The Necessity of Monetary Discipline

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Commentators on the current economic landscape in the United States have opined about the many uncertainties regarding the economy’s immediate outlook. Some worry that we are on the precipice of a recession. Others predict that tariffs will exacerbate inflation. Job creation for the year ending in March was recently revised down by almost 1 million, stoking fears about labor market fragility. Recently, Fed Chair Jerome Powell made allusions to imminent rate cuts in his speech at Jackson Hole, citing concerns about payroll and labor force growth.

Inflation concerns paired with what the Fed perceives to be an increasingly slack labor market means that the Fed is between a rock and a hard place: lowering interest rates could set off another bout of inflation, but keeping interest rates steady may entail increased unemployment and a recession. So, what is the Fed’s best course here?

With so much uncertainty and apprehension, the best thing for the Fed to do is to lean heavily on the first pillar of its dual mandate: to maximize price stability. Powell mentioned in his speech that the neutral level of interest rates “may now be higher than during the 2010s, reflecting changes in the productivity, demographics, fiscal policy, and other factors that affect the balance between saving and investment.” Aside from the fact that the zero lower bound period is a dubious baseline, what isn’t explicitly stated here is that the higher nominal interest rates are the inexorable effect of the massive pandemic-era deficits and loose monetary policy. It was entirely foreseeable that this would eventually beget higher interest rates, but this does not mean that r-star must remain higher in perpetuity.

If the Fed wants to get inflation under control, then it needs to properly anchor expectations by signaling an unwavering commitment to price level stability– a necessary condition for economic stability. Committing to such a policy over the foreseeable future will enable everything else fall into place. Once prices stabilize, interest rates will come down and employment will recover.

This discipline becomes increasingly important as concerns are raised in some quarters about the impact of tariffs on the economic outlook. In July of this year, President and CEO of the New York Fed, John C. Williams, stated, “I expect uncertainty and tariffs to restrain spending and reduced immigration to slow labor force growth. As a result, I expect real GDP growth this year to be about 1 percent.” When pairing Williams’ apprehensiveness about growth with Powell’s comments about possible rate cuts due to apparent fractures in the labor market, one gets the sense that the Fed may be inclined to put more emphasis on the outlook of GDP and unemployment when curating their policy stance than inflation.

The risk that the Fed runs here is creating stimulus in response to what is fundamentally a supply problem. If tariffs are truly behind the lackluster economic outlook, then attempts to stimulate the economic activity will not only fail to resolve the supply issue, they'll compound cost-push dynamics with the forces of demand-pull inflation. Markets are likely to read this as a signal from the Fed that it is willing to subordinate price stability to its desired employment levels, revising people's expectations and potentially setting off another round of inflation, setting us back to square one and undermining the Fed's credibility. Ignoring these consequences may force us to relearn the lessons of the 70s all over again, the hard way.

The experience of the 70s with the 80s tells a tale of two Feds. The former period witnessed a Fed that sacrificed inflation on the altar of maximum employment, summoning the tempest of stagflation with it. The latter period began with Volcker making a hard and fast commitment to get inflation under control. Although this approach initially put us through the painful, yet necessary, hangover recovery process stemming from the previous inflationary spiral, it ultimately brought us back to our inflation target, and with it, anchored expectations and put the economy back on a path of healthy growth for decades.

Given the challenges that the Fed currently faces in performing its dual-mandate balancing act, the wise path forward is for the Fed is to continue shrinking their balance sheet at a steady pace and demonstrate that their commitment to price stability is iron-clad. The upshot is that economic stability follows price stability, meaning that both horns of the mandate can be satisfied by pursuing one of them vigorously. The wrong decision puts us at risk of repeating the same mistakes of the past, expecting a different result.