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# CF40 INTERVIEW ON US INFLATION AND MONETARY POLICY

**(Full article on qq.com here)**

**October 2, 2022**

1. ***US inflation ran slightly higher than expected in August, indicating a level of stickiness. What factors have been propping it up? Do you see it peaking at the moment? How do you foresee inflation and its mid- to long-term average in the US going forward? Is it ever possible to go back to 2%?***

"Slightly higher" is an under-statement of the disappointing August inflation reports. Yes, following extremely rapid increases in May and June, the August figures were "only" slightly higher when compared with July on a sequential basis; however, they were significantly above the expectations of most forecasters and financial market participants who were expecting a significant sequential decline. Moreover, in keeping with earlier disappointments on the inflation front, the disappointments in August were broad-based. The total personal consumption expenditures (PCE) deflator was up 0.3% sequentially, and the "core" PCE deflator — long the Fed's favorite inflation metric — was up 0.6%; on a year-over-year basis, the core PCE deflator accelerated to 4.9% in August (from 4.7% in July) — again, rising instead of falling as most were expecting. Yes, these numbers remain below the peak rates of last March. But the debate over "peak inflation" misses the most crucial aspect of the US inflation problem: While the overshoot in March may well have been the peak, far more important is the trajectory of post-peak moderation; the subsequent slowing from the March 2022 peak — disinflation in a technical sense — has been disappointingly modest, at best. With persistent and broad-based inflation proving exceedingly intractable, the return to the Fed's 2% target is likely to be a long and arduous process. The peak inflation debate is just another way to pre-judge the inflation problem as transitory. That will go down in history as a major mistake.

2. ***The Federal funds rate has been elevated to 3.00-3.25%. What is your prediction of the pace of the Fed's rate hike and balance sheet reduction in Q4 and 2023? And at what level do you expect the Federal funds rate to peak?***

The nominal federal funds rate (FFR), now effectively at 3.1%, remains five full percentage points below the three-month average of the headline CPI inflation rate of 8%. That raises an important point. In judging the stance of monetary policy, I think it is important to focus on headline inflation — not the core. The very premise of the core is to dismiss major price shocks as transitory, just as Powell initially did. I am still haunted by Arthur Burns, who as Fed Chair (and my first boss) in the early 1970s committed the "original sin" of ignoring one transitory price shock after another until it was far too late. To the extent that today's monetary policymakers continue to be misled by an inflation problem that proves to be more intractable than a focus on core inflation suggests, by stripping out so-called one-off, or idiosyncratic factors, they and the financial markets are underestimating the diffusion of price pressures and the ultimate extent of monetary tightening that will be required to return inflation to a 2% target.

Fed Chair Jerome Powell has now conceded that a "restrictive" monetary policy will be needed to tame inflation. Based on the headline CPI, the *neutral* policy rate – basically an average of the real FFR from 1960 to 2021 – is +1.1%. *Restrictive*, by definition, must be a number greater than neutrality; for the sake of argument, call it a 2% real FFR. With the real FFR currently at -5%, the Fed is not even close to being neutral, let alone restrictive. Under the presumption that the disinflationary trajectory proves to be more drawn out than most are expecting, I suspect that the nominal FFR may well have to rise into the 5% to 6% zone to accomplish that task. That suggests that the Fed may have only completed about half of its inflation-control campaign.

3. ***How do you evaluate the impact on the US economy of the latest rate hike? What is your outlook of the US economy? Has the Fed underestimated the likelihood of a recession and labor market collapse?***

The US economy has clearly slowed, but, as an exceedingly tight US labor market suggests, most certainly is not in recession today. Two consecutive quarterly declines in real GDP in the first half of 2022, while invariably associated with recessions in the past, currently appear to be more technical than decisive in signaling the onset of a broad-based cyclical contraction. But, if I am even close to being correct on the Fed rate hikes required for inflation control, recession is the most likely destination for the US economy in 2023. We all know that monetary policy impacts the real economy with long and variable lags – somewhere in the 12-to-18-month range. My own research has long stressed that *changes* in real interest rates are especially critical in assessing the impacts of monetary policy on the real economy. On that basis, the verdict is inescapable: The Fed has conveyed the message that it will be moving from a record degree of monetary accommodation to a restrictive posture. This is the functional equivalent of a major regime change. The three consecutive 75 basis points rate hikes in the last three FOMC meetings are already the sharpest Fed tightening since early 1982 in the Volcker era. With several more rate hikes to come before the policy rate reaches the restrictive zone, the ultimate regime change is likely to be all the more dramatic, leading me to conclude that recession in the US economy should inevitably follow in 2023.

