

# RESEARCH REPORTS

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## RESEARCH REPORTS

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# Contents

## **Business Conditions Monthly**

ROBERT HUGHES 1

## **FOMC Projects Even Higher Inflation**

WILLIAM J. LUTHER & MORGAN TIMMANN 11

## **No, Putin Didn't Cause Inflation**

PETER C. EARLE 14

## **Will Federal Reserve Losses Impact Fed Shareholders or Affect Monetary Policy?**

PAUL H. KUPIEC AND ALEX J. POLLOCK 16

## **Making Sense of Monetary Policy and the Future of Inflation**

JAMES L. CATON 20

## **Can The Fed Save Us?**

RYAN M. YONK & FERNANDO M. D'ANDREA 24

## **Student-Loan Forgiveness Will Cover Non-Education Purchases, Say, Newer Cars**

RICHARD MCKENZIE 26

## **The US-China Currency Rivalry: Choosing Sides**

ETHAN YANG & DOROTHY CHAN 28

## **In Bernanke We Trust?**

SAMUEL GREGG 31

## **Setting the Record Straight on "Setting the Record Straight on the Libertarian South African Economist W.H. Hutt and James M. Buchanan"**

ART CARDEN & PHILLIP W. MAGNESS 35

## **New Study Challenges CDC Evidence on School Masking**

DAVID WAUGH 39

## **The "Unlivable" World of Global Warming Is Much Wealthier Than Today**

JAMES E. HANLEY 41

## **Of Patriots and Freedom**

JAMES R. HARRIGAN 45

# BUSINESS CONDITIONS MONTHLY

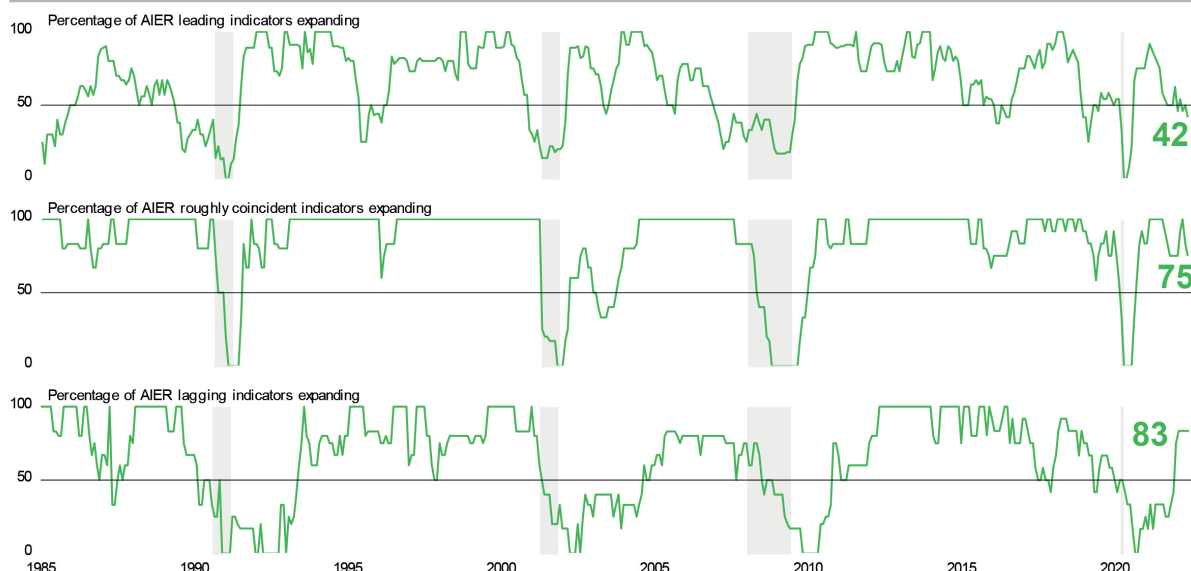
Robert Hughes

SENIOR RESEARCH FACULTY



## AIER Leading Indicators Index Falls to the Lowest Level Since August 2020

### Indicators at a glance



### Summary

AIER's Leading Indicators Index fell back below the neutral 50 threshold in June, dropping eight points to a reading of 42, and the lowest level since August 2020. Despite the new cycle low, the Leading Indicators Index continues to fluctuate around the neutral 50 threshold, with the average over the last nine months coming in at exactly 50 (see chart). Over the last nine months, the Leading Indicators index has been above neutral twice, below neutral three times, and exactly neutral four times. Any additional declines that take the leading index farther below the current 42 reading would suggest a significantly higher risk of recession.

Persistently elevated rates of price increases and an intensifying Fed tightening cycle are impacting economic activity. Consumer attitudes and consumer spending are flashing warning signs while higher mortgage rates are weighing on housing. However, the strong labor market continues to provide support for consumer incomes. The outlook remains highly uncertain. Caution is warranted.

### AIER Leading Indicators Index Falls to 42 in June

The AIER Leading Indicators index posted a decline in June, dropping eight points to 42. Over the last nine months, the Leading Indicators index has been above neutral twice, below neutral three times, and exactly neutral four times, with the average over that period coming in exactly neutral at 50. Any additional declines that take the leading index farther below the current 42 reading would suggest a significantly higher risk of recession.

Two leading indicators changed signal in June. The real new orders for consumer goods indicator weakened to a negative trend from a neutral trend just one month after turning from a negative trend to neutral. Frequent shifts in trend suggest the indicator may be in a transition phase. Trends in this indicator, along with the real retail sales indicator, may be critical over coming months.

The trend in the real retail sales indicator has been improving recently. Over the first six months of 2022, the real retail sales indicator was trending lower in January and February, trending flat in March and April, and trending higher in May and June. However, over the last six months, actual real retail sales have posted monthly gains in three months (January, February, and April) and declines in three months, including a 1.3 percent drop in May. The next few months may be critical.

Housing permits weakened from a positive trend to a neutral trend in June. Given the sharp rise in mortgage rates and elevated home prices, this is not a surprising development. Other housing-related data point to softening activity as well.

Among the 12 leading indicators, four were in a positive trend in June while six were trending lower and two were trending flat or neutral.

The Roughly Coincident Indicators index posted a second consecutive decline in June, dropping to a reading of 75 from 83 in May, and a perfect 100 in April. One indicator weakened in June. The Conference Board Consumer Confidence in the Present Situation fell from a positive trend to a neutral trend. Most measures of consumer attitudes are weakening, primarily a result of persistent, elevated rates of price increase.

Overall, four indicators – nonfarm payrolls, employment-to-population ratio, industrial production, and real personal income excluding transfers were trending higher in June while the real manufacturing and trade sales indicator was in a

negative trend and the Conference Board Consumer Confidence in the Present Situation was in a flat or neutral trend.

AIER's Lagging Indicators index was unchanged for the fifth consecutive month, holding at 83 in June. February through June was the best five-month run since June through October 2018. No individual indicators changed trend for the month. In total, five indicators were in favorable trends, one indicator had an unfavorable trend, and none had a neutral trend.

Persistently elevated rates of price increase are weighing heavily on consumer attitudes and may be starting to impact spending patterns. Furthermore, they have pushed the Fed to intensify the current policy tightening cycle, raising the risk of a policy mistake. Meanwhile, the fallout from the Russian invasion of Ukraine continues to disrupt global supply chains, and ongoing labor shortages and turnover are challenging businesses, though there may be some early signs of easing on the labor front.

The outlook is for continued economic growth, but risks remain elevated. Consumer spending is facing strengthening headwinds from declining confidence while housing is showing some signs of fatigue as record home prices and surging mortgage rates temper demand.

Additionally, 2022 is a Congressional election year. Intensely bitter partisanship and a deeply divided populace could lead to turmoil as confidence in election results come under attack. Contested results around the country could lead to additional economic disruptions and government paralysis, again testing the durability of democracy. Caution is warranted.

## **Consumer Sentiment Plunged to a Record Low in June**

The final June results from the University of Michigan Surveys of Consumers show overall consumer sentiment plunged to a new record low.

The composite consumer sentiment index decreased to 50.0 in June, down from 58.4 in May, a loss of 8.4 points or 14.4 percent. The index is at a level that is consistent with prior recessions.

Both component indexes posted sharp declines. The current-economic-conditions index fell to 53.8 from 63.3 in May. That is a 9.5-point or 15.0 percent decrease for the month, leaving the index at a record low.

The second sub-index — that of consumer expectations, one of the AIER leading indicators — lost 7.7 points or 13.9 percent for the month, dropping to 47.5. The index is at its lowest level since May 1980.

According to the report, “Consumers across income, age, education, geographic region, political affiliation, stockholding and homeownership status all posted large declines. About 79% of consumers expected bad times in the year ahead for business conditions, the highest since 2009.”

The one-year inflation expectations was unchanged at 5.3 percent in June, just below the March and April 2022 level of 5.4 percent. The one-year expectations has spiked above 3.5 percent several times since 2005 only to fall back. The five-year inflation expectations ticked up to 3.1 percent in June. That result remains within the 25-year range of 2.2 percent to 3.5 percent.

According to the report, “Inflation continued to be of paramount concern to consumers; 47% of consumers blamed inflation for eroding their living standards, just one point shy of the all-time high last reached during the Great Recession. Since the preliminary sentiment reading in mid-June, the Federal Reserve raised interest rates by 75 basis points, exceeding the 50 basis point hike that had been previously telegraphed.”

The report adds, “Consumers also expressed the highest level of uncertainty over long-run inflation since 1991, continuing a sharp increase that began in 2021.”

The plunge in consumer attitudes reflects a confluence of events, with inflation leading the pack. Persistently elevated price increases affect consumer and business decision-making and distort economic activity. Overall, economic risks remain elevated due to the impact of inflation, an intensifying Fed tightening cycle, and disruptions associated with the Russian invasion of Ukraine and periodic lockdowns in China. As the midterm elections approach, negative political ads may also weigh on consumer sentiment.

### **Inflation Fears Continue to Drag Consumer Expectations Lower**

The Consumer Confidence Index from The Conference Board fell again in June, the second drop in a row and seventh in the last twelve months. The composite index decreased 4.5 points or 4.4 percent to 98.7, the lowest level since February 2021. From a year ago, the index is down 23.4 percent. The decline was concentrated in consumer’s expectations for the future.

The expectations component sank 7.3 points, or 9.9 percent, to 66.4 while the present-situation component – one of AIER’s Roughly Coincident Indicators – fell just 0.3 points to 147.1. The expectations index is down 38.8 percent from a year ago and is at its lowest level since March 2013. The index is below the readings just before the start of three of the last four recessions.

Within the expectations index, all three components fell versus May. The index for expectations for higher income fell 2.0 points to 15.9 while the index for expectations for lower income rose 0.7 points, leaving the net (expected higher income - expected lower income) down 2.7 points to 0.7.

The index for expectations for better business conditions fell 1.7 points to 14.7 while the index for expected worse conditions rose 3.1 points, leaving the net (expected business conditions better

- expected business conditions worse) down 4.8 points to -14.8.

The outlook for the jobs market weakened in June as the expectations for more jobs index fell 1.2 points to 16.3 while the expectations for fewer jobs index rose by 2.5 points to 22.0, putting the net down 3.7 points to -5.7.

For the present situation index components, current business conditions and employment conditions weakened slightly. The net reading for current business conditions (current business conditions good - current business conditions bad) was -3.4 in June, down from -1.9 in May. Current views for the labor market saw the jobs hard to get index decrease, falling 0.8 points to 11.6 as the jobs plentiful index fell 0.6 points to a still-strong 51.3 resulting in a 0.2-point gain in the net to 39.7. A net above 40 is considered strong by historical comparison.

Inflation expectations rose to 8.0 percent in June, a record high; expectations were 4.4 percent in January 2020. The sharp rise in expected inflation from The Conference Board survey is consistent with the University of Michigan survey results, though the magnitudes are different. Inflation expectations remain extremely high as prices for many goods and services continue to rise at an elevated pace. The extreme outlook for inflation is a key driver of weaker expectations among consumers.

### **Retail Sales Decline in May**

Retail sales and food-services spending fell 0.3 percent in May following a 0.7 percent gain in April. From a year ago, retail sales are up 8.1 percent. Total nominal retail sales remain well above the pre-pandemic trend.

However, these data are not adjusted for price changes. In real terms, total retail sales were down 1.3 percent in May following a 1.0 percent increase in April and a 0.5 percent drop in March. From a year ago, real total retail sales are down 3.1 percent.

As with nominal retail sales, real retail sales remain well above trend.

Core retail sales, which exclude motor vehicle dealers and gasoline retailers, rose 0.1 percent for the month following an 0.8 percent gain in April. The gains leave that measure with a 7.9 percent increase from a year ago.

After adjusting for price changes, real core retail sales fell 0.6 percent in May but are up 1.8 percent from a year ago. Real core retail sales are well above its prior trend.

Categories were mixed for the month with seven up and six down in May, on a nominal basis. The gains were led by gasoline spending, up 4.0 percent for the month. However, the average price for a gallon of gasoline was \$4.70, up 7.5 percent from \$4.37 in April, suggesting price changes more than accounted for the rise. Food and beverage store sales were up 1.2 percent in May while restaurants posted a 0.7 percent gain, and sporting goods, hobby, musical instrument, and bookstores sales were up 0.4 percent.

Among the decliners, automotive retailers had a 3.5 percent decrease in sales followed by electronics and appliance store sales (off 1.3 percent), miscellaneous store retailers (down 1.1 percent) and nonstore retailers (down 1.0 percent).

Overall, retail sales fell for the month and were dragged down by slower auto sales but remain well above trend. Excluding autos and gas, nominal core retail sales managed a small gain. However, rising prices are still providing a significant boost to the numbers. In real terms, total and core retail sales were down for the month. Furthermore, persistently elevated rates of price increase are starting to have a negative effect on consumer attitudes and may lead to a retrenchment in spending.

## **Existing Home Sales Fell to the Lowest Level Since June 2020**

Sales of existing homes decreased 3.4 percent in May, to a 5.41 million seasonally adjusted annual rate. That is the fourth consecutive monthly decline, leaving the selling pace at the lowest level since June 2020 following the lockdown recession. Sales were down 8.6 percent from a year ago.

Sales in the market for existing single-family homes, which account for about 89 percent of total existing-home sales, dropped 3.6 percent in May, coming in at a 4.80 million seasonally adjusted annual rate. From a year ago, sales were down 7.7 percent. Single-family sales also fell for the fourth consecutive month and were at their slowest pace since June 2020.

The single-family segment saw sales decline in three of the four regions. Sales fell 6.0 percent in the West, 5.7 percent in the Midwest, and 2.7 percent in the South, the largest region by volume while sales were up 1.8 in the Northeast, the smallest region by volume. Measured from a year ago, sales were down in all four regions (-10.5 percent in the West, -9.5 percent in the Northeast, -7.2 percent in the Midwest, and -6.2 percent in the South).

Condo and co-op sales fell 1.6 percent for the month, leaving sales at a 610,000 annual rate versus 620,000 in April. From a year ago, condo and co-op sales were off 15.3 percent and were at their slowest pace since July 2020.

Condo and co-op sales were down in one region in May, falling 3.4 percent in the South and were unchanged in the other three regions. From a year ago, sales were down in all four regions (-22.6 percent in the South, -11.1 percent in the Midwest, -8.3 percent in the Northeast, and -6.7 percent in the West).

