

Nersisyan, Yeva; Wray, L. Randall

Research Report

Is it time for rate hikes? The Fed cannot engineer a soft landing but risks stagflation by trying

Public Policy Brief, No. 157 (2022)

Provided in Cooperation with:

Levy Economics Institute of Bard College

Suggested Citation: Nersisyan, Yeva; Wray, L. Randall (2022) : Is it time for rate hikes? The Fed cannot engineer a soft landing but risks stagflation by trying, Public Policy Brief, No. 157 (2022), ISBN 978-0-941276-41-2, Levy Economics Institute of Bard College, Annandale-on-Hudson, NY

This Version is available at:

<https://hdl.handle.net/10419/284013>

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.



Levy Economics Institute of Bard College

Public Policy Brief

No. 157, 2022

IS IT TIME FOR RATE HIKES? THE FED CANNOT ENGINEER A SOFT LANDING BUT RISKS STAGFLATION BY TRYING

YEVA NERSISYAN and L. RANDALL WRAY

Contents

3 Preface

Dimitri B. Papadimitriou

4 Is It Time for Rate Hikes? The Fed Cannot Engineer a Soft Landing but Risks Stagflation by Trying

Yeva Nersisyan and L. Randall Wray

12 About the Authors

The Levy Economics Institute of Bard College, founded in 1986, is an autonomous research organization. It is nonpartisan, open to the examination of diverse points of view, and dedicated to public service.

The Institute is publishing this research with the conviction that it is a constructive and positive contribution to discussions and debates on relevant policy issues. Neither the Institute's Board of Governors nor its advisers necessarily endorse any proposal made by the authors.

The Institute believes in the potential for the study of economics to improve the human condition. Through scholarship and research it generates viable, effective public policy responses to important economic problems that profoundly affect the quality of life in the United States and abroad.

The present research agenda includes such issues as financial instability, poverty, employment, gender, problems associated with the distribution of income and wealth, and international trade and competitiveness. In all its endeavors, the Institute places heavy emphasis on the values of personal freedom and justice.

Editor: Michael Stephens
Text Editor: Elizabeth Dunn

The Public Policy Brief Series is a publication of the Levy Economics Institute of Bard College, Blithewood, PO Box 5000, Annandale-on-Hudson, NY 12504-5000.
For information about the Levy Institute, call 845-758-7700, e-mail info@levy.org, or visit the Levy Institute website at www.levyinstitute.org.

The Public Policy Brief Series is produced by the Bard Publications Office.

Copyright © 2022 by the Levy Economics Institute. All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording, or any information-retrieval system, without permission in writing from the publisher.

ISSN 1063-5297
ISBN 978-0-941276-41-2

Preface

Roughly two years into the economic recovery from the COVID-19 crisis, the topic of elevated inflation dominates the economic policy discourse in the United States. And the aggressive use of fiscal policy to support demand and incomes—over \$5 trillion of pandemic relief spending spread between the Trump and Biden administrations—has commonly been singled out as the culprit. Equally as prevalent is the clamor for the Federal Reserve to raise interest rates to relieve inflationary pressures.

According to Research Scholar Yeva Nersisyan and Senior Scholar L. Randall Wray, this narrative is flawed in a number of ways. The problem with the US economy is not one of excess of demand in their view, and the Federal Reserve will not be able to engineer a “soft landing” in the way many seem to be expecting. The authors also deliver a warning: excessive tightening, combined with headwinds in 2022, could lead to stagflation.

Those who stress the demand-side explanation for current inflationary pressures have at least one thing right, according to Nersisyan and Wray: had there been a dramatically scaled back fiscal response to the pandemic crisis, inflation would likely have been lower—and unemployment and poverty would have ended up significantly higher. It is difficult to see the validity of an argument that, say, those at the bottom of the income distribution would have been better off in this counterfactual scenario.

Moreover, while this recovery looks robust in comparison to the jobless recoveries and secular stagnation that have typified the last few decades, in Nersisyan and Wray’s estimation there are few signs of an overheating economy to be found in the macro data. They observe that increases in the consumer price index are outpacing labor cost increases by a wide margin; wages, far from driving this inflation, appear to be playing catch-up. Even according to the flawed measure of “potential GDP,” the economy’s productive potential was only supposedly exceeded in 2021Q4 (well after, as they note, inflation had been rising). In fact, as Nersisyan and Wray explain, the demand side of the economy is already going to be facing challenges in 2022: due to new strains of COVID-19 throughout the world, the war in Ukraine, and the expiration of the federal government’s pandemic spending, among other reasons.

In their view, this inflation is not centrally demand driven; dynamics at the micro level are playing a much more central role

in driving the price increases in question. Significant supply chain problems have curtailed productive capacity by disrupting the availability of critical inputs. In addition, they note that there is some evidence that firms with pricing power have taken advantage of the pandemic to boost or maintain profit margins, and that this could be another factor contributing to rising prices.

