DOLLAR & SENSE: THE BROOKINGS TRADE PODCAST

WHAT'S CAUSING INFLATION IN THE U.S. AND HOW WE CAN GET OUT OF IT

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DOLLAR: Hi, I'm David Dollar, host of the Brookings Trade podcast Dollar and Sense. Today, we're going to talk about a hot topic, which is inflation. After a long period of low inflation, we now face about 7 percent consumer price increases in the U.S. So, I have a great guest to talk about this, how we got here, and what to do about it. Don Kohn is a senior fellow in economic studies at Brookings. He worked 40 years in the Federal Reserve system, including a long stint as vice chair of the Board of Governors. So welcome to the show, Don.

KOHN: Well, thank you, David. Thank you for having me on. I'm looking forward to our conversation.

DOLLAR: So, what are the main factors that have led to this inflation? I mean, I'd really gotten used to living in a low inflation environment for so long. What's the role of policy here versus external shocks?

KOHN: So, I think you and I and the Federal Reserve had gotten used to living in a low inflation environment. So I think this has been a learning experience for all of us. So I would say it's a combination of policy and external shocks. The external shock, obviously, is the pandemic, and the pandemic has a lot to do with the current high level of inflation. It disrupted the supply of goods and services to consumers and businesses. The supply chains—we've heard a lot in the news about supply chains—the flow of goods coming from abroad, in particular through the ports of Los Angeles, et cetera.

Like many of the listeners to this podcast, I'm a resident of the of the Washington area and I'm occasionally out on the Chesapeake Bay and in my sailboat, and I see long lines—so it's not only the West Coast, but Baltimore also—I see long lines of cargo ships lined up to get into the Port of Baltimore. So there is disruption to the supply of stuff coming particularly from the Far East, I think, because of the way they've responded to the pandemic. China, in particular, has this zero COVID policy, so they shut factories down. They shut cities down, stuff that didn't get produced. It can't get shipped to the United States. But there's also been problems in United States port, too.

It discourage workers, so people retired early, took early retirement that they had offered to them in this situation. But even people that weren't offered early retirement, I think, got sick or were caring for sick relatives or friends, that disrupted school and child care. So to the extent that you had children at home, it was hard to continue working under those circumstances. So the pandemic has played a big role.

So when the stuff isn't coming in and people want it, the price tends to go up. And the shortages are some things like chips that go into cars, have really put upward pressure on automobile prices, for example. And when you people want stuff and the workers aren't there to produce it, then that puts upward pressure on wages. So the pandemic discouraging supply is one part.

But the other part is the policy response to the pandemic. So both monetary and fiscal policy went all in on supporting the economy as the pandemic set in. So fiscal transfers, those payments to people—lump sum, but also payments to state and local governments—to help them through the pandemic have given people a lot of excess savings that they're sitting on. The easy monetary policy, when the pandemic set in, the Fed immediately went to zero interest rates and started buying large volumes of securities. Some of that was to keep the securities markets functioning well. But even after the functioning was restored, they continued to buy a lot of securities, putting downward pressure on interest rates. Those lower interest rates helped, for example, push mortgage rates down, and contributed to very strong demand for housing, help people finance automobiles, et cetera, help businesses borrow money to finance capital spending. The wealth went up, so equity prices went up, people were wealthier, they spend some of that.

So I think you have the pandemic impinging on supply, the response pushing on demand, and those two things tend to push prices up. And we have gotten this inflation and inflation which has been stronger and persisted much longer than most people thought it would.

DOLLAR: Thank you, Don, that was very clear. Kind of a perfect storm of supply side problems and demand side stimulus. You know, we had a very good year of economic growth last year, real growth. So there's a positive side. But I, for one, am somewhat worried about 7 percent inflation. So, the Fed has signaled very clearly, I think, that it's going to increase its policy rates and reduce the size of its balance sheet in 2022. There's a whole industry out there trying to predict will there be three increases, four increases, five increases. I don't think that's all that interesting. And nobody can predict. I like the fact that Jay Powell, very clear that this is all data dependent. But can you walk us through what we might think of as different scenarios for monetary policy in 2022? What's likely to happen or what is the range of possibilities?

KOHN: So I think the first thing to emphasize is the one that you quoted Chairman Powell on, which is no one really knows what's going to happen here and what's going to be required. So it is incumbent upon the Federal Reserve , it is important that I think the Federal Reserve said we are not going to commit to a particular set of rate increases or particular wind down of our portfolio immediately. So they've said they're data dependent. This is really one case where you could say it's a unique situation. We hope there aren't pandemics more than once a century. And so they need to be quite flexible.

