Inflation

Inflation was most voters' top issue in the 2024 election, even amid all the other distractions. While inflation is now back down to near target levels, Congress should prioritize making sure inflation does not come back. There are three things Congress can do to contain inflation for the long term: spend less, enact a monetary policy rule for the Federal Reserve, and give the Federal Reserve a single mandate of keeping inflation low.

Policymakers should also remember that inflation does not come from corporate greed, or from the other party being power. It does not come from supply shocks, or even from bad policies such as tariffs. Inflation comes from the money supply outstripping real productivity.

When the money supply grows faster than real goods and services, you get inflation. If the money supply grows more slowly than real goods and services, you get deflation.

Good monetary policy is a matching game, where the Federal Reserve tries to keep the money supply in sync with what the real economy is doing. In the simplest version, if the economy grows by 5 percent, then the money supply should grow by 5 percent to match.

In the real world, there are other variables such as the velocity of money, or how fast dollars get spent and re-spent; lag times from the Fed's actions, which are long and variable; and other policy constraints the Fed must deal with. But that matching game concept is crucial to understanding how inflation works, and how to keep it under control. With this dynamic in mind, Congress should:

- Spend less and lower the budget deficit;
- Ensure the Fed's independence with a monetary policy rule; and
- Oppose efforts to expand the Fed's dual mandate to include non-economic issues such as climate and social justice.

Spend less: Stimulus spending, paid for with massive money supply growth, is what caused the great post-pandemic inflation. In the short run, Congress needs to reject calls for more stimulus spending.

The Fed started growing the money supply on its own within weeks of COVID arriving in America. This was to help counter a slower velocity of money during lockdowns, when people were staying home and spending less. The Fed overdid it, which gave the COVID inflation its start. Then Congress began a series of trillion-dollar stimulus bills, which made inflation even worse. These bills included the CARES Act, the CHIPS Act, an infrastructure bill, the Inflation Reduction Act, and others. The Trump administration added more than $6 trillion to the federal debt after COVID-19 hit, and the Biden administration was no better.

While the Federal Reserve is independent, when Congress grows the debt by such large amounts, the Fed more or less has to help finance it. Add those trillions of dollars of debt to the stimulus the Fed was already doing on its own, and the result was massive inflation. The Fed grew the money supply at quadruple its usual rate. As a result, inflation roughly quadrupled as well, from around 2 percent to a peak of more than 9 percent.

As of this writing, the Fed has rolled back its excesses enough to get inflation back under 3 percent. Inflation remains above its 2 percent target largely because the Fed and Congress lack credibility on future spending restraint. Markets expect more stimulus whenever there is a downturn, so people are pricing that expected inflation into their contracts, investments, and other long-term decisions.

In the short run, Congress can help by rejecting stimulus spending, loud and clear.

In the long run, Congress will have to grab onto the third rail of politics—entitlement reform. This is not optional. The current pay-as-you-go model is unsustainable. The only way to have a solvent entitlement system is to transition to a personal accounts model, as more than 30 countries have already done.

Social Security and Medicare currently have more than $110 trillion in unfunded liabilities. This is roughly four times America's GDP. Without entitlement reform, there is a real risk Congress will turn to the monetary printing press rather than risk political blowback from tax hikes and benefit cuts.

Pass monetary rule: Congress should help the Fed commit to a rule-based monetary policy. During the Great Moderation that lasted from the early 1990s to 2007, inflation remained low and stable. A major reason was that the Fed informally committed itself to a predetermined policy rule: If inflation reaches a certain level, the Fed automatically adjusted interest rates (and, indirectly, the money supply) by a matching amount determined by the rule.

When Fed policy makers take a more discretionary approach, the result is often higher and more volatile inflation, with all the economic harm that implies. That was the case during most of the 1960s and 1970s, when inflation was all over the map and peaked at nearly 15 percent.

During most of the Great Moderation, the Fed followed a “Taylor rule,” which focuses on interest rates. There are other possible rules the Fed could adopt that would also work well. The Fed could directly target the money supply or focus on nominal gross domestic product (NGDP). The rule that is chosen is less important than choosing a rule in the first place and committing to it.

Credibly committing to a rule has two major benefits.

One is predictability, which is good for long-term planning and investment. Predictability also helps to manage inflation expectations, which are the biggest remaining problem from the post-COVID inflation.

Under the current discretion-based system, policymakers are tempted to use emergency measures and a try-anything approach during downturns. That often makes things worse than sticking to a rule.

In the long term, too much monetary discretion can discourage investment because people become reluctant to make lengthy commitments if they don’t know what the monetary environment will look like the next time a recession hits.

Companies will set prices based on where they think inflation is headed. If they expect inflation to be high, they will increase their prices early and often. A credible Fed policy rule would keep inflation expectations low and stable—and accordingly influence the way companies adjust their prices.

Monetary rules also safeguard the Fed against political interference. President Lyndon Johnson physically intimidated then-Fed Chairman William McChesney Martin at his Texas ranch to convince him to boost inflation to stimulate the economy leading up to the 1968 election. President Richard Nixon made threats against then-Chairman Arthur Burns for similar reasons during his tenure. More recently, Presidents Trump and Biden have also made unsubtle hints about what they would like the Fed to do.

Those tactics worked because the Fed had the discretion to enact those policies. If the Fed was bound by a monetary rule, Fed chairs can tell politicians that they do not have the authority to do what they are being asked.

A monetary rule is one way to preserve the Fed’s independence while adding predictability that entrepreneurs and investors can plan around. Congress should help the Fed enact such a rule, whether that rule targets interest rates, the money supply, or NGDP.

Simplify Fed's mission: The Fed already has a self-contradictory dual mandate: Keep inflation low and employment high. In the short run, the Fed can boost employment by boosting inflation. Cutting inflation can come at the cost of a slower economy.

It can achieve one of its goals or the other, but not both. That tension limits the Fed's effectiveness because it requires Fed policy makers to use discretion as to which plank to prioritize at a given time. More discretion means less predictability, which makes long-term investments and other decisions more difficult throughout the economy.

Congress should simplify the Fed's job to a single mandate of keeping inflation low. Congress should also oppose efforts to expand the Fed's mission to include environmental and social policy considerations.

The dual mandate status quo is bad enough. If Congress were to also require the Fed to also factor climate change, economic inequality, and social justice issues into its monetary policy decisions, the results would be even less predictable inflation.

In the long run, an incoherent mission can threaten the Fed's independence. If the Fed is given a quadruple or even quintuple mandate, some parts of it will be impossible to fulfill.

The fact that tradeoffs exist will anger some members of Congress, who will propose taking control of some aspect of the Fed's contradictory mandates, until the Fed is no longer independent. As countries from Argentina to Zimbabwe can attest, central bank independence is fundamental to preventing runaway inflation.

Instead, the Fed should have a single mandate: Keep inflation low. There are better ways to pursue other policy objectives, and they will be more effective in pursuing those goals when inflation is stable and low.

Expert: Ryan Young

For further reading:

Ryan Young, "What Inflation Is and What It Isn't," Open Market, Competitive Enterprise Institute, May 17, 2021, https://cei.org/blog/what-inflation-is-and-what-it-isnt/.

Ryan Young, "Supply Shocks Are Not Inflation," National Review, March 15, 2022, https://cei.org/opeds_articles/supply-shocks-are-not-inflation/.

Ryan Young, "Has Inflation Peaked?" Reason, June 10, 2022, https://reason.com/2022/06/10/has-inflation-peaked/.