# How to Fight Inflation

## The views of four distinguished experts.

With U.S. inflation still far higher than expected, various firefighting teams of experts have stepped forward, offering to come to the rescue. Here's a scorecard of some of the players:

- U.S. Senator Elizabeth Warren (D-MA) is leader of the "Full Speed Ahead Rescue Squad." Enact President Biden's latest fiscal stimulus package, she suggests, and force the Federal Reserve chair to agree there'll be no more central bank increases in short-term interest rates.
- Former Treasury Secretary Larry Summers argues in favor of the "Let the Fed Do Its Job But Raise Taxes to Dampen Demand Rescue Squad." The subsequent rise in unemployment, he argues, will break the back of inflation as it did in the early 1980s. Summers has the credibility of being one of the few economists to predict the current outbreak of inflation.
- Then there's the "Don't Do Anything Rescue Squad." Adherents argue the Milton Friedman monetarist line that "inflation is always and everywhere a monetary phenomenon." If you follow the money supply measure M2 (currency in circulation plus bank and money market fund liquid balances), they argue, the inflation problem will take care of itself. After rising sharply, M2 is coming down. Within a year, inflation will have dropped sharply.
- There's also the "Produce More Oil and Gas to Bring Down Energy Costs Rescue Squad."
- Finally, there's the "Let the Dollar Soar Rescue Squad." Proponents believe the Fed's rising short-term interest rates will continue to produce a strengthening U.S. dollar, putting the global economy in a quandary. The rest of the world will face ever-higher import and other prices (particularly food prices with coming global shortages). Dollar-denominated debt defaults will jump. A dollar shortage could occur, putting pressure on global financial conditions. Meanwhile, the strong dollar will help bring down import costs paid for by American consumers. Even better, the U.S. stock market and other assets will look attractive to foreign investors as long as the U.S. Treasury publicly supports a strong dollar. (It will.) So do nothing, they say. Let the Fed do its job. The United States is in the best position to ride out the storm.

Which team offers the most compelling prescription for handling inflation? Or have we missed an important option looming on the horizon? Is the "Let the Dollar Soar Rescue Squad" the most likely given that action from the U.S. Congress or a change in Federal Reserve policy is not required? Is the International Monetary Fund view correct that the world is about to experience a heightened period of chaos, violence, and political volatility? Is this chaos in part the result of the expected effects of a strong dollar? Will global chaos eventually bring down global inflation?

How do you see things stacking up?

***The U.S. Federal Reserve faces an acute trade-off.***

**PHILIPP HILDEBRAND**
***Vice Chairman, BlackRock, and former Chairman of the Governing Board, Swiss National Bank***

The U.S. Federal Reserve faces an acute trade-off. It either needs to raise rates high enough to crush the economy in order to kill inflation. Or we might need to live with higher inflation than in the past.

The post-Covid restart of the U.S. economy has not been the same as a typical business cycle recovery, so it calls for a different evaluation. Pandemic-induced lockdowns and their subsequent relaxation have created production constraints not seen for four decades.

There are two main reasons: first, a massive shift in consumer spending away from services to goods; and second, job vacancies that companies find hard to fill. Both factors seem persistent. BlackRock Investment Institute estimates put the U.S. economy's production capacity down by around 7 percent relative to the pre-pandemic trend—while seeing only about half of that being eventually restored. This explains why price pressures have been broad based, despite levels of economic activity that aren't unusually high.

Raising interest rates won't pep up production capacity. Nor will fiscal policy—at least in the near term. It is possible to bring inflation back to 2 percent quickly. But the BlackRock Investment Institute calculates that the Fed would need to raise rates to force GDP to fall by a little over 2 percent in total, which could push the unemployment rate above 5 percent—with up to three million additional people out of work.

We are facing the starkest trade-off between inflation and growth since the early 1980s. This is not a trivial choice. We need a proper debate about how much inflation should be tolerated to stabilize economic growth. Such nuanced framing is difficult in today's hyper-politicized environment, but it's what we badly need.

While an absolutist, "whatever it takes" approach was the right call to stem the financial crisis, today's inflation calls for a more delicate approach. The right approach now is to clearly articulate the very unusual nature of today's inflation and the stark trade-off it entails. This would help to keep inflation expectations anchored. And then it is to bring inflation down only gradually with moderately restrictive policy, thus enabling some growth to be preserved and minimizing the damage to employment.

***The long-term capital investment slowdown is setting the stage for a period of inflation surges that short-term monetary policy cannot easily address.***

**MICHAEL MANDEL**
***Chief Economist and Vice President, Progressive Policy Institute***

Should policy be aimed solely at extinguishing a one-time inflation flare? Or should economists also address structural problems which expose American workers and consumers to recurring inflationary shocks?

The long-term capital investment slowdown is setting the stage for a period of inflation surges that short-term monetary policy cannot easily address. Since the financial crisis of 2008–2009, the rate of capital accumulation in the United States slowed by half, from roughly 2.6 percent per year to 1.3 percent per year, even including investment in intangibles such as software and research and development. Domestic manufacturing capacity, outside of high tech, peaked in 2007, and since then has fallen by almost 10 percent. Over the same period, consumer purchases of goods, outside of tech, are up 45 percent. With this growing mismatch between supply and demand, it should not come as a surprise that the United States has become ever more vulnerable to shocks in the global trading system.