But I think we can think of both. As I said, when the pandemic set in, the Fed did two things. It reduced interest rates to zero, which helped demand in a number of ways. And it started buying securities, which also helped demand by driving interest rates lower. So it's got a very accommodative monetary policy, which is pushing on demand against limited supply. Now it's got to take that accommodation away.

So I think at one point to emphasize is, we are not talking about stepping on the brakes here, if we're going to get to an auto analogy. We're talking about taking our foot off the gas. So the zero interest rates, the securities purchases have been very much about pushing demand, adding to demand, pushing on the accelerator. So now the Fed's taking its foot off the accelerator, and there are two aspects of this, as you said. One is getting interest rates higher. So you've got interest rates, the Fed target interest rate, overnight interest rate, is very close to zero now, and they've already said they're going to be raising it and they're going to raise it very, very likely the first increase in March. But there will be more increases after that. But also they they're winding down their purchases of securities. And some point later this year, probably this summer, they'll start to let those securities run off. So they've got a portfolio of securities, a bunch of them mature every month. Right now, they're taking all the maturing securities, the interest they're earning and then reinvesting it and actually buying some more for another month. At some point this summer, they're going to say, let's take a bunch of those maturing securities and just let them mature. Let them go. And we won't hold them anymore. Take them off our portfolio.

So they'll be doing both things, raising interest rates and allowing the securities to run off. And that will put upward pressure on short-term rates as they raise their target rate, and not buying the securities and letting the securities run off will tend to put at least some upward pressure on longer term interest rates because a lot of the securities that they own are longer term. So as they run off, the Fed won't be buying them. The public will need to buy them, and that'll take some adjustment.

So I think we've already seen the financial markets bring forward their expectations of interest rate increases and portfolio run off. And we've seen mortgage rates go up. We've seen some drop in equity prices. We've seen the dollar strengthen and I think you want to get into that a little bit in a second. So we've seen financial conditions tighten some, which should discourage some increases in spending. I think what the Fed would like to do is raise those interest rates, let that portfolio run off. They don't want to create a recession or even a massive slowdown in spending, but they want to get back to a more sustainable situation, taking some pressure off of inflation.

DOLLAR: So all of that sounds very reasonable and sensible approach for the Fed. But I've been struck by how volatile different markets, particularly the stock market, but also more frontier markets like cryptocurrencies, they've been awfully nervous the last month or so. They seem very worried that the Fed will overcorrect. But if decisions are data dependent, what's the worry? If it seems like the Fed's overcorrecting, then they'll ease up a little bit, right?

KOHN: That's correct. But actually, I think I'm going to dispute part of the premise of your question. So I do think it's a very uncertain time here. And the uncertainty derives first from the course of the virus and the peoples' response to the virus. People didn't expect the delta wave, they didn't expect the omicron wave. What's coming next? How are people going to respond? How are governments going to respond? Et cetera. So it's a time of huge uncertainty, so it's not surprising that markets would be volatile in a situation like this as new information comes in and they try to digest it.

So adding to that is the fact that the Federal Reserve had said that we're going to keep our foot on the accelerator for a long time. Now they're taking their foot off, so I think that adds to some extent to the uncertainty. But they need to do that in order to control inflation. And I don't think the resulting volatility has been all that bad. And I think what's happened in markets is largely what the Fed would like to happen in markets—things tighten up a little bit, so to tamp down increases in spending to better control inflation.

What I dispute to some extent is your characterization that markets think the Fed is going to fail, that this is going to be a hard landing. I don't see that. I think that if you look at the yield curve, if you look at equity prices, if you look at risk spreads in bond markets—to be sure, risk spreads have gone up a little, equity prices going down some, but that's what you'd expect to happen as interest rates rose some. A lot of businesses have taken on a lot of debt. Now they're going to have to pay more a little bit more to service that debt. So there's they're a little riskier. But I think overall, if you look at all the constellation of financial market prices, they're looking for a soft landing. They're looking for a very modest increase in interest rates up into the 2 percent, or maybe even a little bit less level from zero now. So about a 2 percentage point increase in rates or one in three quarters. And bringing us into the long-term inflation embedded in securities markets is very close to the Fed's 2 percent target. So I don't see the expectations of failure here. I do see the uncertainty, but not the expectations of failure.