Total inventory of existing homes for sale rose in May, increasing by 12.6 percent to 1.16 million, leaving the months' supply (inventory times 12 divided by the annual selling rate) up 0.4 months

at 2.6, the highest since August 2021 but still low by historical comparison.

For the single-family segment, inventory was up 13.2 percent for the month at 1.03 million but is 1.0 percent below the May 2021 level. The months' supply was 2.6, up from 2.2 in the prior month, the highest since September 2020.

The condo and co-op inventory increased 7.3 percent to 132,000, pushing the months' supply up to 2.6 from 2.4 in April. Months' supply is still 10.3 percent below May 2021 but has risen for four consecutive months.

The median sale price in May of an existing home was \$407,600, 14.8 percent above the year ago price. For single-family existing home sales in May, the price was \$414,200, a 14.6 percent rise over the past year and a record high. The median price for a condo/co-op was \$355,700, 14.8 percent above May 2021 and also a record high. At the same time, mortgage rates have rocketed higher recently, reaching 5.78 percent by mid-June.

The combination of record-high home prices and sharply higher mortgage rates has sent housing affordability plunging. The Housing Affordability Index from the National Association of Realtors measures whether or not a typical family could qualify for a mortgage loan on a typical home. A typical home is defined as the national median-priced, existing single-family home as calculated by NAR. The typical family is defined as one earning the median family income as reported by the U.S. Bureau of the Census. A value of 100 means that a family with the median income has exactly enough income to qualify for a mortgage on a median-priced home. An index above 100 signifies that a family earning the median income has more than enough income to qualify for a mortgage loan on a median-priced home, assuming a 20% down payment. As of April, the index stood at 109.2, the lowest since July 2007.



Housing is likely to be under intense pressure as record-high prices and the recent surge in mortgage rates reduce affordability and push more and more buyers out of the market.

### **Home Construction Falls Again in May**

Total housing starts fell to a 1.549 million annual rate in May from a 1.810 million pace in April, a 14.4 percent plunge. From a year ago, total starts are down 3.3 percent. Total housing permits also fell in May, posting a 7.0 percent drop to 1.695 million versus 1.823 million in April. Total permits are still up 0.2 percent from the May 2021 level.

Starts in the dominant single-family segment posted a rate of 1.051 million in May versus 1.157 million in April, a drop of 9.2 percent and are down 5.3 percent from a year ago. Single-family permits fell 5.5 percent to 1.048 million versus 1.109 million in April.

Starts of multifamily structures with five or more units decreased 26.8 percent to 469,000 and are off 3.3 percent over the past year while starts for the two- to four-family-unit segment jumped 141.7 percent to a 29,000-unit pace versus 12,000 in April. Combined, multifamily starts were off 23.7 percent to 498,000 in May and show a gain of 0.6 percent from a year ago.

Multifamily permits for the 5-or-more group fell 10.0 percent to 592,000 while permits for the two-to-four-unit category decreased 1.8 percent to 55,000. Combined, multifamily permits were 647,000, off 9.4 percent for the month but up 17.0 percent from a year ago.

Meanwhile, the National Association of Home Builders' Housing Market Index, a measure of homebuilder sentiment, fell again in June, coming in at 67 versus 69 in May. That is the sixth consecutive drop and the lowest reading since June 2020. The index is down sharply from recent highs of 84 in December 2021 and 90 in November 2020. Rising mortgage rates, elevated home prices, and declining

consumer sentiment are weakening demand while higher input costs, except for lumber, are a major concern for builders.

All three components of the Housing Market Index fell again in May. The expected single-family sales index dropped to 61 from 63 in the prior month, the current single-family sales index was down to 77 from 78 in May, and the traffic of prospective buyers index plunged again, hitting 48 from 53 in the prior month.

Input costs are still a concern for builders though lumber prices have declined sharply recently. Lumber recently traded around \$560 per 1,000 board feet in mid-June, down from peaks around \$1,700 in May 2021 and \$1,500 in early March 2022. Other input materials such as copper were down slightly but still elevated with copper at \$9,200 per metric ton. The high input costs will continue to pressure profits at builders.

Mortgage rates have rocketed higher recently, with the rate on a 30-year fixed rate mortgage coming in at 5.25 percent in mid-June, nearly double the lows in early 2021.

While the implementation of permanent remote working arrangements for some employees may have been providing continued support for housing demand, record-high home prices combined with the surge in mortgage rates and falling consumer attitudes are working to weaken demand. Pressure on housing demand combined with elevated input costs is sending homebuilder sentiment plunging. The outlook for housing is deteriorating rapidly.

### **New Single-Family Home Sales Bounce Higher in May**

Sales of new single-family homes rose in May, rising 10.7 percent to 696,000 at a seasonally-adjusted annual rate from a 629,000 pace in April. The May gain follows a 12.0 percent decline in April, a 9.5 percent fall in March, a 4.9 percent fall in

February, and a 1.0 percent drop in January. Despite the May gain, the four-month run of decreases leaves sales down 5.9 percent from the year-ago level. Meanwhile, 30-year fixed rate mortgages were 5.25 percent in late May, up sharply from a low of 2.65 percent in January 2021. Rates have continued to move higher in June, reaching 5.81 percent in late June, suggesting headwinds for housing continue to gain strength.

Sales of new single-family homes were up in two of the country's four regions in May. Sales in the South, the largest by volume, rose 12.8 percent, while sales in the West surged 39.3 percent. However, sales in the Midwest decreased 18.3 percent, and sales in the Northeast, the smallest region by volume, plunged 51.1 percent for the month. Over the last 12 months, sales were down 42.5 percent in the Northeast and off 37.0 percent in the Midwest, but up 0.5 percent in the West and 1.5 percent in the South.

The median sales price of a new single-family home was \$449,000, down from \$454,700 in May (not seasonally adjusted). The gain from a year ago is 15.0 percent versus a 20.7 percent 12-month gain in April. On a 12-month average basis, the median single-family home price is still at a record high.

The total inventory of new single-family homes for sale rose 1.6 percent to 444,000 in May, putting the months' supply (inventory times 12 divided by the annual selling rate) at 7.7, down 7.2 percent from April but still 42.6 percent above the year-ago level. The months' supply is very high by historical comparison. The high level of prices, elevated months' supply, and surge in mortgage rates should weigh on housing activity in the coming months and quarters. However, the median time on the market for a new home remained very low in May, coming in at 2.4 months versus 3.1 in April.

## CAPITAL MARKET PERFORMANCE

(Percent change)

|  | June | Latest<br>3M | Latest<br>12M | 2021  | Calendar Year<br>2020 | 2019 | 3-year | Annualized<br>5-year | 10-year |
|--|------|--------------|---------------|-------|-----------------------|------|--------|----------------------|---------|
| <b>Equity Markets</b>                            |      |              |               |       |                       |      |        |                      |         |
| S&P 1500   | -8.5 | -16.4        | -12.3         | 26.7  | 15.8                  | 28.3 | 8.5    | 9.0                  | 10.7    |
| S&P 500 - total return                           | -8.3 | -16.1        | -10.6         | 28.7  | 18.4                  | 31.5 | 10.6   | 11.3                 | 13.0    |
| S&P 500 - price only                             | -8.4 | -16.5        | -11.9         | 26.9  | 16.3                  | 28.9 | 8.8    | 9.3                  | 10.8    |
| S&P 400  | -9.8 | -15.8        | -15.8         | 23.2  | 11.8                  | 24.1 | 5.3    | 5.4                  | 9.2     |
| Russell 2000                                     | -8.4 | -17.5        | -26.1         | 13.7  | 18.4                  | 23.7 | 2.9    | 3.8                  | 7.9     |
| Dow Jones Global Large-Cap Index                 | -8.2 | -16.0        | -16.8         | 16.2  | 14.7                  | 23.8 | 4.6    | 5.3                  | 6.7     |
| Dow Jones Global Large-Cap ex-U.S. Index         | -8.5 | -14.2        | -21.0         | 4.9   | 8.8                   | 18.2 | -0.8   | 0.3                  | 2.3     |
| STOXX Europe 600 Index                           | -8.2 | -10.7        | -10.1         | 22.2  | -4.0                  | 23.2 | 1.9    | 1.4                  | 5.0     |
| <b>Bond Markets</b>                              |      |              |               |       |                       |      |        |                      |         |
| iShares 20-plus Year Treasury Bond ETF           | -1.4 | -13.0        | -20.4         | -6.0  | 16.4                  | 11.5 | -4.7   | -1.7                 | -0.9    |
| iShares AAA - A Corporate Bond Fund              | -3.0 | -6.9         | -15.1         | -4.2  | 7.1                   | 9.1  | -3.5   | -1.6                 | NA      |
| <b>Commodity Markets</b>                         |      |              |               |       |                       |      |        |                      |         |
| Gold   | -2.1 | -6.9         | 2.4           | -4.0  | 24.8                  | 18.7 | 8.6    | 7.8                  | 1.2     |
| Silver   | -6.2 | -17.7        | -20.8         | -12.8 | 46.8                  | 16.7 | 10.3   | 4.4                  | -2.8    |
| Refinitiv CoreCommodities CRB total return index | -7.9 | -1.1         | 37.0          | 38.5  | -9.3                  | 11.8 | 17.8   | 12.0                 | 0.9     |

**Sources:** Barrons, Dow Jones, Frank Russell, iShares, Standard & Poor's, STOXX Europe 600, Refinitiv.

## CONSUMER FINANCE RATES

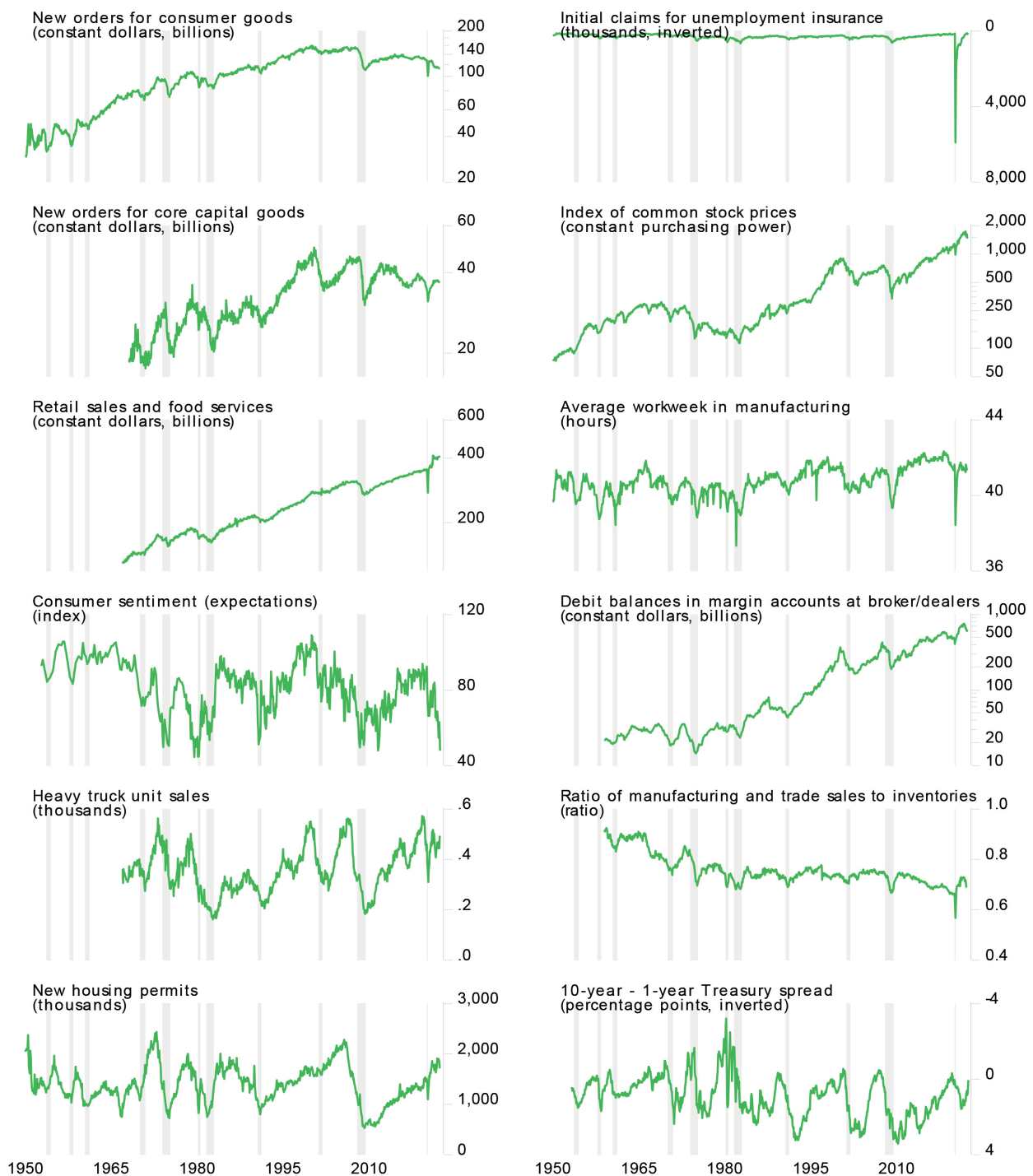
(Percent)

|                           | June | Latest<br>3M | Latest<br>12M | Average for Year |      |      | Average over Period |        |         |
|---------------------------|------|--------------|---------------|------------------|------|------|---------------------|--------|---------|
|                           | June | 3M           | 12M           | 2021             | 2020 | 2019 | 3-year              | 5-year | 10-year |
| 30-yr. fixed mortgage     | 5.2  | 4.8          | 3.5           | 3.0              | 3.1  | 3.9  | 3.3                 | 3.7    | 3.8     |
| 15-yr. fixed mortgage     | 4.4  | 4.0          | 2.8           | 2.3              | 2.6  | 3.4  | 2.7                 | 3.1    | 3.1     |
| 5-yr. adjustable mortgage | 4.1  | 3.7          | 2.8           | 2.6              | 3.1  | 3.6  | 3.0                 | 3.3    | 3.1     |
| 48-month new car loan     | 4.9  | 4.9          | 5.0           | 5.1              | 5.1  | 5.4  | 5.1                 | 5.1    | 4.7     |

**Sources:** Bankrate, Federal Reserve.



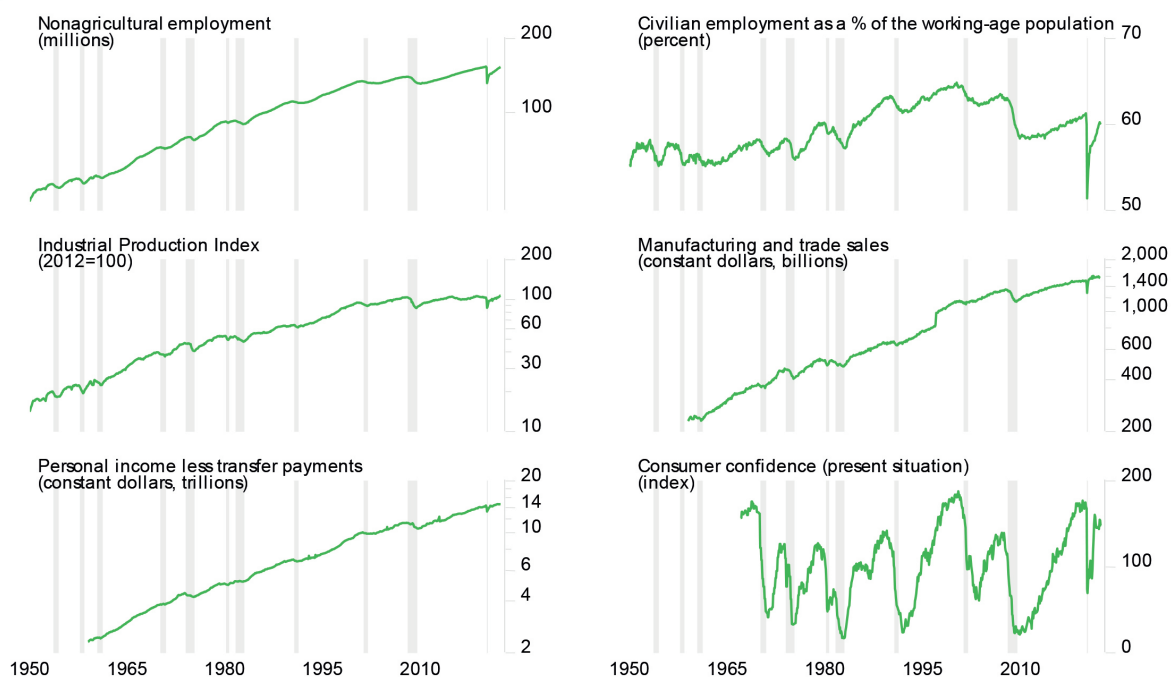
## LEADING INDICATORS (1950-2022)



Note: Shaded areas denote recessions.

