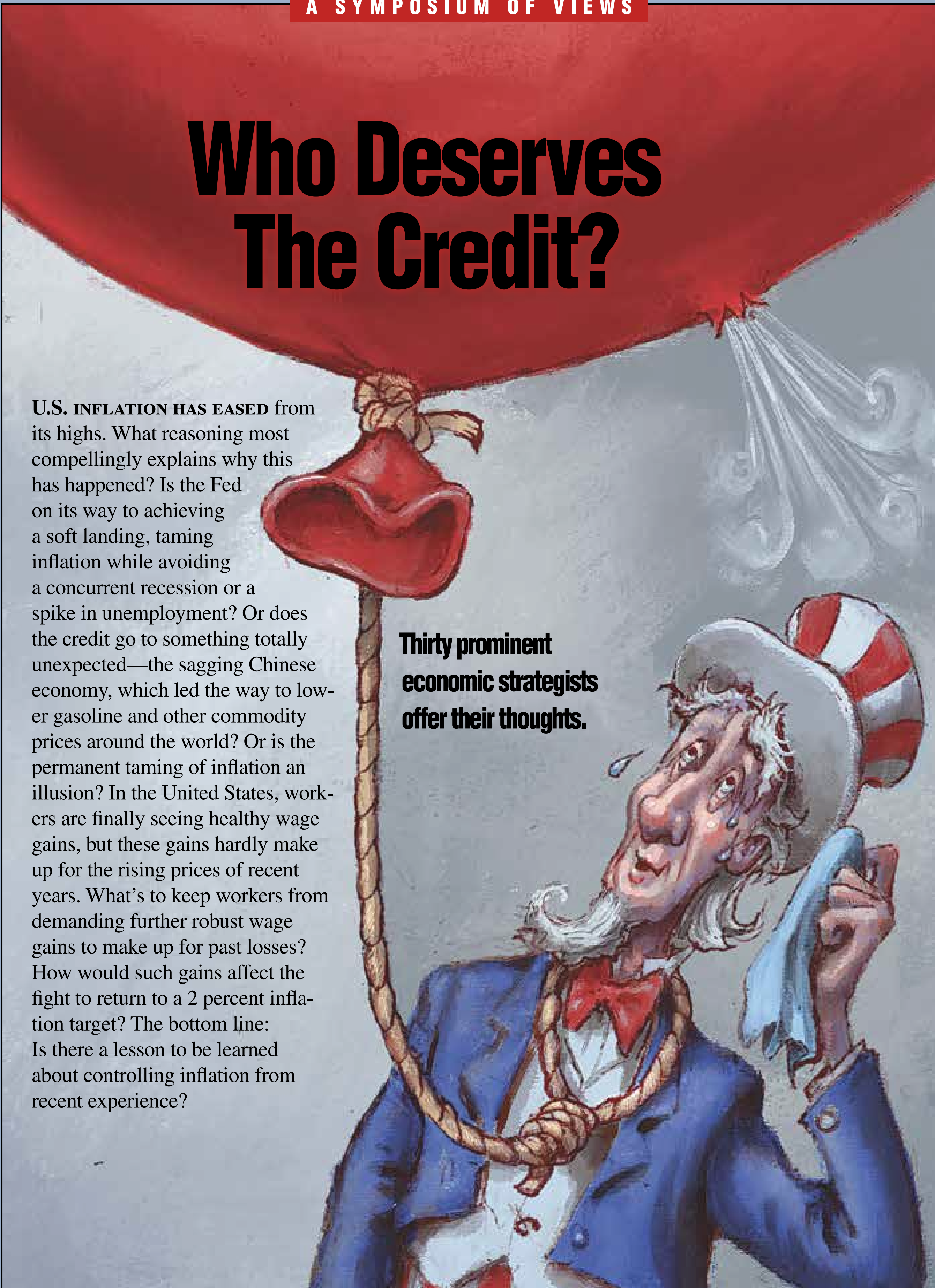
A SYMPOSIUM OF VIEWS

Who Deserves The Credit?



U.S. INFLATION HAS EASED from its highs. What reasoning most compellingly explains why this has happened? Is the Fed on its way to achieving a soft landing, taming inflation while avoiding a concurrent recession or a spike in unemployment? Or does the credit go to something totally unexpected—the sagging Chinese economy, which led the way to lower gasoline and other commodity prices around the world? Or is the permanent taming of inflation an illusion? In the United States, workers are finally seeing healthy wage gains, but these gains hardly make up for the rising prices of recent years. What's to keep workers from demanding further robust wage gains to make up for past losses? How would such gains affect the fight to return to a 2 percent inflation target? The bottom line: Is there a lesson to be learned about controlling inflation from recent experience?

Thirty prominent economic strategists offer their thoughts.

Tighter money, higher real rates, and crowding out have reined in the boom and made room for crowding in of green investment. An excellent set of outcomes.

ROBERT J. BARBERA
Director, Center for Financial Economics, Johns Hopkins University

How much of the recent swings for U.S. inflation reflect policy? Imagine a world akin to the dream in place in early 2000. No wars, no plagues, and certainly no coup attempts. In such quiescent circumstances, the ups and downs of key macroeconomic barometers can signal good or bad policy. But for 2020–2023?

In succession, the world experienced a once-in-a-century pandemic, a war eclipsing any European conflagration since World War II, and just for good measure, a coup attempt in the United States. Is it reasonable to assert that policy adjustments could have ensured steady macroeconomic performance?

Of course, policy matters amid crisis. Indeed, it matters much more. That said, how one defines success or failure can be very different. The 2020–2023 period forces us to stop and think about what could have gone very badly, and what was a reasonable price to pay to mitigate against deep and protracted decline.

Economic forecasts for 2021—as shown in the Philadelphia Fed survey—went from confident to confused after covid hit. By May 2020, forecasters collectively thought there was only a 16 percent chance that unemployment would fall below 6 percent, and they saw a 25 percent chance that joblessness would exceed 10 percent.

Amid such panic and confusion, policymakers rightly took extraordinary steps in 2020.

What about in 2021 and 2022? Again, amid the dreamlike geopolitical backdrop of spring 2000, limited additional fiscal stimulus and rapid removal of easy money might have made sense. But joblessness was still near 7 percent as Joe Biden took office, and much of the Republican Party, in full denial on climate change and election outcomes, was chomping at the bit to regain power and derail all attempts to kick the fossil fuel habit. In such circumstances, rapid recovery had to be a priority. And offering carrots was the only politically viable strategy to jumpstart investing in the green economy.

That was tried, and it worked.

The economy surged, unemployment plunged, and a boom in renewables investment ensued. To be sure, inflation leapt. But most of the wave of unsettling price pressures has come and gone without any material rise for U.S. unemployment.

What about Federal Reserve policy? Aggressive Fed tightening has been slowing jobs growth, hopefully ahead of any second-stage wage-push inflationary pressures. The striking rise for borrowing costs suggests investment will be curtailed, but not in the renewables energy space. So tighter money, higher real rates, and some crowding out have reined in the boom and made room for crowding in, if you will, of green investment. In all, an excellent set of outcomes amid a once-in-a-lifetime (hopefully) set of extraordinary shocks.

What are the prospective risks for a resurgence of inflation? Many economists using a Phillips curve framework have their eyes trained on wage settlements. My angst lies elsewhere. A return to $6 gas engineered through slashing of Saudi/Russian output is clearly the last best hope for Donald Trump and, in turn, Russian President Vladimir Putin. The possibility that Mohammed bin Salman may see this as an opportunity for Saudi Arabia to achieve serious global power in the dystopian world that would define a second Trump presidency? Sad.

I would be surprised if inflation continues falling. Perhaps the most important lesson is the power of central bank credibility and the inflation anchor.

JASON FURMAN
Aetna Professor of the Practice of Economic Policy, Harvard University's Kennedy School, and former Chair, President's Council of Economic Advisors

There are endless debates about the best models for inflation, but one thing just about every economist agrees on is that it is best to look at inflation excluding food and energy—that is, to look at core inflation. While headline inflation rose to 9 percent, core inflation never rose above 5 percent. And while the pace of inflation in recent months has been as low as 2 percent, when you exclude food and energy, it has been 3 percent. In other words, the majority of the decline in inflation was due to external events. Inflation rose unusually high due to the Russian invasion of Ukraine and rising oil prices, and now it is unusually low as the oil price increases reverse.

Stripping away volatile factors, my estimate of underlying inflation has fallen from about 4.0–4.5 percent to 3.0–3.5 percent. It is less clear what caused this 1 percentage point reduction in inflation, but part of it was an unusual immaculate loosening in labor markets that followed the unusual immaculate tightening in labor markets. Specifically, job openings fell from extremely high to merely high without the unemployment rate rising—thus cooling off labor markets.

