The Ghost of Arthur Burns

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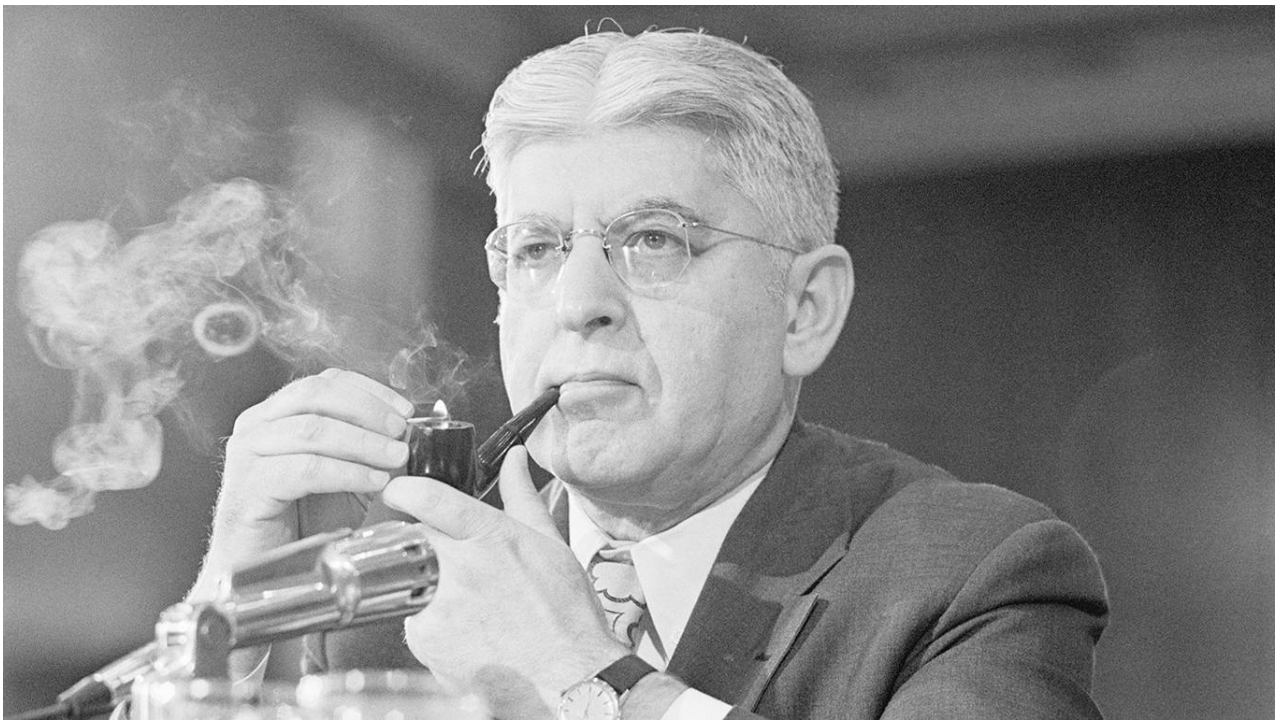

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May 25, 2021 Stephen S. Roach

The US Federal Reserve is insisting that recent increases in the price of food, construction materials, used cars, personal health products, gasoline, and appliances reflect transitory factors that will quickly fade with post-pandemic normalization. But what if they are a harbinger, not a "noisy" deviation?

NEW HAVEN – Memories can be tricky. I have long been haunted by the inflation of the 1970s. Fifty years ago, when I had just started my career as a professional economist at the Federal Reserve, I was witness to the birth of the Great Inflation as a Fed insider. That left me with the recurring nightmares of a financial post-traumatic stress disorder. The bad dreams are back.

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They center on the Fed's legendary chairman at the time, Arthur F. Burns, who brought a unique perspective to the US central bank as an expert on the business cycle. In 1946, he co-authored the definitive treatise on the seemingly rhythmic ups and downs of the US economy back to the mid-nineteenth century. Working for him was intimidating, especially for someone in my position. I had been tasked with formal weekly briefings on the very subjects Burns knew best. He used that knowledge to poke holes in staff presentations. I found quickly that you couldn't tell him anything.