Believing the Fed can fine tune the economy with marginal changes to interest rates is wishful thinking, they write. Many seem to be pinning their hopes on the Fed being able to pull off something it has rarely, if ever, been able to do: guide the economy to a soft landing by gradually bringing down the inflation rate with incremental interest rate hikes. Far more common, Nersisyan and Wray explain, is the Fed raising rates into a recession. Monetary policy can only realistically affect inflation by significantly increasing unemployment and lowering wages (which are not, as the authors observe, driving inflation anyway). Meanwhile, as noted, the winding down of federal fiscal policy is already set to act as a deflationary impulse—excess demand is unlikely to be a problem in 2022.

Furthermore, higher interest rates will not address the forces that are driving price pressures—the Federal Reserve can do little about supply chain problems. If anything, rate increases could be counterproductive. As the authors argue, alleviating supply-side constraints through greater investment would be one way of easing inflation. But rate hikes, to the extent they reduce interest-sensitive spending, would have the opposite effect: constraining the capacity to produce.

While fiscal (as well as regulatory) policy is better able to handle the current inflationary environment, our approach to fiscal policy needs to change, in their view. Commentators may be on the wrong track in singling out the pandemic relief spending for creating inflation, but there is a better way to conduct policy—one oriented around targeted investments that would increase our real resource space. This will serve not only to address inflationary pressures, according to Nersisyan and Wray, but also the far more pressing climate emergency.

As always, I welcome your comments.

Dimitri B. Papadimitriou, *President*

Introduction

Many economists and pundits have been calling on the Federal Reserve to raise interest rates to fight inflation. While the Fed resisted earlier calls to make a move, arguing that inflation was transitory, a consensus has emerged that the time is nigh. If history is a guide (as former Fed Chairman Alan Greenspan liked to put it), the Fed is not going to stop with a few rate hikes. And because a higher interest rate is not the answer to our inflation problem, the Fed will likely stay the course through a long series of ineffectual rate hikes. Given major disruptions in the global economy due to the pandemic and war in Ukraine, this will cause high unemployment and slower growth without much reduction of inflation pressures. It might even bring back stagflation: policy-induced high unemployment combined with stubbornly high inflation, similar to what we experienced in the Ford–Carter–Reagan years.

Those advocating for a rate hike see current inflation as a problem of too much demand—with a lot of finger pointing at President Biden’s last round of relief that supposedly pushed the economy beyond full employment. But what we are dealing with is not demand-driven inflation in an overheating economy. The COVID-19 crisis started as a supply-side crisis that severely disrupted production, causing income and demand to crash. Fiscal relief partially restored income but the supply side is still shaky due to the pandemic and now the war in Ukraine. Most of the government’s income support has already disappeared, so going forward it is not an important contributor to demand in the economy.

In this policy brief we examine the causes of inflation’s acceleration from both macroeconomic (aggregate supply and demand) and microeconomic (firms’ pricing decisions and supply-side disruptions) perspectives. It is undoubtedly true that if the fiscal relief spending had never come, Americans would be much poorer, the unemployment rate would be higher, and inflation would be less of a problem. But this would not resolve the persistent supply-side problems—and Americans would be worse off. As we will argue, higher interest rates will not constrain the forces that are generating price pressure.

The Macro Picture: Supply and Demand

The Trump and Biden administrations responded to the COVID-19 crisis with over \$5 trillion of relief spending. Some argued at the time it was too much, and that view has gained

much more credence as inflation picked up, even as it looks as though the supply side has largely recovered. In this section we first examine the growth of income, spending, and output to see whether pressures come largely from the demand side (and hence can be blamed on the relief packages); we then turn to the supply side.

Demand Side

GDP fell sharply when the pandemic hit, falling by \$2 trillion by 2020Q2, hitting wage income hard. This would have collapsed both consumption and saving even more were it not for the relief packages (plus regular social spending, such as the usual unemployment benefits that were boosted above normal by the relief). With government’s help, growth picked up and by 2021Q3 nominal GDP reached the level that had been forecast for that quarter back in January 2020, and in 2021Q4 it was up by about \$2.3 trillion over the 2019Q4 level.¹

Government social benefits to individuals grew by \$2.4 trillion in 2020Q2 over payments the previous quarter; by 2020Q4 they had fallen from their peak by almost \$2 trillion. Another \$2.3 trillion in social benefit payments was added in 2021Q1—bringing total social benefit payments that quarter to nearly \$6 trillion—double what they had been in 2019. Over the next three quarters, social benefit payments fell by over \$2 trillion, ending 2021 about \$770 billion above where they had been in 2019Q4. However, taxes were also up by about \$700 billion—so the government’s contribution to personal income netted to just \$70 billion at the end of last year.

