

## **Cold War Lessons to Contain Russian Aggression & Risks to Rising Inflation What Happens Next in 6 Minutes – March 13th, 2022**

Larry Bernstein:

Welcome to What Happens Next in 6 Minutes.

My name is Larry Bernstein.

What Happens Next is a podcast where the speaker gets to present his argument in just Six Minutes and that is followed by a question-and-answer period for deeper engagement.

Today's discussion will be on two topics: Learning Lessons from the Cold War to Contain Russian Aggression and. Will Curbing Inflation Require a Recession?

Our first speaker will be Hal Brands who is the Henry Kissinger Professor of Global Affairs at John Hopkins SAIS. He is also the author of the new book entitled The Twilight Struggle: What the Cold War Teaches Us about Great-Power Rivalry Today.

I want to speak to Hal about these topics: How will the Ukraine war play out, how will it impact the great power rivalries going forward, and what does this mean for the relationship between the US, Russia and China? Can we split Russia and China? And what are the consequences of not doing so?

Our second speaker will be Desmond Lachman who works at AEI. Des has been a very good friend of mine for the past 25 years and we worked together when Des was the Chief Emerging Markets Economist at Salomon Brothers.

I want to learn from Des if the rising inflation is transitory and why is inflation rising so rapidly? If the economy is overheating, why are we still increasing fiscal stimulus, and why hasn't the Fed raised rates and why are they so far behind the curve?

And most importantly if interest rates are going to have to rise, what does this mean for stock, bond, and real estate prices? Des, how bad is it out there?

You can find transcripts for this program and all of our previous episodes on our website [whathappensnextin6minutes.com](http://whathappensnextin6minutes.com), and you can listen on Podbean, Apple Podcasts and Spotify.

Let's begin with our first speaker Hal Brands.

Hal Brands:

Thanks for having me, Larry. My recent book is called The Twilight Struggle: What the Cold War Teaches Us about Great-Power Rivalry. When we think about the US competition with China or

with Russia today, these are not the same things as the US/Soviet Cold War. Xi's China is not a Stalin Soviet Union or even Mao's China. Putin's Russia is not Stalin's Soviet Union either. Now, we worry about a beleaguered international order that's coming under strain. Back in the late 1940s, there was no international order and that was part of the problem.

The geography, the levels of economic interconnectedness are different. And when I talk about lessons of the Cold War, I'm not arguing that everything is the same and we can just simply rerun the Cold War playbook in vastly dissimilar circumstances today. We can learn by looking back on the Cold War for a couple of reasons. The first reason is that the Cold War itself wasn't that exceptional, it was just one manifestation of a much longer competition between great powers to shape the international system going back to the ancient world. We can see it in the early modern era, we can see it in the 20th century, the US/China and US/Russia relationships today are just part of this larger phenomenon as well.

There's one time in our history that we've geared up for extended decades-long competition with an authoritarian great power. And that is the Cold War.

The United States to succeed in the Cold War had to rally big unwieldy coalitions of allies. It had to blend competition with negotiation and cooperation. All Current events are making the history of the Cold War look more relevant.

We've had a period of heightened tensions in US/China relations over the past 18 months, it's become increasingly common to refer to the US/China relationship as a new Cold War. There's a nontrivial danger of hot war in flashpoints like the Taiwan Strait. And the competencies that were necessary to get through the old Cold War with the Soviet Union successfully are going to be necessary with China today. We're seeing the same thing when we look at US relations with Russia. Russia remains the more aggressive of the two great power rivals. And it's a country that we ignore at our peril.

Autocratic great powers are willing to use force in international affairs. Those conflicts present real risks of spillover and escalation. And the crisis in Ukraine has intensified protracted competition for influence with Putin's Russia in Eastern Europe and potentially beyond. We've had the luxury of 30 years of post-Cold War peace. That period's over now. We're heading into a period of much higher danger and we need to learn from the past if we're going to navigate the future and its challenges successfully.

Larry Bernstein:

Hal, how do you compare the beginning of the Cold War with today?

Hal Brands:

One of the really striking parallels is that during the early Cold War, the United States is often pushed along faster by its allies. NATO itself was a European initiative. Creating a transatlantic

alliance was about the last thing that Harry Truman had in mind. We did it because that was the only way of reassuring the Europeans.