As of now, I see no reason to revisit any of our economic theories based on these experiences. But I would be surprised if inflation continues falling to 2.5 percent and would be very surprised if it falls to 2 percent. If that happens, a greater degree of rethinking will be in order—with perhaps the most important lesson being the power of central bank credibility and the inflation anchor.

Progress on supply side factors has played an important role in the U.S. economy's recent improbable performance.

BRIAN C. DEESE
Former Director, White House National Economic Council

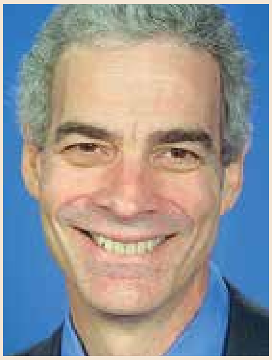
While the final chapter of America's recovery has not been written, progress on supply side factors—aided by sound policy—has played an important role in the U.S. economy's recent improbable performance.

In the last year, the confluence of resilient growth and falling inflation has defied many economists' expectations. Three-month annualized core PCE inflation last month was 2.8 percent, down from 4.4 percent a year ago, while the unemployment rate has stayed largely flat. Globally, the United States has seen the strongest real GDP growth in the G7, and—despite seeing inflation rise and peak earlier in the pandemic—the United States now has the lowest harmonized inflation in the G7, both for overall and core inflation.

While demand factors are at play, the supply side is notable. The unsnarling of supply chains that were historically disrupted by the pandemic took longer than some predicted to filter through, but has eased recent goods inflation. The production of vehicles in the United States has only recently returned to pre-pandemic levels, contributing to easing in new and used car prices. Supply constraints in metals and construction materials have eased, bringing down construction costs even as we are seeing the beginnings of an investment boom in the United States that could deliver longer-term economic benefits.

Perhaps most strikingly, in the labor market, we have seen labor supply rebound strongly. Contrary to the dominant concern that Covid-19 and the fiscal policy response to the pandemic would push millions of Americans permanently out of the workforce, labor force participation has rebounded faster than in any recovery in fifty years. Labor force participation for prime-age workers sits today at its highest level since 2002. This expansion in labor supply has widened the runway for a soft landing by allowing the job market to normalize without a pronounced jump in unemployment or a steep decline in wage growth. It has been aided by strong labor market policies that have helped pull workers off the sidelines—particularly women, immigrants, and people with disabilities.

Supply-driven progress risks reverses in coming months, most worryingly if OPEC+ continues to restrict energy supply in an effort to artificially drive up prices. But the improbable progress we have made to date helps create space for the Fed to be patient going forward, with a more symmetrical view of risks. That is the prudent course. This progress also underscores the value and urgency of additional fiscal policies that would enable further supply side progress—like childcare incentives to help more parents work and incentives to increase the supply of affordable housing.



The Fed has a history of deflecting blame and may be quick to declare victory and tilt its assessment toward attributing the higher inflation to supply constraints rather than monetary and fiscal policies.

MICKEY D. LEVY
Senior Economist, Berenberg Capital Markets, and Visiting Scholar, Hoover Institution

The surge in inflation was generated by excessive fiscal stimulus and the Fed's monetary accommodation that resulted in excess demand aggravated by pandemic-related supply shortages. I predicted the rise in inflation early on ("The Short March Back to Inflation," *Wall Street Journal,* February 3, 2021), and it is baffling that the Fed and its macroeconomic model (FRB/US) failed to predict the inflationary impact of $5 trillion in deficit spending, zero rates, and the Fed purchasing one-half of the new government debt—the root of its misguided monetary policies. Equally dismaying, the Fed and its mainstream consensus blamed the inflation on transitory supply shocks even as nominal GDP, the broadest measure of aggregate demand, soared.

The Fed's misguided policies were accentuated by its ineffective efforts to manage inflationary expectations through forward guidance, followed by bureaucratic group-think that led it to delay raising rates until it had concluded the tapering of its asset purchases ("The Fed: Bad Forecasts and Misguided Monetary Policy," the Hoover Institution Monetary Policy Conference, May 12, 2023). As central banker, the Fed was at fault, but too little blame is attributable to excessive fiscal policies.

The Fed turned the corner in mid-2022 with a series of aggressive rate increases that dampened inflationary expectations and inflation—something its convoluted forward guidance was incapable of doing. The Fed—and Chair Jay Powell in particular—deserve credit for lifting the Fed funds rate above inflation in March 2023, which, combined with declining M2 money, resulted in a restrictive monetary policy.

In response, the growth of nominal GDP has slowed materially, although it is reaccelerating in the third quarter of 2023. Along with easing supply constraints, the slowdown in aggregate demand has reduced inflation. However, core inflation remains sticky and well above target, particularly in services. Aggregate demand must moderate further to be consistent with further progress on inflation.

Fortunately, healthy characteristics in the private sector have protected businesses and consumers from any jarring impacts of the Fed's tightening, providing economic resilience and raising the probability of an economic soft landing. Business inventories are generally low and labor inputs and operating costs are manageable. Regarding consumers, while the excess savings from the government's pandemic excesses that boosted disposable personal income have dissipated, household net worth, a broader measure of savings, has risen to an all-time staggering high of $154 trillion, providing a sizable buffer and increasing the propensity to spend.

The Fed deserves credit, but I worry that key lessons of the last three years will be lost on the Fed. The Fed has a history of deflecting blame and may be quick to declare victory and tilt its assessment toward attributing the higher inflation to supply constraints rather than monetary and fiscal policies. Of note, some Fed members argue that its new strategic plan established in 2019 is sound, but was just implemented improperly. These are worrisome bases for the prospects of maintaining stable low inflation.

The excellent performance of monetary policy can be traced, in part, to the moderating influence of the digital sector on inflation.

MICHAEL MANDEL
Chief Economist & Vice President, Progressive Policy Institute

The economy seems to be making the mythical soft landing, with no recession and slowing inflation. I want to suggest that the excellent performance of monetary policy can be traced, in part, to the moderating influence of the digital sector on inflation. More precisely, inflation actually slowed in the digital sector in 2022, compared to 2019. To the degree that digital products and services such as search, data processing, and wireless are more economically important than they used to be, this slowdown in digital inflation helped create the conditions for a soft landing.

We cite price data from the Bureau of Economic Analysis's GDP by Industry data set, downloaded September 28, 2023. Overall inflation, as measured by the GDP price index, accelerated from 1.7 percent in 2019 to 7.1 percent in 2022. Value-added inflation accelerated in almost every major industry over this stretch. By contrast, in the information sector, inflation fell from -0.7 percent in 2019 to -1.8 percent in 2022. In the computer systems design industry, inflation fell from -2.9 percent to -3.0 percent.

What these two sectors have in common is that they are leaders in investing in information technology equipment and software. These investments in capacity, combined with intense competition in these sectors, helped bring about the fall in prices.

Now, according to the BEA, the impact of falling prices in the digital sector on overall inflation was visible but not large. That's because according to the official statistics, value added in the digital sector—information plus computer systems design—was only about 7 percent of overall GDP. That's enough to move the needle, but not very far.

But the way we define the digital sector includes all the tech companies, except hardware makers like Intel; all the telecom/broadband/internet providers, including satellite communications providers; all the content producers and distributors, including television networks and movie producers; all data processing companies; and for good measure, media companies such as newspapers.

These are important and pervasive activities, which may enter into the day-to-day economy in ways that are not fully captured by the official statistics, and may have more influence on the economy's inflation performance than the BEA's calculations show. I suggest that the falling prices in these sectors are a key reason why inflation has moderated and the economy has so far escaped recession.

There is a clear prospect of a soft landing, but if this disinflationary dynamic does not continue to play out, central banks may cause a mild recession.

JOSEPH E. GAGNON
Senior Fellow, Peterson Institute for International Economics

A country's inflation rate is determined by global commodity prices, tightness in its labor market, long-term inflation expectations, and occasional unexpected shocks. The labor market effect on inflation is highly nonlinear. When unemployment is high, changes in the labor market have only a small impact on inflation, but when unemployment is low, inflation is very sensitive to labor market conditions.

The covid inflation surge had four components: fiscal packages that supported strong consumer demand; a reduction in labor supply caused by illness, fear of illness, and school shutdowns; the Ukraine war's effect on commodity prices; and supply bottlenecks unique to the pandemic. The first two components affect inflation through the labor market, which was extremely tight in 2021–2022 and is now easing slowly. The proportions differ somewhat across countries, with the Ukraine war more important in Europe and fiscal packages more important in the United States. Supply bottlenecks reflect both direct disruptions from covid shutdowns and the rotation of demand away from services toward goods, which pushed up goods prices much more than it reduced services prices (reflecting nonlinear effects of excess demand at the sectoral level).