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, The conference Board, Census Bureau, Department of Labor, Federal Reserve, Institute for Supply Management, Standard & Poor's, AIER (Refinitiv).

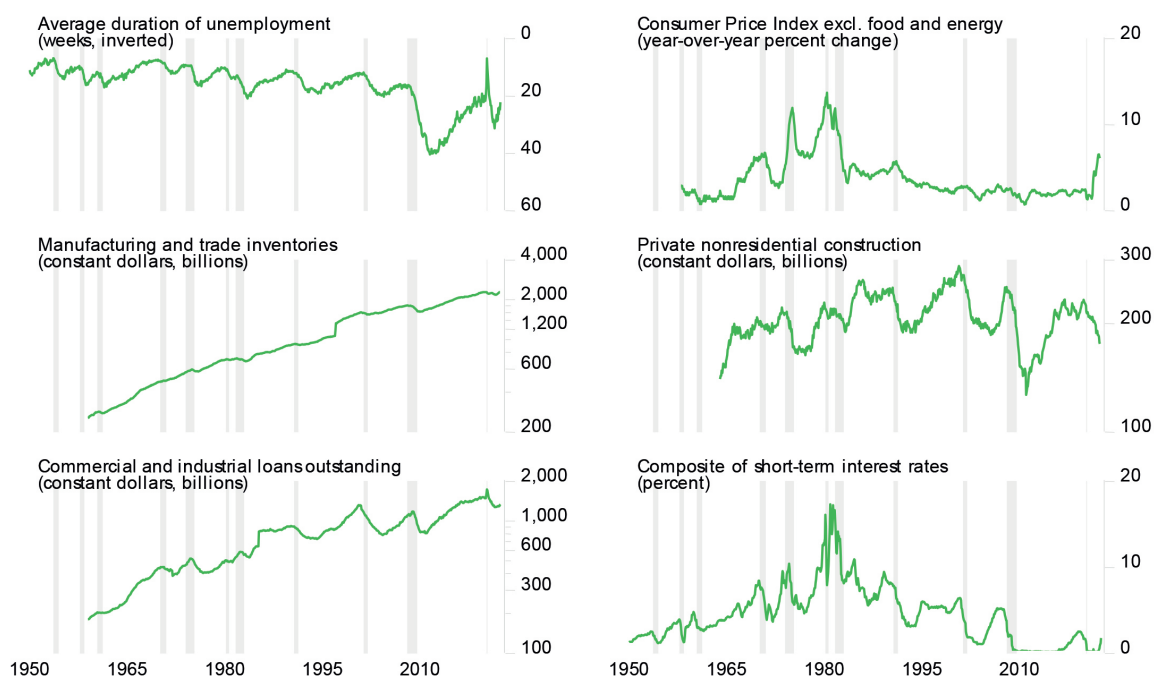
## ROUGHLY COINCIDENT INDICATORS (1950-2022)



Note: Shaded areas denote recessions.

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, The conference Board, Census Bureau, Department of Labor, Federal Reserve, Institute for Supply Management, Standard & Poor's, AIER (Refinitiv).

## LAGGING INDICATORS (1950-2022)



Note: Shaded areas denote recessions.

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, The conference Board, Census Bureau, Department of Labor, Federal Reserve, Institute for Supply Management, Standard & Poor's, AIER (Refinitiv).

# FOMC Projects Even Higher Inflation

WILLIAM J. LUTHER (Director, Sound Money Project) & MORGAN TIMMANN (Contributor)

Fed officials raised their projections for inflation this week. The median Federal Open Market Committee (FOMC) member now projects inflation will be 5.2 percent in 2022, up from 4.3 percent projected back in March. The most recent revision follows a string of misses at the Fed, which has consistently underestimated the extent to which prices would grow over the last year and a half. The median FOMC member’s projection of inflation has increased every quarter since June 2020.

The Personal Consumption Expenditures Price Index (PCEPI), which is the Fed’s preferred measure for inflation, grew at a continuously-compounding annual rate of 6.1 percent from April 2021 to April 2022. Core PCEPI, which excludes volatile food and energy prices, grew 4.8 percent. The extraordinary growth in the Consumer Price Index, released last Friday, portends an uptick in PCEPI inflation for May.

## FOMC Projections

It is difficult to predict how the FOMC will conduct monetary policy over the next few years. It raised its federal funds rate target by 75 basis points on June 15, even though Chair Powell seemed to have ruled out increases of greater than 50 basis points after the previous meeting.

The FOMC says it will continue hiking rates and reducing its balance sheet to bring inflation back down to 2 percent. But inflation looks likely to remain above the Fed’s target for some time. Immediately following this week’s FOMC meeting, bond markets were pricing in around 2.80 percent inflation on average over the next five years, down from 2.86 percent the week prior.

FOMC member projections provide some indication of how quickly the Fed intends to bring down inflation. Members are asked to project inflation under the assumption that the Fed conducts monetary policy appropriately. Hence, the projections indicate how inflation will evolve if FOMC members do what they say they should do.

The median, central tendency, and range of FOMC member projections are presented in The Summary of Economic Projections and reproduced in the tables below. The central tendency of PCEPI projections is constructed by removing the three lowest and highest projections submitted for each period.

Table 1. Median FOMC member projections of inflation

| Projection Date | 2021 | 2022 | 2023 | 2024 | Longer run |
|-----------------|------|------|------|------|------------|
| June 2020       | 1.6  | 1.7  |      |      | 2.0        |
| September 2020  | 1.7  | 1.8  | 2.0  |      | 2.0        |
| December 2020   | 1.8  | 1.9  | 2.0  |      | 2.0        |
| March 2021      | 2.4  | 2.0  | 2.1  |      | 2.0        |
| June 2021       | 3.4  | 2.1  | 2.2  |      | 2.0        |
| September 2021  | 4.2  | 2.2  | 2.2  | 2.1  | 2.0        |
| December 2021   | 5.3  | 2.6  | 2.3  | 2.1  | 2.0        |
| March 2022      |      | 4.3  | 2.7  | 2.3  | 2.0        |
| June 2022       |      | 5.2  | 2.6  | 2.2  | 2.0        |

**Table 2. Central tendency of FOMC member projections of inflation**

| Projection Date | 2021    | 2022    | 2023    | 2024    | Longer run |
|-----------------|---------|---------|---------|---------|------------|
| June 2020       | 1.4-1.7 | 1.6-1.8 |         |         | 2.0        |
| September 2020  | 1.6-1.9 | 1.7-1.9 | 1.9-2.0 |         | 2.0        |
| December 2020   | 1.9-1.9 | 1.8-2.0 | 1.9-2.1 |         | 2.0        |
| March 2021      | 2.2-2.4 | 1.8-2.1 | 2.0-2.2 |         | 2.0        |
| June 2021       | 3.1-3.5 | 1.9-2.3 | 2.0-2.2 |         | 2.0        |
| September 2021  | 4.0-4.3 | 2.0-2.5 | 2.0-2.3 | 2.0-2.2 | 2.0        |
| December 2021   | 5.3-5.4 | 2.2-3.0 | 2.1-2.5 | 2.0-2.2 | 2.0        |
| March 2022      |         | 4.1-4.7 | 2.3-3.0 | 2.1-2.4 | 2.0        |
| June 2022       |         | 5.0-5.3 | 2.4-3.0 | 2.0-2.5 | 2.0        |

**Table 3.  
Range of FOMC member projections of inflation**

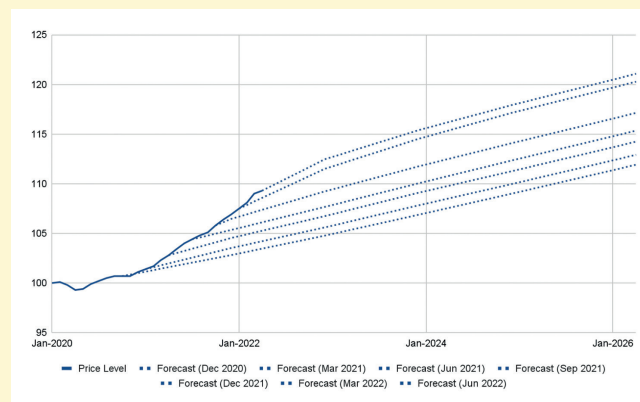
| Projection Date | 2021    | 2022    | 2023    | 2024    | Longer run |
|-----------------|---------|---------|---------|---------|------------|
| June 2020       | 1.1-2.0 | 1.4-2.2 |         |         | 2.0        |
| September 2020  | 1.3-2.4 | 1.5-2.2 | 1.7-2.1 |         | 2.0        |
| December 2020   | 1.5-2.3 | 1.6-2.2 | 1.7-2.2 |         | 2.0        |
| March 2021      | 2.1-2.6 | 1.8-2.3 | 1.9-2.3 |         | 2.0        |
| June 2021       | 3.0-3.9 | 1.6-2.5 | 1.9-2.3 |         | 2.0        |
| September 2021  | 3.4-4.4 | 1.7-3.0 | 1.9-2.4 | 2.0-2.3 | 2.0        |
| December 2021   | 5.3-5.5 | 2.0-3.2 | 2.0-2.5 | 2.0-2.2 | 2.0        |
| March 2022      |         | 3.7-5.5 | 2.0-2.5 | 2.0-2.2 | 2.0        |
| June 2022       |         | 4.8-6.2 | 2.3-4.0 | 2.0-3.0 | 2.0        |

The median FOMC members' inflation projection for 2022 increased by 0.9 percentage points between March and June. Projections now range from 4.8 to 6.2 percent, with a central tendency of 5.0 to 5.3 percent. Back in March, projections ranged from 3.7 to 5.5 percent, with a central tendency of 4.1 to 4.7 percent.

## Forecasting Prices

Higher projected inflation rates over the next three years suggest prices will be much higher than previously implied by Fed officials. We forecast prices from FOMC member projections under

the assumptions that (1) FOMC members set monetary policy consistent with their projections, (2) inflation is constant from month to month across each year, and (3) there are no unforeseen shocks to the economy over the forecast period. Forecasts from projections made since December 2020 are presented alongside the actual time series from January 2020 to April 2022 in Figure 1.



*Figure 1. Forecast of price level from FOMC member projections*

Our forecast of the price level based on median FOMC member projections indicates that prices will be roughly 12.7 percent higher in January 2023 than they were in January 2020, just prior to the pandemic. That amounts to a continuously compounding annual rate of inflation of 4.0 percent since January 2020. In March, the median FOMC member projected prices would be just 11.7 percent higher in January 2023—a continuously compounding annual rate of 3.7 percent since January 2020.

The median FOMC member now projects the price level will be 15.6 percent higher in January 2024 than it had been in January 2020—up from 14.7 percent projected in March. By January 2025, prices are projected to be 18.1 percent higher. Based on current projections, one can expect inflation to average 3.3 percent from January 2020 to January 2025—10 basis points higher than the median FOMC member projected in March and 130 basis

points above the Fed's average inflation target.

It seems clear that the Fed has abandoned the plain meaning of its average inflation target. Inflation has been above target for more than a year. The Fed does not intend to offset this period of above-target inflation with a period of below-target inflation, to ensure that inflation is on target on average. It is not even committed to bringing inflation back down to 2 percent very quickly. The median FOMC member currently projects inflation will remain above target through 2024.

We had better get used to high inflation. We will likely be dealing with it for years.

– June 17, 2022

# No, Putin Didn't Cause Inflation

PETER C. EARLE

Research Faculty

The May 2022 Consumer Price Index (CPI) release was worse than virtually any forecast predicted. The year-over-year CPI came in at 8.6 percent, not only higher than expected but notching a new four-decade high. The month-over-month CPI (April to May) also came in higher than expected: 1 percent versus 0.7 percent surveyed. Today's release makes clear that the Fed is behind the curve in terms of employing policy measures to blunt the rise in prices. The response from the Biden Administration, meanwhile, has been to blame Vladimir Putin (an easily disproved assertion) and weaponize rising prices in the service of interventionist policy measures.

It is worth noting that while the Fed was dithering—categorizing the rise in prices which began in the spring of 2021 as “transitory”—a litany of additional missions have been added to their already cumbersome mandate. Over the past few years, the Fed has been tasked to craft monetary policy in manners explicitly supporting social justice, climate change, ESG, and other political goals.

This is not particularly surprising, given the trend in mission creep since the Fed's founding. At inception the Fed was tasked to prevent financial panics and bank runs. When millions of veterans returned from foreign battlefields after WWII, Congress added the requirement that the Fed should conduct monetary policy in such a way that employment conditions are maximized. In 1978 both “reasonable price stability” and the “maintain[ence] of long-run growth” were appended to the Fed mandate, and after the 2008 financial crisis financial stability joined the Fed's list of responsibilities.

When, in addition to this, one considers attempts by recent administrations to appoint ideological

candidates to the Fed, missteps and failure become easier to explain. The considerable advantages of monetary policy over fiscal policy measures, in particular not having to go through Congressional horse trading, make the incentives to influence the Fed readily apparent.

Just this afternoon during President Biden's speech in Los Angeles, he referred to inflation, or at least the energy portion of it, as “Putin's tax.” It is a demonstrably false characterization of the current inflation. In fact, by any number of measures prices began rising above trend in March 2021, almost a full year before the Ukrainian conflict began. A second, steeper uptrend in prices began in September 2021, six months before war broke out in central Europe.