In the Ukraine crisis, we've experienced about 10 years of history in 10 days. We've seen pledges to dramatically increase German defense spending, much more assertive foreign policies from countries in the European Union. Crisis catalyze big departures in American foreign policy. The threats that a communist insurgency to Greece and the Soviet pressure to Turkey led Harry Truman to go before Congress in March 1947 and give his famous two ways of life speech where he outlined the ideological rationale for the Cold War. It was the Korean War that led to the approval of NSC-68 and much higher defense spending along with a global network of alliances.

America's approach evolve in fits and starts. And those are often prompted by unexpected crisis like the ones we have today.

Larry Bernstein:

What do you think of John Mearsheimer's argument that it was a mistake to push our NATO alliance to Russia's borders because it scared Putin and forced his hand?

Hal Brands:

His argument was NATO expansion that antagonized the Russians and have caused them to lash out violently in Georgia and Ukraine.

I don't find that argument particularly persuasive. Russia has long sought to create a sphere of influence in its near abroad. It didn't need NATO expansion to want to exert that influence as it started to recover from the extreme weakness of the 1990s.

Larry Bernstein:

Yale professor John Lewis Gaddis wrote the definitive history of cold war strategy in his book *Strategies of Containment*. Gaddis describes two different methods to undermine Soviet aggression: The symmetric and the asymmetric approach. Symmetric implies that if the Russians attack the Ukraine, then we defend it. The asymmetric approach would be to challenge the Russians in a different way, economic sanctions, attack Russia somewhere else.

How could the US use asymmetry against Russia in the Ukraine?

Hal Brands:

I think asymmetric response is almost always desirable in principle. The idea of playing to your strengths, choosing areas of the competition where you can really thrive, not reacting to your opponents every thrust. That's really compelling, and has a strong logic as John points out in that book, which is the Bible of strategic studies from a historian's perspective. There were a

number of US initiatives during the Cold War that employed that asymmetric logic to very good effect.

The Marshall Plan was a great example of asymmetric containment. We're going to use money, technology, expertise, to revive the economies of Western Europe in a way that the Soviets cannot hope to match in Eastern Europe. The military strategies that the Reagan administration pursued in the 1980s as an example of asymmetric strategies. Make investments in missile defense, accurate precision-guided munitions that the Soviets can't match.

I don't know whether the economic sanctions are going to work, in terms of pushing Russia out of Ukraine. That's a big ask, but they have certainly shown that the United States and its allies can do an incredible amount of damage to a relatively significant economy in a short amount of time. This is the most comprehensive sanctions package ever put in place on a great power.

Russia has been almost totally disconnected from the world in the past 10 days, and the speed and severity of it has just been striking. It's a testament to the strength of US economic and financial power, especially when you combine us with our allies, and I'm sure the Chinese are taking note of this right now. The problem with asymmetric strategies is that they require leaving things undefended. If an asymmetric strategy doesn't succeed in getting the Russians out of Ukraine, then you've still got to deal with that problem. During the Cold War, asymmetric strategies didn't deal with the North Korean invasion of South Korea, which is why we ended up in a symmetrical response.

Larry Bernstein:

Will there be a peace deal in the Ukraine?

Hal Brands:

I don't think that Putin is going to go to the Ukrainians with a set of demands that they can accept. The minimal Russian demands still involve the destruction of Ukrainian sovereignty, the recognition of Russian sovereignty over Crimea and the Donbas, probably pretty severe constraints on Ukraine's political autonomy and its foreign policy.

I don't see the Ukrainians accepting that sort of settlement right now, because they would leave themselves vulnerable to the utter destruction of the Ukrainian state, and probably the murder of most of their political leaders.

Putin motivated his enemies in Ukraine. They're not going to give up. They're actually doing fairly well, militarily. I mean, shockingly well compared to what most expectations were at the outset.

I'm not entirely sure whose side time is on at this point. Maybe the Russians will get it together with their operations. Maybe they will start fighting in an even worse way, where they're just leveling major Ukrainian cities and ramping up the pain to where Zelenskyy feels that he has to

yield, but the Russians are going to start absorbing pretty high casualties. That's going to take a toll. They're starting to lose significant amounts of equipment.

