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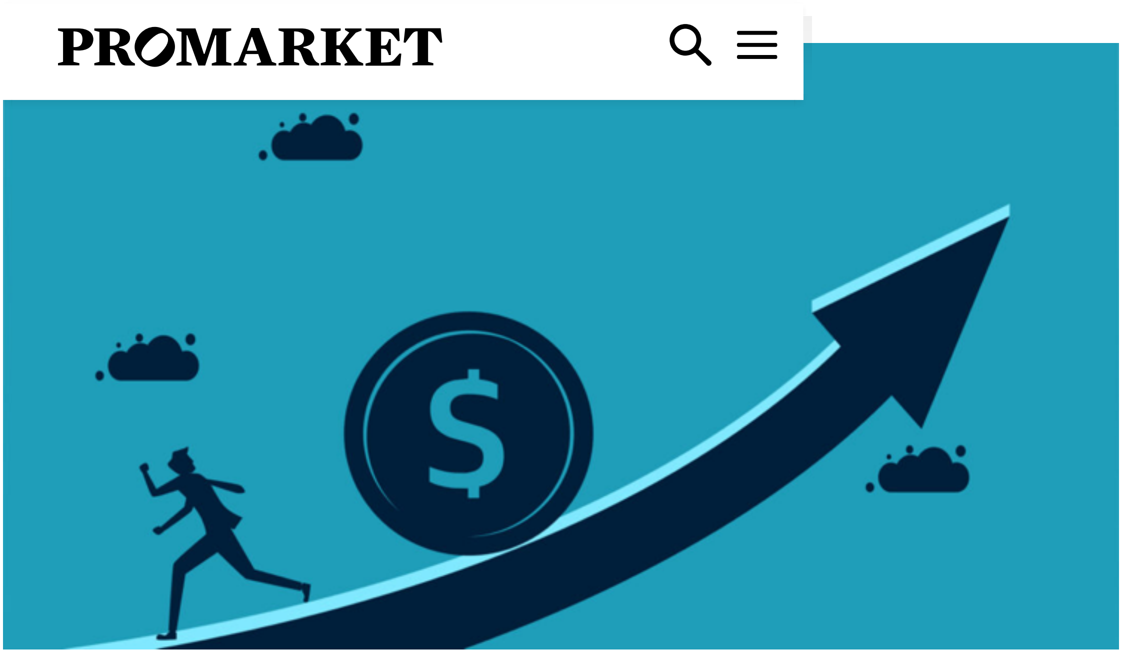
Inflation Paranoia and the Return of the New Consensus in Macroeconomics

BY MATÍAS VERNENGO *July 12, 2023*



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Economists have proposed two main theories to explain the recent spike in prices. Progressives have attributed the rise in inflation to corporate greed and have suggested price controls in response. Other economists have turned back to the New Consensus in Macroeconomics that arose in the 1970s in response to steep inflation blamed on the large Keynesian fiscal expansion of the preceding decades. Matías Vernengo writes that neither camp has correctly diagnosed the problems with current inflation. Proponents of Greedflation overlook the price stability of the last few decades even as market concentration increased. On the other hand, advocates of the New Consensus similarly forget their history and the commodity shocks and price-wage spiral that were the real culprit for inflation in the 1970s.

Conventional wisdom suggests that the Great Inflation of the 1970s resulted from the failures of the old Keynesian Consensus that had pushed for excessively large fiscal expansion, combined with a relatively weak reaction by the deferential Federal Reserve under Arthur Burns, which was too close to President Richard Nixon's administration to pursue a more aggressive anti-inflationary policy. The Federal Reserve lost credibility, in this view, and inflation expectations accelerated. The consensus that formed after Fed Chair Paul Volcker's strongly contractionary monetary policy and the stabilization of the economy in the 1980s, fundamentally influenced by Milton Friedman, suggested that an independent central bank, concerned with inflation, could maintain price stability, and that the level of unemployment would take care of itself. This New Consensus in Macroeconomics, later reinforced by the inflation-targeting-policy framework to manage inflation expectations, held its ground more or less until the collapse of the subprime housing market bubble and the Global Financial Crisis that ensued in 2008-9.

By then it was clear that the American economy had structural problems and that economic growth had slowed down, and maybe the New Consensus needed some rethinking. Robert Gordon suggested that the reasons for the slowdown were fundamentally concerned with the smaller effects of the third Industrial Revolution, related to information technology and automation, as compared to previous technological breakthroughs that had a large impact on productivity and required large public investment in infrastructure. The general mood was captured by Lawrence Summers with the revival of the old Keynesian notion of secular stagnation. In this view, the lower opportunities for productive investment implied that the economy would have to adapt to lower levels of growth, and this was related to the declining bargaining power of workers, lower wages, and wage share in total income. This would require higher levels of government spending, but in this view, as exemplified by Olivier Blanchard's presidential address to American Economic Association, this was not a problem, since in an environment of low interest rates, fiscal expansion and higher public debt levels were relatively safe.

In a sense, the 2008-9 crisis, and the critiques of the New Consensus, had gone some way into allowing for a return of the old Keynesian Consensus, and the notion that government intervention is necessary if the economy is to grow fast and maintain low levels of unemployment. Inflation, in this view, was not a significant problem, and, perhaps, even a higher inflation target than the Fed's 2% goal would be acceptable. Blanchard famously suggested doubling the target rate to about 4%, and eventually, Jerome Powell, the Fed's current chairman, announced a more flexible approach to targeting that would allow for higher temporary levels of inflation, maintaining the 2% level over an indeterminate period of time.

