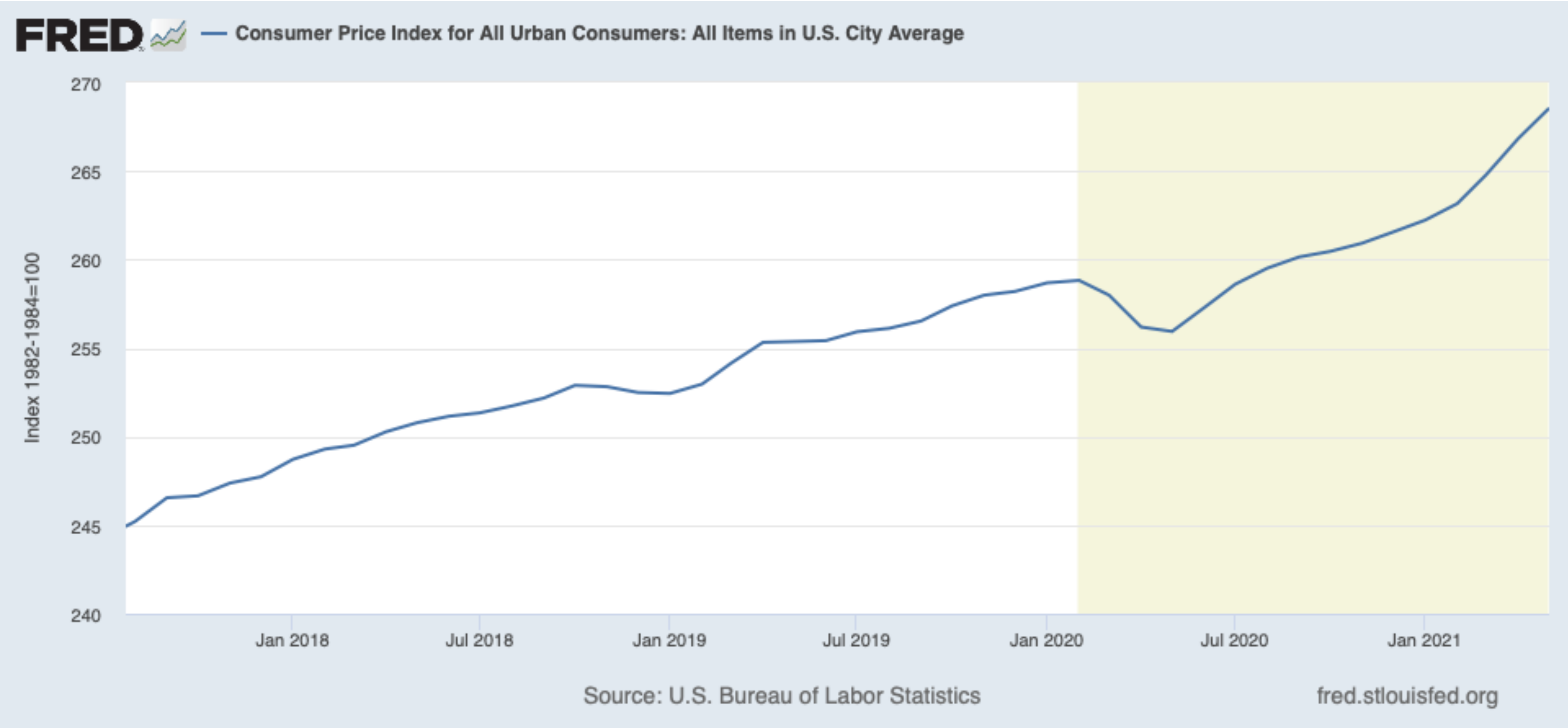
Whither the Fed?