Though we see large increases in relief payments in two quarters, the extra boost to income from social benefit payments largely had disappeared by the beginning of 2022. Government purchases (including by state and local governments) are up moderately compared with 2019. Investment is up, but that is driven mostly by housing construction and inventory restocking. Inventories can help to reduce inflation pressures, and housing construction could help dampen growth of rents if it increased supply where there are shortages.

Disposable personal income grew by about \$1.76 trillion between 2019Q4 and 2021Q4. Total domestic demand grew by \$2.7 trillion since the end of 2019, but \$430 billion of that growth was satisfied by net imports—meaning total demand for domestic output increased by about \$2.3 trillion. Over that time, personal consumption expenditures grew by \$1.7 trillion—equal to the growth in disposable personal income. If we apportion net

imports across all categories of domestic spending according to each category's share of total demand, about \$270 billion might have been spent by domestic consumers on imports. With that assumption, consumption spending on domestic output since the trough of the recession grew by what amounted to about \$1.4 trillion.²

Total pandemic relief provided to households through direct payments plus unemployment benefits and food stamps was about \$1.6 trillion.³ This is approximately equal to the entire growth in consumption spending on domestic output in the recovery. While we cannot conclude that consumption would have remained stagnant in the absence of such relief, it is likely that recovery would have been significantly delayed. And it is important to repeat that the relief has run its course. We do not see significant continuing demand pressures coming from consumption, government spending, investment, or foreign trade.

If we were to look only at the data on output and income, the recovery seems to have been completed by the end of 2021. While output is up slightly above what had been projected a couple of years ago (pre-pandemic), growth relative to 2019 would not have raised eyebrows if there had been no pandemic or if one ignored the ups and downs in disposable income and saving during the pandemic (real GDP growth averaged only 1.15 percent over 2020 and 2021). Even according to traditional measures, we only reached and exceeded potential GDP during the final quarter of 2021. Meanwhile, inflation has been rising since at least March of 2021—a clue that maybe this is not a demand-driven problem.

In sum, what we find when looking at current aggregate levels of both spending and income, there is little reason to worry that demand is growing too quickly. Real GDP growth is not rapid, the boost from relief is all but played out, and inflation is sucking incomes out of the economy. There is no excess income left to drive the economy beyond capacity.

The implication we draw from the macro data is further reinforced by survey data from firms that do not expect

their sales to be so high as to force them to raise prices going forward. The Business Inflation Expectation survey by the Federal Reserve Bank of Atlanta (2022) asks firms to estimate the percentage by which sales are above or below normal.⁴ At the depths of the pandemic recession, sales were more than 31 percent below what firms thought was normal; in January 2022 they were above normal by 3.3 percent for small, 1.3 percent for mid-sized, and 3.8 percent for large firms. Turning to the future influence of sales levels on prices over the next 12 months, the index shows that expected price pressures due to sales have already declined from a peak a few months ago. The most important point is that there is nothing unusual about the survey results regarding views on the future influence of sales on expected prices. Firms do not expect sales to be so high that they would be pressured to raise prices. Since 2012 such expectations have typically been as high as, or higher than, they are now. That would not seem to indicate that firms are feeling unusually high pressure on capacity.

Supply Side

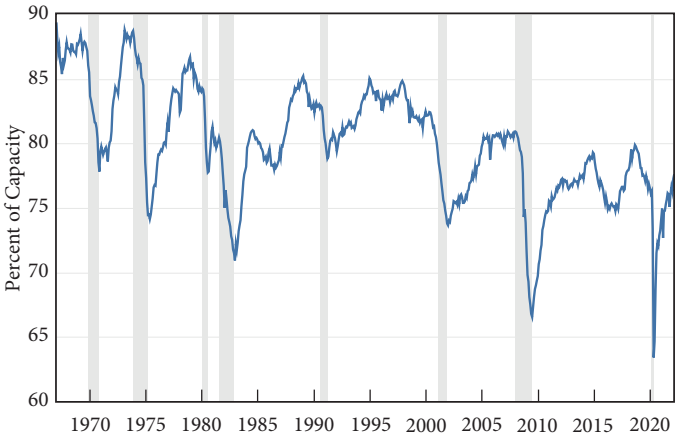
Turning to the aggregate supply side, we can see from Figure 1 that even though capacity utilization has substantially recovered, it has not reached the pre-pandemic levels, and is not even close to pre-global financial crisis levels. It's likely that firms are unable to utilize their operating capacity at the desired rate, in part due to supply chain and labor market disruptions. It could also indicate that those with the power to set prices are purposely constraining output in order to raise and hold

Table 1 Nominal and Real GDP Growth Rate

	2019	2020	2021
Nominal GDP growth rate	4.1	-2.2	10.1
Real GDP growth	2.3	-3.4	5.7

Source: Bureau of Economic Analysis

Figure 1 Capacity Utilization: Total Index



Source: Board of Governors of the Federal Reserve System

prices higher—artificially creating scarcity. Still, Figure 1 does not paint a picture of an economy that has exceeded its productive capacity. Instead, this graph seems to be more consistent with either a “long-term secular stagnation” thesis—aggregate demand is chronically too low—or with an inability to expand production to capacity because of disruptions in the supply of critical inputs.