**WTI & National Average Gasoline  
Price per Gallon, 2021 – present**



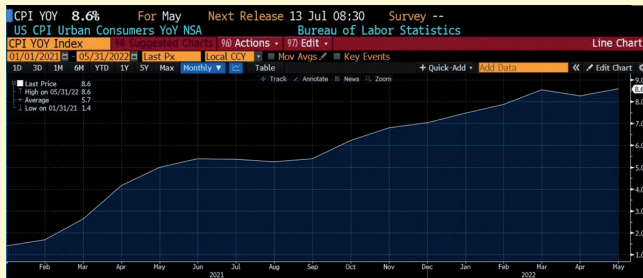
(Source: Bloomberg Finance, LP)

The WTI price increase was mostly demand-driven: \$47.47 per barrel in Jan 2021, and doubled to \$95 per barrel by Feb '22. Since the war started, the price has risen to roughly \$118 per barrel. The average US price of gasoline was \$2.57 per gallon in January 2021 and reached \$3.75 per gallon in early February 2022. Inflation more broadly was well underway by the end of 2021, but it was only in November that



the Fed began to back away from its assurances that price level increases were transitory. Worse yet, it wasn't until March 2022 that the Fed began to implement measures to arrest the rise in prices.

US CPI (yoy), 2021 – present



(Source: Bloomberg Finance, LP)

The May 2022 CPI numbers released today show that not only is inflation rising undeterred by the Fed, but worsening. More prices are rising more quickly, and possibly accelerating. The likelihood that the Fed will have to act aggressively enough that a recession results is materially higher now than it was even a few months ago. Allowing political officials to blame Putin, large corporations, shipping firms, billionaires, insufficient taxation, “greed,” or any of a number of other tired scapegoats misleads the public. It also distracts attention from the pernicious effects of a politicized and increasingly influence-able central bank.

– June 13, 2022

# Will Federal Reserve Losses Impact Fed Shareholders or Affect Monetary Policy?

PAUL H. KUPIEC & ALEX J. POLLOCK

Contributors

The United States is experiencing the highest inflation in 40 years. The Federal Reserve has finally started raising interest rates to get inflation under control. However, higher interest rates have the negative side effect of reducing the value of the securities owned by the Fed, which could inhibit its monetary policy and result in losses to the U.S. Treasury and therefore to American taxpayers.

Among Federal Reserve officials and many economists, it is fashionable to argue that Federal Reserve system losses, no matter how large, will have no operational consequence for Fed monetary policy but could create “communications challenges.” Fed Chair Jerome Powell recently testified that unrealized losses on the Fed’s securities portfolio “play no role in our decision making [and] have no effect at all on our ability to conduct monetary policy.”

We are about to learn if this is true. Since it started raising interest rates, the Fed has already experienced mark-to-market losses of epic proportions, and will soon face large operating losses, something it has never seen in its 108-year history.

We estimate that at the end of May 2022, the Federal Reserve had an unrecognized loss of about \$540 billion on the market value of its \$8.8 trillion System Open Market Account (SOMA) portfolio of Treasury bonds and mortgage securities. This loss, which will only get larger as interest rates increase, is equivalent to 60 percent of the Fed’s total assets in early September 2008, and more than 13 times the Federal Reserve System’s current reported consolidated capital of \$41 billion. The Fed’s liabilities—primarily Federal Reserve notes and member bank reserve balances—are half a trillion dollars larger than the market value of the assets the Fed owns.

Any other financial institution this economically insolvent would be closed, but unlike regulated banks and other financial institutions, no matter how big the losses it may face, the Federal Reserve will not fail and can continue to print money even while deeply insolvent. But this does not mean that Fed losses will never have an impact on its ability to conduct monetary policy.

The Federal Reserve Board sets its own accounting rules, which are used to calculate the Fed’s income and report its financial condition. The Board has decided that, when it calculates income, it will not recognize mark-to-market losses on its giant securities portfolio. The Fed includes two types of losses in its reported income: realized losses on its securities and foreign exchange positions, and operating losses.

The Fed accounts for the securities it owns on an amortized cost basis, meaning it records a book value equal to a security’s par value plus the amortized premium (discount) it paid (received) when it purchased the security. If the Fed sells a security for more or less than its amortized cost, it generates a realized gain or loss in reported income. The primary components of the Fed’s operating income (loss) are: interest income, less interest expense; plus (minus) realized gains (losses) on securities and foreign exchange; less Federal Reserve district bank and Federal Reserve Board operating expenses; less the cost of funding the Bureau of Consumer Financial Protection. Operating expenses for district banks, the Board of Governors and the CFPB run about \$9 billion annually.

The story of how the Fed accounts for losses, how the losses may impact monetary policy, and



who ultimately pays for these losses is a complicated one. Federal Reserve system member banks must subscribe to the shares issued by their district bank in a dollar value equal to 6 percent of a member institution's paid-in capital and surplus. Member banks only pay for half the subscribed shares "while the remaining half of the subscription shall be subject to call by the Board." Each member bank must true up its district bank stock subscription annually to reflect changes in the member bank's capital and surplus.

Under the Federal Reserve Act, in addition to being subject to calls to buy more Federal Reserve bank stock, member banks are also required to contribute additional funds to cover district reserve bank annual operating losses in an amount not to exceed twice the par value of their Federal Reserve district bank stock subscription. Note especially the use of the term "shall" and not "may" in the Federal Reserve Act:

The shareholders of every Federal reserve bank *shall* be held individually responsible, equally and ratably, and not one for another, for all contracts, debts, and engagements of such bank to the extent of the amount subscriptions to such stock at the par value thereof in addition to the amount subscribed, whether such subscriptions have been paid up in whole or in part under the provisions of this Act. (emphasis added)

Despite congressional revisions to the Federal Reserve Act over more than a century, the current Act still contains this exact passage. Until now, the Federal Reserve System posted an operating loss in only a single year, 1915. At that time, the Board voted to approve a call on member bank resources to cover the loss, but the district reserve banks failed to do so because they feared a call would discourage state banks from joining the Federal Reserve system.

By the FOMC's own estimates, short-term policy rates will approach 3.5 percent by the end of 2022. Several bank economists think the FOMC is overly optimistic and project that higher policy rates, maybe much higher, will be needed before the Fed successfully contains surging inflation. The level of short-term interest rates is important because our estimates suggest that the Federal Reserve will begin reporting net operating losses once short-term interest rates reach 2.7 percent. This estimate assumes the Fed has no realized losses from selling SOMA securities. If the Fed were to sell a significant amount of securities from its \$8.8 trillion SOMA portfolio, given that the average interest rate on securities in this portfolio is only slightly more than 1.7 percent, the Fed would book operating losses long before short-term interest rates reach 2.7 percent. Ignoring mark-to-market losses and absent any realized losses from SOMA asset sales, we project that the Fed would post an annualized operating loss of \$62 billion should short-term rates rise to 4 percent. Such a loss is equivalent to 150 percent of the Federal Reserve system's total capital.

This unenviable financial situation in which the Fed has placed itself—huge mark-to-market investment losses and possibly negative operating income—is the predictable consequence of the balance sheet the Fed owns as it transitions to an inflation-fighting monetary policy. The Fed will pay rising rates of interest on bank reserves and reverse repurchase transactions after more than a decade of Fed quantitative easing and zero interest rate policies stuffed the Fed's balance sheet with low-yielding long-term fixed-rate securities. The Fed's earning dynamics now resemble those of a typical failing 1980s savings and loan.

In 2011, the Federal Reserve announced its official position regarding realized losses on its SOMA portfolio and system operating losses is,

[I]n the unlikely scenario in which realized losses were sufficiently large enough to result in an overall net income loss for the Reserve Banks, the Federal Reserve would still meet its financial obligations to cover operating expenses. In that case, remittances to the Treasury would be suspended and a deferred asset would be recorded on the Federal Reserve's balance sheet, representing a claim on future net earnings that the Reserve Banks would need to realize before remittances to the Treasury would resume.

At the time it explained its strategy for managing realized losses, the Federal Reserve Board apparently had not considered the possibility that its interest expense could drive its operating earnings negative even without any realized losses on SOMA portfolio sales.

The Federal Reserve Board's official position on losses is: (1) it does not recognize mark-to-market losses on its SOMA securities; (2) should it face operating losses, it would not reduce its paid-in book capital and retained surplus, but instead would just create the money needed to meet operating expenses and offset the newly printed money by creating an imaginary "deferred asset" on its balance sheet; and (3) subsequently, in the future, as the reserve banks start making positive operating earnings, after paying member bank dividends, the Fed will reduce the deferred asset balance to zero before resuming their remittance payments to the US Treasury. In the meantime, the Treasury and the budget deficit will miss their accustomed remittance payments from the Fed.

All Fed member banks were originally entitled to receive a generous 6-percent dividend on the par value of their paid-in shares. The dividend is cumulative in the event a district bank has

insufficient operating revenues to cover expenses and dividends in any given year. More recently, the dividend rate was reduced for large banks, currently defined to be banks with assets in excess of \$11.2 billion. The annual dividend rate for these banks is the lesser of, "the high yield of the 10-year Treasury note auctioned at the last auction held prior to the payment of such dividend, or 6 percent."

Under the Fed's current stated policy accounting for operating losses, the Federal Reserve's reported capital and surplus will not be depleted by operating losses. According to the Financial Accounting Manual for Federal Reserve Banks (p. 201), bank dividend payments will continue to be paid as long as a reserve bank has a positive surplus account, a fate that would seem to be ensured under the "deferred asset" accounting entry district reserve banks will book to offset an operating loss.

The Fed's somewhat cavalier treatment of its impending losses is curious since it is at odds with the way Federal Reserve system losses should be treated according to the Federal Reserve Act. Moreover, given the growing interest income banks will earn on their reserve balances, the issue of burden sharing of Federal Reserve System losses is likely to become more contentious as the Fed executes inflation-fighting policies that will directly benefit the member banks that own the 12 Federal Reserve district banks.

The issue of maintaining a positive Federal Reserve system capital cushion was once a necessity to maintain public confidence in convertibility under the international gold standard. It is often argued that the size of the Fed's loss absorbing capital cushion is no longer an issue of practical importance since Federal Reserve notes and member bank reserve bank balances have not been convertible into gold for almost 90 years. The pure fiat currency the Federal Reserve issues today has no commodity backing and there is no longer any constraint on the

amount the Fed can issue. Given the Fed's stated intention to monetize operating losses and back any newly created currency with imaginary "deferred assets," the Fed has demonstrated it no longer has a concern in maintaining the market value of the assets backing its capital and surplus accounts.

The Federal Reserve Board's proposed treatment of system operating losses is inconsistent with the treatment prescribed by the Federal Reserve Act. In all likelihood, operating losses, should they occur, will in large part be a consequence of the interest payments on member banks' reserve balances. The original authors of the Federal Reserve Act would never have approved of allowing the Fed to create an imaginary "deferred asset" as a mechanism to hide the fact that the Fed is depleting its cushion of loss-absorbing assets while paying banks interest on their reserve balances, since the Act itself requires member banks as stockholders to be liable for Federal Reserve district bank operating losses.

If the Federal Reserve were required to comply with the language in the Federal Reserve Act and assess the member banks to cover operating losses, monetary policy could be significantly impacted in a number of ways. Just as it did in 1915, the issue of imposing operating losses on member banks would focus the attention of the district bank presidents who vote on FOMC monetary policies to answer to the member banks who own stock and elect the district bank board members who select the reserve bank president.

As short-term interest rates rise and the interest expense needed to fund reverse repurchase agreements and member bank reserve balances consumes more of the interest earnings on its SOMA portfolio, the FOMC may become reluctant to shrink its balance sheet by liquidating SOMA assets at a loss. The prospect of passing Federal Reserve system operating losses on to member banks could create pressure to avoid losses by limiting the interest rate

paid to member banks. Should this occur, it would directly impact the FOMC's primary monetary policy tool for constraining inflation. Moreover, some member banks' capital positions could become tenuous should the Federal Reserve Board require district reserve banks to pass large operating losses on to their shareholders.

Under its post-crisis monetary operating policies, as the Fed raises rates, banks will earn larger interest payments on their reserve balances held at the Fed district banks while continuing to accrue dividends on their Federal Reserve district bank shares. Meanwhile, the Fed's actions will impose higher interest rates on the public at large, losses in the value of the public's bonds and stocks held in savings and retirement accounts, reduced growth, and likely a significant increase in unemployment before the Fed successfully arrests the inflationary pressures stoked by its prior policies. If the Fed's monetary policies lead to Federal Reserve system operating losses, and the Fed follows its plan to monetize these losses, the losses will only contribute to the inflationary pressures the Fed seeks to control.

Once the public understands the implications of the Fed's mark-to-market losses and its potential future operating losses, its proposed policy to monetize these losses, and how existing laws, if enforced, would benefit its stockholding member banks, we agree that the Fed is likely to face a serious communications challenge.

– June 25, 2022

# Making Sense of Monetary Policy and the Future of Inflation

JAMES L. CATON

Fellow, Sound Money Project

High inflation rates have been making headlines since the beginning of the year. Inflation seems to have caught even investors by surprise. While I'm optimistic that inflation will fall over the next year, this belief is formed with the expectation that the stance of monetary policy should and will remain tight. The effective Federal Funds rate is currently 0.83 percent after spending nearly two years under 0.1 percent. The logic behind the increases in the federal funds rate, driven by simultaneous increases in the rate paid on reserves held at the Fed, is that higher interest rates indicate tighter monetary policy. This is an age-old wisdom inherited most plainly from Paul Volcker's tenure at the Fed.

But monetary policy no longer works the way it did under Volcker and Greenspan. In the Volcker-Greenspan era, when the Federal Reserve raised the federal funds rate, the Federal Open Market Committee (FOMC) would slow the rate of expansion of currency circulating in the financial system by slowing its purchases of US Treasuries. The slowing of monetary expansion translated to an increase in interest rates. As financial activity would begin to falter in response to higher rates, the FOMC would reverse course, lowering the federal fund target and increasing the rate of expansion of currency.

Since the Volcker-Greenspan era, it has become common to interpret the stance of monetary policy by the level of interest rates. This age-old wisdom, however, is misapplied. It fails to account for the disconnect between interest rates and the quantity of money allowed to circulate in the economy. The FOMC no longer needs to support the federal funds rate target by changing the rate of expansion of circulating currency. The old mechanism used by

Volcker and Greenspan still operates. It's just not as important. Instead, the Federal Reserve simply changes the rate it pays on deposits. Currently the rate paid on reserve balances is 10 basis points (0.10 percentage points) below the upper limit of the federal funds target range. When member banks choose where to invest funds, the rate paid on reserves held at the Fed represents a zero-risk option. Competing investment opportunities must offer a higher rate of return to offset risk of investment in the market. By its payment of interest on reserves, the FOMC sets the base of the yield curve.

This, of course, requires that the Federal Reserve is able to manage interest payments. At low interest rates, this isn't a major problem. The Federal Reserve currently holds \$3.315 trillion in deposits. At the current interest rate of 0.9 percent, this means that it must pay out \$30 billion in interest each year to maintain this balance. The Fed currently borrows \$2.26 trillion from the overnight lending market. With the effective federal funds rate at 0.83 percent, this amounts to \$19 billion in interest payments over the year. This borrowing from the overnight lending market puts upward pressure on the federal funds rate, but apparently not enough for the rate to rise above the floor set by the rate paid on reserves held at the Fed.