They have 100% of their force that they mobilized committed in Ukraine. You can only keep that going for so long because people and equipment starts becoming combat ineffective, and the sanctions are going to bite harder with time.

Larry Bernstein:

Should the Ukraine consider hitting the Russians on their home turf to escalate the fight in an asymmetric way?

Hal Brands:

I don't think it helps the Ukrainians, militarily. Their problems are in Ukraine, not in Russia, and it hurts them politically, where they've been incredibly shrewd so far at garnering the sympathies of the democratic world, at positioning themselves as sort of the plucky underdog against the Russian Goliath, and if they start taking shots at major cities that could change relatively quickly.

I don't know that Ukraine has the offensive capabilities. The Ukrainians are going to be hard-pressed just to defend the major cities, prevent their forces from being encircled in key places.

There is a political dynamic here, the longer and the costlier the war gets for Russia, the more Putin has to worry about his own political standing at home. If not with the Russian people, then with the group of intelligence, military, and economic elites whose support he relies on to remain in power. And, one exit scenario from this war is that somebody in Moscow gets tired of Putin's costly war and takes matters into their own hands.

Larry Bernstein:

John Mearsheimer has stated that the real enemy is a great power that can challenge America's international order and today that is China and not Russia. So, we should try to get Russia on our side to balance the Chinese.

Hal Brands:

I think it's hard to argue right now when Russia has unleashed the largest interstate war in Europe since World War II that Russia doesn't present a significant threat to the existing international order. There are times when you really don't have an alternative but to take on multiple enemies at once.

During the early Cold War, the United States sought to contain communist China and the Soviet Union simultaneously. We should look for opportunities to play on differences between the Russians and the Chinese. If the Russians ever have a change of heart about their alignment, we should certainly welcome greater cooperation with them, but that's a pretty distant prospect.

We have to reconcile ourselves with the fact that we face two big threats to the international order that we've created, and we've got to deal with them both.

Larry Bernstein:

Since the end of the cold war, the US has combined hard military power with soft economic or cultural power, and the Europeans have encouraged diplomacy and soft power and objected to the use of hard power to solve disagreements, probably because Europe lacks hard power. And now, with the invasion of the Ukraine, soft power seems useless. Has this realization been the driving force for the European desire for moving toward acquiring hard power?

Hal Brands:

Well, Putin accomplished in a few days what the United States had failed to accomplish in about 10 years, which was to get Germany to take defense seriously. Ukraine is a really big country that has frontage on a bunch of Eastern European states. It's not that far from Germany. Putin's invasion has really driven home to European leaders in a very visceral way that they still live in a dangerous neighborhood, and there's no way of making the military math add up if Germany's going to spend 1.4% of GDP on defense.

If Putin had rolled through the Ukrainian defenses like a lot of people had expected, and had effective control over the most of the country right now, Europe's security situation would be a lot worse, because combined with the effective Russian occupation of Belarus, you would have a much-enhanced Russian ability to apply pressure against NATO states from the Baltic all the way down to the Black Sea.

And that really would be an epic security crisis for Europe that we haven't seen in decades.

Larry Bernstein:

Why didn't Putin find a diplomatic solution instead of attacking the Ukraine?

Hal Brands:

The Biden administration tried to give Putin a decent off-ramp. If you're really worried about NATO military deployments in Eastern Europe, we're willing to talk about that, and we're willing to address concerns about long-range strike systems. Putin was interested in the destruction of Ukraine as an independent state, and we shouldn't be surprised, because he's been telling us that for a number of years. Putin wanted war in this crisis, or he wanted a complete Ukrainian capitulation, which he probably only could have gotten through war. His behavior throughout this crisis simply reveals that.

Larry Bernstein:

It seems that the Russian military was caught off guard by the sudden invasion, as if they expected Putin to be only blustering.

Hal Brands:

As amazing as it sounds, I think the answer to that is yes. I think there was a very small circle of people around Putin who understood this was real, and most of the Russian military, perhaps even much of the high command thought it was diplomatic posturing, and I think that helps explain why a lot of the operations have been so shambolic.