Finally, while the labor market has tightened (and that should be celebrated not feared), it is not yet back to its pre-pandemic state based on a number of indicators. Total employment is still two million below its 2019 level (and given population growth, we would need even more jobs). The employment rate for the 15–64 age group was at 70.72 percent in January 2022, below its pre-pandemic level of 71.77 percent. And even that was below its peak of 74 percent in the early 2000s. The labor force participation rate tells a similar story. At 62.2 percent as of January 2022, it is below its pre-pandemic level of 63.4 percent, which was significantly below the pre–Great Recession levels of about 66 percent (itself well below our postwar peak).

But is the strengthening of the labor market driving our current inflation? Many report that the employment cost index has increased (which it has, as seen in Figure 2). At the same time, the 12-month change in the employment cost index is not extraordinary and is comparable to that of the early 2000s. But what is important to keep in mind is that wages are playing catch-up with prices, as shown in Figure 2, rather than driving the price changes. Indeed, what we see is that price increases are outpacing labor cost increases by a wide margin. The latest data from the Bureau of Labor Statistics (March 10, 2022) show that

real average hourly earnings fell by 0.8 percent in February—with nominal wages flat and the consumer price index (CPI) rising by 0.8 percent. Previous to February, real wages had been essentially flat—meaning that any nominal wage increases were offset by inflation. Wages are—at best—simply playing catch-up, not a source of inflation pressure.

The Micro Picture: Profit Margins and Supply Chain Disruptions

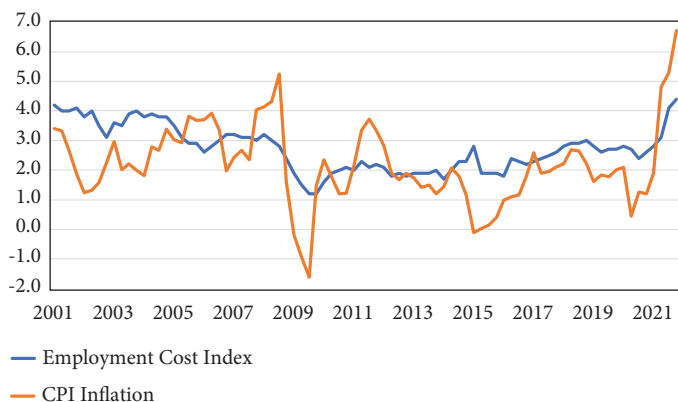
Profit Margins

The macro data discussed above paints a picture of a relatively quick recovery, but not an overheating economy. It is therefore useful to examine the micro-level explanations for price increases, such as profit margins and supply chain disruptions.

Many have argued that the rising prices we see are due to firms with pricing power taking advantage of the pandemic to boost profit margins.⁵ There is some evidence of this. As Matt Stoller (2021) reports, in a survey of retailers by Digital.com, 56 percent said “inflation has given them the ability to raise prices beyond what’s required to offset higher costs.” Not surprisingly, the bigger the firm, the easier it is to do this: 63 percent of large firms versus 52 percent of small and medium-sized businesses agreed with the statement. In fact, 28 percent of large firms increased prices by 50 percent or more (Stoller 2021). President Biden’s office (White House 2021) has also pointed its finger at markups, which have tripled since the 1980s, as concentration of pricing power across 75 percent of America’s industries has risen. In the November 2021 Atlanta Fed’s Business Expectations survey, 23 percent of firms indicated that their profit margins were higher than usual and about half of these said it was because they had raised their prices. Another 44 percent of the remaining firms whose profit margins were not above normal indicated plans to increase their prices to improve or maintain their profit margins.⁶

Still, the survey shows that the vast majority of firms do not see current profit margins as higher than normal. Indeed, far more see margins as below normal than the percent who see them as above normal. Paradoxically, firms are optimistic about their ability to raise margins over the next 12 months. Indeed, they have not been so optimistic over the past decade. This stands in stark contrast to data indicating that firms do not expect sales to pressure them to raise prices; it is their pricing

Figure 2 Employment Cost Index versus Inflation



Source: Bureau of Labor Statistics

ability that they believe will cause prices to rise. Firms say current mark-ups are not extraordinary but expect to be able to raise them in the future. At the same time, they say that it is not sales—excess demand—that is pressuring them to do so.

Supply Chain Disruptions

While some economists have dismissed the supply chain argument for inflation, the reality is that many firms are still facing significant disruptions. In a February 2022 survey by the Atlanta Fed, 71 percent of firms in the sample reported supplier delays in the previous week, with 60 percent of these indicating that the disruption to their business was moderate to severe. Further, 40 percent reported difficulty locating alternate suppliers, with half of these reporting a moderate to severe disruption and 45 percent reporting delays in delivery/shipping to customers (52 percent reporting moderate to severe disruption). While only 21 percent reported difficulty in rehiring furloughed or laid-off employees as a source of disruption, 62 percent noted the availability of workers to work affected their operating capacity (with 57 percent reporting a moderate to severe disruption).