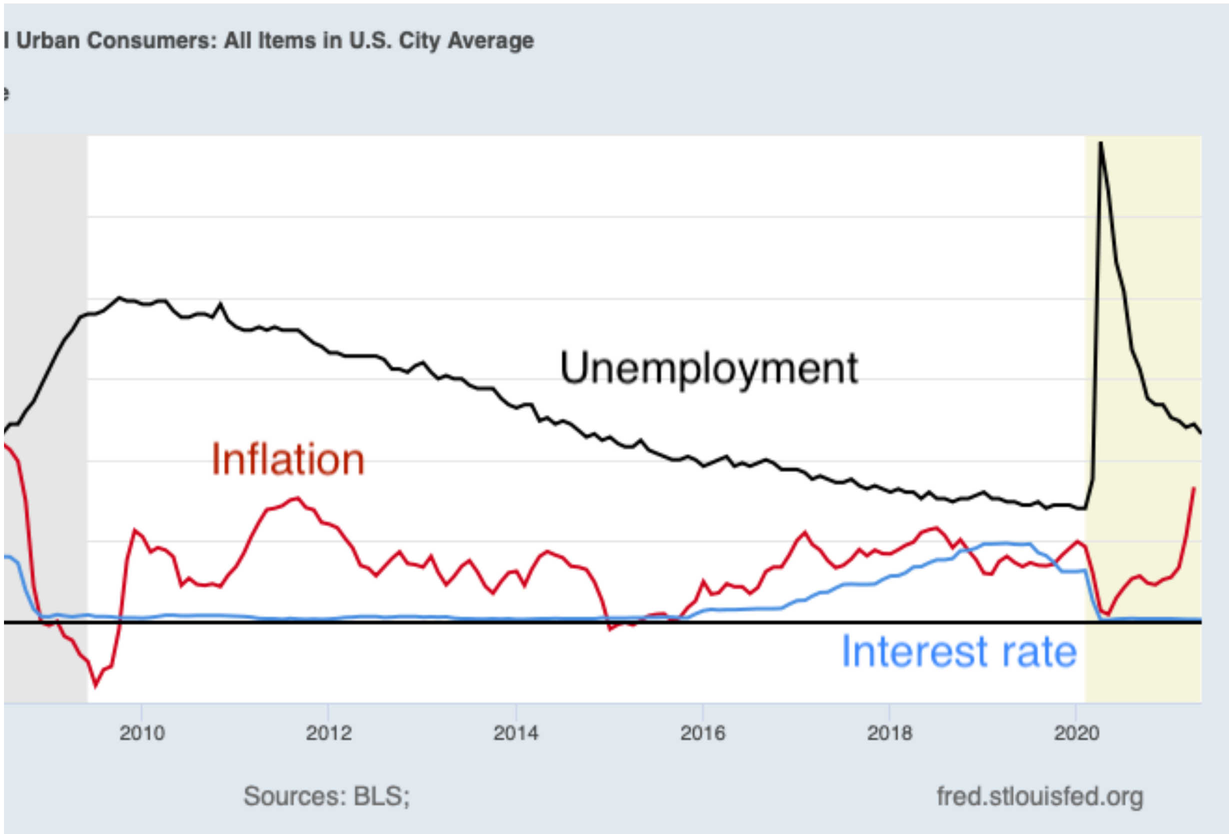
John H. Cochrane
Hoover Institution, Stanford University
AKA “The Grumpy Economist”

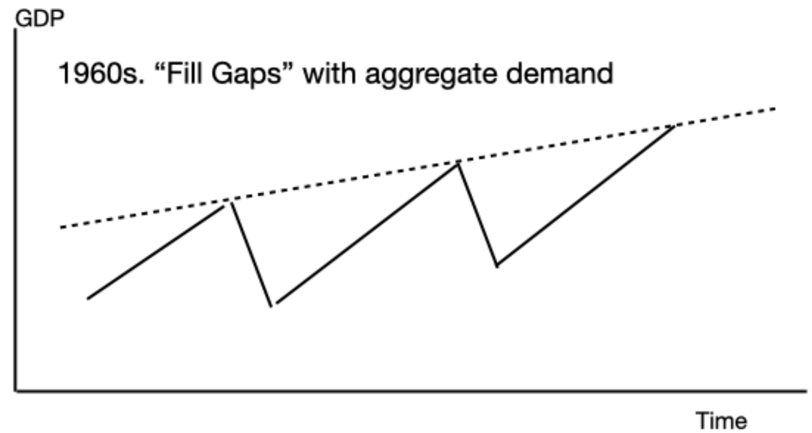
Is inflation on the way?