At current rates, the Federal Reserve must pay out \$49 billion in interest each year to maintain the current level of deposits and loans from the overnight lending market that enable it to borrow these funds. In 2021, the Federal Reserve earned \$122.4 billion in revenue, which is obviously more than enough to offset these costs. And as interest rates rise, newly purchased financial instruments will also yield higher rates of interest. At present,



31 percent of the Fed's purchases of US Treasuries mature within 2.25 years (this excludes Treasury Inflation-Protected Securities, or TIPS held by the Fed). These securities must be replaced as they mature. We can expect, then, that as interest rates rise, so too will revenues earned by the Federal Reserve as it rolls over maturing investments.

In the last few weeks, the Federal Reserve has modestly begun to reduce its balance sheet. As rising rates increase interest payments by the Federal Reserve, a reduction of the level of deposits held at the Federal Reserve will help reduce the burden of these payments. As long as the Fed's revenues exceed its expenditures, it can continue to set the federal funds target without relying on expansion of circulating currency through traditional open-market purchases.

### **Interest Rates and the Implementation of Monetary Policy**

It is unclear that policymakers truly understand the cause of inflation. Federal Reserve Chairman Jerome Powell admitted in June 2021 that inflationary "effects have been larger than we expected and may turn out to be more persistent than we expected. Treasury Secretary Janet Yellen similarly admitted to Wolf Blitzer that she "was wrong then about the path that inflation would take." In other words, it appears that policymakers do not understand the full extent of the impact of their policies.

The recent jump in inflation is the consequence of a massive increase in the quantity of circulating currency. The high rate of expansion has moderated, with the quantity of circulating currency increasing by less than 5 percent in the last year. This is a bit less than the rate of expansion that preceded the advent of COVID-19. It is not clear, on the other hand, that balance sheet expansion absent an expansion of circulating currency positively impacts the level of expenditures in the economy. The balance sheet expanded during the decade following the 2008

Financial Crisis. This expansion failed to generate high rates of inflation. In fact, inflation measured by core CPI was less than two percent on average during the decade following the 2008 Financial Crisis. In that time, the balance sheet increased from around \$900 billion to \$4.5 trillion.

If this kind of expansion is not itself inflationary, why should we expect that balance sheet reduction indicates tightening that will diminish inflationary pressure? The size of the balance sheet does not seem to influence the total level of spending. Expenditures are dependent upon the availability of currency to serve as reserves within the financial system rather than being held at the Fed.

The large balance sheet does impact relative interest rates. In particular, the rates of US Treasuries and of mortgages declined in response to major purchases of these asset classes by the Federal Reserve. Together, these assets comprise nearly \$8.5 trillion of all assets held by the Fed. By holding these assets, the Federal Reserve channels liquidity toward the federal government and the real estate sector. Rates on these instruments fall relative to rates on other instruments. Since short-term US Treasuries are investments comparable to investment in the overnight lending market, the lifting of the federal funds rate is consistent with a balance sheet reduction that will tend to raise rates on US Treasuries relative to other rates in the market. However, this channel does not appear to influence inflation. Luckily, the slowing rate of expansion of circulating currency suggests that tightening will be effective in lowering inflation.

### **Inflation Expectations and Interest Rates**

In the last year, interest rates on short-term debt have begun to reflect rising inflation expectations. The interest rate charged on 2-year US Treasuries was less than 0.3 percent as recently as October 2021. A year ago, the interest rate on the 2-year US Treasuries hovered around 0.15 percent. Yet, by

April 2022, this interest rate reached 2.7 percent. This is a seismic shift in short-run inflation expectations. The rate on the 2-year hasn't been this high since 2018, when the federal funds rate was above 2 percent. The rate on the 1-year US Treasury is not far behind, having risen from under 0.1 percent in October to over 2 percent since April.

This rise in interest rates has motivated the shift toward tightening at the Fed. Interest rates reflect expectations about returns to investment. Part of the return is due to genuine economic growth (we call this real growth). Part is due to expectations about inflation. The rise in the short-term rates has signaled to the Fed that short-term inflation expectations are rising alongside higher inflation readings.

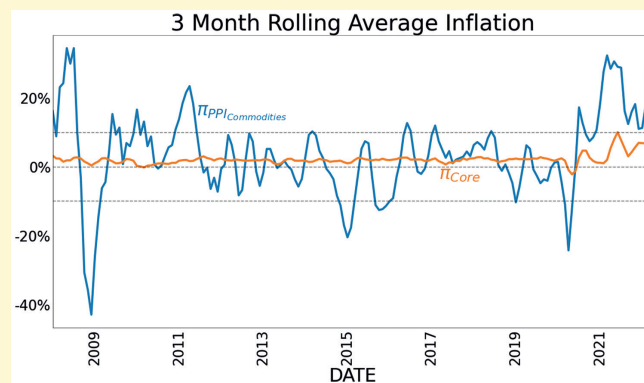
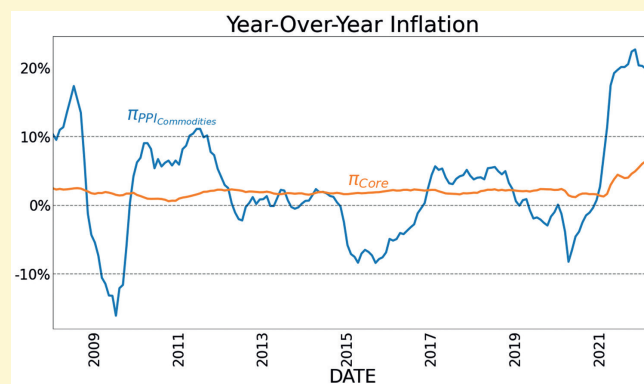
Since October, the market has been catching up with the reality of inflation. The 5-year breakeven inflation rate was hovering around 2.5 percent in September 2022 and reached a high of 3.59 percent at the end of March. Investors seem to have been skeptical of the Fed's willingness and ability to lift inflation. The realization of higher inflation rates succeeded in undoing this skepticism. The 5-year breakeven rate has since fallen, currently hovering around 3 percent as investors seem to be persuaded by the willingness of the Federal Reserve to tighten policy.

Many investors seem to trust the Fed to manage the situation now that it has taken a more aggressive stance. Inflation is higher than it has been for 4 decades, but it is not clear that this high rate will persist. The most recent monthly readings of inflation have provided investors hope that inflation might have reached a high point.

Short-term readings of inflation can be quite volatile and, therefore, difficult to gauge. The annualized rate of core inflation in March was 3.95 percent, the lowest reading since September 2021, when it was 3.10 percent. The following month, however, generated an annualized rate of 7.05 percent. One way of reducing this volatility is to

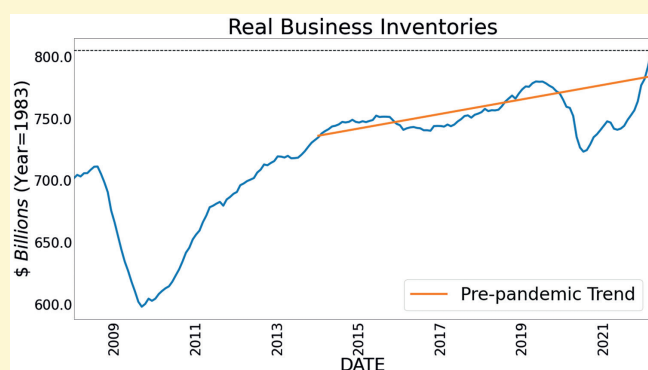
observe the inflation over the course of the previous year. While this tends to stabilize the inflation reading, the long span of time prevents the reading from indicating the present state of inflation.

To generate stable readings of inflation, I have taken the 3-month rolling average of inflation. We can see that core inflation seems to be moderating in recent months. It is still too early to tell for sure, but if estimates of inflation in May and June stabilize at or under 6 percent, investors will likely interpret this as meaning that inflation has begun to stabilize and, hopefully, will diminish. Again, the recent downward moderation of the 5-year breakeven rate suggests that investors are still optimistic about the Fed's ability to control inflation.



However, not all markets reflect that investors are convinced about the ability and willingness of the Federal Reserve to swiftly reduce inflation. The Producer Price Index's measure of year-over-year

commodity price inflation has remained elevated over the last year. Commodity prices tend to be more volatile than more general measures of the price level. Persistently high readings of the index suggest that investors are purchasing commodities to hedge for inflation. While this is an indicator that deserves our attention, it is not a perfect predictor of the future. In 2008, investors were hedging for inflation when many believed that monetary policy had been too easy for too long. This jump in commodity price inflation, and similar jumps over the last decade have been followed by periods where this inflation measure was low or even moved into negative territory. If tightening by the FOMC is effective, we will likely see a continuation of this pattern.



Finally, one measure of the relative intensity of demand is the level of business inventories. In the graph above I have adjusted the value of inventories to changes in the price level measured by core CPI. Inventories have recovered to well above pre-pandemic levels and are well above trend, defined by levels between 2014 and 2019. Having accumulated a significant level of inventories, it is likely that the rush for inventory accumulation has played a significant role in driving higher levels of inflation. This accumulation, of course, has been supported by currency expansion. But it is difficult to imagine that, absent similar expansion, these increases in

inventories will continue for more than a few months before either stabilizing or reversing.

## Summing Up

The opaqueness of monetary policy slowed the response of inflation expectations to the monetary expansion that began two years ago. The Federal Reserve has shown that it is able to raise inflation. By Powell's own admission, policy was too successful in lifting inflation. Yet, investors have maintained faith in the ability of monetary policy to also reduce inflation. The shift in the stance of monetary policy and the response of inflation expectations suggest that we are reaching a cyclical peak in inflation.

The Fed's move toward tighter monetary policy can be observed by several measures. The balance sheet has stopped expanding and has begun to contract. The federal funds rate target is rising and will continue to rise at least through the end of the year. Further, inflation expectations as measured by the 5-year breakeven rate have receded since April. Finally, and most importantly, the expansion of circulating currency has diminished to rates comparable to pre-pandemic lows. These factors and the current state of business inventories suggest that inflationary pressures are likely near their limit.

– June 10, 2022

# Can The Fed Save Us?

RYAN M. YONK (Senior Research Faculty) & FERNANDO M. D'ANDREA (Contributor)

It is no surprise to anyone who has been to the grocery store, the gas station, or just about anywhere else where things are bought and sold that every dollar in 2022 buys considerably less than it did one year ago. Just how much less may be surprising. The May Consumer Price Index (CPI) increase was the highest since the early 1980s, having increased 8.6 percent. To put that in perspective this year one dollar only buys what ninety one cents did in 2021. Remember the “Dollar Tree?” It is now the Dollar & 25 Tree”, blaming the price hike on inflation. In addition to this, market projections, including the Fed’s itself, suggest inflation will continue to be higher than the usual 2-percent target. And a number of specialists are talking about a large risk of recession in 2023. This reality of increases in the general level of prices is what economists call inflation.

The Fed is, of course, the agency most closely associated with dealing with the causes and effects of inflation. This association is highly influenced by the Fed itself. Whenever there is an economic disruption, the clarion call is that the Fed must do something. Elected officials and the public expect the Fed to provide nonpartisan economic analysis to help manage the economy and avoid large-scale economic disruptions. Despite this expectation, and the real expertise within the Fed, high levels of inflation are with us, and most experts expect them to continue.

Which points to the biggest problem the Fed faces. In contrast to the perception that the Fed is comprised of non-political experts on the mechanics of the economy, the Fed is expected to manage the economy *within* a political system. The Nobel Prize-winning economist James Buchanan expressed

deep skepticism on the possibility of such a system’s succeeding. Buchanan, who is best remembered for helping to establish Public Choice Economics, asserted that in examining the political system we should do so without the romance often associated with governmental service. He and the Public Choice scholars who build on his work rightly assert that simply because someone is working for the public, they aren’t suddenly more moral or less subject to their self-interest.

In their book *Democracy in Deficit*, Buchanan and Wagner observe that, “The election of neither more honest nor more enlightened politicians will resolve our difficulties.”

Their observation is an important one in light of the calls for the group of nonpartisan experts in the Fed to respond to every economic crisis. They are expected to simultaneously maintain inflation and unemployment rates to ensure economic prosperity. The expectations of many are that they do just that, but the truth is less clear. They instead are limited by what actions are politically acceptable.

Despite their technical expertise, those who work at the Fed are not exempt from the political incentives and their own self-interest, including wanting to maintain influence in the economic system. While they pull the levers of the daily working of the state apparatus, have immense power, and most importantly, are not directly accountable for the success or failure of their attempts to manage the economy, they do not act simply as objective experts.

The Fed’s mandate rests on two assumptions. First, those within the Fed can know what the ‘right decision’ to achieve its mandates is, a tenuous proposition at best if you’ve read Hayek. And second, that



they are able and willing to make those decisions outside of the larger political system, and without being influenced by their own self-interest.

Even if we set aside Hayek's strong objection to the first assumption, the second has been thoroughly debunked by Public Choice. The notion that those who work at the Fed are simply public-spirited experts who are guarded against political pressure and their own desire to remain relevant is laughable.

Instead, those working within the Fed respond to political incentives and their own self-interest. Indeed, like all those working within government, their policy decisions, according to Buchanan and Wagner, "respond to demands, both of the public and of the bureaucracy itself."

Those who assert that somehow the Fed will solve economic problems by simply applying neutral expertise should be mindful of the public choice reality that all who work within government face. The incentives of the people working at the Fed can be identified. To be sure, they do have incentives to maintain economic stability by controlling inflation and unemployment via monetary policy. But their incentives go beyond those that are clearly expressed by their mandate. They also face incentives to defend their own short-term positions often with macroeconomic stability coming later in their priority scale when conditions change. Further, despite their nonpartisan nature they remain part of the political system and are interested in continuing to have influence and power.

The realities of Public Choice should make everyone think twice when asserting that the Fed or any agency should be doing something specific to fix the economy and that they will be able to make the right choice. Like all government agencies, there is always more going on than just dispassionately applying the right answer for the right reasons.

– June 22, 2022

# Student-Loan Forgiveness Will Cover Non-Education Purchases, Say, Newer Cars

RICHARD MCKENZIE

Contributor

The *Wall Street Journal* editors, and many other policy analysts and pundits, have criticized, correctly, student-loan forgiveness proposals on fairness grounds. Loan forgiveness shifts the debt burden from students who voluntarily took out the loans, to taxpayers, many of whom have lower incomes than the student-loan recipients.

But the critics of student-loan forgiveness have overlooked how student-loan forgiveness can effectively morph into forgiveness of other non-education purchases, say, cars, trips, and home remodels (and a multitude of other goods). This is made possible by student loans that come with government subsidies and guarantees and, consequently, more attractive interest rates and repayment terms than personal loans (and, now, with the added prospects of payment pauses and loan forgiveness).

Loan forgiveness proposals also smack of unfairness, because the benefits will disproportionately go to a relatively privileged group, those in the 40 percent of high school graduates who are admitted to college. Many college graduates and graduate students (at least those who align their majors with job-market demands) use the student loans to catapult themselves into higher income brackets than many taxpayers who will be asked to share in the tax burden required to cover the forgiven loans. *WSJ* editors add, “Now millions of borrowers can’t or don’t want to repay their loans, so President Biden says he may cancel their debt. The taxpayers who repaid their loans or didn’t go to college [or who worked their ways through college to avoid student loans] will pay instead.” Where are the social justice warriors?