The dog that did not bark is long-term inflation expectations, which have been remarkably stable, a testament to central bank credibility. Central bankers are determined to protect their credibility with tighter policy already adopted and a promise of further tightening if needed.

Given the stability of expectations, all that was needed to bring inflation back down was a reversal of the factors that drove it up in the first place. Commodity prices have eased, fiscal packages are long behind us, workers have returned, and demand is rotating back toward services. Ultra-low inventories, especially in the auto sector, suggest that the process is not yet complete, and the current autoworker strike will not help.

As inventories rebuild, competitive pressure in goods markets should restore the long-run downtrend in goods prices relative to wages, which will enable workers to recoup their lost purchasing power even as wages also slow. The prospect of a soft landing is clear, but if this disinflationary dynamic does not continue to play out, central banks may be forced to tighten further and cause a mild recession.

Assertions that a single macroeconomic policy benefits society without losses for some and gains for others seem less like sophisticated technocratic expertise and more like unwitting political suicide.

MICHAEL LIND
Fellow, New America, and author,* Hell to Pay: How the Suppression of Wages Is Destroying America *(2023)

The lesson of the Covid-19 pandemic and the inflation that followed is that it is moral and political folly to ignore the different effects of the same conditions and the same policies on different income and occupational groups. According to the Bureau of Labor Statistics, for example, workers in the leisure and hospitality sector suffered 16.7 percent unemployment in December 2020, compared to 7.4 percent in other services and 6.1 percent in business and professional services. Workers in leisure, hospitality, and other low-wage service sectors next suffered more than most from post-pandemic inflation. Now the costs of the higher interest rates that the Federal Reserve has used with some success to moderate inflation tend to fall most heavily with those with the least ability to bear increases in car payments and mortgages. Those who suffered the most from the disease also suffer the most from the cure.

At the other end of the U.S. class hierarchy, members of the "laptop class" often kept their jobs and survived the pandemic in comfort, with help from Zoom and home delivery services. Most of the pandemic-era savings whose depletion has helped provide a soft landing to date were accumulated by the affluent. And the well-to-do are less threatened than the working poor by higher interest rates.

In America's increasingly unequal and polarized society, confident assertions that a single macroeconomic policy benefits society as a whole, without losses for some and gains for others, seem less like sophisticated technocratic expertise and more like unwitting political suicide. The U.S. economy has become a post-industrial version of a dual economy, with the low-wage service sector playing the role of the low-wage rural sector in a half-modernized developing country. The political pathologies of such dual economies, from demagogic populists to widespread alienation, are increasingly evident in the United States.

Having a Third World service sector inside a First World country is a formula for political instability and social decay, in the United States and elsewhere. Perhaps the Federal Reserve needs a third mission, in addition to its mandates of seeking price stability and full employment in general. This hypothetical third mission might be to prefer policies that would help, rather than undercut, concurrent fiscal and labor market reforms, including permanent, sector-specific pay increases, that are necessary to integrate the American "precariat" into the prosperous working class. The alternative is to treat millions of the working poor—the first to suffer from lay-offs, the last to be hired, and the most affected by interest rate hikes—as shock absorbers for an economy that chiefly benefits better-off Americans.

The further pass-through of the easing of supply constraints and decline in shelter inflation alone may get the job done.

LAURENCE MEYER
Former Member, Federal Reserve Board of Governors

Explaining the soaring inflation we have experienced and the disinflation that now appears to be underway is not difficult: Supply and demand.

We know the demand story: A very brief but very sharp downturn that drove inflation from 2 percent to zero, followed by large fiscal stimulus and reopening of the economy, which helped to lower the unemployment rate back to its pre-pandemic level when core inflation was 2 percent. And we also know the supply story: Pandemic-related supply constraints precipitated a temporary inflation impulse. The result was a collision between the sharp increase in demand and constrained post-pandemic supply. And then there was a more traditional supply shock coming from the war in Ukraine and a rise in shelter inflation, a temporary acceleration as the earlier sharp rise in home prices passed through to rents.

There is also a labor market story: The recovery in labor supply following the pandemic-related decline was disappointingly slow. But supply is increasing, the labor market is cooling, and wage growth is moderating.

With respect to monetary policy, the Fed's new framework and the associated forward guidance were problematic. First, it made policy asymmetric: responsive to the unemployment rate rising, but not falling. This ruled out preemptive policy. The Federal Open Market Committee also had trouble developing an operational definition of maximum employment. In the end, it couldn't raise rates until it thought it had achieved maximum employment, at which point inflation was already 2 percent and the FOMC was way behind the curve. But the market understood the FOMC's reaction function and reacted in advance of the first rate hike.

What about the disinflation now underway? So far, it's about an easing of supply constraints and moderation in shelter inflation. What about demand? The economy slowed in 2022 to a below-trend rate, but the unemployment rate remained near a fifty-year low. Yet growth has accelerated this year to an above-trend rate.

So who or what is to blame, and who or what gets credit? Fiscal policy gets some blame, but it's hard to say that it was inappropriate given the circumstances and outlook at the time. Monetary policy gets some blame. It accommodated the fiscal stimulus, but that was understandable under the circumstances. The new forward guidance delayed easing. The FOMC also engaged in massive asset purchases to calm financial markets but did not slow them down when markets calmed. Instead, it morphed into further policy stimulus. Still, it has communicated its reaction function to the markets and maintained its credibility.

How do we get the last mile of disinflation? So far, through an easing of supply constraints. As a result, monetary policy may not deserve much credit. While Fed Chair Jay Powell said that a period of below-trend growth is expected to be required to get the job done, I believe the further pass-through of the easing of supply constraints and decline in shelter inflation alone may get the job done. Still, if there is a soft landing…

STEPHEN G. CECCHETTI
Rosen Family Chair in International Finance, Brandeis International Business School; Chair of the Advisory Scientific Committee, European Systemic Risk Board, and co-author,* Money, Banking and Financial Markets, *2020, Sixth Edition

KERMIT L. SCHOENHOLTZ
Clinical Professor Emeritus, New York University's Leonard N. Stern School of Business; former Chief Global Economist, Citigroup; and co-author,* Money, Banking and Financial Markets, *2020, Sixth Edition

Employment costs are about 4.5 percent higher than a year ago, while nonfarm productivity is increasing about 1.5 percent annually; this is consistent with inflation of 3 percent, not 2 percent.

When the Fed began its current tightening cycle, U.S. trend inflation was running above 5 percent. Since 1950, the Fed has never lowered trend inflation by 3 percentage points without a recession. Will this time be different?

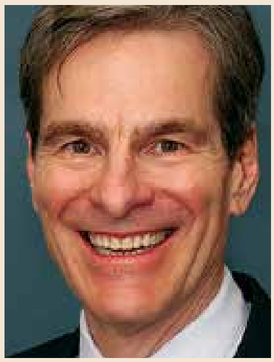
Disinflation already has advanced further without any rise in the unemployment rate that experience suggests. That success reflects both the fading impact of massive supply disturbances—the pandemic and the Russian invasion of Ukraine—and the Fed's aggressive, if belated, tightening that has capped inflation expectations while helping to slow the pace of aggregate demand. Fading fiscal stimulus, restrained regional bank lending, and slowdowns abroad also are playing a role.

Perhaps most impressive is the flexibility of the U.S. labor market. By one measure—the ratio of vacancies to unemployment—labor market conditions remain tighter than they were in any previous inflationary episode since the early 1970s. Yet, as Fed economist Andrew Figura and Fed Governor Chris Waller anticipated more than a year ago, vacancies are plunging without a rise of the unemployment rate. This is indeed unprecedented.

If things continue to break in their favor, Chair Jay Powell and his Federal Open Market Committee colleagues will be able to take credit for engineering the greatest soft landing in Fed history.

That said, trend inflation is still in the 3–4 percent range, and it remains unclear that policy is sufficiently restrictive to drive it down to the 2 percent target by 2025 without a substantial increase in labor market slack. Employment costs are about 4.5 percent higher than a year ago, while nonfarm productivity is increasing about 1.5 percent annually; this is consistent with inflation of 3 percent, not 2 percent. It would hardly be surprising if further disinflation were associated with a rise of the unemployment rate to about 4.5 percent, as policymakers themselves predicted in June.

While fortune may favor the bold, it is not a basis for economic forecasting. Is the Fed now rewriting economic history? That still seems more like the triumph of hope over experience.



The Fed did not cause this inflation, so there is no reason to think its actions are solely responsible for its end.