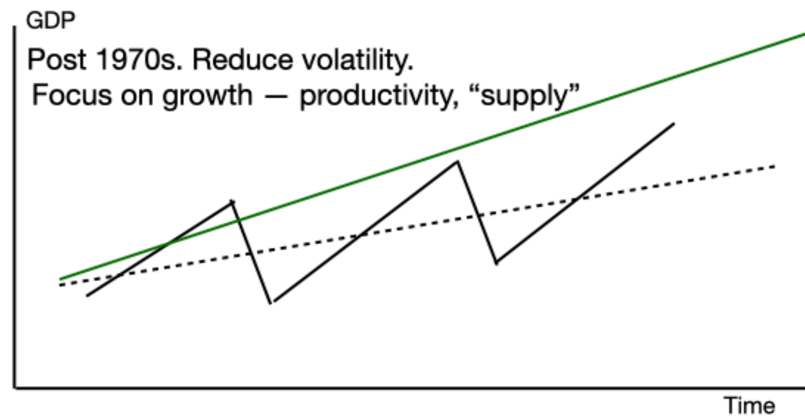


"Transitory?"
What is the Fed doing and how will it react?
New Fed strategy?

New Fed strategy

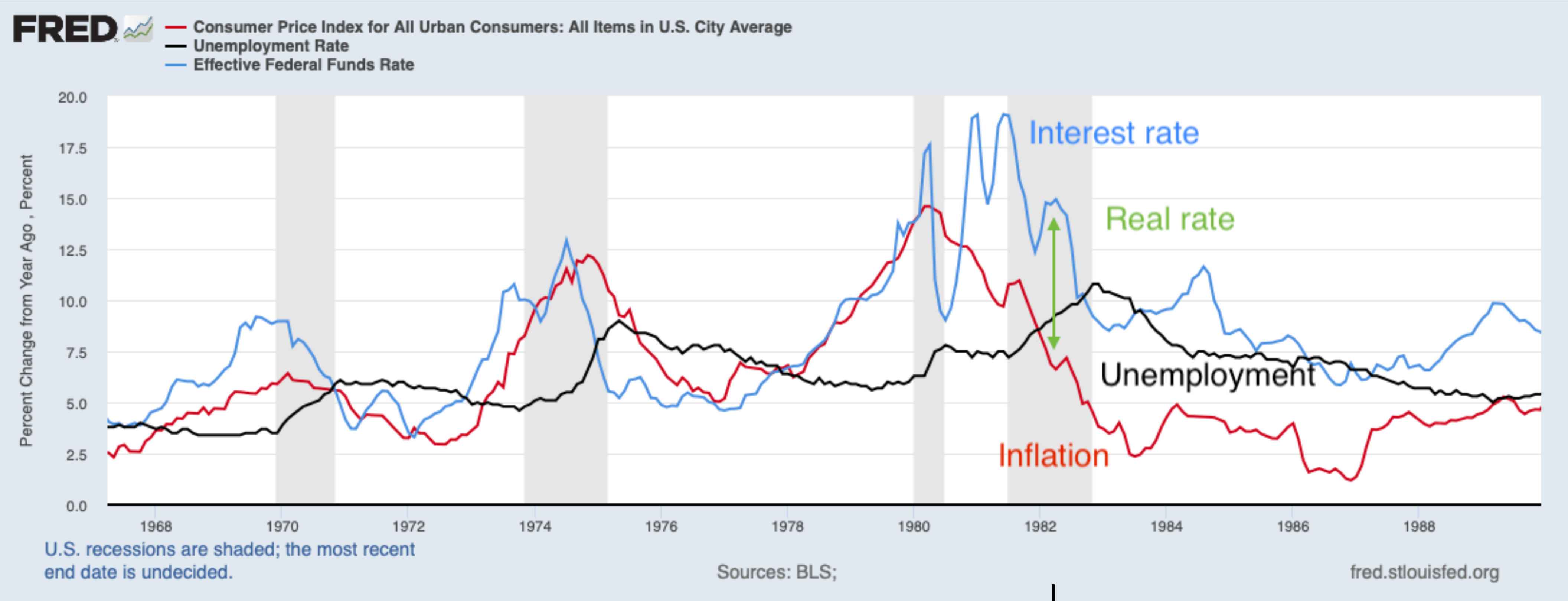


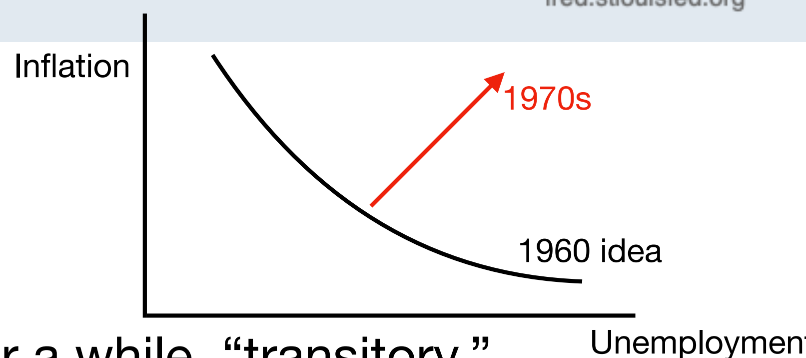




- Wait to see inflation.
- Allow inflation above target for a while.
- Fill "shortfalls" not "stabilize."
- "Inclusive growth."
- "Forward guidance" promises. (Now falling apart)
- Vague & complex enough to justify anything.
- A lot like the 1970s?

