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‘A hellishly difficult task.’ Can the Federal Reserve lower inflation without causing a recession?

Jim Puzzanghera - January 22, 2022

WASHINGTON — The last time annual inflation was running as high as it is now, about four decades ago, Federal Reserve officials took decisive action and brought it back down.

In the process, they also pushed the US economy into a pair of recessions, including a deep one that lasted more than a year and drove unemployment over 10 percent.

It’s been a reliable pattern since World War II: The central bank hikes interest rates to reverse rapidly rising prices, but the collateral damage is an economic contraction.

Now, with inflation recently soaring to its highest level since 1982, the Fed is preparing to return to its conventional inflation-fighting playbook — but this time, there’s hope they can skip the recession part.

The unique effects of COVID-19 have created the potential that history won’t repeat itself and inflation can be reined in without shrinking the economy, economists said. But that’s possible only if Fed Chair Jerome Powell and the other central bank policymakers proceed cautiously and nimbly amid the evolving pandemic’s unprecedented supply chain and labor force problems.

“The virus is unpredictable. People’s responses to the virus are unpredictable. It’s not a garden variety business cycle by any means,” said Donald Kohn, a senior fellow at the Brookings Institution think tank who served as Fed vice chair from 2006-10. “It’s much harder to peer into the future and know how to calibrate your monetary policy.”

Bernard Baumohl, chief global economist at the Economic Outlook Group, a forecasting firm, was more blunt.

“The Fed has a hellishly difficult task right now,” he said. “There is absolutely no history for the Fed to lean on to deal with this kind of inflation.”

A lot is riding — economically and politically — on whether the Fed can pull it off.

COVID-19′s arrival in early 2020 and the subsequent shutdowns immediately plunged the US into a severe recession. More than 22 million people lost their jobs, sending the unemployment rate soaring to 14.7 percent, the worst since the Great Depression. But the economy quickly bounced back as businesses reopened.

The recession technically lasted just two months — the shortest in US history — but the nation is still recovering from its damage. Even after strong economic growth and record job creation last year, the US had 3.6 million fewer jobs in December than its pre-pandemic level.

Despite the economy’s improvement, consumer confidence began tumbling last spring as prices began sharply rising. A closely watched measure of consumer sentiment from the University of Michigan this month hit its second-lowest level in the past decade, largely because of inflation worries after the Consumer Price Index jumped 7 percent last year. With Americans paying more for gas, food, and other essentials than a year ago, a third of respondents in the Michigan survey said they were worse off financially than a year earlier, just a tick above the level in April 2020 amid the COVID shutdowns.

Consumer prices popped again in December, casting a shadow over the economy

The White House and the Fed, along with most economists, predicted last spring that high inflation would be temporary, pointing to the supply chain problems caused by restarting the US and world economies. But former Treasury Secretary Lawrence H. Summers and some other economists warned the $1.9 trillion COVID aid bill enacted last March risked fueling longer-lasting inflation by pumping too much money into the already recovering US economy.

Is it time to worry about inflation? Some experts say the rising prices will be short-lived

As inflation became more persistent, Republicans have turned the issue into a partisan hammer, pounding President Biden and the Democrats for driving up the cost of living for average Americans. The president’s approval rating has fallen partly because of Americans’ worsening view of his economic stewardship, and inflation is set to be a major issue in this fall’s congressional midterm elections. Nearly two-thirds of respondents in a CBS News/YouGov poll released this month said Biden wasn’t paying enough attention to inflation.

“One thing that has become very clear over the last six months is people hate inflation much more than economists hate inflation,” Kohn said. “Economists see it will go up and go down ... but people see inflation and they don’t like it.”

Biden in recent months has acknowledged inflation is a problem and said he’s trying to address it by working to ease supply chain bottlenecks, increase oil supplies, and promote competition in highly concentrated markets like meat processing. He’s also argued that parts of his derailed Build Back Better social spending and climate change legislation would ease inflation’s impact by cutting other household costs, like those for prescription drugs, child care, and energy.

Will Biden’s big spending bills equal more inflation? It’s complicated

“It’s not going to be easy, but I think we can get it done,” Biden said at his Wednesday news conference, when asked about lowering inflation. “But it’s going to be painful for a lot of people in the meantime.”