JOHN H. COCHRANE
Senior Fellow, Hoover Institution, Stanford University, and author,* The Fiscal Theory of the Price Level *(2023)

Our bout of inflation has a clear cause: In 2020–2022, the U.S. government printed $3 trillion of new money, borrowed $2 trillion more, and sent checks to people and businesses, with no plan or promise of how the new debt would be repaid. People spent the bonanza, sending the price level up. Such a one-time fiscal blowout leads to a one-time rise in the price level, a surge of inflation that eventually goes away even if the U.S. Federal Reserve does nothing. Formal modeling backs up this statement. The Fed has some power to guide inflation, but the Fed did not cause this inflation, so there is no reason to think its actions are solely responsible for its end. However, fiscal policy is not on a sustainable path, and new bouts of fiscal inflation can break out if people do not gain faith in the value of government debt.

The Fat Lady has not yet sung on any stage. The funds rate will have to remain at this level, or more likely higher, for another eighteen months at least.

EDWIN M. TRUMAN
Senior Fellow, Mossavar-Rahmani Center for Business and Government, Harvard Kennedy School, former Assistant Secretary for International Affairs, U.S. Treasury, and former Director, International Finance, Federal Reserve Board

It is too early to say who deserves the credit for taming the recent surge in inflation around the world. The Fat Lady has not yet sung on any stage. No major economy with the anomalist exception of China has an inflation rate for consumer prices of 2 percent or less. It follows that it is too early to learn the lesson or lessons about reducing inflation from recent experience.

No two inflation shocks are alike because their origins differ, and the prevailing macroeconomic conditions differ across countries and in different time periods. This episode is unique because the supply shocks came from several directions at roughly the same time and the forcefulness of the policy responses differed in timing and vigor.

What we, or at least I, can say at this hoped-for midpoint in success for countries that do succeed is, first, the monetary authorities should act quickly; second, they should act forcefully, and last, they should not prematurely declare victory. Look at the United States in the 1970s when the Federal Reserve did not act at all to the 1973 shock, and delayed acting to confront the rising inflation before the 1979 shock. By contrast, in the current episode the Federal Open Market Committee should have acted sooner, but they missed by at most a few months, and so far, have kept at it. They should not declare victory. It is not necessary that the result of their policy is a U.S. recession, but some rise in unemployment is inevitable if the inflation is to return to something like 2 percent. The Fed has been at it for about eighteen months. History tells us that it is likely that the funds rate will have to remain at this level, or more likely higher, for another eighteen months at least.

The wheel is still very much in spin. The answer will be found in geopolitics.

LYRIC HUGHES HALE
***Editor-in-Chief,* EconVue**

The answer to this question seems to be changing almost daily. In fact, soon there might be a new question—"Who deserves the blame?"—particularly now that gasoline prices have continued to rise amid historic low supplies and producer-induced production cuts. China might no longer play the role of the spoiler in the latter half of this year if their brand of fiscal stimulus succeeds, which would likely push up commodity prices worldwide.

U.S. inflation surprised on the upside recently, driven by energy and food prices. Are higher levels of inflation temporary, or has covid permanently affected the global economy in ways we are just beginning to understand? It is conceivable that the world's largest exogenous economic shock might have altered the world's trajectory, much like a powerful meteorite can knock a planet into a new orbit.

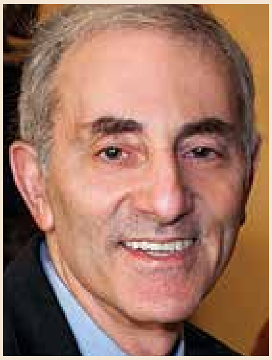
In the long run, overall demand will decline due to changing demographics. In the medium term, geopolitics is driving economic policy. Political instability, conflict, and a raft of elections in 2024 will create both internal strains and external trade tensions which show no signs of abating. It is not just U.S.-China trade—the European Union is about to take legal action against China for dumping electric vehicles.

As *TIE*'s question foresees, workers are demanding higher wages. The unprecedented United Auto Workers strike across all manufacturers could embolden other unions to do something similar. In a full employment economy, there could undoubtedly be inflationary consequences. If covid aftershocks have permanently or prematurely sidelined some workers, U.S. manufacturing will struggle to find manpower. This could lead to decreased production and increased prices, and a supply-induced recession.

What could keep inflation down? Technology and innovation. Productivity seems to be ticking up. In addition, the IMF/World Bank is projecting slower global growth, which should be a headwind for inflation. However, efforts in the world's two largest economies to create greater self-sufficiency will increase costs even as they decrease risks. Redundancy is expensive.

It could be that the 2 percent inflation target has simply become outdated, and 3 percent is more practical in the world we now live in. Federal Reserve Chair Jay Powell did his best to deny this at Jackson Hole this August, but 2 percent is after all an arbitrary number. A U.S. inflation target was first set by Congress in 1977. The Humphrey-Hawkins Act legislated a goal of 4 percent unemployment and 3 percent inflation. Of course, no law can guarantee these numbers in the real world. Neither can the Fed.

The wheel is still very much in spin. It is not just about incoming economic data—the answer to the question will be found in geopolitics. If the last few years have not taught us humility in economic forecasting, nothing will.



Lessons for the Fed: stick to data dependence. And thank those who take on thankless task of serving on the Fed's board.

ROBERT E. LITAN
Non-Resident Senior Fellow in Economic Studies, Brookings Institution

The honest answer to all of the questions posed is "Who knows?" That's because the single greatest lesson from the inflation and disinflation episodes since the pandemic and Russia's invasion of Ukraine is that macro models literally go haywire with supply shocks. That's why the Fed has had no other choice than to pursue a data-dependent monetary policy.

So far, it seems to be working, but another part of the "who knows?" problem is that we still don't know the length and magnitude of the lags in monetary policy. We may get that soft landing, or it may get bumpier and harder in the months ahead. But the fact that core inflation has come down so far gives the Fed the time to pause its disinflation campaign to wait and see, and then if necessary, tighten up further until it gets the 2 percent core rate it is committed to achieving. (For those who want a higher inflation target, sorry, that ship has sailed; the Fed would lose too much credibility for it to backtrack now.)

The future inflation outlook is not much clearer. Seemingly permanent deficits in the 5 percent of GDP range, or higher, point to higher inflation down the road. But AI-driven productivity increases could be substantial, and thus exert a major moderating impact. No economist I know—or anyone else, for that matter—has a good crystal ball, however, for predicting productivity growth with any precision. My own guess, and that is all it is, is that any productivity increase that materializes will not be enough to fully offset the deficit-driven inflationary bias that seems baked into our economy.

I am more certain that the inflationary tilt will not disappear anytime soon. Our politics are even more polarized than when the Obama-Boehner budget deficit deal almost happened in 2011. And there is no political will, in our two parties and among voters, to agree on the kind of grand bargain that marries trimming of future entitlement spending and higher taxes. Both political parties are too afraid to touch Medicare and Social Security (although Republicans are more than willing to cut Medicaid). Both parties, too, are fearful of any tax increases, except for Democrats who don't mind taxing the rich, but then only for the purpose of new social spending, which I agree is required to expand economic opportunity, but not for deficit reduction.

As for workers demanding higher wages feeding into higher prices, much will depend, as I write this, on the outcome of the auto strike and the magnitude of the wage increases that auto workers eventually will get. A substantial wage boost will encourage workers elsewhere to seek similar deals, but that effect will be moderated if, as I expect, economic growth cools and unemployment increases somewhat.

As for lessons for the Fed: stick to data dependence. And thank those who take on thankless task of serving on the Fed's board.

I'm betting the economy will move into a mild recession.

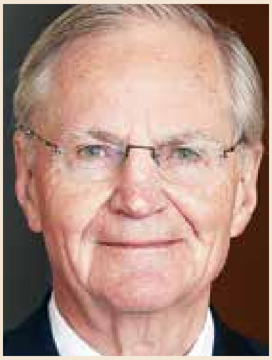
STEVEN B. KAMIN
Senior Fellow, American Enterprise Institute, and former Director, International Finance, Federal Reserve Board of Governors

It is difficult to pin down the reasons why U.S. CPI inflation has fallen so much since last summer—from 9 percent in June 2022 to 3.7 percent in August—when we don't fully understand why prices surged so much in the first place. But several explanations seem plausible. First, and most obviously, oil prices have reversed much of their earlier surge. Second, many of the supply disruptions leading to shortages immediately following the pandemic recession are now largely resolved. Third, the sharp rise in the dollar over the past couple of years has helped hold down import prices. And fourth, tightening monetary policy has not only pushed up the dollar but likely has helped to restrain spending, at least relative to if the Fed had kept rates unchanged.

Finally, despite widespread angst about a wage-price spiral, earnings growth has also cooled. The U.S. Bureau of Labor Statistics' average hourly earnings index slid from 5.9 percent growth in May 2022 to 4.3 percent this July. As many observers have pointed out, this is still higher than is consistent with the Fed's 2 percent inflation target. But it's not that much higher. From 2001 to 2019, wage growth exceeded inflation by almost 1 percentage point, consistent with rising labor productivity. So assuming earlier trends continue, wage growth will only need to slow to around 3 percent for the Fed to achieve its goal.