DOLLAR: Yeah, that's a very helpful clarification. I think the one thing I would add that's useful for listeners, and I don't know if you agree with this, but I wanted to add that monetary policy tends to work with something of a lag, pretty significant, maybe six to nine month lag. So if you over tighten, you may not know you made a mistake for six to nine months. So it's nice to say we're data independent, but it's kind of hard to fine tune things day by day.

KOHN: Well, I think that's an excellent point, David, and I completely agree that monetary policy works with a lag. What's interesting is that the financial markets, there's no lag between what the Fed says and how financial markets respond. But there is a lag between you and me saying that mortgage rates have gone up by 25, 50, 75 basis points, and how we decide whether we're going to buy a new house or not. So the lag is between the financial markets and what people do. There's a lot of dispute about how long those lags are. Milton

Friedman said that lags between monetary policy and economy are long and variable. There are some arguments that they shortened some over the last couple of decades, but they're still lags in there. So you're absolutely right. If you're just basing policy on incoming data, then you're going to overshoot on the easy side and on the tight side, because you won't see the effects. The art of making monetary policy is taking the incoming data, feeding that into a forecast, a projection about where you're going to be a year or two from now, and adjusting policy to that forecast, which is heavily influenced by the incoming data, but isn't just the incoming data.

DOLLAR: So let's talk a little bit about how as the U.S. adjusts its macro policies, what's the role of trade and the exchange rate? You pointed to some of the supply bottlenecks very much in the trade supply chain. But despite the bottlenecks, the U.S. actually imported a historic amount of stuff in 2021, and we had a historically high trade deficit in 2021. So how do you see trade and the exchange rate? What role do they play as the U.S. adjusts its monetary policy?

KOHN: Well, I think they play a very constructive role, and I think what you point out is important. Although there are supply bottlenecks, the demand for the stuff in those supply chains has been so strong that more is being supplied into the United States, but it's not enough to keep the prices down because the demand is so strong.

So I think the exchange rate channel for monetary policy is an important one and one that helps quite a bit. So as the U.S. tightens, particularly if the Fed tightens faster than the ECB, if the People's Bank of China at the same time is lowering their interest rates, which they seem to be doing, and the dollar strengthens, that makes imports less expensive for the U.S. So that's going to help keep inflation down and the imports flowing in take pressure off of U.S. businesses that are having a great deal of trouble hiring people, and our paying up and then passing those wage increases through in prices. So I do think that foreign channels—the higher imports, the lower prices for those imports as the dollar strengthens—reinforces what the Fed is trying to do with its monetary policy. They play a constructive role here.

DOLLAR: So, while we're primarily talking about U.S. policy, there's interest all around the world in what's happening here. A lot of developing countries are concerned about what's going to happen as the U.S. tightens and the dollar appreciates. I thought it was quite remarkable that President Xi Jinping of China used his speech at Davos—I mean, he didn't mention the U.S. or the Fed by name, but it was clearly a signal to the Fed that advanced economies should be very careful about tightening their monetary policy because of the spillover effect on developing countries. So, what are developing countries worried about in this situation?

KOHN: A number of developing countries have borrowed in dollars and used it for domestic investment in their native currencies, denominated in their home country currencies. So to the extent that they have borrowing in dollars, they're being hit by higher interest rates if that borrowing is a floating rate, and the fact that the dollar is strengthened. So it takes much more of their own currency to repay that thing. So if they have imbalances in their borrowing and lending, then the stronger dollar and the higher interest rates will have negative effects on them. And they must worry if the inflation expectations in their own countries aren't well anchored. The stronger dollar means that the goods that the U.S. is shipping to them are more expensive. So if inflation expectations aren't well anchored in those countries, then they could see as their currency depreciates, they could see this feed through inflation in their countries.

But I think if those countries have good, stable policy regimes, they have nothing to be concerned about. And in fact, they should be concerned if the U.S. allows inflation to continue for very long. What they don't need is instability in the most important economy in the global economy. That is not going to be helpful to them.

So it's in their interests that the Federal Reserve and fiscal policy and whatever other tools are used are used to control inflation, keep growth in the U.S. on a sustained basis. I think it's important that Jay Powell has pointed out many times that controlling inflation is necessary to sustain growth in the U.S., to keep the U.S. growing. So would be even worse for emerging market economies would be a recession in the U.S. So, I do think what the Federal Reserve is doing may have some spillover effects, but it's in the best interest of the global economy, including the emerging market economies and they'll be able to cope with it. There are exceptions where there are bad monetary regimes—Turkey is an obvious example—but for the most part, they'll be able to cope with it and they'll benefit from such sustained growth in the United States.