The availability of other suppliers or inputs used to provide goods and services affected 50 percent of the firms, with 64 percent of these reporting moderate to severe disruption to their business; 55 percent of firms expected the availability of supplies to affect operations for 6–12 months or longer. (Data for 2021 were comparable, so these supply disruptions have been affecting firms throughout 2021, if not longer.) So as far as supply chains go, firms are worried about supplier delays for the near future, and worries rise the farther into the future firms look.

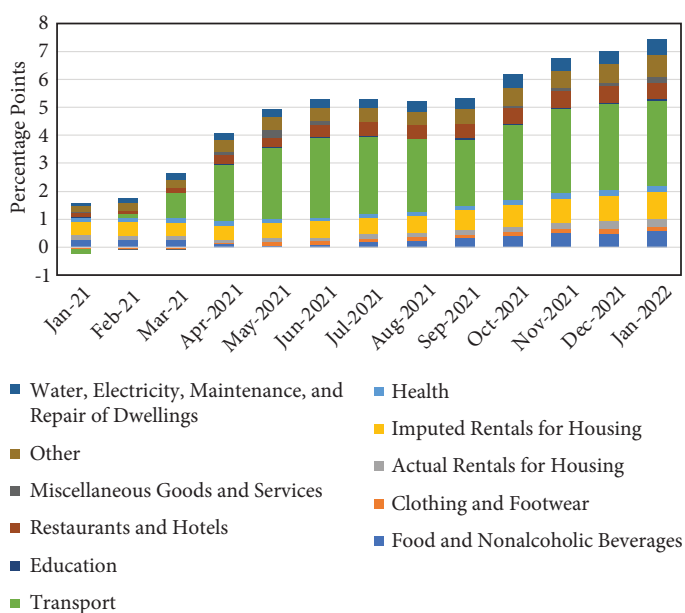
Firms are more worried about supply chains than about operations impacting their business. Even availability of employees is not a serious concern for most firms—only 25 percent say they expect it will be a problem 12 months and beyond.

In the next section we take a look at the sources of measured inflation.

Sources of CPI Inflation

Figure 3 shows that transport and housing account for about 4 percentage points of the measured 7.4 percent inflation rate. The biggest contributor is transportation—oil, shipping, and purchasing and fueling automobiles, in particular. As of January 2022, according to the Bureau of Labor Statistics, the 12-month change in the price of motor fuel for urban consumers was 40

Figure 3 Contribution to Inflation by CPI Component, January 2021–January 2022



Source: OECD Stat and authors' calculations

percent. With sanctions on Russia, transportation prices might rise further on the expectation of substantial cuts to supply.

The next most important component is imputed rentals for housing,⁷ adding about 1 percentage point to inflation as of January 2022. This is not a “market price”—it is not directly based on house prices or the cost of owning a house. It is imputed based largely on rents paid for “comparable” rented housing. It is frequently the largest contributor to measured inflation and can be quite misleading as a measure of pressure on prices coming from aggregate demand or as a measure of how inflation actually affects people’s pocketbooks. Actual rents account for about 0.25 percentage points of the measured inflation rate—up from about 0.15 percent at the start of the year. It is probable that both rents and imputed rents will continue to rise over this year, especially as moratoria on evictions and rent hikes have been eliminated. There are housing shortages throughout the country—especially for low and moderately priced housing—and the construction sector has been hit hard by the pandemic (as well as by the global financial crisis).

Food is typically the third component of the basket in terms of contribution to measured inflation. There have been significant disruptions in supply chains (especially for meat), compounded by industry consolidation that increases the power to

boost prices. Restaurants and hotels represent the remaining big contributor to measured inflation, at 0.6 percentage points. Obviously they have faced higher costs both because of safety concerns and higher pay for workers (which is also in part due to safety concerns). They might also be raising prices to make up for lost profits during lockdowns. The war in Ukraine will almost certainly lead to a boost to food prices as Ukrainian production of grain will fall and Russian production is sanctioned.

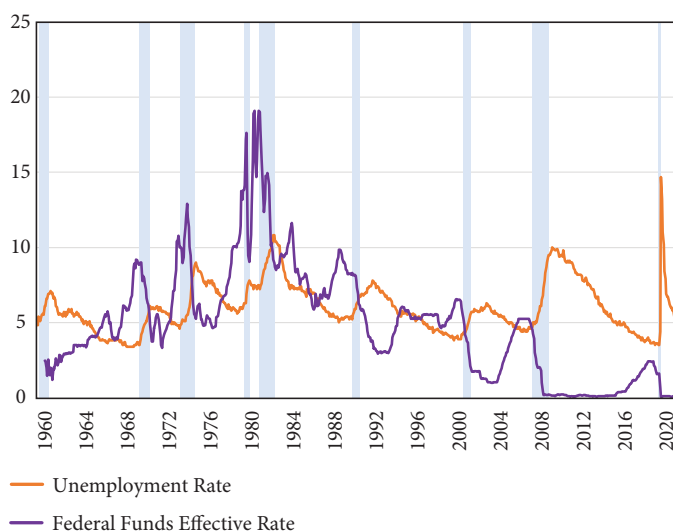
What Is the Possible Impact of Fed Rate Hikes?

