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OPINION | THE WEEKEND INTERVIEW

How Government Spending Fuels Inflation

When debt grows so much that people don't believe the Treasury will pay it, they sell their bonds and buy other things, sending prices through the roof.

By Tunku Varadarajan
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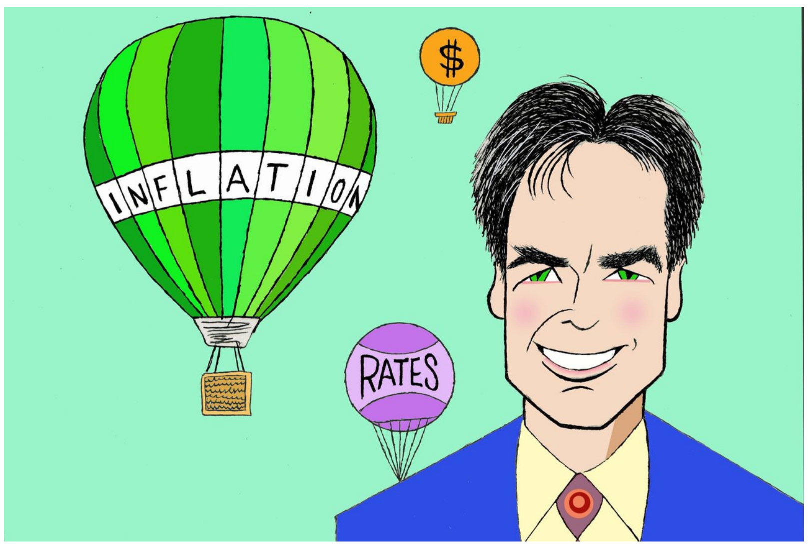

John Cochrane
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Annual inflation in the U.S. rose to 7.5% in January, the highest it's been since February 1982, when it was 7.6% and declining. This current crisis, economist John Cochrane says, came as "a complete surprise" to the Federal Reserve. "All of the governors who reported forecasts, all of the staff, missed it." When he calls this an "institutional failure," he sounds almost kind.

Mr. Cochrane, 64, parses the present inflation in a conversation by Zoom from his house in Palo Alto, Calif., near Stanford University, where he's a senior fellow at the Hoover Institution. His tone is wry, and it's obvious he doesn't hold this Fed in the greatest esteem. "They're leading us in the dark," he says, "with a great pretense of knowing exactly what the map is in front of us."

He traces the present inflation to the pandemic and the government's response. Starting in March 2020, "the Treasury issued $3 trillion of new debt, which the Fed quickly bought in return for $3 trillion of new reserves." The Treasury then sent checks to people and businesses, later borrowing another $2 trillion and sending more checks. Overall federal debt rose nearly 30%. "Is it at all a surprise," Mr. Cochrane asks, "that a year later inflation breaks out?"

He likens this $5 trillion in checks to a "classic parable" of Milton Friedman (1912-2006), the great monetarist at the University of Chicago, where Mr. Cochrane was a professor for 30 years before moving to Stanford in 2015. "Let us suppose now that one day a helicopter flies over this community and drops an additional $1,000 in bills from the sky, which is, of course, hastily collected by members of the community," Friedman wrote in "The Optimum Quantity of Money" (1969). If they spent the money, inflation would result.

The Covid checks, Mr. Cochrane says, were "an immense fiscal helicopter drop. People are spending the money, driving prices up."

Why didn't the Fed see that this massive stimulus would cause inflation? Mr. Cochrane sees a "big blind spot" in the institution and its "large circle of policy commentators." The Fed's "modeling and understanding of 'supply' constraints is very simplistic," he says. It focuses only on unemployment "as a measure of slack in the economy. There is no group of analysts at the Fed measuring how many containers can get through the ports." More deeply, he says, "the Fed and its larger intellectual circle don't think about supply at all. All variation in the economy is more or less demand."