Moreover, insofar as wages have barely kept up with prices since the pandemic started, they include almost no compensation for productivity growth over the past three years. This implies a "wage gap" between real wages and their trend level and, for firms, inflated markups of price over cost. As my colleague John Roberts (former macro-modeler for the Fed) and I have analyzed in a recent paper, there are different ways this gap can be resolved. If workers decide not to claw back their lost compensation while monetary policy remains tight, we will likely see declining wage growth and sustained disinflation, but at the cost of higher unemployment and sustained shortfalls in real wages. Conversely, if workers seek greater wage gains but firms pass on all additional costs to consumers, this will trigger a wage-price spiral with much higher inflation, much higher interest rates, and much higher unemployment. Finally, if slowing demand helps push down inflated markups, disinflation could proceed alongside a recovery of real wages, allowing for lower interest rates and a soft landing for the economy.

It is too soon to say which of these scenarios will prevail, but I'm betting on a messy combination of all three: further declines in wage growth will be slow; weakening demand and shrinking markups will lead inflation to fall just a bit faster; the Fed will keep interest rates high for much of the coming year; and the economy will move into a mild recession. Not the best possible outcome, but if the result is an eventual return of inflation to around 2 percent, Fed Chair Jay Powell can and will put it in the win column!



It may be too early to break out the champagne.

WILLIAM R. CLINE

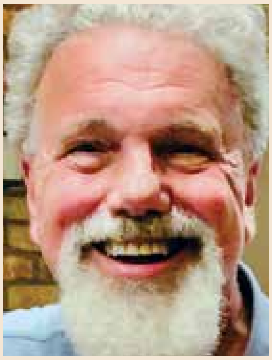
President, Economics International Inc., and Senior Fellow Emeritus, Peterson Institute for International Economics

Despite recent good news on inflation, it may be too early to break out the champagne to celebrate and debate who deserves the credit. U.S. trend inflation calculated as the average of six-month annualized rates for four measures (Consumer Price Index and Personal Consumption Expenditures price index, with and without food and energy) reached a peak of 7.4 percent in June 2022 and plateaued at about 4 percent in the first half of 2023. It is encouraging that this measure fell to 3.1 percent in July, but a similar large decline that occurred in December was followed by a rebound in January.

As for credit or blame, it is important to recognize that although Covid-19 supply disruptions plus the outbreak of the Russia-Ukraine war contributed to the surge in inflation, so did excessive U.S. pandemic relief fiscal expenditures. Only about 40 percent of those expenditures were focused on sectors and recipients most affected by the pandemic. Comparison of timing of consumption expenditure flows from the fiscal stimulus against potential output under constrained supply conditions suggests that perhaps half of the surge in U.S. inflation was attributable to excessive stimulus.

That excess reflected the dominant perception that too little stimulus had been undertaken to bring the economy out of the Great Recession of 2007–2009, leading to a long and slow recovery. There was also a dominant perception that "recession" was synonymous with "deficient demand," whereas the pandemic output loss and unemployment surge stemmed in the first instance from a wartime-like loss of available resources due to lockdowns and social distancing. The political change in 2021 added a strong redistributive impulse, best symbolized by the $1,400 per person checks widely disbursed in the American Recovery Plan.

A central question now is whether the low-inflation anchor to expectations achieved after the 1980s has been dislodged. Some recent labor actions, notably the United Auto Workers' demand for a 46 percent wage increase over the next four years, are not reassuring in this regard. Even so, if a recession is required to reach target inflation, it seems more likely to be mild than severe. A negative legacy of the policy reaction to the pandemic shock has been an increase in the debt burden by about 13 percent of GDP from the pre-covid baseline, and an associated increase of the net interest burden by 2030 from 2.6 percent of GDP to 3.3 percent (Congressional Budget Office projections in May 2023 versus those in January 2020). Moreover, a kinked Phillips curve may mean that policymakers will need to settle for inflation somewhere between 2 and 3 percent rather than pursue 2 percent at mounting cost in unemployment, even though announcing a shift in the target now would likely send the wrong signal about resolve to avoid repeating the mistakes of the late 1960s and the 1970s.



Supply is the wild card.

EV EHRLICH
President, ESC Company, former Undersecretary of Commerce,1993–1997, and former Chief Economist and Head of Strategic Planning, Unisys Corporation

Economists of a certain age and venerability have seen it all regarding inflation. The United States experienced demand-pull inflation in the late 1960s, a rightward shift in aggregate demand driven by the war in Indochina and supported by an egalitarian recovery in which labor's share of national income rose from a then-trough to a still-peak. In the late 1970s, it was cost-push inflation following OPEC II—a leftward shift in aggregate supply superimposed over widespread indexing in labor arrangements.

Today, we confront both of these issues. Covid (particularly in China) and the Russian aggression in Ukraine have pushed supply inward as U.S. fiscal deficits have pushed demand out. And now that inflation is dampening, we should look for credit using the same lens. Supply is stabilizing as covid contagions recede, although Ukraine remains an open question. And Fed Chair Jay Powell's visible and effective commitment to stabilizing prices has helped soften demand and, more pointedly, expectations—implied ten-year expected inflation is now 60-plus basis points below its peak of last spring.

U.S. fiscal deficits remain and should be expected to be sizable, but are far from the villain in the plot. The current surge in deficits reflects a national response to three challenges. The first is the climate crisis. Granted, a carbon-equivalent tax is (part of) the best response, but here the perfect is the enemy of both the good and the planet; the budget-busting response to clean-energy tax incentives denotes a good thing, not a bad one. Similarly, we have had years of "infrastructure week" promises but we now will have an "infrastructure decade" of results. And the third challenge is preserving the high-tech industrial base given the (probability unknown) prospect of a long-term conflict with China. The first is existential, the second imperative and overdue, the third a hedge against alarming geopolitical conflict. No one would defer meeting these needs because of short-term fiscal concerns. As financier Felix Rohatyn would have said, would you have told Jefferson not to purchase Louisiana?

Congress could have paid for these with tax increases or entitlement reform. Yeah, sure. So it left to Powell the job of fitting the demand potatoes in a smaller supply bag. He is doing that job adroitly, aided (paradoxically) by the "budget-busting" covid stimulus checks that shored up consumer balance sheets and helped make the unicorn-like "soft landing" likely.

Inflation is down, but not out. Supply is the wild card, but that risk is finally two-tailed. The primary long-term issue is not deficits (which have risen to fund inflation-abating investments) so much as a retreat from a globalized productive system and liberal trade rules, which made the Golden Era possible. It was fun while it lasted.

The Fed gets credit after all.

JEFFREY A. FRANKEL
Harpel Professor of Capital Formation and Growth, Harvard University's Kennedy School

Fingers crossed, but the U.S. inflation rate seems to be coming down in a way that few predicted—that is, without a decline in economic activity or employment.

By the traditional rules of Washington politics, the Federal Reserve and the administration should logically get political credit for the soft landing that occurred on their watch, regardless of whether they caused it or not. But political practices provide too low a bar. We want to figure out causation. If tighter monetary policy is responsible for the disinflation, it does not seem to have operated through the usual causal route of declines in output and employment.

Some possible channels of transmission from interest rates to inflation do not pass through GDP or jobs. Three such channels are housing, the exchange rate, and commodity prices. Mortgage interest rates help determine the demand for housing. They have risen sharply. Next, since 2021, the dollar has appreciated 10 percent against other major currencies. (This is the narrow effective exchange rate.) Admittedly, the dampening effect of appreciation on tradable goods prices is much weaker in the case of the United States than it would be in other countries. And finally, an insufficiently noticed channel is that high real interest rates put downward pressure on the prices of commodities. The global price index for all commodities fell more than 40 percent, from March 2022 to July 2023 (as one could have predicted). This is in dollar terms, where the dollar appreciation boosts the effect a bit.

But it is unlikely that the exchange rate, commodities, or housing are the main story. One possible explanation for the rapid fall in inflation, accompanied by very little loss in economic activity, is that when unemployment is below 4 percent, and especially when job vacancies run above 7 percent, decreases in demand go almost entirely into lower inflation, rather than lower economic activity. In other words, the Phillips curve becomes much steeper when near full employment.

An explanation that is potentially more powerful is that supply factors, which had been adverse in 2020–2022, reversed and became favorable in 2023. The decline in commodity prices over the last year has already been noted. In addition, snarled supply chains, and the rest of the covid-related disruptions that so dominated life in 2020–2022, became unsnarled and undisrupted in 2023. Back to normal.