DOLLAR: Yeah, I think that's a nice distinction that the developing countries that have pretty good macroeconomic management will obviously benefit if the U.S. can handle this well and bring about a soft landing. And on the other hand, you've got some countries that have overborrowed in the international market, in foreign currencies. And that was going to run into problems sooner or later, and then the Fed can't really run its policy around protecting those countries.

KOHN: And even for those countries, I think the evolution over the last 20 years has been for those countries that have put in stable macroeconomic policy regimes have been able to reduce the imbalances in their borrowings. So what really did in a lot of countries in the '90s—think about the Asian financial crisis of the late '90s—is a huge amount of very short-term borrowing. And Mexico in the mid the mid-'90s as well. A huge amount of short-term borrowing and dollars funding longer term investments in their home currencies. And I think as emerging market regimes have strengthened that imbalance has actually been reduced and there is much more borrowing and lending in their home currencies and much less reliance on very short-term borrowing in dollars.

DOLLAR: Last question for you, Don, is what can President Biden and the White House do about inflation? This whole inflationary episode seems to be an important factor in perceptions of Biden's performance. It's a big issue on the minds of Americans. They think the administration is not doing a good job. Does the president really have much influence over inflation? What should he be doing?

KOHN: So I think he's done the most important thing he should do, which is support the Federal Reserve's battle against inflation, and support them taking steps to contain inflation. And he has recognized that it's really the Federal Reserve's mandate from Congress and the Federal Reserve's tools that are best positioned to deal with this inflation problem. And the administration has very limited things it can do on its own to deal with inflation. They have talked about steps to encourage competition in meatpacking and other places. I think there are good reasons to deal with concentrations of power in corporations and monopoly type and oligopoly type positions. But controlling inflation isn't really one of them. It will have no effect, no real effect on inflation.

I think one thing they could do, and I'd be actually interested in your views on this, David, is to reduce the tariffs that they put on. We talked a second ago about the constructive role that imports could play in fighting inflation. The administration does have tools in that regard. The Trump administration put tariffs on, those tariffs raised prices for consumers, and the Biden administration has kept them there. So I recognize that the tariffs in some cases were there to try to force other countries to behave better—China is the obvious example in the global trading system—to abide by the rules better. But I do think there may be opportunities for the administration to lower those tariffs, which would have a very direct impact on prices in the U.S.

And the other channel it has is immigration. So labor markets are extremely tight. And our legal immigration has been held at very low levels. So I think you could benefit U.S.

businesses and U.S. consumers taking some of the pressure off of labor markets by allowing more high skilled workers into the U.S. That would increase the dynamism of the U.S. economy as well. So I think in both cases, the administration has some buttons it can push, it doesn't seem to be willing to push those buttons.

DOLLAR: Yeah, I think those are really excellent points, Don, I completely agree. I think the tariffs aimed at China have not succeeded, and they are part of the supply bottlenecks we're talking about. And I love your point about immigration. A lot of people have retired early, and labor force participation is down, and our own demographics is pushing us in a direction of very low labor force growth. And we have an opportunity to let talented people, particularly missing skills, into our economy. And I think you can quibble with measures like these on the structural side that any one of them is probably not going to have a large, measurable effect on inflation. But they're going to have an effect in the right direction. They'll be good for the dynamism of the economy, and the White House will be seen to be doing something constructive. And people give administrations credit for that.

I'm David Dollar and I've been having a delightful conversation with my colleague, Don Kohn, who's given us a very clear understanding of how we got into this inflationary situation, what the Fed is likely to do to get us out of it, and some of the related issues like what's happening with exchange rates and trade, developing countries. So thank you very much, Don.

KOHN: Great to be with you, David.

DOLLAR: Thank you all for listening. We'll be releasing new episodes of Dollar and Sense every other week, so if you haven't already, follow us wherever you get your podcasts and stay tuned. Dollar and Sense is part of the Brookings Podcast Network. It's made possible by support from producer Fred Dews, our audio engineer Gaston Reboredo, and other Brookings colleagues. If you have questions about the show or episode suggestions, you can email us bcp@brookings.edu, and follow us on Twitter @policypodcasts.

Until next time, I'm David Dollar and this has been Dollar and Sense.