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## **How to protect the economy from the ghosts of 1979**

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When [Kevin Warsh](#) was nominated in January to be Federal Reserve chair, the monetary policy debate was over how quickly to [lower interest rates](#). The Fed forecast that inflation would return to the central bank's 2 percent target, already suggesting that interest rates should ease. The debate was over faster cuts. Artificial intelligence, the story goes, will swiftly raise productivity, making everything cheaper. Therefore, the Fed should quickly lower interest rates to steady prices and let wages rise.

Now, one could debate how soon and how reliably AI will create such bounty. One could also debate whether deflation (falling prices) with steady wages induced by AI-led productivity is a problem at all. Everything would become a lot more "affordable," of course. There's also an argument that higher real (after adjusting for inflation) interest rates are needed to induce savings and investment to build AI. Whether the Fed should act in anticipation of a productivity bonanza is another question.

But today the Fed faces essentially the opposite problem, a [stagflationary shock](#) that looks eerily like 1979. Inflation never really went away. It is [now surging](#), thanks to tariffs and energy costs via a conflict with Iran. Should the central bank fight that inflation by raising rates, swiftly incurring President Donald Trump's wrath and risking a weaker economy? Or should the Fed once again look through a price-level rise, hoping that the economy will stabilize at higher prices, and swiftly incurring the wrath of regular people already unhappy about today's high prices?

Warsh, who was confirmed by the Senate last week as chair, has advocated that the Fed reduce its balance sheet by selling assets. Most economists believe reserves past \$2 trillion or so have little long-run effect on the economy. But the Fed may be tempted to reduce reserves until bank operations are squeezed, in order to tighten without raising interest rates, a version of monetarist restraint. The United States tried a similar idea in 1980, imposing [credit controls](#) by tightening bank regulation. They produced financial chaos and stagnation.

Warsh wants to reexamine the Fed's models and overall approach. This is wise. Inflation, peaking at [9 percent in June 2022](#), was a failure that the Fed has not satisfactorily accounted for. It was not an individual failure. The Fed's actions were backed by consensus in and outside the central bank. It was a collective, conceptual, institutional failure. The models don't work. The forecasts don't work. But there is no off-the-shelf alternative. Nobody really knows how monetary policy works, and certainly not with the complex technocratic expertise that the Fed pretends. Other forecasts do not reliably outperform the Fed's.

The Fed should instead act with more humility. Recognize the fog in which it is trying to steer the ship. Refrain from acting (again) based on forecasts and what-if analyses that have proved unreliable.

Bigger challenges lie ahead. Because the [national debt](#) is beyond 100 percent of gross domestic product, every percentage point that the Fed raises interest rates increases interest costs on the debt and thereby the deficit by 1 percent of GDP. Neither Congress nor the president will be happy about that.

Fiscal pressure on the central bank will mount. Today's precedent for reduced Fed independence is the era from World War II to 1951, when it was obliged to hold down long-term rates for fiscal reasons, not 1972, when President Richard M. Nixon pressured the Fed for election-year ease.

Countries that run uncontrolled deficits soon face higher borrowing costs. The Fed will feel pressure to hold down those costs. "Moderate long-term interest rates" is, after all, part of the Fed's [legal mandate](#). With the precedents of massive bond buying in the 2010s and again in 2020, it will be hard to resist. Rising yields will also tempt

financial repression. The Fed will be tempted to force banks, insurance companies and other institutions to hold Treasury debt, impose capital controls and so on.

That's the optimistic scenario. In the next crisis, 2020 will replay at a larger scale. The Treasury will want to borrow trillions for bailouts, stimulus and likely military investment. But bond investors will be skittish, having suffered a substantial loss due to inflation last time they lent to the U.S., and with still no plan for the government to start repaying debts. Inflation expectations are primed to jump, so inflation itself can break out even more quickly. Pressure for the Fed to monetize government debt will be immense.

There is a limit to how much the Fed should resist. If Congress and the president want massive money-printing to finance a crisis response, should the central bank really force the government to borrow at much greater cost, spend differently, sharply raise taxes, restructure debt or withdraw from a confrontation? Tax, spending and foreign policy, even if unwise, are far outside the Fed's limited mandate.

I would rather see a Congress impose a strong price-stability mandate, with restrictions on bond-buying, but one that Congress suspends in times of crisis, as it did under the [Troubled Asset Relief Program](#) in 2008. Meanwhile, the Fed needs to face squarely its role in facilitating the fiscal blowout of 2020 and begin to think about resisting next time.

Many challenges lie ahead. But challenges are opportunities. Great leaders are forged by their wisdom in the face of adversity. And every time the president tweets his disapproval, Warsh's reputation for independence will grow.