4. ***How will the USD index evolve going forward? What amplification or spillover effect will a strong dollar have on non-dollar economies and the global market? Why do dollar fluctuations have such strong global impacts?***

I will attempt to answer this important question with a great sense of personal humility. A little over two years ago, I warned of a crash in the US dollar. It was a terrible forecast – the dollar, of course soared rather than plunged. That has made me wary of attempting to say anything intelligent about a currency forecast. My dollar crash call was based on three factors – a sharply widening US current account deficit, a then passive Fed, and excess negativism on other currencies — especially the euro, the renminbi, and the currencies of America's NAFTA (now USMCA) partners, Mexico, and Canada. While the US current account deficit did, indeed, go from bad to worse as I had expected, that hasn't really mattered – at least, not yet. The Fed, of course, finally woke up from its slumber and has led the charge in tackling a serious US inflation problem. That was the decisive factor in pushing the dollar sharply higher. As I have argued above, I suspect the Fed had considerably further to go on its anti-inflation monetary tightening campaign than market participants expect. By the postmortem "logic" of assessing my mistaken dollar forecast, that suggests that strength of the greenback is likely to persist. But I underscore the painful disclaimer that I must attach to that conclusion – my forecasting record on the dollar is terrible!

The spillovers speak for themselves. While rest of the world enjoys a boost in competitiveness that comes from weakness in their currencies that arise from a surging dollar, the problem shows up on the debt service side of their financial equations. That is especially the case for overly-indebted emerging economies — from Sri Lanka, Lebanon, and Zambia where debt defaults have already occurred to Argentina — long the world's favorite basket case — Bangladesh, and Pakistan where troublesome signs on debt service are already evident.

5. **Countries around the world are racing to raise the interest rate. Some believe this is risking a "reverse currency war." Do you share this view or not? What harm would such a war do if it were to happen? Are we facing a new round of financial crisis or global recession before inflation is brought under control?**

To the extent the inflation outbreak is global in scope — and that is certainly the case in most major economies, with the notable exception of China — then monetary tightening is also appropriate in nations other than the United States. However, with the Fed leading the charge in addressing inflation and with the US dollar still the dominant reserve currency in the world, central bankers around the world are waking up to the most uncomfortable truth in a generation — that the days of zero interest rates are over. Underpinned by the false presumption that inflation was dead, there was little or no discipline to sovereign debt management practices; fiscal authorities spent with reckless abandon because debt service was costless, and they mistakenly thought it would stay that way in perpetuity. Today's inflation surge, and the monetary policy implications it implies, turns that misdirected logic inside out. With Europe already in the early stages of a recession induced by constraints on Russian energy supply as an outgrowth of the war in Ukraine and with the US likely to be headed for the same fate in 2023 as

I indicated above, it will take nothing short of a miracle to avoid a global recession. In the post-GFC era – especially the years 2012-16 — the world could count on a resilient Chinese economy to cushion any blow. That will not be the case this time, as the Chinese economy is facing very stiff headwinds of its own on many fronts — from the temporary impacts of zero-Covid policies and property sector deleveraging as well as from longer term factors such a weak productivity, a decline in the working age population, and anti-market regulatory pressures. The US, Europe, and China collectively account for 49% of world GDP. With no one to fill the void as this dominant chunk of the world weakens, global recession in 2023 seems increasingly inevitable.