This "intellectual failing" showed up first in the recession that followed Covid. "The economy didn't need demand-side stimulus," Mr. Cochrane says. "It's not 1933 again and again. A pandemic is, to the economy, like a huge snowstorm. Sending people money won't get them out to closed bars, restaurants, airlines and businesses."

The government did have to act "as a sort of insurer, making sure there wasn't a wave of bankruptcy and helping people really hurt by the recession." But it should have been obvious that supply constraints would lead to inflation after the recession ended. "The Fed being surprised by supply shocks is as excusable as the Army losing a battle because its leaders are surprised the enemy might attack," Mr. Cochrane says.

He notes that even Lawrence Summers, who served as Bill Clinton's Treasury secretary and Barack Obama's director of the National Economic Council, foresaw inflation as early as February 2021 (in a column in the Washington Post). "Summers, who'd argued for big deficits and loose monetary policy to combat low inflation and 'secular stagnation' for a decade, saw inflation coming, and saw its source in the massive fiscal stimulus of the Covid recession. So why didn't the Fed?"

I invite Mr. Cochrane to give the current inflation a name to distinguish it from previous episodes. “Naming it sounds like a fun project,” he says. “Our partisan world will likely call it the Biden Inflation, given that it started pretty much on Inauguration Day. But there was a lot of needless stimulus under Trump as well.” The administration may wish to call it the “It’s Not Our Fault Supply-Shock Inflation,” he says. “I’d like to call it the Fiscal Theory of the Price Level Inflation.”

“The Fiscal Theory of the Price Level” is the title of Mr. Cochrane’s next book, to be published in the fall. It’s a challenge to monetarism, the theory of controlling money as the chief method of stabilizing the economy. The new theory holds that when the overall amount of government debt is more than people expect the government to repay, we see inflation. The price of everything goes up, and the value of the dollar declines.

How does this work? “The U.S. government has $20 trillion of debt outstanding,” Mr. Cochrane says. “That means, over the long run, people must expect taxes to exceed spending by $20 trillion to repay the debt.” But if they think the government will be able to pay back only $10 trillion in today’s money, “people will try to get rid of their government debt fast, before it is worth less. They try to sell it in order to buy other things,” driving up the price of everything else. “That keeps going until all prices have doubled—until the $20 trillion promise is only worth $10 trillion at today’s prices.”

Why hasn’t “fiscal inflation” of this kind happened sooner? After all, the government has been borrowing money, as Mr. Cochrane puts it, “like the proverbial sailor”—the drunken one—for decades.

“Inflation comes when government debt increases relative to people’s expectations of what government will repay,” Mr. Cochrane says. “If the Treasury borrows but everyone understands it will later raise tax revenues or cut spending to repay the debt, that debt doesn’t cause inflation.” The borrowing and money-printing in 2020-21 was different: “It came without a corresponding increase in expectations that the government would someday raise surpluses by $5 trillion in present value to repay the debt.”

The failure of the Democrats’ Build Back Better bill “may augur well for budget seriousness,” Mr. Cochrane allows. But the “troublesome question” remains: “Do people, having decided that at least some of our government’s new debt will not be repaid—leading them to spend it now and inflate it away—also think that the government is less likely to repay its existing debts, or future borrowing? If so, even more inflation can break out seemingly—as always—out of nowhere.”

Mr. Cochrane believes that “we overstate the Fed’s power” to respond: “The Fed likes to say it has ‘the tools’ to contain inflation, but never dares to say just what those tools are.” In recent historical experience, “its tool is to replay 1980,” the year when inflation peaked at 14.8%. That means “20% interest rates, a bruising recession that hurts the disadvantaged, with the medicine applied for as long as it takes. Will our Fed really do that? Will our Congress let our Fed do that?”