We have placed our collective trust in the Fed's ability to solve the inflation problem. Economists such as Paul Krugman have been more dovish on the fiscal stimulus, partly because of their belief in the Fed's ability to bring inflation under control. Others, such as Larry Summers (2021, 2022) have continuously chastised the Fed for not raising the rates sooner (or raising them more aggressively once they start on that path). But what can the Fed do about supply-side problems, including labor shortages, oil, shipping delays, the war in Ukraine, and housing shortages? Importantly, even if the Fed could affect demand, it is unlikely we will have a demand problem in 2022.

Pundits suppose that the Fed can engineer a soft landing—i.e., lower inflation without hurting economic growth—through a steady stream of small rate hikes spread over a year or two to signal to markets that it is serious about fighting inflation. But the Fed has never managed to guide the economy to a soft landing with rate hikes. Many point to Fed Chairman Paul Volcker's interest rate hikes in the 1970s—to 20 percent and beyond (and above 15 percent for a couple of years)—as an example of using monetary policy to quell inflation. But the economy crashed into deep recession, and a series of financial crises (the thrift crisis of the early 1980s, the developing country debt crisis later in the 1980s, and the big bank crisis at the end of the 1980s) can all be traced to Volcker's experiment. Chairman Greenspan's tightening in the early 1990s brought on a recession followed by our first jobless recovery, and his tightening in 2004 helped to bring on the global financial crisis and another, even longer, jobless recovery.

The believers in monetary policy are not advocating Volcker-level hikes precisely because they believe policy to be powerful even with marginal changes to rates. That is wishful thinking. A 1–2 percentage point hike is unlikely to have a major impact on interest-sensitive spending, whether it is car

Figure 4 Unemployment and the Federal Funds Rate, 1960–2021



Source: FRED

purchases, college education, or investment. People do not usually borrow to buy fuel for their cars, purchase groceries, or pay rent—the categories currently driving inflation. Indeed, raising rates can even be perverse by reducing home purchases and pushing up rents.

As Figure 4 shows, the Fed always raises rates as the economy moves into recession, and the unemployment rate then rises significantly. It is rare for the Fed to raise rates without unemployment following closely on the heels of the tightening. The first time was in the late 1960s when the unemployment rate continued to fall as rates were raised; the second was in the aftermath of Volcker's devastating rate hikes, when another interest rate hike to nearly 12 percent did not overcome the Reagan recovery in 1984; and the final case was a rate hike in 1995, to almost 6 percent at the beginning of the "Goldilocks" years. In each of these cases, strong economic growth continued, and unemployment continued to fall. Outside those cases, the Fed's timing was impeccable and the outcome was assured: rates are always raised before recessions and recessions always increase unemployment.

Realistically, the only way in which monetary policy can affect inflation is by significantly slowing down the economy and raising unemployment sufficiently to alleviate wage pressures—which, as we have argued, are not now driving inflation, but are simply trying to catch up to price increases. Small rate

hikes do not reduce inflation; it takes large rate hikes that create financial crises, insolvency, and bankruptcies severe enough to crash the economy—followed by jobless recoveries. In other words, the Fed would be using unemployment as a tool to control the rate of inflation. Killing the recovery also means reversing the progress made recently on raising incomes at the bottom (see Galbraith 2022).

There is one more interesting pattern: in an expansion, as income and employment grow, the federal budget deficit declines, as shown in Figure 5. The reduction of the deficit pulls demand out of the economy, slowing growth and increasing unemployment. At approximately the same time—although the decline in the deficit usually takes precedence—the Fed chooses to raise rates to add to the economic headwinds. The combination of a falling deficit (smaller net injection of government demand into the economy) plus the Fed’s rate hike is sufficient to cause a recession that increases unemployment—as shown in Figure 4. When the recession hits, the deficit increases sharply, as job losses reduce tax revenues (and some kinds of social spending increase).

According to the most recent Bureau of Economic Analysis data available, the federal government net lending/borrowing fell from \$4.4 trillion (20 percent of GDP) in 2021Q1 to \$2.3 trillion (10 percent of GDP) in 2021Q3. The Office of Management and Budget projects a budget deficit of 7.6 percent in 2022, falling further to 5.3 percent of GDP in 2023. If the past is any guide

(borrowing Greenspan’s phrase again), the reduction of the deficit is likely to push the economy into another recession. Hence, the Fed’s prospective rate hikes will—again—be impeccably timed.