A favorable shift of the aggregate supply curve should allow lower inflation with higher growth. We haven't had rapid growth in 2022 and 2023, just a gentle easing of the torrid growth rate of 2021. (Isn't that the definition of a soft landing?) The withdrawal of monetary stimulus must help explain why U.S. inflation came down rapidly in 2023 nonetheless. If the Fed hadn't raised interest rates after March 2022, chances are that the economy would have truly overheated, notwithstanding the favorable supply shift, and inflation would still be high. So the Fed gets credit after all.

The Fed's pat-on-its-own-back for a "soft landing" is a bit of self-indulgent magical thinking.

JAMES K. GALBRAITH
Lloyd M. Bentsen, Jr., Chair in Government/Business Relations, LBJ School of Public Affairs, University of Texas at Austin

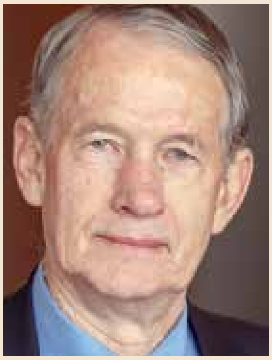
We now have Fed Chair Jerome Powell's own word for it, delivered at Jackson Hole on August 25, 2023: most of the decline in "headline PCE inflation" since it peaked way back in June 2022 is due to "global factors." It is not related to anything the Federal Reserve did or didn't do.

The supposedly non-global "core PCE"—Powell's declared focus—has a large housing component. Housing inflation, which surged until very recently, is driven by rental rates and their derivative, "imputed rents"—a statistical figment supposedly paid by U.S. homeowners to themselves. Homeowners neither suffer nor benefit from those "rents." The actual rental market—the turnover of existing leases in a given month—is comparatively thin, volatile, and consists of units of a different type and quality from most U.S. housing. It is not an indicator of the cost of housing for most Americans. Thus, the Fed's concern with "core PCE" is vastly overblown. Rapidly rising rents are a problem, but it's the "global" elements (food and energy) that most people experience as "inflation."

Further, the Fed's self-declared target of 2 percent core PCE inflation is arbitrary, capricious, and unfounded in law. It does not justify Powell's stated desire to "rebalance" the labor market, a ridiculous euphemism for further damaging American workers, whose bargaining power was already largely destroyed forty years ago. Today's unorganized workforce cannot press for wage increases above inflation, except by a simple, noble refusal to accept bad jobs at crummy pay. Note to Fed: making jobs scarce and wage offers worse won't help with that.

Finally, an amusing irony: There is no evidence that monetary policy has had Powell's intended effect on jobs and wages so far. There is no reason, neither theory nor evidence, to expect high interest rates to quell inflation, except by slowing economic growth and pushing up unemployment. And this has not happened yet. Therefore, whatever happens, the Fed's pat-on-its-own-back for a "soft landing" is a bit of self-indulgent magical thinking.

Most likely prognosis: If rents stabilize, the (mostly irrelevant) core PCE inflation rate will continue to edge down, whatever the Fed does. However, other hits are always possible, notably to energy costs which underpin everything, including core PCE indirectly. The notion that those "global factors" can be separated from what happens in the national economy is another … weird thought.



Higher unemployment and lower job vacancies will be needed to force inflation under 2 percent.

GARY CLYDE HUFBAUER

Nonresident Senior Fellow, Peterson Institute for International Economics

Financial pundits love to speculate on the likelihood and timing of another Fed rate hike, elevating the policy range to 5.50–5.75 percent. But the more important question is whether the Fed will wait until the three-month inflation rate falls decisively below 2 percent before initiating its first cut in the policy rate.

Thanks to a fortuitous drop in energy prices, mid-year 2023 inflation measured by the personal consumption expenditure index fell below 4 percent. Influential commentators quickly claimed "mission almost accomplished" and urged the Fed to ease just as soon as inflation falls below 3 percent. Without being explicit, these soothsayers want the Fed to abandon the 2 percent target that was officially adopted by Chair Ben Bernanke in 2012.

That would be an awful mistake. If Fed actions tolerate persistent inflation above 2 percent, the Fed will lose a chunk of its hard-earned credibility—even if Chair Jay Powell continues to insist that 2 percent remains the target. Bond holders will conclude that the Fed is unwilling to endure a recession in a presidential election year. Treasury bond rates will grow accustomed to a floor of 4 percent, rather than drift back to the pre-pandemic rate under 2 percent.

If inflationary forces could be slayed with unemployment below 4 percent and with job vacancies far exceeding the number of idle workers, at a time when non-farm productivity growth hovers at 1.4 percent annually, Powell's dream of a soft landing would come true. But experience and arithmetic indicate that higher unemployment and lower job vacancies will be needed to force inflation under 2 percent.

China and its partners seek to push the dollar off its perch as the world's core currency. The Fed should not help the BRICS club by going squishy on the inflation target.

PETER R. ORSZAG

CEO, Lazard, former Director, Office of Management and Budget, and former Director, Congressional Budget Office

WILLIAM MURDOCK III

Associate, Special Opportunities Group, Lazard, and former Policy Advisor to U.S. Senator Chris Murphy

The natural dissipation of transitory pandemic-era factors and the Fed's contractionary monetary policy deserve credit for the reduction in inflation.

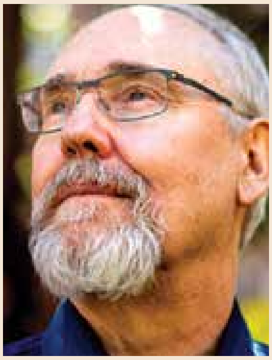
In a note published this past spring, Peter directly answered a key component of this question with co-author Robin Brooks, chief economist of the Institute of International Finance. The paper found that in the final quarter of 2022, 70 percent of core U.S. inflation could still be attributed to lingering effects of supply chain disruptions at the height of the Covid-19 pandemic. Recent research by Nobel laureate and former Federal Reserve Chair Ben Bernanke and economist Olivier Blanchard is at least partially consistent with these findings, showing that transitory factors such as shocks to commodity prices and supply chain shortages played outsized roles in generating excess inflation through the first quarter of 2023.

The large contribution of pandemic and other non-permanent forces to the inflation spike might suggest to some that the Fed played almost no role in easing inflation—inflation would have fallen on its own, right? One must acknowledge that the Fed's unprecedented 525 basis points of rate hikes had some effect, though. This is true for at least two reasons. First, the increased rates reduced demand in some disrupted sectors, reinforcing the disinflationary impact from easing supply chain dynamics. For example, rising interest rates for financing new and used cars have depressed auto loan applications and increased loan rejection rates to all-time highs, contributing to price drops. Similar dynamics are playing out in the housing market. Second, the Fed's actions underscored their commitment to tackling inflation, thereby keeping inflation expectations anchored (though there was no evidence of a threat to those expectations becoming unanchored even in the absence of the Fed action). One-year ahead inflation expectations were only 0.5 percent higher in August 2023 than they were in January 2021. With anchored expectations, the tight labor market has thus far had relatively little impact on inflation. And with both labor market tightness and inflation expectations trending downwards, we believe the economy will avoid an entrenched wage-price spiral.

We expect researchers to dedicate countless future publications to untangling the forces that contributed to pandemic-era inflation easing, but initial research suggests that both elements discussed above—the natural dissipation of transitory pandemic-era factors and the Fed's contractionary monetary policy—deserve credit for the reduction in inflation we have observed thus far. We would put more weight on the pandemic easing channel than the central estimates of research to date, but this question deserves more scrutiny.

The risk at this point is that the Fed's actions may have played a minor role in disinflation to date and the economic pain from this tightening has not been fully felt yet. Across economic studies, estimates of the lag between monetary tightening and the full impact flowing through to the economy range from two quarters to more than eight quarters. Given that all 525 basis points of monetary tightening occurred within the past eight quarters, and 100 basis points occurred in 2023 alone, we believe a sizable portion of the Fed's impact has not yet materialized. With the U.S. economy already showing some areas of weakness—such as increased consumer credit strain, commercial real estate distress, and the collapse of some regional banks—unnecessarily tight monetary policy could have significant negative effects.

In general, we believe central banks should move slowly in combating inflation when the sources of that inflation are ambiguous and long-term inflationary expectations remain well-anchored.



The decline in inflation was inevitable—or almost inevitable.

WILLIAM T. DICKENS

University Distinguished Professor of Economics and Public Policy, Northeastern University

Unemployment in the United States is around 3.5 percent and has been below 4 percent for about eighteen months. Yet year-over-year CPI inflation has fallen from just under 9 percent to just over 3 percent. Behind this mystery hides two other mysteries: Why was the inflation from a transitory supply shock so persistent, and how is it that the United States is able to maintain such low unemployment without accelerating inflation?