6. ***What policy suggestions do you have for non-dollar economies and their central banks on how to cope with inflation and the risks of recession and financial crisis? What are the key factors that are indispensable to global efforts to pull the economy out of stagflation?***

There is no simple answer, no sure-fire policy recipe, to address this important question. With the benefit of hindsight, it is easy to be critical of leading central bankers, especially Ben Bernanke and Alan Greenspan of the United States, who threw the full force of their considerable reputational capital behind the fantasy of the "Great Moderation." As we are seeing today, belief in the permanence of such a depiction was an outgrowth of one key erroneous assumption — that inflation was, indeed, dead. Market participants, fiscal authorities, and sovereign debt managers were all more than happy to go along for the ride, and they had the charlatans of a new theory — modern monetary theory — to provide intellectual support for their collective gambit. In many respects, this is the mirror image of what happened in the early 1970s, when fresh out of graduate school, I began my career as professional economist at the Federal Reserve Board. As I noted above, for then Fed Chair Arthur Burns, the outbreak of inflation was all transitory — "special (nonrecurring) factors" as we dubbed them back then — that had nothing to do with monetary policy. Jerome Powell, unfortunately, made the same mistake some 50 years later. The indispensable recipe for solving this tough set of problems, especially in today's highly charge political climate, can be found in the discipline and legacy of Paul Volcker. Apparently, Powell has placed Volcker's autobiography, *Keeping At It*, in a prominent place on his desk. I don't doubt that he has read it carefully — his August 2022 Jackson Hole speech was crystal clear on that point. But it's one thing to understand the merits of monetary discipline, especially after the lack of such discipline during the Great Moderation. It is another matter altogether to stay the course of restoring that discipline as the only real antidote for a stagflationary world headed for crisis. Like Volcker, this will be Powell's ultimate test.

7. ***A volatile dollar would usually throw the global monetary system into "unanchored" turmoil, as seen in history. What new trends do you expect to see in the global monetary system? How can countries work together to improve global monetary governance? Should central banks consider replacing the single mandate of inflation targeting with a multi-target system that also aims at sustained growth and financial stability?***

I have long been on record in favoring the addition of a financial stability mandate to the goals and objectives of modern-day central banking. I first argued the case in the aftermath of the bursting of the dotcom bubble in the early 2000s and then I reiterated the point again and again in the aftermath of the Global Financial Crisis of 2008-09. Central banks were reckless and irresponsible, I maintained, in encouraging the all-too-convenient transition from income-based to asset-dependent economies. Enabled by blind faith in the Great Moderation, the combination of exceedingly low interest rates, and new technologies of wealth extraction from over-valued assets, the asset-dependent economy purportedly could support income-constrained economic growth with great impunity. Or so they thought. The day would come, I warned *ad nauseum*, when inflation would return, and the Great Moderation would no longer be great. That day is now at hand — and financial stability risks are now in the danger zone around the world. Yes, central bankers had an inkling that this risk should be taken more seriously; in the aftermath of the GFC, most major central banks started issuing periodic "financial stability reports," and the IMF now does the same on a global basis. This is not enough — it is a soft financial stability mandate, at best, and merely pays lip-service to the possibility of a major problem. The factors that determine financial stability — asset values, leverage ratios, and asset-related distortions to real economies — need to be made explicit and codified into formal, legally binding (i.e.., congressionally legislated), central bank mandates.

Moving from a soft to a hard financial stability mandate, without compromising existing price stability and full employment mandates, would be an important step in the direction toward a "multi-objective monetary policy" as sketched out Zhou Xiaochuan for China in 2016. While international coordination of a multi-target system would be desirable in theory, the practical possibility of that ever occurring is close to zero. That puts on the onus on individual central banks to address their own financial stability risks, while at the same time taking into account the potential global spillovers of their actions. Federal Reserve Vice Chair Lael Brainard's recent speech at a New York Fed research conference is an important nod in this latter direction. That poses one of the toughest questions of all — balancing multiple mandates with a single policy tool. Today, that means addressing the tradeoff between inflation control and financial stability; tomorrow, as unemployment undoubtedly rises, it may mean something else. Only central banks that are operating in a fashion that is truly independent of political pressures can be expected to tackle this tough issue with Volckeresque discipline and focus. "Keeping At It" won't be easy – but in the end, it is the only way out.

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