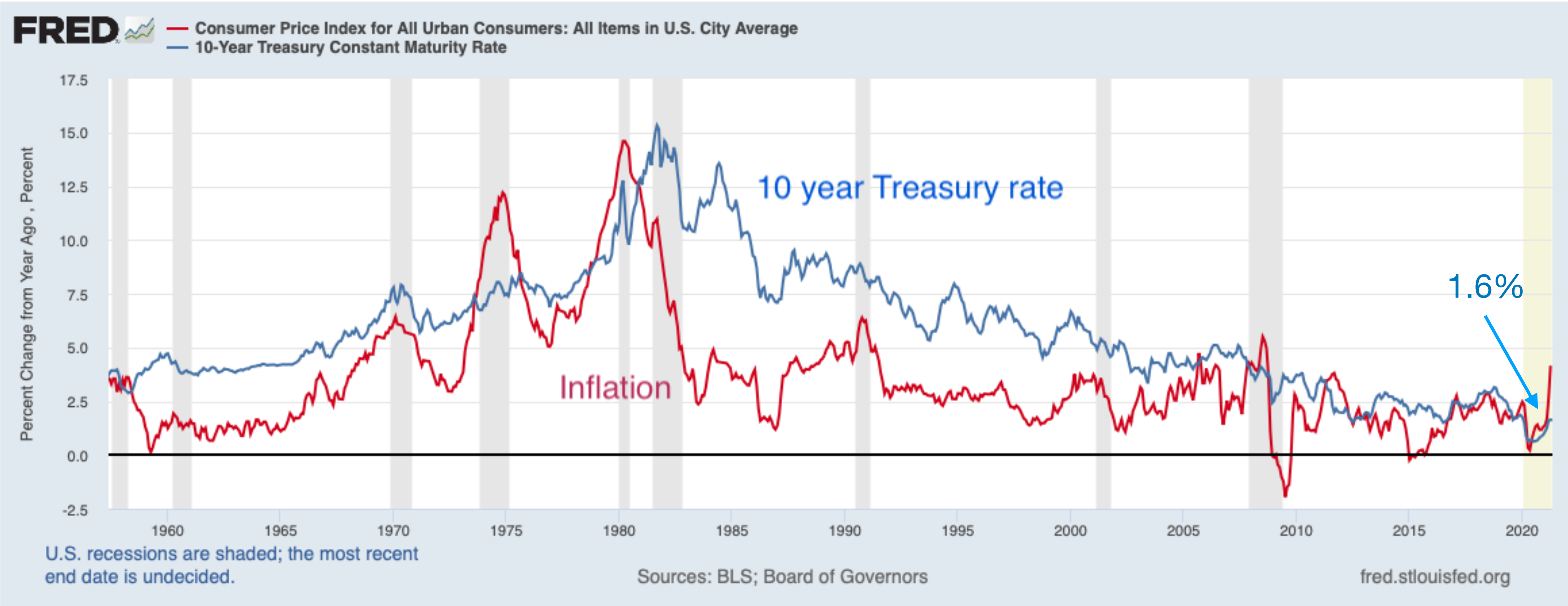
The 1970s



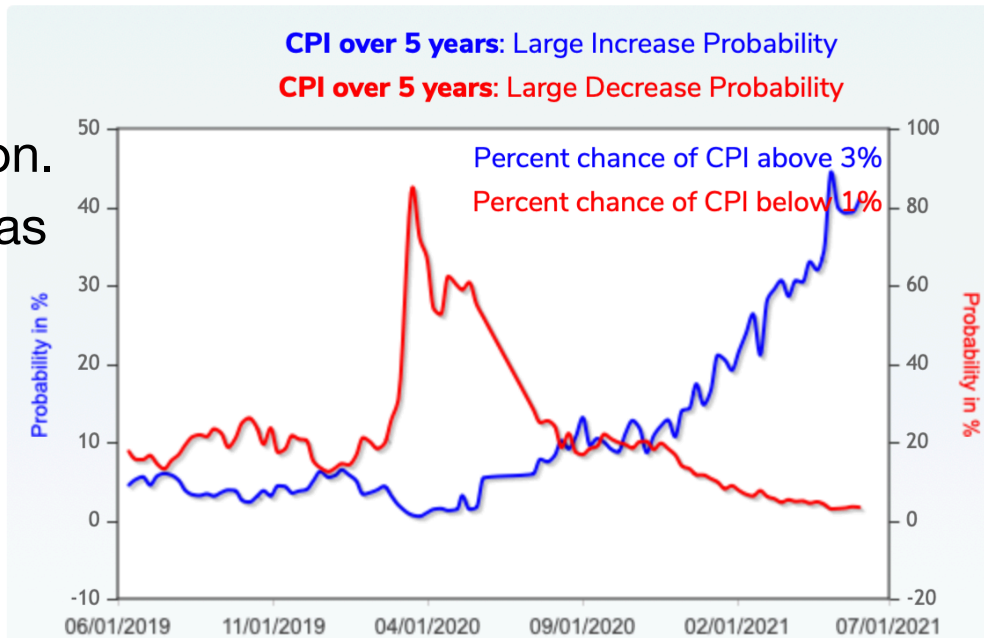


- 1960s: More inflation to drive down unemployment.
- 1970s: More of both. *No permanent unemployment/ inflation tradeoff.*
- 1970s: Wait to really see inflation, allow to run hot for a while, “transitory.”
- Lesson: *Expectations matter*. **Inflation = expected inflation + pressure.**
- Anchored? “We have the tools.” What are they? Repeat 1980-1984?
- Raising interest rates will be much harder now. Pay banks, raise deficit.
- Bottom line. Yes some “transitory.” But not all, and the “anchor” is ephemeral.
- Conventional monetary economics: Worry!

