THE GREAT INFLATION AND THE U.S. MONETARY POLICY

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Inflation has skyrocketed in recent months causing immense suffering for communities across America. In March consumer prices soared 8.5% higher than a year earlier, the fastest annual increase since 1981 (The Economist, April 23rd. 2022). The burning question that faces us, as consumers, is how long the prices will continue to rise, and is it controllable by the Fed monetary policies within a reasonable period of time? This paper examines the dynamics of inflation from the demand and supply side of the economy and presents the challenges the Fed faces in reversing the QE (quantitative easing) policies to tame the inflation and the associated risks to the economy from such policies, particularly from the current increases in the federal funds rate.

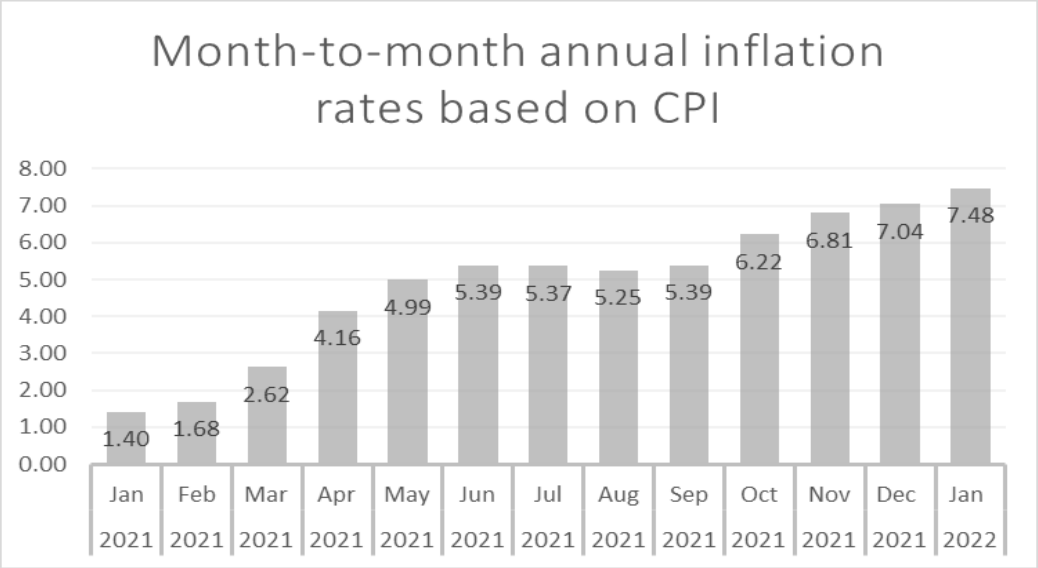
The year 2021 began with optimism spurred by strong economic performance, the availability of vaccines, and the return of consumers to normal activities. Soon the surge in prices of day-to-day items from groceries to appliances sparked discontent among the public and created headaches for the Federal Reserve System (Fed) authorities. Inflation started gathering momentum in March 2021 when the annual inflation rate, based over 12 months, exceeded the Fed's target of 2 percent. Mr. Jerome Powell, the Fed Chair wanted to keep the policy rate low as long as it is needed to get the economy back on track from the pandemic. The Fed also didn't want to undertake preemptive policies to reduce /inflationary pressures.

During the summer, the Fed considered the inflation to be transitory, being fueled by short-term bottlenecks such as the massive lockdowns, shutdowns of factories, congestion in ports, and labor shortages. The Fed expected that these supply bottlenecks would disappear soon with more ships plying in the oceans, airlines resuming normal flights, public resuming vacations, ports returning to operations at normal capacities, and workers returning to their jobs; ultimately, inflation would ease and there would be no need for changing the course of monetary policy. However, 2021 was not 2008 when zero interest monetary policy worked with additional non-conventional monetary policies, known as QE (quantitative easing) policies. Those optimistic scenarios mentioned above either did not play out or materialize fast enough to reduce the pressure of inflation. The inflation rate continued to rise throughout the summer fueled by high energy prices.

