KU's Dr. William A. Barnett recently published an important op ed as to why high levels of inflation seemed to catch the Federal Reserve flat-footed.

Barnett Op Ed Outlines Why Fed Was Caught Unawares by Inflation

When inflation in the US this spring began hitting levels not seen in over 40 years, seemingly catching the Federal Reserve flat-footed, KU's own Dr. William A. Barnett published an insightful op ed in the *Kansas City Star* ("Why the Federal Reserve's Inflation Forecast Was Wrong" - May 4, 2022).

Shortly before the 2022 price surge began, Fed public forecasts had predicted that both inflation and interest rates would stay at near zero for at least three more years; and even after prices had begun to spike, the inflation forecast was only modified slightly to account for a temporary self-correcting increase in prices as a result of supply-chain disruptions.

In that piece, Dr. Barnett outlined why the two most common explanations for the Fed's erroneous inflation forecasts – the pandemic and greed – were "inadequate at best." He observed that the Fed, as well as virtually everyone else in the world, knew about the pandemic as it was occurring in extraordinary detail - and that it was therefore difficult to understand why the Fed would have incorrectly assessed its inflationary implications. As for corporate greed, he noted that models used by central banks have always assumed that firms seek to maximize profits in the best interest of their shareholders. He also observed that shortages of goods at the retail level imply pricing below, not above, the market-clearing perfectly competitive level.

Dr. Barnett, KU's Oswald Distinguished Professor of Macroeconomics, suggested that the most likely explanation for the Fed's late-to-the-party acknowledgment about the severity and duration of inflation was that there was something fundamentally wrong with the simulation and forecasting models the nation's central bank has been using.

And given his track record of critiquing modeling utilized by the Fed, it's a safe bet that people should pay attention to his comments regarding how the central bank is currently evaluating inflation risk.

A former Federal Reserve Board employee, who worked in its Special Studies Section during much of the 1970s and early 1980s during a time of tremendous economic upheaval, Dr. Barnett's landmark research as to how the Fed's use of inadequate and faulty monetary statistics helped undermine the economy in the run up to the Great Recession was the subject of an award-winning 2012 book (*Getting it Wrong: How Faulty Monetary Statistics Undermine the Fed, the Financial System and the Economy*, MIT Press). He also serves as Director of Advances in Monetary and Financial Measurement at the Center for Financial Stability in New York; and as Editor of the prestigious Cambridge University Press journal, *Macroeconomic Dynamics*. (For background on Dr. Barnett's remarkable career path from rocket scientist to renowned economist, see this 2017 interview on the Center for Financial Stability website; or *KU Economist*, spring 2018 issue.)

The *KC Star* column revealed that most central bank econometric models are "New Keynesian" in nature and are missing the Government Budget Constraint, an accounting identity providing that government spending must be equal to the sum of taxes, borrowing, and new money creation. Dr. Barnett went on to explain that without that accounting identity, the "seigniorage tax" – government revenue received from new money creation by the central bank – appears to be free.

"An implication of such defective models is that the central bank has a large store of magical fairy dust, which the central bank can sprinkle around the country to help people at no cost to anyone," he added.

On the other hand, classical economics suggests that when government spending is funded via the seigniorage tax (as it certainly was in historic terms during the pandemic), the public will end up paying for it in the future with the consequent inflation tax, which can often appear after a long lag. Following the inflation of the 1970s, Carl Christ at Johns Hopkins University and Nobel Laureate, Chris Sims, had similarly emphasized the need for that missing constraint in Keynesian macroeconomic models at the Federal Reserve.

"Since this conclusion is so elementary to anyone familiar with classical economic theory, the failure of the Fed to anticipate the consequences of government policies during the pandemic can only reflect a major defect in the models used to forecast inflation," Dr. Barnett opined. "It is time for the Federal Reserve to admit the failure of its models and make the needed corrections to avoid future major errors."