Larry Bernstein:

Ok, let's say that the Russian military was taken by surprise by their supreme leader and now realize that they are in for the long haul in the Ukraine, can they regroup to win the battle?

Hal Brands:

That's a really interesting question. Militaries do typically learn in wartime. We're only, what 12 days into this conflict? They don't appear to be learning very fast, though, and that's a puzzle for me, and, and I can't tell whether that indicates that their heart isn't in it, or there's some other pathology that's preventing them from getting smart fast.

Larry Bernstein:

In the Cold War, the US and the Soviet Union did not fight directly but instead used proxies and provided arms to their respective proxies, is that what we will see in the Ukraine?

Hal Brands:

I think you're seeing a similar pattern today. Putin attacks countries that are not US allies. He doesn't attack countries that are US allies. The US provides the arms. It provides intelligence. It provides other forms of support to the Ukrainians. It doesn't send its own troops into combat. So far, there seems to be at least a semi-tacit agreement on the rules of the game on what each side can do without eliciting a military response. The question is, will it break down if Putin gets more desperate as the conflict goes on?

Larry Bernstein:

Do you think that the Russians will attack the NATO supply lines to the Ukraine?

Hal Brands:

Right now, he doesn't have the forces to cut down through western Ukraine and basically sever the land bridge between NATO countries and Ukraine. They might wish to do that, and if you get into a situation where there's a Ukrainian insurgency or something like that that's being supplied from the west, the Russians would certainly try to apply various forms of pressure to do that.

During the 1980s, the Soviets occasionally went across the border from Afghanistan into Pakistan to try to clean out some of the sanctuaries that the anti-Soviet guerrillas had created there.

Larry Bernstein:

If the Ukrainian masses are engaged in street-to-street fighting, do you think that Putin will get frustrated and turn to massive civilian attacks?

Hal Brands:

Well, he is already killing lots of civilians, unfortunately. There have been bombardments of civilian areas in major cities, targeting of civilians fleeing the fighting. It could get a lot worse obviously in the way that you allude to.

Vastly higher numbers of civilian casualties would provoke a really anguished debate in the United States and other societies about whether we should be doing more to defeat Russia in Ukraine. Any use of force in Ukraine obviously brings nuclear dynamics into play and not something that should be taken lightly.

I don't have sympathy for proposals for a no flight zone. But if this thing gets as ugly, then it would raise questions about whether deeper Western involvement in the war is warranted.

Larry Bernstein:

What Happens Next with the military engagement in the Ukraine?

Hal Brands:

The Russians have some major decisions to make in the next couple of weeks. Are they going to commit more forces to the fighting? Are they going to level the major cities as a way of coercing capitulation?

Putin is not going to give up. I don't think the Ukrainians want to give up either right now. I would not be surprised if we end up in a conflict that drags on. I'm driving in the dark as well as anybody.

Larry Bernstein:

What do you make of the private firms choosing to leave Russia?

Hal Brands:

This was relatively unexpected. I don't think many people predicted that you are going to see Russia isolated from the international economy as thoroughly over such a short period. And, this is provoking some degree of introspection, if not Putin then among people around him that they may have miscalculated the cost of this whole thing.

Private sector sanctions are not new. They played an important role in the end of an apartheid in South Africa, for instance, when major banks stopped rolling over South African debt in the late 1980s.

The Chinese have sanctioned entities that do business with Lithuania because Lithuania opened a Taiwan representative's office in Vilnius.

Larry Bernstein:

Has the Ukraine situation changed the Chinese calculus for invading Taiwan?

Hal Brands:

I think there are a bunch of interesting lessons. The Chinese need to double down on indigenous technological development. They've probably also been shocked by the ferocity of the international response.

This episode has shown the importance of talking in advance about what economic and technological sanctions you might put in place, if China were to jump Taiwan. It probably indicates that you want to strengthen your forward position in the Western Pacific. It's just a big reminder that major war is not passe.

Larry Bernstein:

I end each session on a note of optimism. Hal, what are you optimistic about?

Hal Brands:

Putin has reminded us of the fragility of the international order that served us very well. And it's already eliciting extraordinary efforts to shore up that international order against countries that are trying to destabilize it.