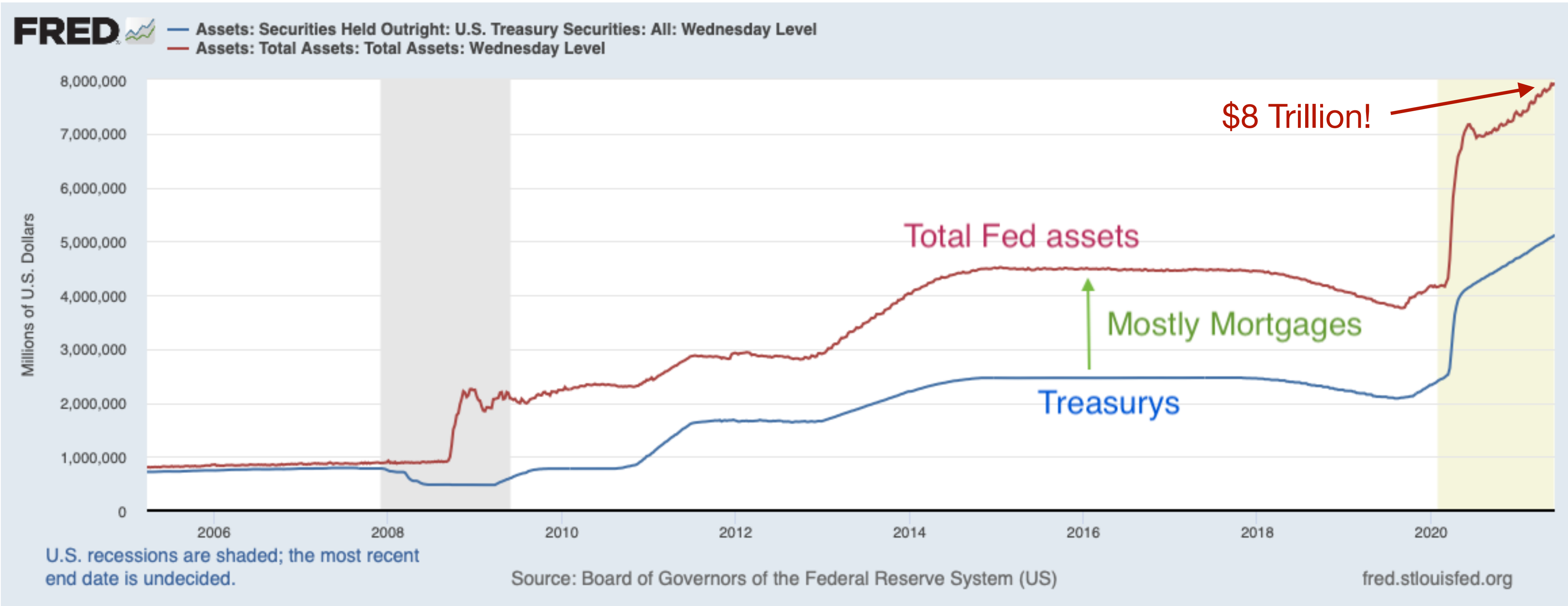
Markets don't see inflation ahead?