In any case, Mr. Cochrane says, raising rates is a “crude tool to fight inflation, especially when the source is fiscal policy.” He likens the situation to a car going too fast. “Fiscal policy is the accelerator; monetary policy controls the oil. OK, if fiscal policy has floored it, you can slow the car down by draining oil, but that’s not a terribly good way to drive.” Fiscal policy sends checks, stoking inflation; monetary policy raises interest rates to discourage borrowing or encourage savers to hold the extra Treasury debt. To change the analogy slightly, the driver is accelerating and braking at the same time.

To overcome inflation, fiscal constraints on monetary policy will need to play a large role, Mr. Cochrane says: “The Fed is merely a copilot.” He notes that in 1980, the ratio of debt to gross domestic product was 25%. Today it is 100% and rising: “Fiscal constraints on monetary policy are four times larger today.” So for a rise in interest rates to lower inflation, “fiscal policy must tighten as well. Without that fiscal cooperation, monetary policy cannot lower inflation.”

An additional complication is that any increase in interest rates raises interest costs of servicing the debt. “The government must pay those higher interest costs by raising tax revenues and cutting spending, or by credibly promising to do so in the future.” At 100% debt to GDP, he says, “5% higher interest rates mean an additional deficit of 5% of GDP, or $1 trillion, for every year that high interest rates continue.” This consideration is especially relevant if fiscal policy is at the root of the inflation.

“If we’re having an inflation because people don’t believe the government can pay off the deficits it’s running to send people checks, and it will not reform the looming larger entitlement promises, then people won’t believe the government can pay off the additional $1 trillion deficit to pay off interest costs.” Result: “The central bank raises rates to fight inflation, which raises the deficit via interest costs, which only makes inflation worse.”

What kind of policy path would it take to stabilize inflation? Mr. Cochrane relies on history as well as theory. “Inflations do not happen to happily growing economies, whose governments run things well and with flush treasuries.”

Historically, inflations have always come “to countries in trouble, primarily fiscal trouble, but fiscal trouble caused by bad macroeconomic policies.”

When people fundamentally distrust the government to repay debt, interest-rate policies and quantitative easing have limited power. So “the bottom line” is to ensure that people have faith in the government as debtor, and that comes “from solid growth, and transparent, responsible, durable institutions.” There’s no way out without “regulatory reform, tax reform, entitlement reform, as well as clear-eyed monetary policy that works on the narrow things it actually understands.”

Mr. Cochrane wants Americans to grasp that ending inflation “isn’t just technocrats at the Federal Reserve fiddling with interest rates.” Healthy economies don’t have inflation “no matter what the central banks do,” while dysfunctional ones have inflation even with “heroic central bank presidents.”

Mr. Cochrane calls himself a free-market economist who’s always “trying to find a better phrase than ‘free market’ or ‘supply side’ or ‘neoclassical’ ” to describe himself. He likes the word “incentivist,” because his understanding of economics is “really not so much about markets, but about paying attention to people’s incentives.”

He’s been this way since he had a “wake-up moment” in 1969, when he was 12 and lived in Italy. (His father was a professor of Florentine history.) Reading the newspaper, he learned that Tuscany had an infestation of vipers, so the authorities had offered a bounty of 1,500 lire per snake, about $1 at the time. “You can guess what happened next,” he says. “It didn’t take long for enterprising Tuscan farmers to figure out how to breed and raise vipers. Unintended consequences!”

That last phrase, Mr. Cochrane says in a follow-up email, could describe the outcome of those Covid stimulus checks. Yet a bout of inflation, he says, “may be useful to our body politic.” Inflation is where “dreams of costless fiscal expansion, flooding the country with borrowed money to address every perceived problem, hit a hard brick wall of reality.”

The present crisis may “reteach our politicians, officials and commentariat the classic lessons that there are fiscal limits, that fiscal and monetary [policy] are intertwined.” It may also teach them, Mr. Cochrane says, “that a country with solid long-term institutions can borrow, but a country without them is in trouble.”

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