I'm optimistic that the West could end up in a stronger place if it uses this crisis as an opportunity to invest in a way that allows us to defend an international order that's come under strain.

Larry Bernstein:

Thanks Hal, and now I will turn to our second speaker Desmond Lachman who is an economist with AEI.

Desmond, why do we see 7.9% inflation?

Desmond Lachman:

The administration and the Federal Reserve would tell you that it's because of supply side problems. COVID interrupted the supply chain. You weren't getting electronic chips and all the rest of that and that's true, that that did curtail supply. But what they're not telling you is that

their demand policies were just totally reckless. If you start with the Biden administration, they come into office March 2021. They pass a \$1.9 trillion-dollar American Rescue Plan. That comes on top of \$3 trillion dollars in bipartisan support. So, you get an increase in government spending of \$5 trillion dollars, which is 20% of GDP. And the problem is that one had an output gap of something like 4, 5% at most.

The fiscal policy is excessive. Larry Summers, described that as, "The most irresponsible fiscal policy in the past 40 years." I would agree with that. Then have a Federal Reserve that they keep interest rates at zero. They buy bonds at a faster rate than Bernanke did in response to 2008. They buy roughly 4 1/2 trillion dollars of bonds in the space of 12 months. It took Bernanke six years to do that. They're letting the money supply balloon. The broad money supply, the last two years has increased by something like 40%. We haven't seen anything like this in 50 years.

So, it's no surprise that we've got this inflation. Now, we're getting hit by this Russian/Ukraine shock sending commodity prices through the roof. The number you saw, the 7.9%, doesn't incorporate the 70 cents a gallon increase in prices since the February 24th invasion. We're going to see inflation at 8 1/2, 9%. We're going to get to inflationary expectations unanchored.

The Federal Reserve, they've done two things by their reckless monetary policy. The one is they've produced inflation. But the second thing is they've produced asset price and credit market bubbles all over. Equities valuations are at a 100-year high, according to Case Schiller. Housing prices, even adjusted for inflation, we're above 2006 level. Then credit spreads narrowing like crazy. You've got a credit bubble. So that puts the Fed in a box now. You've got inflation out of control. It needs high interest rates. But high interest rates would kill these bubbles. So (laughs), they've really got a very delicate balance to do.

Larry Bernstein:

How do you explain the surge in inflation, I don't think supply chain disruption is responsible for price increases across all products: housing, autos, wages, its everywhere? Why is the Biden administration sticking to the supply chain causality and the transitory nature of inflation?

Desmond Lachman:

That is politically what they have to do. Biden is having to pander to his progressive base. He does the expenditures and then he's going to somehow explain that the inflation has got nothing to do with him. It's either going to do with COVID or Putin. The Fed is a lot less excusable.

The Fed, their job is supposed to be price stability and they've made huge misjudgments. What we learned in the '70s and '80s was that monetary policy operates with long and variable lags. Here, we've got a Fed that is so data-dependent, they don't anticipate things occurring.

March 19th, 2021, when Biden introduces this massive package, the Fed sticks to its same monetary policy. Really, it boggles my mind how incompetent this Federal Reserve has been. There's no excuse.

That inflation is the result of too much demand and too little supply. What they've done is that as the supply has gone down, they seem to have been increasing the demand either by ballooning budget deficits or by the Fed having its pedal to the metal. I don't see the logic of what they're doing.

They are talking about very gradual increases. Let's just look where interest rates are. Your interest rates at zero and inflation at seven.

But the point I'd emphasize is that for them to squeeze inflation out of this economy is not going to be easy because of the distortions not only in the United States asset and credit markets but it's a global. Federal Reserve along with the ECB, the Bank of Japan, the Bank of England. All of them doing the same thing, flooding the market with liquidity.

Larry Bernstein:

Any introductory macroeconomics textbook describes effective Keynesian economic policy when fiscal stimulus is applied counter-cyclically, but in the past year the Federal Government spent more money ever in a pro-cyclical action. The proposed Build Back Better bill would have added further stimulus of additional trillions. Other than Joe Manchin, every other Democratic member of the House and Senate supported the additional spending despite the Keynesian argument to cut spending. How do you explain the Democrats abandonment of Keynesian principles?