The inflation rate reached 5 percent in May, 2021 from a year ago and remained over 5 percent for five consecutive months. In August 2021, because of the persistence of the inflation rate at above 2 percent, the Fed changed its fixed target to a "flexible average inflation target" which means that the inflation rate is allowed to go higher than 2 percent as long as it comes down to below the target sometime in the future. However, there was no sign of inflation easing in sight. The inflation rate reached 6.2 percent in October, marking a 31-year high, and 6.9 percent in November, belying the expectations of the Fed. It became clear to the Fed that inflation was not going to go away and the Board of Governors realized that the time for being combative against inflation had finally arrived. In the policy meeting on December 15-16, the Fed gave the signal for the first time since the pandemic began that it will increase the interest rate and cut back on

the bond purchases. Table 1 shows the month-to-month annual inflation rates based on CPI from January 2021 to January 2022.

Table 1



The current inflation contains elements of both demand-pull and cost-push factors. The stimulus money helped accommodate the surge in the pent-up demand since the Covid-19 virus hit the economy the worst during most of 2020. On the demand side, apart from the savings generated by low spending during the height of the pandemic, the federal government stimulus money raised the disposable income (income minus taxes). The Fed also engaged in the quantitative easing (QE) policies similar to those employed during the Great Recession (2007-08). However, there is an important difference. In 2007-08, QE policies were needed to offset money supply shrinkage caused by the vast reductions in bank lending. In contrast, the QE policies adopted during the last two years have massively increased the money supply. QE policies were financed by a spree of bond purchases from financial intuitions that expanded the balance sheet of the Fed and created new money, so the expansionary effect of these policies was much stronger this time than they were during 2007-08. This new money helped the government finance the transfer payments including stimulus packages, wage subsidies, furlough, payments for enhanced unemployment insurance packages, etc. The *'Economist'* magazine reported that a fifth of the total money supply in the USA was created in 2020. The *'Wall Street Journal'* in a recent editorial attributed the persistence in inflation to the Fed's expansionary monetary policies long after Covid passed. As Milton Friedman, monetarist guru and Nobel laureate, famously said, "Inflation always and everywhere is a monetary phenomenon" which means that if the Fed is serious about controlling inflation, it has to turn off the spigot of money.

Economists generally agree that whether or not an increase in money supply creates inflation depends on the state of the economy. In a recessionary economy, an increase in the money supply and government spending normally create jobs and raise real GDP without adding inflationary pressure. As the economy approaches full employment, the economy feels the pinch of wage and price pressures. So the same economic forces that initially led to the creation of jobs and an increase in production could also lead to a rise in wages and prices as the economy

recovers. If the government continues to engage in an expansionary monetary policy when the economy is at or near full employment, the wage-price spiral will inevitably escalate. With the unemployment rate at 4.2 percent in November 2021, the economy is currently very close to full employment and so the inflationary effects of the money supply increase are playing out. So the question is why it took so long for the Fed to recognize the extent and the staying power of inflation and act upon it. The answer is to be found in the uncharted terrain of the supply chain issues.

Let us look at some supply chain issues that continue to pose a threat to the economy and prevent the Fed from taking a tough stance to ride out the inflation. These issues were compounded by a recent rise in commodity prices, particularly raw materials and other inputs needed to maintain industrial production. This past year witnessed a roller-coaster ride in commodity prices as production widely fluctuated due to a host of factors. Prices for certain important resources such as microchips, copper, lithium, and fossil fuels, to name a few, soared last year.

Covid-19 has exposed a serious fault line in the manufacturing production, particularly in the category of high-tech products. Since manufacturing products are becoming more and more high-tech, and high-tech products are becoming increasingly dependent on microchips, microchips have emerged as the most strategic input for industrial production. The recent global microchip shortage affected many industries from phones to play stations, but nowhere is it more evident than in the empty car lots of local car dealerships.