But the loan-forgiveness proposals are problematic for another unseen, unconsidered, possibly more

important economic reason: Proponents and critics of loan forgiveness have failed to consider that the subsidies, and, ergo, money, at the heart of all loans is fungible. For the tens of millions of borrowers, there are surely many who use the loans to cover their tuition payments, leaving them with personal funds that can be used to upgrade their college accommodations, as well as buy better and newer cars.

Similarly, many parents who set aside funds to cover their children’s college expenses likely have pressed their children to take out student loans to free up their savings for, say, home repairs, vacations, or other luxuries.

Why would they do that? Again, government-backed student loans come with lower interest rates and/or better terms than they could receive from a private bank on, say, a new car. (If that were not the case, the government would not need to be in the student-loan business.)

To see how the loan switch-a-roo can be pulled off, consider a revealing illustration, parents who, over the years, saved \$30,000 for their child’s college expenses. At the time of their child’s college matriculation, the parents also would like a new all-electric car (or any other purchase). They can take out a loan at the car dealership with a 5 percent interest rate and payments for 60 months (with the terms illustrative only). But their child’s college qualifies him (by demonstrating only a “a financial need”) for \$30,000 in student loans over four years, which will carry lower interest rate—say, 3 or 4 percent—after graduation and can be paid off over decades (and just might be forgiven).

What will many thinking students and parents (even those not financially distressed) do? The

question answers itself. Many parents will use their savings to buy the car and have their child apply for student loans. Voila! The subsidized student loans effectively pay for the parents' new car, albeit indirectly and unseen by loan-forgiveness backers. Many colleges won't mind the shift in parents' shifts in their money resources because they understand that the federally subsidized student loans will increase their demand, enabling them to absorb some of the subsidies through higher tuition and fees. Many faculty and administrators will support the loans because high college costs can be absorbed in higher faculty salaries, benefits, and reduced teaching loads.

The fungibility of student loans means that many forgiven loans will be an indirect (and surreptitious) way of forgiving parents and students for their would-be "loans" on cars and home remodels. It means that taxpayers will be saddled with paying for parents' and students' non-college purchases. Many professors will, understandably, root for student-loan forgiveness.

– June 17, 2022

# The US-China Currency Rivalry: Choosing Sides

ETHAN YANG (Adjunct Research Fellow) & DOROTHY CHAN (Contributor)

The recent dollar-denominated financial sanctions on Russia by the United States inadvertently highlight the growing significance of the yuan (RMB) as an alternative currency. Although today's immediate concerns revolve around the potential for Moscow to avoid sanctions by transacting in RMB, the significance of the emerging US-China currency rivalry exhibits far broader implications. Many countries are reevaluating their commercial and strategic interests, including increasing their usage of the yuan. As a result, China's effort to internationalize the yuan is seeing increasing success after six years of stagnation. If the US is to protect its position in the world financial order, it must uphold its sound institutions underpinning the world's faith in the dollar.

At the beginning of January 2022, the Chinese yuan's share of world payments hit a record high, as shown in the graph below.



Countries blacklisted by the US transact in the yuan, which supports China's currency internationalization plans. For example, nearly half of North Koreans use the yuan for domestic transactions. Iran and Myanmar accept yuan-denominated purchases

from China. After its ban from the Western financial system, Russia is now paying off its foreign debt in yuan. In all these cases, dollar-denominated sanctions pushed countries towards the dollar's competitor, the yuan.

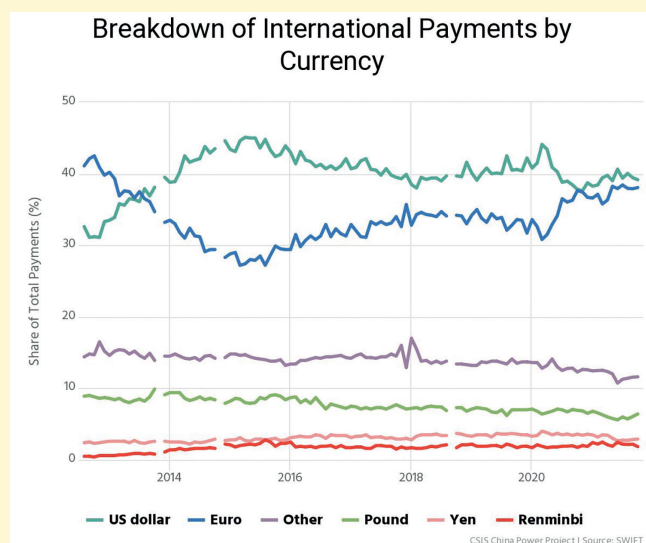
Other countries that maintain trade relations with the US are reconsidering dollars as their trade and investment with China increases. Saudi Arabia, a major oil supplier for the US and China, is considering a yuan-denominated oil deal with Beijing. In 2018, officials from 14 African countries discussed using the yuan as a regional reserve currency. A large impetus likely stems from their involvement in Beijing's Belt and Road Initiative (BRI), a global economic program that seeks to reorient global commerce around China. In Zimbabwe, the yuan became legal tender after China canceled its debt. ASEAN, a Southeast Asian alliance, adopted bilateral currency swaps with China, which World Financial Review economist Dr. Kalim Siddiqui argues will be the "demise of the US dollar." Indonesia signed a bilateral agreement to promote the yuan's use. Baizhu Chen, a clinical finance and business economics professor at the University of Southern California, explains that such countries "feel their economies could be held hostage to US policies" and "want to diversify their risk."

China also plans to reshape its payment system with the rollout of a digital yuan, or e-CNY. In response, members of Congress raised concerns over the digital yuan's potential to circumvent US sanctions and threaten the dollar's status as a reserve currency. In addition, the digital yuan can facilitate cross-border payments without SWIFT, a global interbank messaging system, undermining

US interests and bolstering China's financial power.

Be that as it may, China's financial structures hinder the internationalization process. Tight capital controls limit convertibility making capital withdrawals out of China extremely difficult for its citizens and investors alike. Foreign businesses registered in China are also bound by strict foreign exchange regulations which delay or restrict business capital transfers. Capital account liberalization is the prerequisite to widespread currency usage, but Peterson Institute for International Economics researchers Nicholas Lardy and Patrick Douglass note that "China does not yet meet any of the conditions necessary for convertibility."

The graph below shows that China's progress lags in promoting the usage of its currency in global commerce. The RMB plateaued at just 2 percent of global transactions, whereas the US dollar still commands 40 percent of all transactions. For now, the dollar remains king.



Source: CSIS China Power Project | SWIFT

## What Do Countries Consider When Using a Currency

While sanctions may force some states to resort to yuan, most countries balance their use of RMB and

USD based on their strategic and economic interests. For example, Japan holds a large percentage of its foreign reserves in US dollars despite China's being its largest trading partner. African countries, which predominantly hold dollars and euros, might add the yuan to their portfolios to pay their Chinese infrastructure loans. In Southeast Asia, Cambodia receives large Chinese investments and displays interest towards the RMB to decrease transaction costs. However, Cambodia still pegs its own currency to the dollar.

The yuan's political controls and difficulty of use in commerce explain these mixed results. China's weak foreign money exchange infrastructure makes it inconvenient for cross-border transactions. Rolling out a digital yuan makes it easier to conduct international payments, but only if other countries establish interoperability with their financial systems. The USD also maintains its first-mover advantage, network effect, and reliability over the Chinese yuan.

Countries also tend to favor the reserve currencies of states with strong diplomatic and military influence, like the US. This tendency exists because states desire to transact in the currency that promotes national security and mutual monetary stability among alliance members.

An American security-dependent state often purchases Washington's currency-denominated debt, such as US Treasury bonds. One study estimates that "military alliances boost the share of international units in foreign exchange reserve holdings by almost 30 percentage points." Another study finds that countries lacking nuclear weapons hold 35 percent more US dollars in reserve than those that do not.

In the context of the US-China rivalry, countries are fundamentally realist in their currency choice. Nations favor economic utility until security concerns become apparent. For some countries aligned with the US, like Australia and Japan, a strong trade relationship with China is increasingly

less relevant in the face of geopolitical tension. Countries often prioritize national security, alliances, and values over maintaining economic relationships when taking sides in a conflict.

Other states, like those in Southeast Asia and Africa, find themselves caught in the middle of a strategic balancing game. As the Chinese economy grows, most countries may hold a diverse portfolio of foreign currencies to hedge against uncertainty. A prime example of this rebalancing act is Israel's central bank adding the yuan to its foreign currency reserve alongside three other currencies. The move comes as Jerusalem bolsters its trade relationship with Beijing and expands technology exports worldwide. Ultimately, the Israelis decreasing their ratio of dollars and euros while adding Chinese currency represents an objective observation about the shifting global balance of strategic and economic power.

### **A Bretton Woods III?**

Another factor that may be contributing to the yuan's ascendancy is a global rethink on the foundation of the monetary status quo. The first Bretton Woods system sought to create a uniform global monetary system with currencies tied to the price of gold. After President Nixon took the US off the gold standard, however, Bretton Woods ceased to exist in its original form. As a result, the world transitioned to Bretton Woods II, a de facto system based on US Treasuries as the anchor. Now, analysts like Credit Suisse Managing Director, Zoltan Pozsar, predict the emergence of a Bretton Woods III backed by commodity prices.

Pozsar notes that a combination of loose monetary policy in the United States, surging commodity prices, and anxiety over the weaponization of the dollar are prompting countries to rethink their relationship with American currency. While the United States is sending Russian commodities into the ground with sanctions, China's central bank

stands to benefit by purchasing Moscow's exports for a discounted rate. After the Russia-Ukraine war concludes, Pozsar predicts that the US dollar will emerge weaker and the RMB stronger and backed by commodities. As a result, reserve portfolios and currency-denominated transactions in Bretton Woods III are likely to be more diversified and dynamic than the status quo. This restructuring provides another opening for the yuan to gain prominence in international currency holding and usage.

Whether China's currency will shave off a sizable portion of the dollar's global usage is yet to be seen. Still, there is no doubt that the world is entering a new monetary rebalancing. But if China intends to establish currency dominance, it must develop trustworthy institutions, respectful diplomacy, and responsible stakeholdership in the international order. Whether Beijing possesses the capability to complete these objectives remains to be seen.

– June 8, 2022



# In Bernanke We Trust?

SAMUEL GREGG

Distinguished Fellow in Political Economy and Senior Research Faculty

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In our present inflationary times, the world's central bankers are under their highest degree of scrutiny since Alan Greenspan found himself facing a Congressional committee in 2008 demanding to know why he hadn't seen the Financial Crisis coming. To say that central bankers—once considered the adults in a room of adolescent politicians—presently have a substantial credibility problem is an understatement.

To be fair to central bankers, part of the difficulty is that their reputation for competence forged in the 1980s and 1990s meant that governments found it convenient to let central banks take the lead when Western economies ran into difficulties in the late-2000s. Unfortunately, this has resulted in monetary stability being subordinated time and again to the perceived necessity to react immediately to crises. Now, however, the bill for such policies has come due in the form of the worst inflationary outbreak since the early-1980s. Even that most conventional of economic and political commentators, *The Economist*, has affirmed that the Federal Reserve failed to fulfill its primary task.

## Personalities, Politics, Mandates

There is more to this, however, than the dysfunctions engendered by central banks using monetary policy to try and address non-monetary problems. When central banking's role is understood in neo-Keynesian terms—i.e., from a macroeconomic standpoint that emphasizes top-down demand-side management of the economy—it's easy to understand why central bankers might gradually succumb to a Masters-of-the-Universe mindset.

That contemporary central banking operates within this conceptual framework is acknowledged by former Fed Chair Ben S. Bernanke in his new book, *21st Century Monetary Policy: The Federal Reserve from the Great Inflation to COVID-19*. “So-called Keynesian economics,” he says, “remains the central paradigm at the Fed and other central banks.” One assumption of this model is that a small group of people, equipped with all the forecasting and management tools developed in the Keynesian revolution's wake, can and should use monetary policy to smooth the business cycle's ups and downs. But what if this assumption leads central bankers to overestimate what they can know and therefore do?

That question isn't addressed in the book. This is a shame because the great strength of Bernanke's text is that it is written by someone deeply versed in economic history and monetary theory who was also the world's most important central banker between 2006 and 2014. That rare combination of scholar, theoretician, and practitioner allows Bernanke to provide insight into how monetary policy is shaped not only by the demands of the moment but also by ideas.

Today's gold standard (forgive the pun) for the history of the Fed remains Allan H. Meltzer's three-volume *History of the Federal Reserve*. The final volume ends with Meltzer remarking that while “The Volcker and Greenspan eras restored independence . . . Chairman Bernanke has acted frequently as a financing arm of the Treasury.”

That's not how Bernanke sees it. His account of the Fed's post-1970s journey begins with Richard Nixon's appointment of Arthur F. Burns as Fed Chair in 1969. Much of Bernanke's subsequent

tale is presented from the standpoint of successive Fed Chairs. He illustrates how their strengths and weaknesses shaped their tenure, and the manner in which intellectual commitment to particular points of monetary theory impacted their leadership. But politics also emerges as very much part of the picture. Bernanke confirms, for instance, the assessment of Meltzer and the economic historian Amity Shlaes that Burns proved very susceptible to political pressures from presidents. By contrast, Paul A. Volcker was far more resistant. “Consistency and persistence,” Bernanke writes, “became Volcker’s hallmarks.” Character, it turns out, matters for central bankers.

So too do the precise tasks with which central banks are charged. Like many others, Bernanke believes that a bridge was crossed in 1977 when Congress amended the Federal Reserve Act to formalize what we now call the Fed’s dual mandate of stable prices and maximum employment. This placated, Bernanke notes, conservatives who prioritized anti-inflationary goals but also progressives anxious to see monetary policy used to stimulate employment. Yet, Bernanke notes, “the 1977 law did not say specifically how the two goals should be weighed in policy decisions.” It’s unclear, to my mind, how any legislation could be feasibly designed to prescribe how such a weighing could occur. The effect, however, has been to allow the Fed to emphasize whichever part of the mandate is most likely to legitimize its decisions.

For example, when Volcker jacked up interest rates from 1979 onwards to bring down inflation, he justified the Fed’s decision by appealing to the price stability part of its mandate. He was consequently accused by legislators of ignoring the maximum employment part. Volcker’s response was to insist that employment issues could not be properly tackled until inflation had been brought under control. As it happens, I think Volcker was dead-right. But his

critics had a point when they said that Volcker was, for all intents and purposes, sidelining the other half of the Fed’s mandate.

Much of Bernanke’s account of the Fed’s post-Great Inflation history presents a succession of Fed Chairs trying to pay more than lip service to the Fed’s dual mandate. Nevertheless, it’s hard not to notice that the Fed’s long-term perspective, by Bernanke’s account, rarely made it past the peculiarities of the business cycle of the moment. The autonomy enjoyed by the Fed is supposed to insulate it from being excessively swayed by such considerations. But Bernanke’s history indicates that such swaying was more or less the norm. Even Greenspan’s prioritization of an inflation-first approach during the Great Moderation comes across as focused, at best, on the medium-term.

### **Normalizing Crisis**

Perpetually reacting to the particularities of a given business cycle or economic downturn was bound to result in the Fed engaging in considerable experimentation. That was a hallmark of the Bernanke Fed’s wrestling with the 2008 Financial Crisis and subsequent Great Recession. This took the form of quantitative easing (QE—the central bank buying bonds and other financial assets to inject money into the economy) as well as efforts to improve management of policymakers’ and the public’s expectations of the probable direction of monetary policy.