Desmond Lachman:

It's difficult. In the United States there's no constituency for sound public finances. Academics, they've been pushing this idea of modern monetary theory. Interest rates are low. You don't have to worry about budget deficits. Apart from Larry Summers, who got it right. But he was very much in the minority.

But the rules of economics don't change. I agree with you that without Joe Manchin, you would've had additional fiscal pressure. It just means that the inflation really gets out of control very, very soon.

Larry Bernstein:

Why weren't academic economists clamoring against increased spending given the economic strength and the supply constraints?

Desmond Lachman:

Academics got it terribly wrong in 2008, they didn't see that coming at all. So for the academics to get it wrong isn't that unusual. Many years of deflationary pressures, we've had China entering the global system, we've had technological progress at a very rapid rate putting downward pressure on prices.

So up until recently, all of the central banks had trouble getting inflation back to where they wanted it. You also had unusually low interest rates. You were at the zero bound. Inflation is so low, we can take risks on the side of inflation. We really don't want to go into this deflationary trap.

So that thinking was okay until you come to the pandemic and then you get the flood gates opening in a way that we've never seen before. Five trillion dollars of fiscal stimulus. When the gap is four percent, you're throwing 20 percent at it. It makes no sense. With monetary policy, what strikes me is you really don't get any mention of the money supply in any of the speeches that Powell gives.

They've really taken their eye off the ball. I have no idea what is the model that they're thinking. All I can say is they've got us into a huge inflationary mess and they've got us into a big equity, housing, credit market bubble. Not just in the United States but globally.

I think we're headed for a hard landing. It's just a question of what is the timing?

Larry Bernstein:

Milton Friedman said that inflation is always a monetary phenomenon. How does that explain the low inflation since 2008 and the rising inflation now?

Desmond Lachman:

When you look at money supply you've got to look at different kinds of money supply. You've got to look at very narrow money supply, what the base money that the Fed is creating, and broad money supply, what most people are holding. It's the broad money supply in Friedman's world that drives the inflation.

In 2008, the Fed did print a boatload of money, but the banks didn't lend that money. So the banks were holding the money, so you didn't get the broad money supply increasing like it did this time around. Now we had banks that were in reasonable shape, when COVID occurs, they get flooded with liquidity, so there's lending that goes on, so the money supply grows at a rate that we haven't seen before.

If you looked at the broad money supply in 2021, the increase is something like 25% in a single year. Generally, when you had peaks earlier, they would walk the order of eight, nine, 10%. You know, we hadn't seen 25%. So, it's an entirely different order of magnitude.

I'm not saying that I subscribe to Milton Friedman's view, because we found in the past that those aggregates weren't that accurate in predicting exactly what is going to occur. However,

when I saw a chart showing that money supply is doing something it hasn't done in 50 years that's really literally off the chart, that there's too much money around and that's overheating and the inflation.

Larry Bernstein:

Any thoughts on tight labor markets further pushing up inflation?

Desmond Lachman:

You've seen wage pressures. Wages increasing now at a pretty rapid rate. Job openings at record levels. You've got too much demand and you don't have an adequate amount of labor supply.

And that the danger for the Fed is that if these inflation numbers go higher, then the inflationary expectations can get unanchored and then we can get into this whole wage price story that we've seen before in the 1970s.

Larry Bernstein:

Why was the Fed saying that inflation is transitory?

Desmond Lachman:

They stuck to that mantra for a long while that inflation was transitory, that's month after month when it proved that it was increasing. They've abandoned that position, so Powell has withdrawn the word transitory, he now realizes that he has to raise interest rates. Previously, they were saying there were going to be no interest rate increases, now they're saying they're going to be three interest rate increases. What they've done is they've stopped the purchasing of all of those bonds. All of that should have been done at least six months behind the curve.

They recognize now that they do have an inflation problem. But the reason that I don't see them moving that rapidly, the first is that we're in the middle of a war. There's a lot of uncertainty, you don't want to move too quickly, do something rash and then regret it.

But it seems to me that the bigger reason is that the financial markets look to me like they're beginning to unravel, so they realize that there are limitations on how much they can do.

If they totally remove the idea that there's a Fed put, that could be very dramatic in the market, so they're between a rock and a hard place. They've got this inflation problem, but they've got the financial markets to worry about.

