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## The Krugman vs Summers Debate on US inflation

## Beware Historical Mythology and Erroneous Findings from the History Laboratory

Nothing works better in attracting audiences for otherwise dry economic analysis than a Punch and Judy show, especially when presented against the background of historical mythology.

That is what we have playing in the spectacle of Nobel Prize winner Professor Paul Krugman vs ex Clinton and Obama Treasury/Economics Chief Professor Larry Summers.

Krugman is telling us not to panic about inflation, saying that it is no re-run of the great inflation of the mid-1960s to the late 1970s. Instead, Krugman points to US inflation following World War 2 as the nearest similar experiment in the laboratory of history. As we outlined in this publication a month ago (before Krugman's NYT op-ed on the subject!), consumer prices rose by 25% in 1946-7, before levelling off and falling moderately during the recession of Autumn 1948 to Autumn 1949, all against the market background of long-term US interest rates stuck at just above 2 per cent.

Summers will have none of this and tells his Bloomberg TV host that Krugman's history telling is "lightweight". Instead, Summers remains adamant in his hypothesis, which he has been advancing since early Spring 2021, that the Biden fiscal "stimulus" was a stimulus too far, driving the US into another Great Inflation. And this will not just fade away as bottlenecks resolve themselves. High inflation by then will have become embedded in expectations. To avoid a multiple car crash further ahead, the Fed and the fiscal policy managers should be tapping the brake now. And no, a modest such tapping now would not cause the economy to spin into recession.

As in any real-life Punch and Judy show, the protagonists do not arrive with clean sheets. Both have tarnished historical records.

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Wasn't it Krugman who advocated during the 2001-2 recession (now in fact wiped out of the record by data revisions) that the Fed should create a housing bubble to stimulate economic recovery?

And Summers enters the show with ready-made antagonism on the progressive wing of the Democratic Party for his alleged self-serving in pursuing a bold form of financial de-regulation when in office. That antagonism, of course, forced him to withdraw his candidature for Fed Chair in 2013 in favour of Janet Yellen, who, as Biden's Treasury Chief, has been the advocate of the big bang stimulus this year.

Both Krugman and Summers enter the show as economic experts who fully endorsed the stepping up of monetary inflation early on in the pandemic. Both were on the record as approving the Fed's then-radical "monetary stimulus" package. Neither had problems with the dominant story-telling that great stimulus was necessary to prevent another extended Great Recession. Perhaps Summers was less inclined than Krugman to embrace the Democratic Party narrative that the problem with the 2009-10 stimulus had been that it was not bold enough and that mistake should not be made again.

It doesn't seem from their public utterances that either protagonist is issuing a mea culpa, apologising for a previous error of judgement. So both are standing by their earlier positions in any theoretical debate if an extraordinary stimulus was appropriate in Spring 2020. A sudden seizing up of economic activity under the threat of disease, indeed likely to be reversed subsequently – does that require the same treatment from policy-makers as an economic collapse brought on by the debt excesses in particular of long-running asset inflation? Though it lurks in the background, that question does not form an explicit part of the present show.

We should say that the Krugman point of view (about 1947-8 being the reference for the present) rather than the Greatest Peacetime Inflation, for now, is dominant in the marketplace. How else to explain 10-year T-bond yields still at barely 1.7%, still somewhat below their Spring peak.

Yet without much doubt, the Summers view is getting more air time (especially on Bloomberg News!), including endorsements from some ex-senior Fed officials, including even some "doves". Without exaggeration, if audience ratings were to swing towards Summers and against Krugman significantly, we should expect blood on the street in the US fixed-rate bond marketplace.

Here at MHA, the Summers view is as wrong about a repeat of the 1965-79 history as the joint Summers/Krugman view was earlier in this pandemic about a Great Recession similar to the 2008-10 period lying ahead. Summers says in passing that we should focus

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mainly on the immediate inflation rate, which has been at 11-12% P.a.; but a cursory look at the 1947-8 period finds monthly rates far above that, and still, the high inflation faded away without significant monetary policy action.

Summers' critical concern is that present high inflation becomes built into expectations and that monetary policy Is continuing and will continue without course correction to fuel the inflationary fires.

Why are we here at MHA not convinced by this argument?

It is true that in the depths of the Great Inflation of 1965-79, the hypothesis became popular that a process was at work where everyone – including wage-earners and enterprise chiefs – came to expect high inflation. So they set forward prices, including multi-year wage settlements based on those expectations. Suppose the Fed did not ratify those expectations. In that case, the shock could generate an economic downturn, so the path of least resistance was for the Fed to accept the high inflation and allow monetary growth to race ahead correspondingly. Both Keynesians and monetarists built such expectations formation into their economic modelling.

But there were unanswered questions that these hypothesised builders did not address, most of all the facts of the second great Burns inflation from 1976-8/9 (the first from 1970 to 1973). Burns did not turn again to rampant monetary inflation as the US economy exited the Great Recession of 1974/5 to ratify high inflation expectations; these had been falling sharply.

Instead, we should look at such factors as the approach of the November 1976 elections into which the Republican establishment post-Nixon were entering with trepidation. By holding back the rise of rates in this environment, the Burns Fed engendered a rapid monetary and credit expansion which was the driving force behind higher inflation (asset inflation and goods/services inflation). And the success of that monetary policy in producing economic boom both in the US and globally through 1976-9 was due to a significant degree to an underlying dynamism in the global economy, manifested by economic miracle, whether in France, Japan, or many emerging market economies.

Fast forward to the present.

The idea that hardened great monopolists throughout the US economy are about to become soft and grant wage increases based on hypothesised higher inflation into the future just does not ring as plausible. Yes, they will pay higher wages, sometimes spectacularly, where there are present labour shortages. But as these shortages lessen amidst a resolution of bottlenecks and increasing supplies, the situation in particular labour markets will decide what follows.

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Yes, potentially Biden's pick for Fed Chief might have implicitly entered a deal with the White House to promote Democratic success in the 2022 mid-term elections and beyond. But first, it is not clear that stepping on the monetary gas at this point would do the trick – with two central reservations at the forefront.

First, high inflation is now ostensibly a vote loser. Second, the US and global economies have become so sclerotic under the influence of advancing monopoly capitalism and accumulating mal-investment that continuing meagre nominal interest rates might well not stimulate economic boom, inflationary or not.

In the immediate, even though rates are highly negative in real terms, supply shortages and bottlenecks mean there is no scope for beating inflation by over-consuming in the present. Further ahead, there will be such an overhang of excess spending on consumer durables and digitalisation more broadly during the pandemic that we should expect some normalisation, as indeed occurred in the 1948-9 recession.

So, with no joy in the performance, indeed only revulsion, our approval rating in the Summers-Krugman show goes to Krugman. A big caveat: this show has absolutely nothing to tell us about the scourge of asset inflation and how it will end. Implicitly Krugman is more concerned than Summers that there could be a bad outcome soon, hence his caution about endorsing a tap on the brakes now to avoid a pile-up later. But Krugman no more than Summers explicitly builds asset inflation into the economic analysis. Here at MHA, key elements in determining asset deflation risks are the course of the business cycle both in the US and globally. We see a heightened risk of a US economic downturn already into the second half of 2022.

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