The key word here is "vulnerable." No one is denying that free trade, globalization, and increased shift to supply chains have helped hold down prices for years. But when globalization and an increased dependence on supply chains is accompanied by a lack of domestic investment, the result is a loss of resilience that is not picked up by conventional economic measures.

In a supply-chain world, a sectoral approach is appropriate for analyzing inflation. Low-investment industries are typically supply-constrained and more likely to boost prices when hit by an unexpected shock. Indeed, as shown in our latest "Investment Heroes" report, low-investment industries—including most of manufacturing, construction, trucking, air transportation, accommodations and food service, and mining—have all shown moderate to high inflation rates.

Conversely, sectors with strong domestic investment seem to have mostly escaped the inflationary surge. For example, high and sustained investment in the digital sector—broadband, tech, and ecommerce—has created enough capacity to hold down most digital price increases, despite the overall inflationary environment. The price of wireless services fell by -0.9 percent in the year ending June 2022. The one exception is the semiconductor industry, where domestic capital investment has lagged, contributing to overall inflation.

The policy and political implications are clear. No matter how we decide to fight inflation in the short run, the goal should be to make the economic house less flammable in the long run. Policymakers should applaud those companies that invest in the United States, and not pursue policies that discourage domestic capital investment.

OFFICIAL WHITE HOUSE PHOTO BY SHEALAH CRAIGHEAD

***The traditional way for the Federal Reserve to conduct tight money is to limit or even reduce balance sheet liabilities.***

## ARTHUR B. LAFFER

***Founder and Chairman, Laffer Associates***

The traditional way for the Federal Reserve to conduct tight money is to limit or even reduce balance sheet liabilities. The normal way for fiscal policy to prompt economic growth is to reduce tax and regulatory hurdles to production. As Robert Mundell reflected in his Nobel Prize lecture in 1999: "Supply-side economics… was based on a policy mix that delivered price stability through monetary discipline, and economic stimulation of employment and growth through the tax and regulatory systems."

Circumstances are not so different today from those of the late 1970s and early 1980s. We are in what some would call a recession while consumer price increases are rising fairly rapidly. The economy surely would grow faster if we had lower, not higher, tax rates, less government spending, and greater incentives for the labor force dropouts to find remunerative work. Inflation would abate as it did in the 1980s if this new production emerged while the Fed normalized its balance sheet.

The simplest way for the Fed to correct itself is to get out of the business of purchasing federal debt. Price controls (which is exactly what the Fed is enforcing given the scale of its federal bond purchases) rarely make things better. The Fed, whether directly or indirectly, has been the principal buyer of the high deficits of the last fourteen years. The Fed's assets now total $8.9 trillion, compared to $900 billion in 2008. If the Fed stopped buying federal debt, interest rates would rise as the money markets priced this asset according to the preferences of actual investors.

If stopping new purchases of federal debt proved insufficient, the Fed should start to sell some of its holdings, again allowing market rates to rise and effectively making government debt attractive to purchasers outside the official financing apparatus. Fiscal policy emphasizing real after-tax rates of return would support this process and lay the groundwork for the kind of disinflationary recovery that this economy was fortunate to experience the last time we had high inflation.

***Persistent inflation is in the cards. The Fed should stop flying blind and put the money supply on its altimeter.***

## STEVE H. HANKE

***Professor of Applied Economics, Johns Hopkins University***

I am solidly in the Milton Friedman camp. However, I don't agree with the way *TIE* editors have portrayed the camp as a "Don't Do Anything Rescue Squad," nor do I agree with the notion that monetarists think "within a year, inflation will have dropped sharply."

A year ago, John Greenwood and I penned an op-ed in the *Wall Street Journal* titled, "Too Much Money Portends High Inflation." To forecast inflation, we used the tried-and-true equation of exchange *MV=PY,* an identity

Milton Friedman proudly displayed on his California license plates. Greenwood and I concluded that, given the unprecedented increase in the money supply (M2), inflation would surge following the Covid pandemic. We even put numbers and dates on our forecast, something that others who were concerned about inflation failed to do, most notably Larry Summers. As we put it last July, "By the end of the year, the year-over-year inflation rate will be at least 6 percent and possibly as high as 9 percent." Using $MV=PY$, we hit the bullseye.

Where are we today? Given the Fed's disinterest in and resulting mismanagement of the money supply, there is a huge overhang of excess money balances in the economy. Indeed, Americans are holding about 20 percent more money relative to their incomes than what they would normally be holding. As a result, Americans will spend their excess money balances and work off the monetary overhang until the relationship between money balances and incomes—the so-called Cambridge $k$—once again reaches normality. This will probably take until the end of 2024, but it could take longer. So nominal spending will be higher during this runoff period than one would expect if one focused solely on new injections into the money supply.

Based on the Quantity Theory of Money and the equation of exchange, Greenwood and I think that persistent inflation is in the cards, with the year-over-year inflation rate at the end of 2022 coming in at 6–8 percent. As for 2023, the inflation rate will fall to 5 percent by the end of the year, a rate which might drag into early 2024.

As far as a prescription for the Fed is concerned, it should stop flying blind and put the money supply on its altimeter. For an eventual soft landing that allows the Fed to hit its inflation target of 2 percent per year, it should keep the annual growth rate of M2 in the 5–6 percent range. ◆