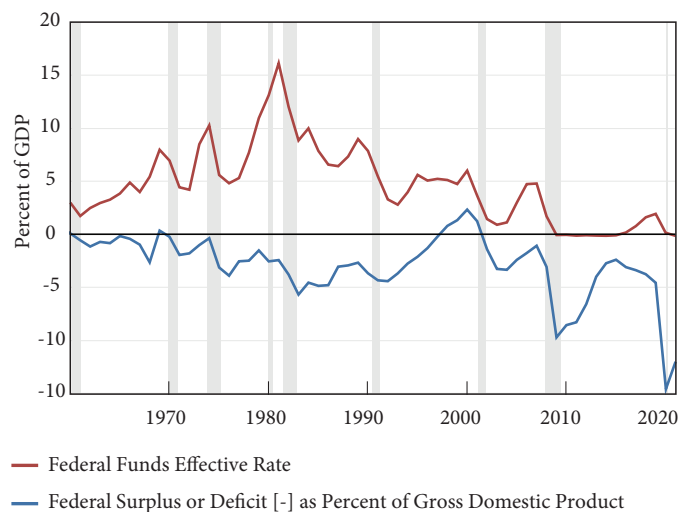
In addition to the “normal” deficit reduction and Fed tightening, we face continuing supply-side disruptions caused by successive waves of COVID-19, exercise of pricing power, and sanctions on Russia. Together these threaten to cause not only a recession but also high inflation. This is a recipe for stagflation—an even more dangerous cocktail than the forces that worked to bring on the stagflation of the 1970s. Further, as we mentioned, the US economy has been prone to secular stagnation for the past half-century, only temporarily relieved largely by financial bubbles—the dot-com bubble of the Clinton years, the combination of the housing, stock market, and commodities market bubble that preceded the global financial crisis, and the long run-up of equities markets over the past decade.

Today’s financial markets are seriously bloated—unfazed by the pandemic and other worrying developments (i.e., failure to make significant progress dealing with the oncoming climate Armageddon, attempted coup in Washington on January 6, 2021, and the war in Ukraine). It is difficult to foresee how financial markets might react to another recession in conjunction with rising interest rates. We know that the financial sector has become accustomed to 15 years of unprecedentedly low borrowing costs. Will it unravel when faced with negative GDP growth and substantially higher interest rates?

The appropriate solution to inflation would be to work to alleviate supply-side constraints. That, however, cannot really be achieved by monetary policy. In fact, cutting interest-sensitive spending, such as investment, would work to constrain our capacity to produce (i.e., supply) in the future. The pandemic has taught us that the United States must become less reliant on foreign production, and we need massive investments in alternative energy projects to free us from the grip of OPEC-Plus, which includes Russian oil production. We need more domestic investment, not less.

The Fed seems to be embarking on a dangerous experiment.

Figure 5 Federal Government Deficit/Surplus and the Federal Funds Rate



Source: FRED

Conclusion

It appears to us that what the United States faces is not a problem of too much demand, but a situation in which demand and job growth has not been slow to recover like it has been in past recoveries. This recovery only seems remarkable because jobless recoveries over the past 30 years have become our new normal. In any event, the high inflation we see today is not due to excess demand. One could go much further and argue that both of our high inflation periods (the early and late 1970s) were not periods of high aggregate demand. But that is too obvious to require embellishment: these were, famously, called periods of stagflation. There is some danger that inappropriate tightening by the Fed now could reproduce stagflation. We already have significant headwinds in the form of periodic outbreaks of new strains of COVID-19 (and frequent lockdowns in China), what is likely to be a drawn-out war in Ukraine, the winding-down of the last remnants of the federal government's pandemic relief programs, and rising tax revenue and falling budget deficits. Growth projections are already being reduced.

We must find a better way to think about, and deal with, inflation. What the pandemic has shown is that the real issue in the economy is the availability (or lack thereof) of real resources. So, the task of policy is to enhance our real resource space, something monetary policy cannot do. Fiscal policy is more fit for the purpose, but that requires rethinking how we implement it.

Indiscriminate stimulus spending of the type we engaged in over the past couple of years is not the best approach. Instead, we need to use a more-targeted approach to spending, where demand is directed to the unemployed through a job guarantee program and to the parts of the economy where demand is insufficient. Further, fiscal policy can be used to direct investment into particular areas of the economy with the goal of increasing our real resource space for the long term. Most importantly, we must tackle climate change to prevent a catastrophe that threatens human survival. Hiking interest rates is, at best, counterproductive.

