is offset by a labor force that remains weak compared to its pre-pandemic state. The labor participation rate as of mid-2021 was still below its level at the start of 2020, and there were still six million more people out of work than before the pandemic struck.

At its June 16 meeting, the Federal Open Market Committee raised its forecast for growth and inflation in 2021 and said its zero interest rate policy would likely end in late 2023. That was sooner than early forecasts that saw the first rate hikes coming in 2024. Even so, Powell stuck to his belief that the economy still needed to heal, that inflation would abate in 2022, and that the Fed had no timetable for curbing its bond purchases. In a sign of how skittish investors are about the Fed's changing forecast, the Dow Jones Industrial Average sank more than five hundred points two days later, when St. Louis Reserve Bank President James Bullard said he expects the Fed to start raising rates as soon as the end of 2022. But by the following Monday, the Dow had soared more than five hundred points.

So who is right? As the old adage goes: Time will tell, but not the economic models. That's because, as Greenspan would quickly point out, too many unanticipated factors are clouding the crystal balls. That view is being embraced by a growing number of economists, but not Summers, so far.

The former Treasury secretary argues that you don't need to look to the future, just open your eyes to what is happening now. "We've already seen inflation statistics far greater than anything anybody expected," he said in mid-May. "Everybody was aware

Impossible to Deny That Inflation Looks More Plausible

"Everybody was aware that there were a lot of transitory factors. Everybody was aware that there were short-term bottlenecks. Nobody predicted anything like recent CPI or average hourly earnings figures. So, I think you've got to say that whatever one thought three months ago, the inflation view has got to look considerably more plausible today that it did then."

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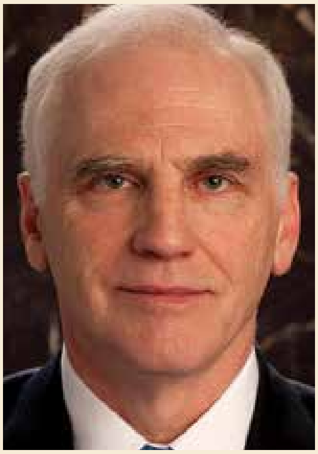

Theory Shortage

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In contrast to true believer Summers, Blanchard, who expressed his worries about inflation in February, was more circumspect just a month later. In his February article for the Peterson Institute for International Economics, where he is a senior fellow, Blanchard wrote: "The issue is whether the current relation between inflation and unemployment would hold, and there are good reasons to worry. The history of the Phillips curve is one of shifts, largely due to the adjustment of expectations of inflation to actual inflation. True, expectations have been extremely sticky for a long time, apparently not reacting to movements in actual inflation. But, with such overheating, expectations might well de-anchor."

Then, in a March 24 article on the great inflation debate in the *New York Times,* he is quoted as saying, "I shall plead Knightian uncertainty. I have no clue as to what happens to inflation and rates, because it is in a part of the space we have not been in for a very long time. Uncertainty about multipliers, uncertainty about the Phillips curve, uncertainty about the dovishness of the Fed, uncertainty about how much of the $1.9 trillion [Biden relief] package will turn out to be permanent, uncertainty about the size and the financing of the [proposed] infrastructure plan. All I know is that any of these pieces could go wrong."

In doubting the accuracy of inflation forecasts, Blanchard is in good company. A former top policymaker at the Fed, who has studied inflationary trends for decades, admitted great uncertainty about the outlook. "We haven't had this kind of experience before and the main reason, frankly, that nobody can be really perfectly sure is that we don't understand the inflation process that well," said the former official, who asked to remain anonymous in order to speak candidly.

"In particular, the conventional view, which I personally believe with a large standard error, is that inflation expectations are really critical but we don't understand inflation expectations very well," he continued. "So, it is possible that the combination of higher gasoline prices and car prices and food prices and all this stuff, which in some sense should fundamentally be temporary, will somehow break into the public consciousness in a way that invokes more of an inflationary psychology.

"And if that happens, then it gets a little tougher because the thing that really made the 1970s so bad was the conviction by the public that the Fed was not going to do anything about inflation and there would be no stability. I don't think that's going to happen. I think the Fed has enough credibility. I think we'll see that the Fed might be a little tighter than the markets think. The people who predicted inflation when the Fed launched QE [quantitative easing] in 2009 were kooks. This is different. An inflationary spiral is not impossible. It's not crazy, but the odds are quite against it going to 3 percent for very long."

Former Fed Governor Daniel Tarullo said he finds the inflation outlook hazy because "I don't believe that there is a working theory of inflation that is relevant to 2021 that allows for more or less confident decisions by the Fed in real time." Tarullo, who served on the Fed Board from 2009 to 2017 and now teaches at Harvard Law School, said output gap analysis is hampered by uncertain estimates of what the gap is, and the Phillips curve is no longer a reliable predictor. "The Fed, as with most central banks, is now highly reliant on expectations theory," he explained. "Intuitively, I think expectations play a role, but talk about something that is under-theorized. How do expectations get established and how do they change? That is the really important point. If we believe inflation expectations provide this incredible anchor, what's the mechanism by which they do it? There's never really been a great account of it."

As a risk manager, Tarullo would have scaled back Biden's relief

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220 I Street, N.E., Suite 200
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Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

package, say, to $1.3 trillion, just to be on the safe side. "If you know you're vulnerable, you want to be careful because you don't want to create a circumstance in which some secondary exogenous event somehow changes the minds of central bankers, foreign exchange guys, asset managers around the world," he said. "Psychology can shift overnight. Underlying conditions may not change from day one to day two, but the world may look at those same conditions very differently on day two."