Still, he noted that the Fed, which is independent from the White House, plays a critical role in fighting inflation.

Keeping prices stable is one-half of the central bank’s dual mandate; the other is promoting maximum employment. But with the unemployment rate down to 3.9 percent in December, the Fed is shifting into inflation-fighting mode — what’s being called the “Powell Pivot” — after boosting the labor market since early 2020 by keeping its benchmark short-term interest rate near zero and buying hundreds of billions of dollars worth of bonds.

“We have to achieve price stability, and I believe we will, and I’m confident we will,” Powell told the Senate Banking committee on Jan. 11 during a hearing on his renomination by Biden for four more years as Fed chair.

The Fed has the most powerful direct tool to reduce inflation — the ability to manipulate interest rates. It now is forecasting it will raise its benchmark rate up to near 1 percent this year while also ending its bond-buying program, which kept money flowing in financial markets and stabilized long-term interest rates. Fed officials believe the combination will slow the economy just enough to lower inflation without causing a recession.

Economists aren’t as confident, but said it’s possible depending on the course of the pandemic.

“I think the Fed can calibrate things carefully and gradually in a way not to push us into a recession,’ said Kathy Bostjancic, chief US financial economist at Oxford Economics, a global forecasting and analysis firm. “But it is a challenge because historically we all know the Federal Reserve and other central banks have not been all that successful in navigating a soft landing for the economy.”

The most recent example was in the early 1980s, when aggressive Fed actions to battle inflation caused a short recession in 1980 and a longer, more severe one from 1981-82. But inflation had been building for years back then, requiring a much more forceful response that ultimately pushed interest rates up near 20 percent. The circumstances today are very different, with inflation spiking suddenly after running low for decades.

“The only reason we have this surge in inflation now is we got hit with a shock, an unprecedented kind of shock,” **Baumohl** said. “In some ways, you can consider it like an earthquake that happened in 2020 and we’ve had these aftershocks as a result of the additional variants.”

He expects inflation to peak in the first three months of this year as economic growth slows — but doesn’t stall — with less federal stimulus spending and as supply chain constraints ease. That would allow the Fed to pull back slightly on interest rate hikes and keep the economy out of recession. Powell and Fed officials will have to move cautiously and not overreact to inflation, **Baumohl** said.

The Fed is also taking action at a time when its influence on the economy may be weaker than in the past. The pandemic has distorted the economy to the point that the Fed’s conventional tools, like interest rate hikes, are limited in their effectiveness, said Stephanie Kelton, an economics and public policy professor at Stony Brook University. That constrains the Fed in bringing down inflation but also makes it harder for Fed intervention to cause a recession, she said.

Kelton pointed to used cars and trucks. Their prices surged 37.3 percent in 2021, a major factor in the overall inflation increase. But people aren’t buying used vehicles because they think it’s a great time to do so, she said. They’re buying them because there aren’t as many new vehicles after production has been constrained by a shortage of computer chips from Asian factories affected by the pandemic.

Given that dynamic, increased interest rates for auto loans are unlikely to significantly tamp down used car demand, Kelton said.

“If you can raise rates but not deter or dampen much other activity then you’re not going to cause a recession,” she said.

by the Fed to raise rates hindering business owners who need low interest rates in order to overcome pandemic disruptions.

“If you raise interest rates you affect Main Street lending and we don’t want that right now,” said William Spriggs, an economics professor at Howard University and chief economist to the AFL-CIO organized labor federation. “Companies need room to ramp up production. Raising interest rates takes away that room.”

Spriggs said Powell is reacting to political pressure from Republicans to address inflation despite the difficulty in determining the real reasons for high prices during an unprecedented pandemic.

“It’s not really inflation. ... What we’re suffering from is price instability, which is something different,” he said. “It’s going to take time [to stabilize] because this is global and the disruptions to supply are a global phenomenon.”

Kohn acknowledged the difficulty in economic forecasting during the pandemic, but said the Fed’s inability to see that this burst of inflation would be more persistent has hurt its credibility. He gives Powell credit for quickly changing course, but sees a risk of recession if the Fed has to act more aggressively than it’s signaled it will this year.

“It’s all built on this very difficult to predict virus,” he said. “For once the word ‘unique’ is justified.”

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