It is worth noticing that many authors, particularly those closer to the Monetarist views of Friedman, resisted this view. Inflation hawks remained vigilant and certain that the same excesses of the 1960s would bring back inflation eventually. For example, in 2009 Allan Meltzer warned against the dangers of excessive monetary expansion after the 2008-9 crisis, saying that "the enormous increase in bank reserves — caused by the Fed's purchases of bonds and mortgages — will surely bring on severe inflation if allowed to remain." The Covid-19 pandemic and the acceleration of inflation, particularly after the beginning of 2021, has strengthened the position of those that always saw price stability as the only reasonable goal for macroeconomic policy. John B. Taylor has suggested recently that unless the Fed commits to a rule-based inflation target approach we will be entering a new era of high inflation.

Perhaps more importantly, Summers, who, together with Blanchard, represented the effort within the profession to rethink the New Consensus that had prevailed since the 1970s, suddenly changed his view on the relative risk of secular stagnation versus the danger of accelerating inflation. Summers argued strongly against the further extension of pandemic relief at the beginning of President Joseph Biden's administration, and more generally against further fiscal expansion. Summers very stringently pressed for more aggressive monetary policy, arguing that inflation resulted fundamentally from a labor market that was beyond full employment, and that higher and persistent unemployment would be needed for controlling inflation. His views have been very influential in policy circles, and the Fed has gone into one of the fastest cycles of interest rate hikes in history. Note that, in this view, inflation is ultimately the result of excessive government spending during the pandemic and a slow reaction from Powell, which allowed inflation expectations to accelerate and undermined the credibility of the Fed. This assessment is very much in line with the post-Volcker consensus of what happened in the 1970s.

Whether the interest rate hikes will lead to a recession is still unclear, even though the limits imposed by debt ceiling negotiations on fiscal policy make it more likely and imply that from now on monetary policy is the only game in town, at least until the next presidential election. More importantly, the significant deceleration of inflation over the last year has gone hand in hand with a relatively stable level of unemployment, that is relatively low by historical standards, even if the official unemployment rate overstates the tightness of the labor market. The decline in the inflation rate with a relatively low unemployment rate contradicts Summers' diagnosis and the New Consensus notion that the economy is beyond the natural rate of unemployment.

The main alternative to the conventional wisdom of the New Consensus has been the belief that "corporations are raising prices because they can—because they have enough monopoly power to do so," as noted recently by Robert Reich. In this view, the greater oligopolistic power of corporations and their ability to greedily increase their profit margins, almost without limit, would explain the recent inflationary bout. Greedflation, or profit-led inflation, would be the main culprit of the current circumstances. Corporate power has certainly been on the rise, and that is the basis for why this historical period has been called a New Gilded Age. The solution for progressives that associate the recent inflationary acceleration with corporate behavior is an old one: price controls. The policy prescription was revived by Isabella Weber, who studied the use of price controls during World War II. The virulent critiques of her proposal indicate that pro-market ideologues, fearful of any government scheme that smacks of planning, were seriously committed to foreclosing the debate and resorted to *ad hominem* attacks rather than debating her ideas.

Price controls can and did work well under certain conditions, particularly during World War II when enforcement was vigorous.

However, under less strict implementation in the 1970s, the price and wage controls employed during the Nixon administration were seen as a failure, and the subsequent stabilization, which in the conventional story was all due to the Volcker Shock, reinforced the view that Keynesian policies had gone too far, and that a degree of monetary austerity was needed for stabilization. Of course, the decline in commodity prices, oil in particular, and the weakening of the trade unions during the Reagan years played an important role in the stabilization of prices.

Yet, the Greedflation explanation has significant problems, like the view that pandemic relief and Fed inaction were the culprits for the recent spike in inflation. For one, corporations did not become suddenly more powerful or greedy in early 2021. Corporate power has been on the rise for decades, and the period has been one of price stability, famously dubbed the Great Moderation by Ben Bernanke, even if the price moderation resulted from stagnant wages, rather than independent central banks. The original Gilded Age, one might add, was a period of deflation. Certainly, corporate power when combined with a vigorous labor movement can lead to incompatible income claims and the acceleration of inflation, as did happen in the 1970s. But this is unlikely to take place now. Forty years of pro-globalization policies, with the consequent deindustrialization, and decreasing unionization, had eroded workers bargaining power. In that respect, this is not a rerun of that '70s show.

However, in another important respect, our current inflationary crisis does resemble the 1970s. The inflation acceleration of the 1970s did not show that Keynesian policies were inefficient or had caused the acceleration of prices. As noted by James Tobin back then, inflation resulted from the oil shocks and the price-wage spiral. But inflation reinforced the social problems that led to the collapse of the old New Deal coalition and the Keynesian Consensus, ushering the Conservative Revolution and the New Consensus in Macroeconomics. The Pandemic inflation acceleration has undermined the revival of Keynesian ideas, and the revision of the New Consensus model that was under course. Instead of the concern with secular stagnation, we are back to inflation paranoia.

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