Yet Burns, who ruled the Fed with an iron fist, lacked an analytical framework to assess the interplay between the real economy and inflation, and how that relationship was connected to monetary policy. As a data junkie, he was prone to segment the problems he faced as a policymaker, especially the emergence of what would soon become the Great Inflation. Like business cycles, he believed price trends were heavily influenced by idiosyncratic, or exogenous, factors – "noise" that had nothing to do with monetary policy.

This was a blunder of epic proportions. When US oil prices quadrupled following the OPEC oil embargo in the aftermath of the 1973 Yom Kippur War, Burns argued that, since this had nothing to do with monetary policy, the Fed should exclude oil and energy-related products (such as home heating oil and electricity) from the consumer price index. The staff protested, arguing that it made no sense to ignore such important items, especially because they had a weight of over 11% in the CPI. Burns was adamant: If we on the staff wouldn't perform the calculation, he would have it done by "someone in New York" – an allusion to his prior affiliations at Columbia University and the National Bureau of Economic Research.

Then came surging food prices, which Burns surmised in 1973 were traceable to unusual weather – specifically, an El Niño event that had decimated Peruvian anchovies in 1972. He insisted that this was the source of rising fertilizer and feedstock prices, in turn driving up beef, poultry, and pork prices. Like good soldiers, we gulped and followed his order to take food – which had a weight of 25% – out of the CPI.

We didn't know it at the time, but we had just created the first version of what is now fondly known as the core inflation rate – that purified portion of the CPI that purportedly is free of the volatile "special factors" of food and energy, where gyrations were traceable to distant wars and weather. Burns was pleased. Monetary policy needed to focus on more stable underlying inflation trends, he argued, and we had provided him with the perfect tool to sharpen his focus.

It was a fair point – to a point; unfortunately, Burns didn't stop there. Over the next few years, he periodically uncovered similar idiosyncratic developments affecting the prices of mobile homes, used cars, children's toys, even women's jewelry (gold mania, he dubbed it); he also raised questions about homeownership costs, which accounted for another 16% of the CPI. Take them all out, he insisted!

By the time Burns was done, only about 35% of the CPI was left – and it was rising at a double-digit rate! Only at that point, in 1975, did Burns concede – far too late – that the United States had an inflation problem. The painful lesson: ignore so-called transitory

factors at great peril.

Fast-forward to today. Evoking an eerie sense of déjà vu, the Fed is insisting that recent increases in the prices of food, construction materials, used cars, personal health products, gasoline, car rentals, and appliances reflect transitory factors that will quickly fade with post-pandemic normalization. Scattered labor shortages and surging home prices are supposedly also transitory. Sound familiar?

There are many more lessons from the 1970s that shed light on today's cavalier dismissal of inflation risk. When the Fed finally tried to tackle the Great Inflation, it fixated on unit labor costs – rising wages accompanied by sagging productivity. While there are always good reasons to worry about productivity, wages appear to be largely in check; unionized labor, which, in the 1970s had sparked a vicious wage-price spiral through cost-of-living indexation, has been neutralized by global competition. But that doesn't rule out a very different form of global cost-push inflation – namely, the confluence of supply-chain congestion (think semiconductors) and protectionist clamoring to reshore production.

But the biggest parallel may be another policy blunder. The Fed poured fuel on the Great Inflation by allowing real interest rates to plunge into negative territory in the 1970s. Today, the federal funds rate is currently more than 2.5 percentage points *below* the inflation rate. Now, add open-ended quantitative easing – some $120 billion per month injected into frothy financial markets – and the largest fiscal stimulus in post-World War II history. All of this is occurring precisely when a post-pandemic boom is absorbing slack capacity at an unprecedented rate. This policy gambit is in a league of its own.

For my money, today's Fed waxes far too confidently about well-anchored inflation expectations. It also preaches the new gospel of "average inflation targeting," convinced that it can condone above-target inflation for an unspecified period to compensate for years of coming in below target. My students would love to throw out their worst grade(s) as well!

No, this isn't the 1970s, but there are haunting similarities that bear watching. Timothy Leary, one of the more memorable gurus of the Age of Aquarius, purportedly said, "If you remember the 1960s, you weren't there." That doesn't apply to the 1970s. Sleepless nights and vivid flashbacks, complete with visions of a pipe-smoking Burns – it's almost like being there again, but without the great music.

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