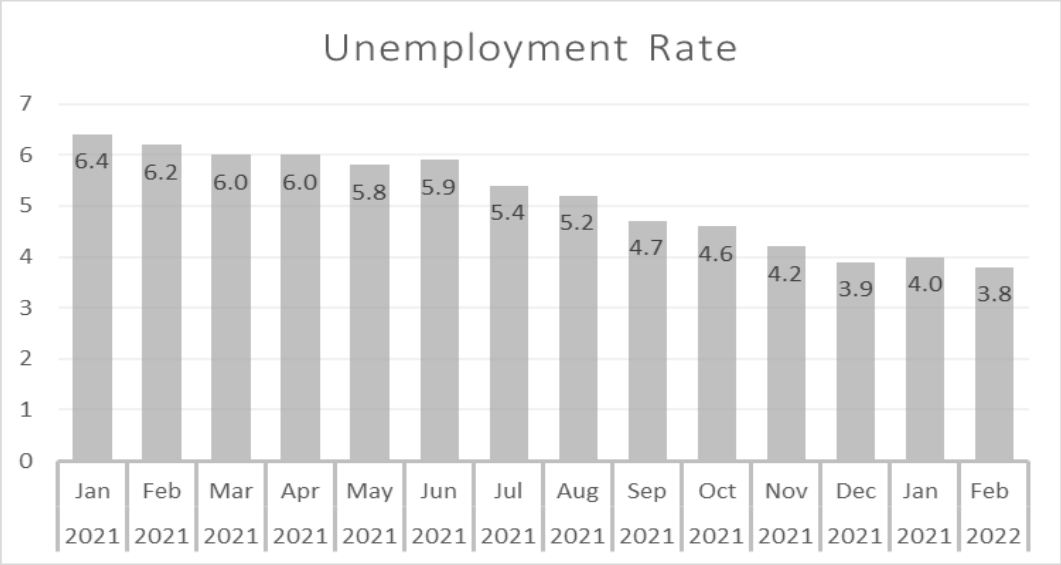
Demand for cars was returning to the pre-pandemic level at the beginning of 2021, thanks to the generous stimulus money and the strong recovery of the economy. However, the production of cars was thwarted by the shortage of microchips due to a few natural and man-made crises in leading locations of chip production such as the flood in Texas, the lockdown in Vietnam, the drought in Taiwan, and less export by China. The other challenge facing the auto industry is that the production of microchips is geared more toward high-grade chips used in smartphones, computers, video games, and other smart gadgets, where the profit margin is much higher than it is for vehicles. Car production also hit additional roadblocks due to rising copper and lithium prices. The copper price rose because of scaled-down mining activities in Chile and Peru due to Covid. Copper is needed in green projects as well as electric cars. Solar and wind-powered electric grids and hydroelectric projects also need copper. Electric car production is being hampered by the soaring cost of lithium, which is a key ingredient for the production of rechargeable batteries used in electric cars. A recent decline in production in Chile and Australia, the global leaders of lithium production, led to an upward trend in lithium prices.

Environmental concerns and political opposition to carbon-based products and promotion of green energy products led to a decline in the production of fossil fuels such as oil and coal. The supply-side factors, in conjunction with the severe winter in Europe, raised the energy cost of heating houses.

The most prominent pieces of the puzzle are the dynamics of the labor market. The reason for hesitation in raising the rate is that any contractionary monetary policy has the possibility of reducing the level of employment. Let us look at the employment situation. From April 2020 to March 2021, the monthly employment levels were lower than the same month a year before. The US economy lost a staggering 20.7 million jobs in one month, April 2020. Although the employment level increased after that month, the level of employment in November 2021, was still lower than that in February of 2020. Some job losses were due to a mass exit from the labor force, termed the Great Resignation. During the past year, labor force participation declined because of widespread sickness, retirement, and hesitation in returning to work amidst the

pandemic. Generous federal unemployment support including support for the longer-term unemployed also kept people from work. Table 2 shows the unemployment rate from January 2021 to February 2022.

Table 2



With spawning vaccinations and the easing of the pandemic situation during the beginning of the last year, it was expected that more workers would be joining the workforce soon reducing the labor crunch. However, the onset of the Omicron virus has thrown a wild card into an already complicated scenario, with rising infections in the USA as well as the rest of the world. The Fed could tame inflation by winding down the bond purchases and allowing interest rates to rise, but the Fed has to carefully weigh the benefits and costs of raising the interest rate. Raising the rate runs the risk of halting the slow recovery process at a time when the country is still not out of woods from the onslaught of the pandemic. The Fed's task is compounded by the fact that the actual weights of demand-pull and cost-push factors in causing the current inflation are unknown and policies are different for the two types of inflation. In Fall 2021, demand-pull pressures were relatively strong for the reasons discussed above. With the eruption of the Omicron virus, the Fed's anticipation that the supply side problems would resolve soon did not materialize. If the cost-push factors are the major driver of inflation, raising the interest will exacerbate supply-side problems and may halt or reverse the painful recovery process that is underway now. On the other hand, if inflation is allowed to continue, economists fear that inflation will become entrenched in the psyche of consumers, workers, and business owners, setting the stage for future, self-fulling inflation. The good news is that inflation may have finally peaked, but it is still too far away from the target of 2%, which will force a painful choice on the fed (The Economist, April 23rd, 2022).

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