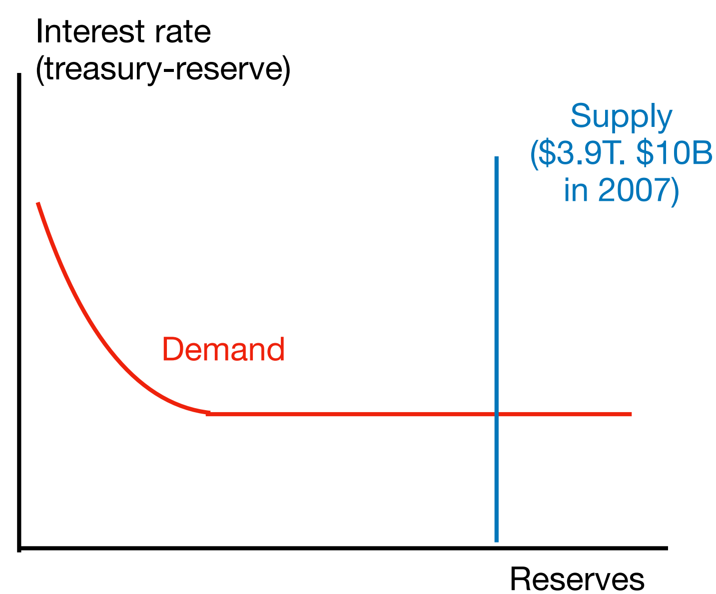
- Current 10 year Treasury: 1.6%
- Bonds never see inflation ahead. Or disinflation.
- Inflation = expected inflation. If you knew it was ahead, it would already be here.
- (Options: greater *chance* of inflation.)



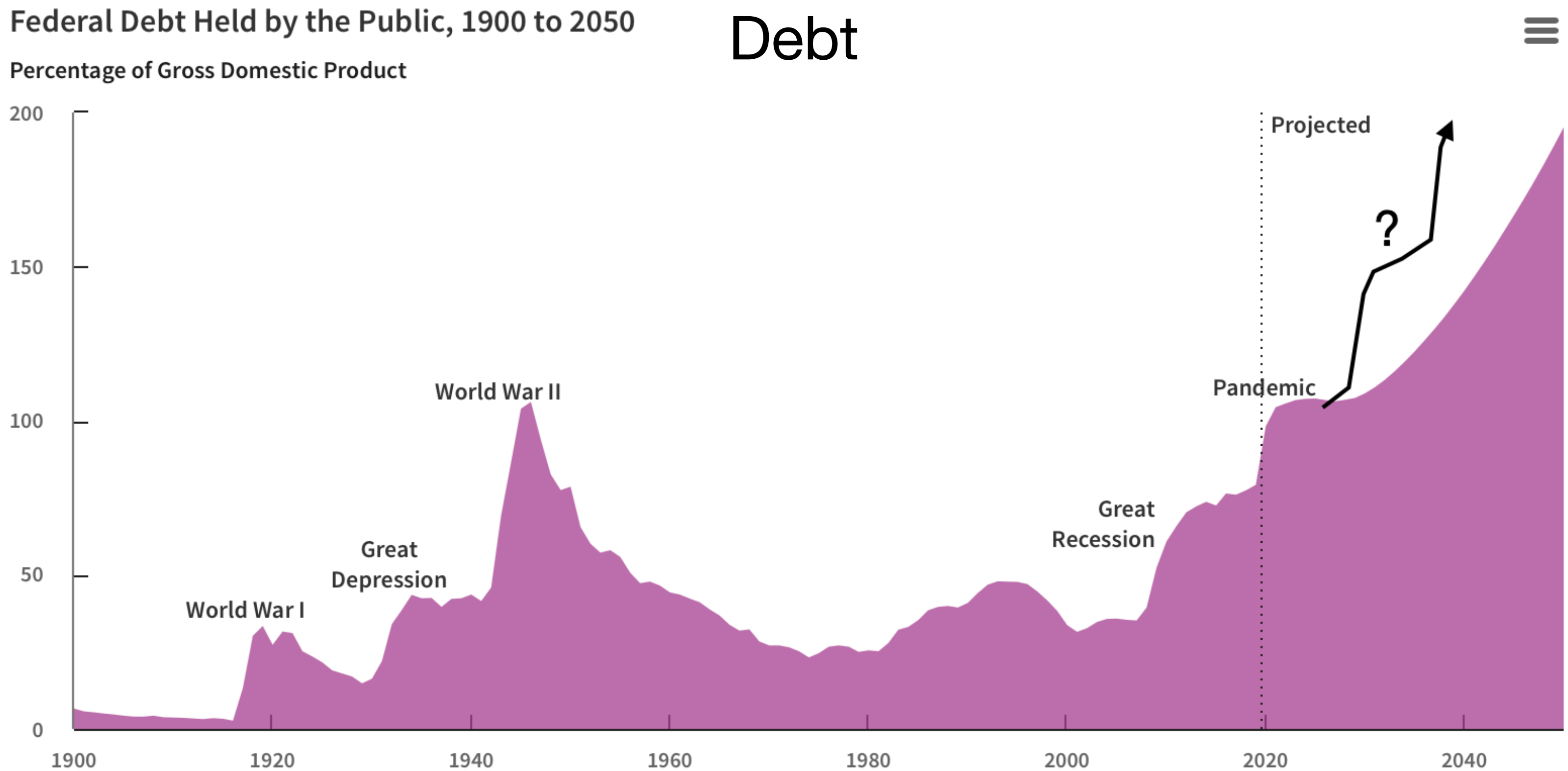
What about QE, asset purchases, M2, etc.?