The answer to the first question that I find most compelling is that transient supply shocks necessarily take a while to work their way through the system. Watching inflation at the product category level over the last year, I believe I saw a pattern where inflation began to fall first in the areas most directly exposed to the supply shocks—oil and grain price increases due to Russia's invasion of Ukraine and supply chain problems due to covid—and then cascading through the economy to those products affected most indirectly by the price shocks.

Contributing to the slow evolution of inflation in response to the shock is the problem with the way the housing component is computed that makes it reflective of conditions as much as a year previous. But if the inflation shock was, ultimately, transient, how is it that 3.5 percent unemployment hasn't triggered a wage-price spiral as most estimates of the Phillips curve suggest it should? In the 2000 Brookings Papers on Economic Activity, George Perry, George Akerlof, and I proposed a theory of a non-linear Phillips curve with a minimum unemployment rate with inflation in the 2 percent to 4 percent range. Inflation lower than that doesn't allow wage adjustment. Inflation higher than that causes economic agents to start building inflationary expectations into wage- and price-setting causing the sort of spiral we saw in the 1970s.

However, most of our estimates in that paper placed the lowest sustainable level of unemployment in the 4 percent to 5 percent range. But these estimates relied heavily on data from the 1970s and 1980s. Estimates of the natural rate using standard Phillips curves suggest that it fell by about a percentage point between the mid-1980s and late 1990s (see Jessica Cohen, William Dickens, and Adam Posen in *The Roaring Nineties,* edited by Alan Krueger and Robert Solow, Russell Sage Foundation, 2002, for an explanation why). Thus I would argue that the decline in inflation was inevitable—or almost inevitable.

In my story, the Fed gets credit for two things. First, by maintaining credibility, it kept inflation expectations anchored which allowed people to go along without building inflationary expectations into wage and price setting, thus avoiding a wage-price spiral. Second, fiscal policy was remarkably effective in bringing a quick end to the covid recession, but it is quite possible that without the Fed's interest rate increases unemployment could have descended into a range incompatible with steady inflation. So credit to the Fed for having learned the hard lessons of the 1970s and 1980s about the importance of credibility, and stable and low inflation expectations.

The problem was always temporary supply disruptions, rather than fundamental macroeconomic imbalance.

J. W. MASON
Associate Professor of Economics, John Jay College of the City University of New York, and Fellow, Roosevelt Institute

The recent fall in U.S. inflation looks consistent with the idea that the problem was always temporary supply disruptions, rather than fundamental macroeconomic imbalance. Resolving these disruptions took longer than most on "Team Transitory" expected. But the basic story was right.

There is little evidence that disinflation is the result of monetary tightening. Think about the usual story for how monetary policy works. Higher interest rates discourage investment, reducing the flow of spending in the economy. This affects inflation both directly, and via weaker labor markets; with less demand for labor, workers must accept slower wage growth, which then gets passed on to prices.

It's very hard to explain the fall in inflation in these terms.

Annual inflation has fallen from 10 percent a year ago to just 4 percent over the three months ending in September. During this period there has been no slowing of growth. Nor has there been any change in the output gap or unemployment, the most common measures of macroeconomic slack. Measures like posted job openings and voluntary quits do, it's true, suggest a labor market that is somewhat softer than a year or two ago—but one that is still extraordinarily tight by historical standards. In particular, wage growth has remained quite strong even while inflation has come down.

Higher rates are conventionally supposed to work through their effect on investment spending. And it is true that new housing construction has slowed noticeably since the Fed began tightening. But nonresidential investment has not. Just the opposite—the United States is in the midst of an unprecedented wave of factory building. Spending on new manufacturing facilities doubled in barely a year over the 2022–2023 period. This is good news for the economy. But it's as far as one could get from a Fed-induced slowing of demand.

Meanwhile, if we dig into the inflation numbers, we see that almost all the fall in inflation has come from internationally traded goods. Energy has contributed the most; prices of durable goods are also a big part of disinflation, as is food. Services, on the other hand, are mostly nontradable and labor-intensive. If the rate hikes were responsible for disinflation, we should see those prices slow first. Yet so far, services' contribution to disinflation has been very modest.

Overall, this is exactly the picture you would expect if disinflation were the result of global supply problems resolving. Auto prices, for example, have been falling in recent months, even as the number of vehicles sold continues to rise. Elementary economics says that when you see prices go down while quantities go up, that is a story about rising supply, not falling demand.

One lesson for the future is that inflation is more of a micro and less of a macro phenomenon than we had previously thought. Prior to the pandemic, economists from a wide variety of perspectives agreed that the economy's productive capacity grows steadily over time. Episodes of unemployment and inflation are the result of aggregate spending either falling behind or running ahead of that steady growth. It follows that macroeconomic stabilization—whether by the central bank or fiscal policy—is a matter of stabilizing the flow of money through the economy.

This no longer looks so straightforward. A combination of brittle global supply chains and inevitable climate-related disruptions mean that supply-side problems in specific industries may be a major source of inflations and recessions going forward. It follows that macroeconomic stability will call for more measures to stabilize production, as well as spending. The answer to energy-driven inflation, for instance, will not come from anything we do on the demand side; it will require a more reliable energy supply—which is another reason for a faster transition away from carbon.

It's fortunate, in this context, that policymakers are rediscovering industrial policy. The Inflation Reduction Act and the CHIPS Act are welcome first steps. But much more along these lines will be needed.

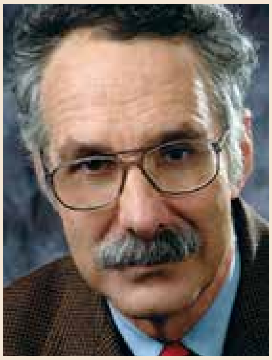
Those who promoted Modern Monetary Theory and/or the notion that interest rates would stay perpetually low and make immense expansions of public debt painless have a lot of explaining to do.

MICHAEL J. BOSKIN
Hoover Institution Senior Fellow and Professor of Economics, Stanford University, and former Chair, President's Council of Economic Advisors

Economists have debated the causes and consequences of inflation for over two centuries. Milton Friedman famously argued "Inflation is always and everywhere a monetary phenomenon." That of course implied monetary policy was the way to end high inflation. The dramatic monetary tightening by Paul Volcker's Fed, followed by a deep recession, were at least the proximate cause of sharply reduced inflation—which had been rising with every cyclical expansion—from double digits to the 4–5 percent range. But Tom Sargent persuasively argued that America's late 1960s through 1970s inflation was started by excessive deficit-financed government spending and, in analyzing the ends of four big inflations, he concluded that it took a credible and dramatic fiscal consolidation to do the trick. This tension between monetary and fiscal explanations continues to this day up to and including my colleague John Cochrane's important new book *The Fiscal Theory of the Price Level.*

Inflation had been quiescent at 2 percent or less for most of several decades. Then, as the economy rebounded sharply from the covid lockdown, it became clear it would soon return to full employment and additional fiscal stimulus risked higher inflation, as pointed out by Larry Summers shortly before, and me shortly after, the passage of the $1.9 trillion American Rescue Plan (which followed $600 billion additional spending approved by Congress and President Trump in December 2020). The Biden plan was three times the Congressional Budget Office estimate of the 2021–2022 combined output gap, making it the primary culprit in the inflation surge. While the Federal Reserve took some time to recognize inflation wasn't transitory, it gets the primary credit for the progress in reducing inflation thus far. Raising its target rate from near zero to 5.25–5.5 percent, getting and keeping it above the expected inflation rate, was key. The slowdown in global demand, especially from China, and other factors helped, just as supply chain and Ukraine war shocks added to the upside. But we are not out of the inflation woods yet. Real wages have finally started rising, after falling for two years, but if not matched by productivity gains risk complicating the path to the Fed's 2 percent target.

What are the lessons to be learned from the recent experience? High inflation is economically costly and politically explosive. It's best to prevent inflation from rising in the first place, as controlling it later risks larger costs. Limiting excessive government spending as the economy approaches full employment is essential (recall President Biden wanted trillions more and was only limited by Senator Joe Manchin (D-WV). Biden would likely push for more in a second term and there is not much evidence former President Trump would curtail spending if he got a return engagement). Monetary policy must play its role despite the political difficulty, or it will be stuck having to administer much tougher medicine later. Finally, those who promoted Modern Monetary Theory and/or the notion that interest rates would stay perpetually low and make immense expansions of public debt painless have a lot of explaining to do.



One wonders whether we learned these lessons from the Volcker/Reagan anti-inflation policies. I am skeptical.