“The bottom-line,” Bernanke states, “is that the bulk of the evidence . . . confirms the effectiveness of the alternative monetary policy tools adopted after 2008.” What’s more, Bernanke insists, these measures have appropriately “become permanent additions of the monetary policy toolkit.” Bernanke adds the caveat that they “are unlikely to be sufficient in all circumstances, particularly in very severe recessions or when the neutral interest rate is quite low.” He subsequently concludes that we



should consider “what else might be done to make monetary policy, and economic stabilization policy more generally, more consistently effective.”

For Bernanke, QE is simply part of central banking’s new normal, and a potential stepping stone to adding more tools to the Fed’s arsenal. Yet Bernanke devotes much of Part Three of his book to defending QE’s effectiveness. This suggests that Bernanke knows that QE’s place in the monetary toolbox is far from achieving universal acceptance. He also responds to claims that QE benefits particular groups (borrowers over savers, investors over non-investors, etc.), risks creating asset bubbles, and distorts capital market signals. In some cases, Bernanke’s responses should give his critics pause for thought. Other replies are less convincing.

Bernanke maintains, for instance, that QE helped sustain America’s economy during the pandemic and get it back on its feet. These policies, he adds, “have not led to sustained excessive inflation.” Much, I’d interject, depends on what constitutes “sustained” and “excessive.” It’s safe to assume that the Powell Fed’s decision to start tapering the pace of its asset purchases in November 2021 before doubling that speed in December 2021 occurred because enough Federal Open Markets Committee (FOMC) members concluded that QE had contributed to the accelerating and damaging inflation rate which gradually engulfed the U.S. economy from April 2021 onwards.

### **Independence Forever?**

Bernanke’s account ends with a reflection on a question that preoccupies most central bankers: how they should deal with the world of politics. In the 1980s, the bolstering of central bank independence against political interference became a priority for some policymakers. No central bank, however, is really above politics, whatever the law says. Certainly for Bernanke, this is simply part of

the reality of modern American politics. To this, one could add that no government agency with delegated powers should be rendered invulnerable from any influence whatsoever from the three central branches of government.

There is, however, a difference between central banks seeking to navigate politics in order to achieve their specific goals, and central bankers choosing to pursue other objectives that reflect immediate political concerns. While Bernanke holds that “Solving our most difficult social problems lies well beyond both the Fed’s capacity and its remit,” he also states that “when the Fed has the opportunity, the means, and the legal authority to contribute constructively, consistent with the direction set by political leaders and the public, it should do so.”

I doubt that I am the only person with reservations about that claim. Institutions generally lose their focus when they take on issues that lie beyond their immediate competence. Central banks are no exception. Indeed, the more central bankers become involved in matters like climate change or economic inequality, the more they insert themselves into questions that Bernanke himself recognizes to be the responsibility of elected officials.

Such drift also incentivizes politicians and activists to pressure central banks to promote their pet schemes (progressives, for instance, have argued in favor of the Fed funding the Green New Deal). That opens the door to central banks being pushed to direct monetary policy to advance the specific interests and concerns of whatever group happens to exert more political leverage at any given time. The problem is that monetary policy seeks to influence macroeconomic variables such as interest rates. Central banks are thus spectacularly ill-equipped to advance directly the economic well-being of particular groups.

This brings us to what I believe has become crucial to the preservation of central bank independence:

the need to narrow the mandate of central banks, including the Fed's, to maintain monetary stability. Bernanke would, I imagine, disagree. But amending the Fed's mandate to, at a minimum, prioritizing monetary stability over other goals—as well as central bankers' willingness to say “No” to politicians, populists, and interest groups looking for quick fixes or favors—is surely the *sine qua non* to enhancing its independence today. In other words, meaningful autonomy for central banks depends on a constrained brief—not expanding it.

I'd like to think that this is something that the Fed might learn from our current inflationary woes. Alas, I fear that the ongoing desire to believe that state institutions can micro-manage economies made up of millions of people and businesses, as well as trillions of economic assets, will continue to thwart any such outcome. In the end, there's a wannabe Master of the Universe lurking within all of us—including central bankers.

– June 9, 2022

# Setting the Record Straight on “Setting the Record Straight on the Libertarian South African Economist W.H. Hutt and James M. Buchanan”

ART CARDEN (Senior Fellow) & PHILLIP W. MAGNESS (Research and Education Director)

In 2005, the comedian Stephen Colbert (re?) introduced the word “truthiness” to the English speaking world. And what, pray tell, is that? How about “a truthful or seemingly truthful quality that is claimed for something not because of supporting facts or evidence but because of a feeling that it is true or a desire for it to be true.” It is an accurate description of the body of scholarship purporting to show that 20th century “neoliberal” economists enabled racists or were the venal mouthpieces of sinister bourgeois interests. It makes many claims that are very *truthy*, but few of its key claims are *true*.

Nancy MacLean’s 2017 book *Democracy in Chains* has become a quintessential example of this literature. The book’s primary villain – described in MacLean’s words as an “evil genius” – is 1986 Nobel laureate economist James M. Buchanan, who she places at the center of an elaborate academic conspiracy to “enchain democracy” at the behest of a plutocratic elite. Race naturally plays a central part in MacLean’s argument as she places Buchanan in league with the segregationist “Massive Resistance” movement of 1950s Virginia as part of an intellectual project to allegedly rehabilitate the pro-slavery constitutional theories of John C. Calhoun.

In a paper published in 2019, we subjected MacLean’s thesis to careful scrutiny, including retracing her steps through the archival materials she claimed to have used and adding other sources that she missed. The results were not pretty for MacLean’s thesis. We found that she had failed to substantiate her central allegation of Buchanan’s complicity with the segregationists, while also ignoring extensive evidence that worked against

this claim. Her archival work produced a long list of misrepresented sources, misread documents, mistaken citations, faulty inferences, historical anachronisms, and outright factual errors. They nonetheless allowed her to construct a narrative about Buchanan that many on the political left accepted for its “truthiness.” Quite simply, MacLean had told a tale that seemed “true” to others who wanted to believe it. Her evidence did not support that story.

One of the main areas where MacLean’s segregationist narrative falters is the case of South African economist W.H. Hutt. In 1965, Buchanan recruited Hutt for a year-long visiting professorship at the University of Virginia. Shortly before he arrived, Hutt published *The Economics of the Colour Bar* – a withering economic broadside against the racist Apartheid regime in South Africa. The book built on decades of Hutt’s anti-Apartheid work, which had previously induced the South African government to suspend his passport in an effort to silence him. After arriving at UVA, Hutt continued his attacks on Apartheid and gave a string of public lectures pointing out its similarities to the segregationist policies of the Jim Crow South. Clearly, something did not add up in MacLean’s book. If Buchanan’s project at UVA existed to give an academic cover to the segregationist “Massive Resistance” movement, as MacLean maintains, why would Buchanan personally invite an economist who was widely known as an outspoken critic of Apartheid?

One of us investigated this inconsistency further in a 2020 article for the journal *Public Choice*. Hutt, it turns out, was one of many visitors Buchanan

brought to UVA in the 1950s and 1960s for the explicit purpose of speaking against segregation in the United States and Apartheid in South Africa. University of Chicago economist Frank Knight also visited, giving an anti-segregation lecture that Buchanan later edited and published as part of a book. Cambridge University development economist Peter Bauer also visited, lecturing against Apartheid. So did Gary Becker, the author of the groundbreaking *The Economics of Discrimination*. Buchanan even sponsored a graduate fellowship for Francis Wilson, a PhD student at Cambridge who came to Charlottesville to write a dissertation on the harms of Apartheid in the South African mining industry. MacLean's attempts to link Buchanan to racial segregation, it appears, were not only without merit – they almost willfully ignored the extensive counter-evidence found in Buchanan's direct sponsorship of anti-segregationist research by Hutt, Knight, Bauer, Becker, and Wilson.

Earlier this month, MacLean (along with two co-authors) published what she imagines to be a rebuttal to this evidence. Rather than amend her thesis to account for its errors of fact and interpretation, the Duke University historian has chosen to expand her foray into the world of truthiness. She now sets her sights on Hutt, lambasting him as a “white supremacist” and advancing an elaborate narrative that aims to discount the sincerity of his anti-Apartheid scholarship as well as its links to Buchanan.

In the interests of a correct historical record and a fair hearing for ideas that, we believe, are most conducive to liberty, prosperity, and equality than those endorsed by the radical left, we offer a paper-length corrective to the claims William Darity, M'balou Camara, and Nancy MacLean make in their recent Institute for New Economic Thinking working paper, “Setting the Record Straight About Libertarian South African Economist W.H. Hutt and

James M. Buchanan.” What they call an “irrefutable” demonstration that Hutt was a “white supremacist” is, in reality, a collection of strained interpretations, mistaken citations, factual errors, and general unfamiliarity with Hutt's work as an economist.

Our full response may be accessed at AIER's working paper series, but here are some highlights:

First, Darity, MacLean, and Camara attempt to link Hutt to Virginia segregationists by a simple confusion of citations in Hutt's work. Their mistake introduces an impossible anachronism into their timeline, dealing a serious blow to their thesis. Darity et al write:

P. 6: “And at a moment when students and faculty in Virginia and elsewhere in the country were demanding an end to the exclusion of African Americans, Hutt advised that owing to this principle of free association, the proscription of discrimination ‘does not mean that the courts must force...every white university to admit non-Whites.’ Footnote 3 (to this sentence) reads “Indeed, in this piece written for young American conservatives, Hutt criticized the Warren Court twice (cagily, not by name). ‘Hutt, An economic plan for the Negro–Civil Rights and Young “Conservatives,”” 793.

As we show, the quote in this passage is not found in the source they cite, nor is it even about Virginia. It is from Hutt's 1965 *Il Politico* article “South Africa's Salvation in Classic Liberalism,” which was written before Hutt arrived in Virginia and which is entirely about South Africa. Hutt “cagily” does not mention the Warren Court by name because the Warren Court has nothing to do with the article they are quoting, and unless we have overlooked it, nothing to do with the article they are citing. They simply transposed the article's date with another and

misinterpreted its contents as a political commentary about the United States.

The errors rack up from there. For example, MacLean and her co-authors repeat a thoroughly-debunked claim about Buchanan allegedly “advising” Augusto Pinochet’s government in the creation of a new Chilean constitution. As Andrew Farrant has shown, the archival evidence simply does not support MacLean’s claims – in fact, she attributes clauses in the Chilean constitution to a 1980 academic lecture in Chile by Buchanan, even though they were already written long before Buchanan’s speech. Curiously, MacLean has yet to respond to this evidence, undermining one of her book’s main charges.

Another of MacLean et al’s errors unfolds in almost comedic fashion. In their new paper, they claim that we “invented” the association between James M. Buchanan and Hutt’s work on Apartheid and its connection to his residency at UVA. We didn’t. The documents we deal with tell a different story.

1. They specifically allege that Buchanan maintained a career-long silence on the importance of Hutt’s *The Economics of the Colour Bar*. To support this claim they invoke and cite a 1983 interview about Hutt that Buchanan did with the Manhattan Institute. Apparently MacLean and her colleagues did not research very deeply into this interview. A full transcript of it exists in Hutt’s papers at the Hoover Institution. When given the chance to comment on Hutt’s work, Buchanan specifically recommends his anti-Apartheid research and links it directly to Hutt’s term at UVA. It appears that MacLean and her co-authors only used a truncated version of the interview in print, despite citing it to the Hoover Institution records. They accordingly missed Buchanan’s extensive praise for Hutt’s anti-Apartheid work.

2. Reading Economists and the Public and *Plan for Reconstruction* carefully would have shown Darity et al. that some elements of Hutt’s analysis they attribute to “white supremacy,” like the importance of honoring people’s established expectations, were applications of more general ideas Hutt had applied to the eventual British recovery from World War II. Buying off special interests might be noxious in the short run, but Hutt saw it as a tiny price to pay for higher long-run growth.
3. Our original argument was that Buchanan’s invitation to Hutt, author of *The Economics of the Colour Bar*, at the height of the Civil Rights era seemed difficult to reconcile with MacLean’s claims about Buchanan’s alleged role in Massive Resistance. MacLean might have anticipated an objection like this, but by her own admission, she didn’t talk to anyone who really knew Buchanan well or who could have helped her understand Buchanan’s ideas because they were considered anathema because of their Koch associations. The past presidents of the Public Choice Society (Geoffrey Brennan, Michael Munger, and Georg Vanberg) and the eminent Hayek scholar (Bruce Caldwell) on MacLean’s own campus at Duke almost certainly would have been happy to help.

In yet another passage, MacLean and her co-authors attempt to link Hutt to Leon Dure, a moderate segregationist who was active in the Charlottesville area in the 1950s and 60s. They allege that Dure’s ideology imprinted itself upon how Hutt interpreted race relations and how he wrote about segregation in his subsequent works. Keep in mind that there’s no evidence that Hutt ever had any meaningful interactions with Dure while at UVA. Instead, MacLean et al purport to infer it by claiming to see similarities between the ways



that Dure and Hutt italicized certain words in their respective writings.

We are honestly not sure if this is a serious claim or a subtle prank by scholars trying to see how much time they could get Hutt defenders like us to waste digging into a silly assertion. We decided to play along and discuss this to give readers an idea of the quality of the interpretive methods one can expect to see in this paper and others like it. We played a few rounds of “Hutt Italics Roulette” with a few of Hutt’s books and show that his italicization style predated his visit to Virginia by decades.

Elsewhere, we show that their charges of “white supremacy” against Hutt arise from plain misconstructions and misrepresentations of Hutt’s own words. In one telling passage, they write that Hutt blamed Africa’s “natural handicaps” on alleged “genetic” characteristics of black Africans. He did nothing of the kind. The “handicaps” in the passage they misquote refer to geography, the tropical disease environment of the continent before the advent of modern medicine, and political institutions – not genes. Elsewhere in documents MacLean and her co-authors cite (but evidently did not read with any care), Hutt explicitly states that he does not believe in race-based hereditary theories.

In our paper, we go on. And on. And on, for about four dozen pages with a long bibliography. With William Darity and M’Balou Camara, Nancy MacLean claims to have “set the record straight” with “irrefutable” evidence that Hutt was a white supremacist. They have in fact set nothing straight, and their argument, far from being “irrefutable,” wrecks itself upon the rocks of at least one major citation error, selective use of documents, and willful misreadings of Hutt’s words devoid of their original context.

– June 27, 2022



# New Study Challenges CDC Evidence on School Masking

DAVID WAUGH

Managing Editor

Throughout the COVID-19 pandemic, adults placed a significant burden on children. An analysis from McKinsey & Co. shows pandemic school closures and hybrid learning resulted in a significant drop in student achievement, costing students \$49,000 to \$61,000 in future lifetime earnings. This outcome in addition to the mental health toll reveals that school closings and various restrictions had significant consequences for students.

As the country revoked masking restrictions, schools came last. Students wore masks for months after business and citywide mandates disappeared. Now large school districts like Philadelphia's, are reintroducing mask mandates in response to rising cases.