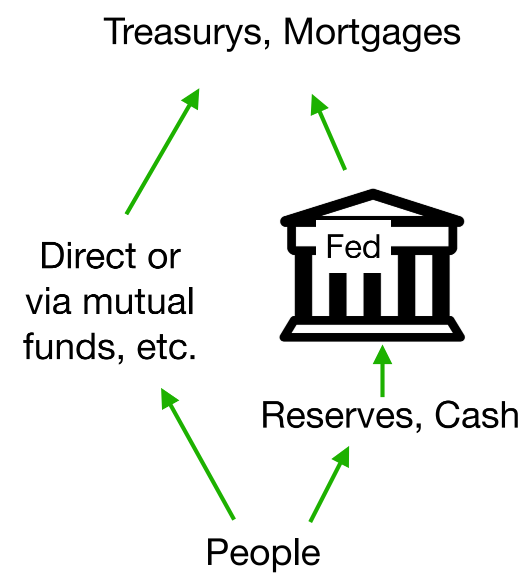
- Immense QE. Now buying 2/3 of treasury issues.
- Government printed $5T reserves, sent to voters.
- But reserves pay = treasurys, perfect substitutes.
- History: no relation between QE, inflation, rates.
- Does *composition* of government debt matter?…



Debt



- The Fed is just a giant money-market fund.
- Does *composition* of government debt matter?
- Or does the *amount*, and (no) plan to repay it, matter?
- What if all reserves converted to Treasury accounts?
- **Inflation comes, fundamentally, when people lose faith that the government will repay its debts.** (Or worry that others will lose that faith!)
- Worry: A fiscal stagflation that the Fed is largely powerless to stop. Interest rate doom loop.
- Loss of *fiscal* anchoring, faith in repayment.
- Not necessarily now.



The Brave new Fed

1. Bailouts. Again.

- Treasurys, dealers, state and local governments (muni bonds), money market funds (!), corporate bonds, PPP…Airlines, stimulus checks, …
- Prices may not go down, creditors may not lose? Moral Hazard?

2. Climate change.

- “Climate risks” Disclose and stress tests. (Actual climate? Regulation? System?)
- Central banks fund (some) “green investments.” Defund (US!) oil, coal.
- Actual risks?

3. Inequality, social justice, racial justice.

- Regulatory power on business practice, direct lending.

4. Source of this vast expansion of power and responsibility?

- The Fed monitors all “risks to the financial system” (Nobody loses? System?)
- Fed tells banks where to lend and where not?
- Fed (and other CB) buy assets to direct credit?
- The fateful 2008 choice: Equity financed banking vs. regulate risk taking.
- Asset purchases, detailed investment regulation = a 2 year old with a hammer.
- Independence in a Democracy: Great power *in a limited domain.*