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The Fed Does Not Deserve All the Inflation Blame

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CAMBRIDGE – A growing crescendo of commentary places the blame for the current surge in US inflation squarely on the Federal Reserve. But much of the criticism is stupefyingly naive about the political pressures that the Fed and other central banks around the world have had to navigate in recent years.

In the United States, pressures on the Fed reached a peak when the Democrats, eager to put progressive ideas into practice, took control of the White House and Congress in January 2021. Yes, the Fed has significant independence in many dimensions, but it does not enjoy nearly the same institutional independence as, say, the European Central Bank.

Instead, the Fed is a creature of Congress that can, in theory, be radically transformed at short notice. Importantly, the term of the Fed's chair always expires one year into a new president's term, and President Joe Biden's administration was able to make several other Fed appointments as well. Although the idea of "Fed packing" (adding new positions to tilt the central bank's voting majority) never gained traction, Fed officials surely noticed the Biden administration's discussion of whether to counter the US Supreme Court's conservative majority by increasing the number of justices.

Given Biden's attempt to administer massive fiscal stimulus, how realistic was it to think that the Fed could have started hiking interest rates in the first half of 2021 as inflation started to rise? Most economists did not yet view inflation as a major macroeconomic concern. Let's remember that when my Harvard colleague Lawrence Summers started gently warning about inflation back in February 2021, many economists did not yet take a durable recovery from the COVID-19 pandemic for granted.

Moreover, progressives were enthralled by the idea that US federal debt could rise substantially without triggering a significant increase in inflation or interest rates. Modern Monetary Theory, or MMT, an extreme version of this idea that called for the Fed to buy up debt as the Treasury issued it, had many influential adherents in politics and the media. As recently as February 2022, with annual US inflation running at 7.9%, the *New York Times* published an admiring profile of leading MMT advocate Stephanie Kelton.

Had the Fed started raising the federal fund rate in the first half of 2021, by even a quarter or half a percentage point, the Biden administration would have made sure that the central bank owned any downturn that followed. And MMT proponents would have said that their experiment was never given a chance. This would have been a highly effective critique of the Fed, given how long inflation had been dormant. Prior to the pandemic, except for a few extreme cases such as Argentina and Venezuela, inflation seemed to have disappeared. At the same time, low prevailing interest rates meant that many governments felt emboldened to run much bigger fiscal deficits.

Respected centrist economists such as Olivier Blanchard had argued prominently that governments should be much less concerned about debt than in the past because interest rates would remain very low relative to GDP growth rates. Others emphasized that governments should allow debt to increase in recessions and crises, but not worry too much about actively bringing it down during booms. Inflation, it seemed, was not a big concern.

Indeed, so-called "helicopter money," or the financing by central banks of fiscal deficits, was being widely promoted as a way to stimulate economies when monetary policymakers found themselves unable to cut interest rates that were already near zero. Although some of us argued forcefully that MMT and even its softer variants were deeply misguided, it was a seductive idea, and, until inflation actually got out of control, its flaws were difficult to demonstrate decisively. In a way, the Biden administration's experiment with hyper-stimulus in a growing economy was one that was demanding to be tried, and progressives would have taken aim at the Fed had it stood in the way.

But while that might explain why the Fed refrained from hiking rates initially, why did it still refuse to act when price growth accelerated in late 2021? Part of the explanation may be that Fed economists really thought inflationary pressures were temporary. But Biden's decision to hold back his reappointment of Fed Chair Jerome Powell until late November also played an influential role. Had the Fed begun increasing rates in the second half of 2021, the president would likely have replaced Powell with someone more dovish, and markets would immediately have discounted the hikes.

Is there any way the Fed can better insulate itself from such pressures in the future? I do fault the Fed for not taking seriously in 2019 the idea of a deep negative interest-rate policy as a way of cushioning against deflation. To be fair, the economics profession has badly lagged in that regard as well. Much of the intellectual resistance to deeply negative interest rates is curiously superficial and needs to be addressed the next time the Fed reviews its monetary framework. If the Fed had a more powerful tool for fighting deflation, it would likely have been braver about raising interest rates sooner as inflation picked up. The full effect of monetary policy on inflation typically takes a few quarters to appear, and the Fed needs the confidence to be more agile.

In sum, the Fed certainly bears its share of blame for the great inflation of the 2020s. But powerful political pressures from the left and overly-optimistic analyses of open-ended debt policy, not to mention genuine uncertainties about inflation and real interest rates, also played a very large role.

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