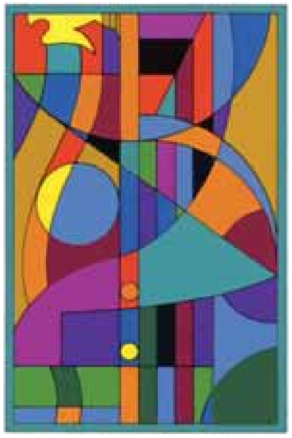

The Monetary Realist

Volcker-Reagan Rerun

BY ADAM S. POSEN

There has been a competition for the most apt historical analogy to the present macroeconomic situation: some liken it to the 1960s for guns and butter problems, some to the 1970s for oil shocks and stagflation, and some even to the 1930s for the potential long-lasting contraction supposedly to come. Actually, the clearly comparable episode to today's situation is the Volcker-Reagan episode of the early 1980s, with currently us sitting in 1979. The good news is that means the present economic challenge is both comprehensible and manageable with current policy tools. The bad news is that we are in for some unpleasant times to come, given the difference in the global situation from then.

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On the monetary side, we have a Federal Reserve that is behind the curve in responding to inflationary pressures, and is seeing some rise in inflation expectations as a result. Unlike under Arthur Burns in the late 1970s, the Bernanke Fed has had very good reason to overshoot on ease this time, but once the current financial situation stabilizes, the macroeconomic impact will be the same—albeit on a smaller scale. The Fed will have to raise rates pretty steadily and significantly to offset the inflationary spillovers of the negative supply shock. Of course, in theory, if inflation expectations stayed anchored at low levels, there would be only first-round effects of the supply shock, and the Fed could hold off raising rates (or perhaps even ease). Only the relative price shift would take place, as desired.

That theory worked in practice for a while, as seen in the lack of inflationary pass-through from oil going to $140-plus per barrel from $20 per barrel over the last few years. That luck will not persist for three reasons omitted from today's standard theory. First, the theory assumes that supply shocks are independent and normally distributed—in other words that you will not get a long series of persistent price movements all in one direction—but that is what we now have with energy, food, commodities, and soon healthcare. Second, the theory assumes that people set their inflation expectations in a forward-looking manner rather than adaptively. Increasingly, however, there is evidence that many price-setters and households learn only from recent data, so the few years of rising prices are now showing up in rising inflation expectations, whatever the Fed says. Third, the theory ignores the political pressures for adjustment and bailouts that arise when there is a relative price shift against labor incomes—the central bank can, and arguably should, treat that like any other price shock, but elected officials cannot.

Which brings us to the fiscal, or Reagan, side of the coming policy mix. The next President, whether Obama or McCain, with Democratic majorities in both houses of Congress, will be undertaking a great deal of new government

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spending. Access to non-emergency health care will be extended to at least twenty million Americans, perhaps thirty million under Obama, unleashing pent-up demand on an inelastic supply of medical services and equipment; the candidates agree that the U.S. military needs to be rebuilt in terms of munitions and manpower, no matter how troops are allocated between Iraq, Afghanistan, and home; some form of climate change response, like a cap-and-trade program, will be legislated, and will inevitably be accompanied by spending on green technologies and affected dirty industries; and the pressures for some further bailouts of recent American home purchasers will mount. All of this spending, except perhaps the last, will be worthwhile and is even overdue, but these programs are unlikely to be paid for as we go, whatever form of tax reform accompanies them. So like in the early 1980s, a tightening monetary policy in an inflationary environment will face up against an expansive fiscal policy.

In the immediate term, this will keep the U.S. economy afloat, especially since the Fed will not be needing to raise interest rates as high as Volcker did, and the rate increases will take time to have their effect on the real economy. But even a mini-Volcker-Reagan rerun will have deleterious effects for the U.S. public debt, essentially reversing the Greenspan-Rubin virtuous circle from lower debt to lower interest payments. More importantly, the Fed will be only one of the vast majority of central banks tightening monetary policy worldwide in coming months, since inflation problems are far worse in the bulk of emerging markets and are clearly emerging in the eurozone and Japan as well.

So we can expect around 2011, give or take a few months, the contractionary effects of a relatively synchronized global disinflation policy, with few if any oases of growth. If other countries also engage in *de facto* structural adjustment programs—that is, fiscal expansion to ease the politically salient pain from supply shocks to energy and food, as some emerging markets are already having to do—the crowding-out effect of increased government spending on interest rates could be greater for the United States and everyone else. In today's world of much larger global capital flows, it is unclear whether the strengthening of the dollar seen in the mid-1980s would repeat—if the interest rate differential of the United States versus other countries was smaller this time through, but the erosion of fiscal discipline were greater than abroad, the dollar could really tumble.

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There are some potential gains from attempting international policy coordination in this situation, starting now. First, a clearly common disinflationary front among major central banks could be more credible, and thus get inflation expectations down more quickly, reducing the output costs of so doing for everyone. Second, getting (almost) every central bank on board could reduce the exchange rate spillovers from some countries free-riding on others' disinflationary efforts, and getting competitive depreciations en route. As was the motivating force for the Plaza and Louvre Accords after Volcker-Reagan, the exchange rate effects of differential disinflations in the coming years could create huge protectionist pressures directly, as well as from any induced recession. Better to see the right historical analogy now and get out ahead of what logically follows. ◆