Notes

1. See Nersisyan and Wray (2022) for a detailed discussion of GDP data.
2. See Nersisyan and Wray (2022) for details. Import prices have, of course, been rising—for many of the reasons already discussed: much higher oil prices, higher shipping costs, and supply chain disruptions. Perhaps demand played some role, too. However, the point is that imports have sucked demand out of the domestic economy that might have otherwise gone toward pushing up inflation at home.
3. See Parlapiano et al. (2022) and Committee for a Responsible Federal Budget (2022).
4. See Nersisyan and Wray (2022) for a detailed analysis of the survey data.
5. See Nersisyan and Wray (2022) for further discussion of examples of use of pricing power.
6. See Nersisyan and Wray (2022) for further discussion of the survey data.
7. See Papadimitriou and Wray (2022).

References

- Committee for a Responsible Federal Budget. 2022. "COVID Money Tracker." Interactive site. Available at: <https://www.covidmoneytracker.org/>
- Federal Reserve Bank of Atlanta. 2022. "Business Inflation Expectation." February 26. Available at: <https://www.atlantafed.org/research/inflationproject/bie>
- Galbraith, J. K. 2022. "How the Left Should Think About Inflation." *The Nation*, February 18.
- Nersisyan, Y., and L. R. Wray. 2022. "What's Causing Accelerating Inflation: Pandemic or Policy Response?" Levy Institute Working Paper No. 1003. Annandale-on-Hudson, NY: Levy Economics Institute of Bard College.
- Papadimitriou, D. B., and L. R. Wray. 2021. "Still Flying Blind after All These Years: The Federal Reserve's Continuing Experiments with Unobservables." Public Policy Brief No. 156. Annandale-on-Hudson, NY: Levy Economics Institute of Bard College. December.
- Parlapiano, A., D. B. Solomon, M. Ngo, and S. Cowley. 2022. "Where \$5 Trillion in Pandemic Stimulus Money Went." *New York Times*, March 11.
- Stoller, M. 2021. "Corporate Profits Drive 60 percent of Inflation Increases." BIG by Matt Stoller blog, December 29.

Summers, L. H. 2022. "Opinion: The Fed is Charting a Course to Stagflation and Recession." *The Washington Post*, March 15.

———. 2021. "Opinion: The Fed's Words Still Don't Measure Up to the Challenge of Inflation." *The Washington Post*, December 16.

White House. 2021. "Fact Sheet: Executive Order on Promoting Competition in the American Economy." July 9. Available at: <https://www.whitehouse.gov/briefing-room/statements-releases/2021/07/09/fact-sheet-executive-order-on-promoting-competition-in-the-american-economy/>

About the Authors

Research Scholar YEVA NERSISYAN is an associate professor of economics at Franklin and Marshall College in Lancaster, PA. She received her BA in economics from Yerevan State University in Yerevan, Armenia in 2006, and her MA and Ph.D. (2013) in economics and mathematics from the University of Missouri–Kansas City.

Nersisyan is a macroeconomist working in the Modern Money Theory, Post-Keynesian, and Institutionalist traditions. Her research interests include banking and financial instability, and fiscal and monetary theory and policy. She has published a number of papers on shadow banking, liquidity creation, the Glass-Steagall Act, and government deficits and debt. Her current research is focused on the affordability and inflationary impact of the Green New Deal. She is also coediting the Elgar Companion to Modern Money Theory with L. Randall Wray.

Senior Scholar L. RANDALL WRAY is a professor of economics at Bard College. His current research focuses on providing a critique of orthodox monetary theory and policy, and the development of an alternative approach. He also publishes extensively in the areas of full employment policy and, more generally, fiscal policy. Wray's most recent book is *A Great Leap Forward* (Academic Press, 2020).

Wray is the author of *Money and Credit in Capitalist Economies: The Endogenous Money Approach* (Edward Elgar, 1990), *Understanding Modern Money: The Key to Full Employment and Price Stability* (Edward Elgar, 1998), *The Rise and Fall of Money Manager Capitalism: Minsky's Half Century from World War Two to the Great Recession* (with É. Tymoigne; Routledge, 2013), *Modern Money Theory: A Primer on Macroeconomics for Sovereign Monetary Systems* (Palgrave Macmillan, 2012; 2nd rev. ed., 2015), *Why Minsky Matters: An Introduction to the Work of a Maverick Economist* (Princeton University Press, 2016), and *Macroeconomics* (with W. Mitchell and M. Watts; Red Globe Press, 2019). He is also coeditor of, and a contributor to, *Money, Financial Instability, and Stabilization Policy* (Edward Elgar, 2006) and *Keynes for the 21st Century: The Continuing Relevance of The General Theory* (Palgrave Macmillan, 2008).

Wray taught at the University of Missouri–Kansas City from 1999 to 2016 and at the University of Denver from 1987 to 1999, and has been a visiting professor at the Universities of Paris and Rome (La Sapienza). He holds a BA from the University of the Pacific and an MA and a Ph.D. from Washington University, where he was a student of Minsky. He has recently completed a Fulbright Specialist Grant at the Tallinn University of Technology in Estonia.