ROBERT J. SAMUELSON
Former economics columnist,* Washington Post, *and author,* The Great Inflation and Its Aftermath: The Past and Future of American Affluence *(2010)

What is crucial is the centrality of public opinion. People must constantly be reminded that without a crude price stability, long-term job creation and economic growth are difficult, if not impossible. Without public support, "painful" short-term policies will be difficult to sustain. The main policy instrument should remain the Fed funds rate with a normal range of zero to 2.99 percent. This would reflect erratic price movements and provide some flexibility. But temporary policies should not be an excuse to abandon a commitment to price stability. One wonders whether we learned these lessons from the Volcker/Reagan anti-inflation policies. I am skeptical.

The Fed made inflation far worse, but Congress and $33 trillion in public debt is the source of inflation. And it has not been tamed.

CHRISTOPHER WHALEN
Chairman, Whalen Global Advisors

Who deserves the credit for taming inflation in 2023? Certainly not the Federal Open Market Committee or any other monetary policy organ.

To review, the FOMC caused the inflationary spike of 2023. The FOMC nearly crashed the U.S. economy in December 2018, when large banks led by JPMorgan closed their books for the year in early November. Reserves fell too low, causing a liquidity crisis. Fed Chair Jerome Powell panicked and in 2019 the FOMC began to drive down interest rates, adopting a "go big" strategy to flood the markets with reserves. A year later, covid exploded onto the scene and the Fed went even bigger, making almost $9 trillion in open market bond purchases that swelled the balance sheets of banks and consumers with free money. MMT arrived early.

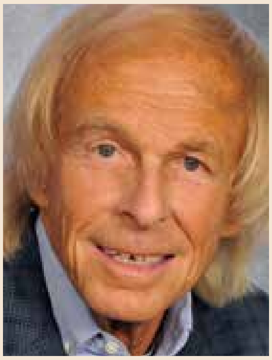
After two years of monetary largesse and trillions more in absurd fiscal giveaways, inflation finally became a problem. Powell and his predecessor Janet Yellen had created a construct whereby the Fed assumed that inflation was too low and, conversely, that deflation represented a real risk. Now after two years of interest rate hikes, we are told that inflation is still too high, but the economy is indifferent. But are interest rates really, really high?

America is addicted to easy money and debt, and seems headed for an eventual debt default *à la* Mexico in the 1970s and 1980s. The FOMC facilitates this process by enabling the Treasury to borrow ever more cash from investors at ever lower rates of interest, a process that perversely may keep the visible rate of inflation low. If the fiat paper dollars in the hands of people around the world were not being soaked up by trillions of dollars in new Treasury debt issuance, what would happen to prices for real goods and assets?

The size of the U.S. banking system has increased almost 600 percent over the past forty years. In 1984, Paul Volcker was Fed chair and inflation was considered to be unacceptable. In the four decades since then, the United States has lost the will to govern itself and public spending. Economist Hyman Minsky coined the "financial instability hypothesis," arguing that lending goes through three distinct stages—the Hedge, the Speculative, and the Ponzi stages, after financial fraudster Charles Ponzi.

In 2023, America has clearly reached the Ponzi phase, where most borrowing is simply rolling old debt used to finance deficits years or decades before. "We have been having inflation," Milton Friedman observed in 1978, "not because evil men at the Fed have been willfully turning the printing press, but because John Q. Public has been demanding inflation and aborting every attempt to stop inflation. We, the public, have been asking Congress to provide us with ever more goodies—yet not to raise our taxes."

The Fed made inflation far worse, but Congress and $33 trillion in public debt is the source of inflation. And it has not been tamed.



The inflationary episode of the 2020s is not over yet!

ALLEN SINAI
Chief Economist/Strategist and President, Decision Economics, Inc.

There is yet no credit to be given for the diminishing inflation seen since the first half of 2022. The inflationary episode of the 2020s is not over yet!

Ongoing price inflation remains "sticky-high," now the number one economic, societal, and political problem of the day, and a long way away from resolution without potentially considerable costs.

There has been a big decline from the peak inflation in the first half of 2022, measured by the Consumption Price Deflator (PCE) and PCE ex-food and energy ("core").

During Covid-19 and the pandemic, U.S. and global price inflation shot sharply upward, with the PCE reaching 6.6 percent year-over-year in the second quarter of 2022 and the PCE-core 5.2 percent in the first quarter.

The shutting down of the supply side of the economy during 2020, massively stimulative monetary and fiscal policies, and an unleashing of pentup demand against the supply-side shock from the pandemic and subsequent Russia-Ukraine war were responsible for the highest inflation since the 1970s.

The current inflation, estimated at 3.4 percent year-over-year for the PCE and 4 percent in the PCE-core, while showing sizable improvement compared with 2022, remains far above any reasonable definition of price stability, the latter one of the two main objectives, price stability and full employment, for the Federal Reserve. Most recently, the deceleration of inflation has stalled and even is reaccelerating some.

It is way too early to take credit on what is now a "sticky-high" entrenched and resilient price inflation, with economic, policy, and societal issues, including egregious inequality, that are bringing huge political challenges as the United States approaches a presidential election year in 2024.

The inflation genie has gotten out of the bottle and is now widespread and infecting prices and costs everywhere. It is set to remain stubbornly resistant to the tightest monetary policy over the shortest span of time in decades in its effects, both short- and long-term.

Why the reduction of inflation? Why too early for credit?

An easing of supply-side shortages and slowing of the economy from a boomy expansion are the main reasons.

Who gets credit for the decline from the peaks so far?

The jury remains out on declaring any victory over the 2020s' inflationary episode. Whether we will see a soft landing or hard landing in the economy and in the response of inflation to it is still an open question.

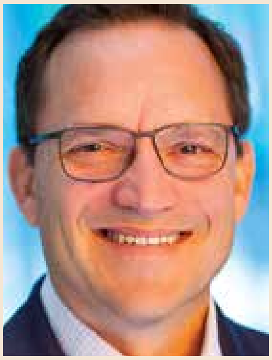
Most likely, one way or the other, economy weakness and a softening labor market will be needed.

But before then, price inflation can reaccelerate—that mischievous genie out-of-the-bottle doing a dance through the inflationary process of rising costs and prices interacting and becoming embedded in higher expected inflation.

Recent labor market strife is another example of the inflationary process—a consequence of a long period of higher actual price inflation. Strikes and generous settlements on the corporate profits that price inflation initially brings almost always induce and incent catch-up by labor. With that comes continuing high, or higher, interest rates, damage in financial markets and to interest-sensitive outlays in the economy, the economy itself, then back to company profits and a weakening labor market.

The basic forecast remains a soft landing through the rest of this year and next. But some day there will be a recession. There always is!

Ultimately, the credit for lower inflation will go to the Federal Reserve, tight money, financial disarray, and much higher unemployment—then the recession itself will get the credit.



If fiscal policy started inflation, it can also be used to finish the job.

MARC SUMERLIN
Managing Partner, Evenflow Macro, and former Deputy Assistant to the President for Economic Policy and Deputy Director of the National Economic Council

Inflation was caused by two years of extraordinary fiscal deficits, which averaged 13.5 percent of GDP over 2020 and 2021. As the excess fiscal spending burned off with time, inflation inevitably decelerated. The twelve-month change in the PCE price index fell from 7 percent last summer to about 3.5 percent in August.

There are ample reasons to be cautious about an early celebration. First, even though the inflation rate has halved, the price level (which drives politics) is still 15 percent higher than it was before the pandemic. Second, the fiscal deficit surged back to 7.5 percent of GDP in 2023, putting upward pressure on inflation again. Most importantly, oil prices are up 30 percent since June. While central bankers claim to look through oil price changes, they do react to changes in inflation expectations, which are often driven by gasoline prices. The Fed, at a minimum, cannot cut rates next year with high commodity prices.

Given that the U.S. banking system is challenged with underwater commercial real estate assets, the best way to control inflation is to constrain fiscal policy. If fiscal policy started inflation, it can also be used to finish the job. If the current administration and Congress are not willing to restore fiscal sanity, the American people will have a chance next year—likely with a third-party option—to pick a new team to run U.S. economic policy.

Increases in the Fed's interest rate are having their expected effect.

MARINA V. N. WHITMAN
Professor of Business Administration and Public Policy Emerita, University of Michigan, former member of the President's Council of Economic Advisors, and former Chief Economist and Group Vice President, General Motors

The main lesson to take from slowing U.S. inflation is that several increases in the Fed's interest rate (with a couple more expected to come) are having their expected effect. Whether such increases are sufficient to reduce U.S. inflation to the 2 percent target is by no means certain—that is a tough target to meet. The drop in real wages, where rising wages are not keeping up with rising prices, suggests that wage pressures are likely to continue, in the absence of any likelihood of a move of the U.S. economy into recession in the near future. Whether that "taming of inflation" is permanent or not is another question, which depends in part on what "permanent" means: Is "permanent" short-run or long-run? Is the meaning dependent on whether the U.S. economy is moving toward recession or not? Answers to such questions are needed to clarify what "permanent" implies in the current context. ◆