Jeffrey Frankel, a member of President Bill Clinton's Council of Economic Advisers who now teaches at Harvard's Kennedy School, noted that inflation predictions have been flawed going back a decade, when inflation first remained higher than expected given the level of unemployment, and then remained stubbornly lower than predicted even as unemployment kept falling. "The entire history can be explained by the Phillips curve being flat, that variations in output and employment just don't have as big of an effect on inflation as they used to," he concluded.

Likewise, former Fed Governor Jeremy Stein, who now chairs Harvard's economics department, said he and his colleagues "need to be super humble because nobody knows a thing about how to forecast inflation. And even if they did, now is a particularly unusual time given all the fiscal stimulus and the rebound of the economy. If you put a gun to my head and said, 'Give me your forecast for inflation three years forward,' I would have moved it up a little bit, 20 or 30 basis points, to 2.3 or 2.5 percent, nothing that if you woke up from a long sleep and found it, you would be terribly concerned by."

A current Fed governor who would not talk on the record also admitted to real uncertainty about the inflation outlook. "I think the jury is still out," the official said. "Remember, we do have both an unprecedented crisis and an unprecedented fiscal response. So, I think it's a real open question about how the economy is going to proceed in the near term. I think it's a real debate, and it's a fair debate to be having certainly. I personally am very attentive to the risks on both sides."

Some former Fed governors are in the Summers camp, convinced that inflation is already accelerating and can't be easily reversed. Hoover Institution Visiting Fellow Kevin Warsh, who was on the Fed board during the 2007–2009 housing crash and subsequent recession, has told colleagues that he considers Powell to have embarked on a "radical" policy of allowing inflation to build up without taking into account the long lag time for interest rate moves to take effect.

Larry Lindsey, who served on the board in the 1990s and then became director of the National Economic Council for President George W. Bush, agrees with Summers that it's impossible to ignore the accumulating evidence of inflation building when you look at all the data coming in and listen to anecdotal reports from company executives. "It's happening, and it's a problem," he said. "The issue of whether inflation is

Forecast Wasteland

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Not Worried at All

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It's All About Validation

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Larry Lindsey, *former director, National Economic Council, and former member, Federal Reserve Board of Governors*

sustainable has to do with whether or not it's validated now. Secretary Yellen and Chairman Powell are saying we may get some inflation but it's going to be short-lived. Yet they're doing everything in their power to validate that inflation. And once it gets into inflation expectations, then the cat is out of the bag."

The current Fed leadership remains unconvinced. Fed Vice Chair Randy Quarles said in a speech to the Brookings Institution on May 26 that he expects inflation to run close to 2 percent at some point during 2022, despite his concerns that the size of Biden's relief package and a recent unexpected acceleration of wage growth "could make above-target inflation more persistent than we currently expect."

A former top policymaker at the Fed, who has studied inflationary trends for decades, admitted great uncertainty about the outlook. "We haven't had this kind of experience before and the main reason, frankly, that nobody can be really perfectly sure is that we don't understand the inflation process that well," said the former official, who asked to remain anonymous to speak candidly.

"I don't want to overstate my concern; I'm not worried about a return to the 1970s," Quarles continued. "We designed our new monetary policy framework for the very different world we live in now, which involves an equilibrium for the economy with slow workforce growth, lower potential growth, lower underlying inflation, and therefore lower interest rates. One of those differences is that the kinds of wage-price spirals that characterized inflation dynamics in the 1970s have not been present for a long time. … The best analysis we currently have is that the rise in inflation to well above our target will be temporary. But those of us on the FOMC are economists and lawyers, not prophets, seers, and revelators. We could be wrong, and what happens then?"

His answer: If inflation overshoots or undershoots the central bank's long-term 2 percent goal, "the Fed has the tools to address inflation that runs too high, while it's more difficult to raise inflation that falls below target. If we're wrong, we know how to bring inflation down," namely phase out the $120 billion monthly bond purchases and start raising interest rates sooner than planned. "Ultimately what drives inflation is people's expectations about what they're going to need in the way of wages, which then feeds into prices, which then feeds into wages," Quarles said, "and if that cycle starts, that's really what drives the kind of inflation spiral that gets difficult for the Fed to control. And I think those are imperfectly measured."

Fed Chair Powell put the quandary about the course of inflation more succinctly following the June 16 FOMC meeting: "We really don't have a template or any experience of a situation like this. We have to be humble about our ability to understand the data."

The Fed certainly should be humble considering its dubious track record over the decades. In the 1930s, it tightened lending during the depth of the Great Depression, which made the downturn even worse. In 1971, when summoned to Camp David, Chair Arthur Burns appeared to succumb to White House pressure to lower interest rates to help President Nixon's re-election, only to unleash runaway inflation a few years later with the help of twin oil shocks. In the early 1980s, Chair Paul Volcker had to reverse policy sharply and virtually overnight, when it became clear the Fed had tightened too much and was putting the economy in grave danger. More recently, Powell himself has been criticized for one too many rate hikes in December 2018, which forced the Fed to start cutting rates in 2019.

Humility is in order, indeed. Perhaps, as Greenspan wisecracked, Powell and Co. will construct a new inflation model—to explain in later years what they did right or wrong in 2021. ◆