School districts justify these mandates by relying on observational studies produced by the CDC. The most influential of these studies is "Pediatric COVID-19 Cases in Counties With and Without School Mask Requirements — United States, July 1–September 4, 2021", authored by Budzyn et al.

Unsurprisingly, the authors find that "Counties without school mask requirements experienced larger increases in pediatric COVID-19 case rates after the start of school compared with counties that had school mask requirements." Yet, one must remember the now overused saying: Correlation does not equal causation.

However, a new re-analysis of the data used in the study, produced by Ambarish Chandra and Tracy Høeg, finds that school masking is not associated with pediatric case rates.

Chandra and Høeg's analysis, which uses a larger population and longer time interval, is more comprehensive than the CDC's. Their results show no relationship between mandating masks in schools

and COVID case rates in students. The authors also highlight problems with the initial CDC study, including context surrounding biases in the CDC's medical journal and related scientific publications.

## Study Methods and Results

The authors maintain that their study serves two purposes: first, to replicate and extend the original study, and second, to illuminate problems with observational studies. Their second purpose is important for public health policy, as observational studies using limited data have been used by the CDC to justify numerous public health interventions.

Using the same methods and criteria as the CDC study, they expand the sample size by analyzing "data from three weeks prior to schools opening to six weeks following opening" in contrast to the two-week timeframe used in the original study. Further, the authors use data from a more recent release (October 25), to create an additional larger sample set of counties which they use to evaluate the robustness of their results.

They find that "using the same methods and sample construction criteria as Budzyn et al., but a larger sample size and expanded time frame for analysis, we fail to detect a significant association between school mask mandates and pediatric COVID-19 cases."

The authors argue that the discrepancies between the two studies are a result of the CDC's oversampling of schools in Southern states that start in August. In contrast, their paper includes Northern states that start school in September.

## **CDC Bias**

The new study also highlights issues of biases within the CDC's research. For instance, the CDC's own journal, the *Morbidity and Mortality Weekly Report* (MMWR) refused to publish Chandra and Høeg's work. This is curious, given that the authors exactly replicated the CDC's own paper with additional data and robustness. As they explain,

Certain journals may also only publish findings that fit their preference, as was the case with our analysis; our expanded version of the original Budzyn et al publication was not accepted for publication by MMWR despite using the same methods, but with an expanded population and time frame. This bias can lead to the published "science" being a self-fulfilling prophecy rather than an unbiased pursuit of truth.

## **Conclusion**

The results of this study demonstrate, with more data and robustness than the CDC's own paper, that masks in schools are an ineffective tool against COVID-19. The CDC's decision not to publish this study in their journal only further discredits the agency. While unsurprising given their propensity for choosing politics over science throughout the pandemic, the CDC is only doing our children a disservice by promoting policies that may do more harm than good.

– June 1, 2022

# The “Unlivable” World of Global Warming Is Much Wealthier Than Today

JAMES E. HANLEY

Contributor

Global warming is real, and it is a problem. But how big of a problem? According to some, humanity’s very existence seems to be at stake. When our responses to global warming snap like a rubber band, warns economist Paul Krugman, “then the megadeaths will begin,” a claim he says, is not hyperbole, just realism. A popular book warns of an uninhabitable earth. And United Nations Secretary-General António Guterres has used his bully pulpit to inform us that we are “firmly on track towards an unlivable world. Like Krugman, he says this is not “fiction or exaggeration,” but simply “what science tells us will result from our current energy policies.”

But does the science really say that the earth will become unlivable? More specifically, does the authoritative Sixth Assessment Report of the Intergovernmental Panel on Climate Change report give us even the slightest indication that the world is at serious risk of becoming uninhabitable due to our current energy policies?

The unequivocal answer is “no.” Put another way, Krugman, Guterres, and others are engaging in hyperbole, exaggeration, and fiction. Because what the IPCC really says is that 1) our current energy policies are better than they were when the Fifth Assessment Report was written, so our predicted warming paths are lower than they were then, and 2) the world will be twice as wealthy by the year 2050, global warming or not. Its most dire economic predictions are for a reduction in economic growth over that time, whereas an uninhabitable world would, of necessity, be one of devastating economic collapse.

This doesn’t mean there won’t be challenges from climate change, with some regions facing greater

challenges than others. And it doesn’t mean we won’t be better off if we mitigate it or at least invest in adaptation strategies. But it does mean that there is a concerted effort by some elite actors to engage in the politics of fear. I will not attempt to discern to what extent these otherwise intelligent people are mistaken, and to what extent they are consciously dishonest. What I will do here is draw directly from the IPCC Report to argue for humanity’s bright future.

## **Myth #1: RCP 8.5 and Very High Levels of Warming**

The most dire predictions come from simulations run under a scenario called representative concentration pathway (RCP) 8.5, sometimes called the “business as usual,” pathway, which would lead to almost five degrees of warming by century’s end (WGIII, 3-118, or Working Group III, ch. 3, p. 118 – pages are cited so others can verify claims made here). In the Fifth Assessment Report, this was seen as the most likely future, but it is now considered to be of low likelihood, with the most likely future paths being much lower – although still harmful – levels of warming. This is primarily because countries have changed their policies and the intended trajectories of their future carbon emissions, even if not rapidly enough to satisfy climate activists.

RCP8.5 is, according to the ICPP, no longer business as usual. The report concludes that while such high-emissions scenarios cannot be completely ruled out, scenarios showing warming of greater than 4°C “would imply a reversal of current technology and/or mitigation policy trends” (WGIII: SPM-22). Current “business as (now) usual scenarios, ones “consistent with the continuation of policies implemented by the

end of 2020,” only lead to a rise in temperature of 2.2 – 3.5°C. The report itself assumes that current policy trends are not going to reverse and that, however gradually, they will continue to trend toward “increasingly stringent . . . climate policies” (WGIII 3-26). A good rough estimate, then might be toward the lower end of that latter warming estimate.

Unfortunately, while the RCP.5 scenario is no longer seen as scientifically valid, it continues to be used extensively. And even as the Sixth Assessment downplays its correlation with reality, the collected reports contain over 1,000 references to it, providing plenty of opportunities for fear-mongers to cherry-pick unlikely disaster scenarios.

### **Myth #2: We’ll All Be Much Worse Off in the Future**

Doomsday scenarios suggest we’ll be much worse off in the future. Scenes of food riots and violent collapse of social order come to mind. And yet the Sixth Assessment Report very explicitly states that “in assessed modeled pathways, regardless of the level of mitigation action, global GDP is projected to at least double (increase by at least 100%) over 2020-2050” (WGIII, SPM-49). So even in the worst case scenarios, the IPCC expects the world to double in wealth over the next several decades (which will, of course, positively impact our capacity to adapt to any level of warming).

However, global warming is predicted to have a negative effect on GDP growth, on the order of .04-.09 percentage points per year, for a total net reduction in 2050 of 1.3 – 2.7 percent (ibid). This is on the order of a serious recession in the year 2050 after years of sustained normal growth, problematic, but hardly catastrophic.

Looking further out, the modeled assumptions for economic growth from 2050 – 2100 are lower on an annual basis, only 1.3 to 2.1 percent per year. But even that reflects a still growing economy. Whether this assumption is correct is relevant – the point is that the

models are anti-doomsday models. In their basics they assume a much richer, albeit much warmer, world, in 2100, even if we do not act to mitigate increasing levels of carbon dioxide in the atmosphere. So they provide no basis for predicting utter catastrophe. The science does not support claims of an existential threat to humanity.

### **Case Study: Africa**

Of course, climate change will affect different regions differently, and some will be hit much harder than others, both because of location and because of limited capacity for adaptation. One of the most at-risk regions is sub-Saharan Africa, because of its low-latitude location and its continuing underdevelopment. IPCC Working Group II’s chapter on Africa makes for grim reading. A selection:

- “In Africa, climate change is [already] reducing crop yields and productivity (*medium confidence*). Agricultural productivity growth has been reduced by 34% since 1961 due to climate change, more than any other region” (WGII, 9-7);
- “Climate change has [already] reduced economic growth across Africa . . . One estimate suggests GDP per capita for 1991-2010 in Africa was 13.6% lower compared to if climate change had not occurred” (WGII, 9-6);
- Morbidity and mortality will escalate with further global warming, placing additional strain on health and economic systems (*high confidence*): At 1.5°C . . . distribution and seasonal transmission of vector-borne diseases is expected to increase, exposing tens of millions more people, mostly in East and Southern Africa (*high confidence*)” (WGII, 9-7).

And yet, the close reader will see that there is good news there as well. Although the report does not give a continent-wide GDP estimate for Africa, nor even one for the sub-Saharan region, it also does not suggest an absolute decline in GDP, but rather hints at

continued growth. For example, the report argues that “across nearly all African countries, GDP per capita is projected to be at least 5% higher by 2050 and 10-20% higher if global warming is held to 1.5°C versus 2°C” (WGII9-7). These are significant numbers, but they indicate again that the question is how much wealthier Africa becomes in a warmer future, not whether Africa becomes wealthier.

And while the IPCC report does not address such questions directly, it is clear that the greater influences on Africa’s economic development will be questions of governance rather than questions of climate.

There are other hints of a positive, albeit difficult, future for Africa. The statement on increases in mortality and morbidity is accompanied by the addendum that warming “risk[s] undermining improvements in health from future socio-economic development” (WGII, 9-7). Fleshed out, that means a wealthier Africa can better deal with morbidity and mortality risks, and rather than guaranteed absolute increases in mortality and morbidity, climate change will be a limiting factor on how much gain is made.

Again, far from an unlivable world, we see even in Africa a world that will be more livable because it will be more wealthy. It just won’t be as much more livable as it would in the absence of significant global warming, and it will continue to lag behind more developed regions of the world.

Finally, the report notes that even in Africa, adaptation can be effective in responding to global warming, in that it will be “cost-effective” (WGII, 9-4). This means that in the absence of mitigation of CO2 emissions, and in spite of the effective certainty that we will not limit the world to 1.5°C of warming – at least in the medium-term – investment in adaptation strategies can help even sub-Saharan Africa sustain growth through a significantly warmer world.

## Conclusion

None of the above is a call for inaction. The IPCC report argues forcefully that the net effect of mitigating atmospheric CO2 concentration is a wealthier world in the future, albeit only marginally so. The mitigation strategies, if the report is correct, will pay for themselves, given time. Of course that is an empirical claim that is subject to debate, and the correct answer is an important, but not the only, element in determining our best public policy responses.

Beyond the empirical question, there is an ethical question of whether a contemporary generation should be asked to pay for the benefits of future generations that are going to be much wealthier than that earlier one. Imagine if we could go back in time and ask folks in 1922 or 1962 to make themselves marginally poorer so we could be five percent wealthier today. They would, at the least, look askance at us, especially if we could transport them forward in time so they could see the phenomenal advantages our greater wealth has provided for us. Most importantly, we should be cautious about throwing ourselves into energy poverty via unreliable energy sources just because they are characterized by the ideological mantra “renewable.”

But if we do not pay for mitigation, we should certainly begin planning for adaptation. Many adaptation measures, such as raising shorelines, preserving open space for flood management, and enhanced disease management will have immediate payoffs, benefiting our own generation as well as future ones. As the Working Group III report notes, “Some of the most substantial health, wellbeing, and equity benefits associated with climate action derive from investing in basic infrastructure: sanitation, clean drinking water, clean energy, affordable healthy diets, clean public transport, and improved air quality” (WGIII, 3-106).

But that’s a far cry from giving in to the politics of fear, which are too often a prelude to a politics

of tyranny. After all, if one truly believes the very existence of humanity is at stake, no regulation goes too far, and no social control is too strict, in order to save our species. And that is a price none of us should have to pay.

– June 29, 2022



# Of Patriots and Freedom

JAMES R. HARRIGAN

Senior Editor

We celebrate a number of holidays every year in the United States, and while each has its partisans, there aren't many that get to the heart of who we are as a people. Indeed, few could. We manage to find the worst in each other in just about every aspect of public life, and we show little interest in finding our best. We are at our hurtful best every Columbus Day, Halloween, Martin Luther King Day, and even Presidents Day. There is almost no such thing as a day of celebration that won't bring with it legions doing their best to exercise the heckler's veto.

Frankly, it makes most of us tired. But the fear of finding themselves at the end of the nearest pitchfork keeps most people of good will quiet.

Of all of the American holidays, only the 4th of July has been given anything resembling a free pass. It's hard to find the racist root of Independence Day, a day commemorating when a bunch of white guys told another group of white guys to go pound sand. It's not like no one's trying, though. And we have been acclimated to offer nothing but silence in the face of even the kookiest of racial claims.

And that's as good as it gets. Coming in a distant second is Thanksgiving, and it's a distant second in no small part because every candid person will admit that the native people who shared a meal with the earliest settlers paid a dear price in the years that followed. Still, it seems we can have a national day of Thanksgiving even so, and that maybe the fuller story is worthy of celebrating as much as a remembrance as a holiday.

After Thanksgiving, there isn't much that we celebrate that allows us time to reflect on what unites us as friends, neighbors, and countrymen. But it is exactly this gap in our public celebrations that recommends two holidays that can draw us together. And they

can draw us together because the best of us want to celebrate our shared lives.

The first of these, Patriots' Day, was born of an 1894 Massachusetts compromise. The towns of Lexington and Concord each wanted a holiday in their own name, putting Governor Frederic T. Greenhalge in a bit of a bind. Greenhalge used the moment to recognize what the people of Massachusetts had known for well over 100 years: The battles of Lexington and Concord were pivotal to the cause of American Independence. The biggest battle on April 19, though, was the Battle of Menotomy.

Pointing to all three battles, he offered the compromise of Patriots' Day. And while Independence Day has always celebrated the machinations of America's colonial ruling class, in this instance a well-deserved celebration, Patriots' Day was a nod to the reality that everyone knows: Without patriots to fight for the cause, Independence would never have happened.

It is a celebration of what countless unknown people sacrificed for a cause much bigger than themselves. It's a celebration for all of us.

Which brings us to the second. Juneteenth commemorates the emancipation of the last slaves in the United States on June 19, 1865, when Union Army General Gordon Granger proclaimed freedom for enslaved people in Galveston, Texas. There were other dates recommending themselves. Lincoln's Emancipation Proclamation of January 1, 1863 was the most obvious of these. But the Emancipation Proclamation, given that it was directed at slaves in the Confederacy, never freed anyone. Also obvious was the 13th Amendment, which rendered slavery constitutionally inadmissible on December 6, 1865. But that was simply some wording after the fact. And while that wording was without question important, it was not as

viscerally important as an announcement of freedom to people who had no idea they were no longer slaves.

And what could have brought the American Experiment into closer focus than a celebration of what countless unknown people sacrificed for a cause much bigger than themselves?

Juneteenth, too, is a celebration for all of us. Because what is a better thing to celebrate than the liberty all Americans know to be their birthright? This is not a partisan victory, nor is it one of one time or another. It's a universal victory, because the cause of freedom is the cause of everyone.

April 19 and June 19 show us how ordinary people did extraordinary things. It's a debt that we can never repay but by paying it forward. Would the rank and file Massachusetts men who fought the first battles of the Revolutionary War want much else from us? Would the freed slaves?

Happy Juneteenth

– June 19, 2022



**AMERICAN INSTITUTE FOR ECONOMIC RESEARCH**  
250 Division Street | PO Box 1000 | Great Barrington, MA 01230-1000