My guess is that what they do is they increase interest rates, but at too slow a pace to make much of a difference to the inflation story. They just kick the can down the road, but what it means is that the landing will be harder when they eventually are forced to slam on the monetary policy brakes.

Larry Bernstein:

Mistakes were made, why not admit them and raise rates quickly and sharply and get us on the right course, why delay things and continue with too low of an interest rate?

Desmond Lachman:

I would say that part of his behavior last year has to be associated with wanting renomination, knowing that raising interest rates could jeopardize his renomination. And I think that that's rather shameful to create an inflationary problem for which we're now going to pay.

Larry Bernstein:

40 years ago, we had high inflation and Volker raised rates. How is it different this time around?

Desmond Lachman:

Well, I guess the way that I see the difference between 40 years ago is that we didn't have these asset and credit market bubbles. So the recession is likely to be deeper this time than a normal recession.

But I would agree that once you've let the inflation genie out of the bottle, as we certainly have, then you're not going to get the inflation down without a period of much slower growth. So the economy really has to slow down. It probably has to go into recession in order to bring the inflation down.

There's not a free lunch that if you screwed up, there's a price you pay, there's no magic way of wishing this away.

Larry Bernstein:

What do you think of Charles Goodhart's thesis that deflation was caused by the one-time addition of Chinese labor to the international economy and that is now over?

Desmond Lachman:

I agree with him that China was a big deflationary force. As we incorporated China and India into the global economy, that put downward pressure on prices. And that probably has run its course.

Where I disagree with him is that you can get other factors to exert downward pressure on wages and prices, and that is technological progress.

If we really are going towards greater robotics, artificial intelligence, 3D printing, in my lifetime, I've seen technological progress make a huge difference. And if this occurs at a faster rate, that can be your offset to the China situation.

Larry Bernstein:

How will higher interest rates effect different sectors of our economy?

Desmond Lachman:

Interest rates will work in a different way this time around, instead of it necessarily slowing the housing market, slowing the auto market, the channel this time around could be through the financial markets.

A lot of these bubbles that we're seeing in the equity, housing, credit markets are premised on the idea that we're going to have zero interest rates forever, and then we see that the interest rates are actually rising meaningfully, and that deflates the bubbles that's the way we'll get the economy slowing.

Larry Bernstein:

How do you explain the significant negative real interest rates in G7 government debt?

Desmond Lachman:

If you look at the ECB and the Fed, between them, they've bought \$10 trillion of bonds. I don't know why one would be surprised that bond rates are that low. As the inflation goes, you might see something different.

The way I'm viewing the world is that I think the bond market has got it right that the short end of the curve is where the interest rate should go up, long should be down, because that seems to be, my view is that this is going to lead to all sorts of financial market dislocation. You get a deep recession, and then we back to the deflationary problem going forward. Short term, we are going to see inflation rise quite a lot.

I think that that's baked in the cake for a number of reasons. One is that this whole Ukrainian commodity price business that isn't in the numbers yet that can easily add alone one and a half, 2% to the inflation rate. Another thing on the inflation side is the housing component. You've got house prices going up by 20%, rents going up by 12%. And you look what they've got in the index, that goes up by three or 4%, so that typically works with a long lag. If you ask me where inflation would be the next six months, we've come pretty close to the 10% range.

But going forward, if we do have a 2008 kind of recession, then inflation's going to be the last of our problems. Nobody's really worried about the public debt anymore, and my experience has been that never ends well in the long, long run. You know, that generally, governments try to inflate this away.

Larry Bernstein:

Sounds like they are inflating it away right now.

Des, I end each episode on a note of optimism, what are you optimistic about?

Desmond Lachman:

I'm always reminded of Herbert Hoover's famous statement where he said, blessed are the children, they'll inherit the national debt. I don't think I'll be around to see the outcome of the real mess that my generation has made of the economies.

Larry Bernstein:

You need to work on your optimism Des.

Thanks to Hal and Desmond for joining us today.

That ends today's session. I want to make a plug for next week's show.

Our first speaker will be Rory MacFarquhar who is a close friend of mine. Rory worked in the Obama White House where he helped craft the Russian oligarch sanctions. I want to hear about why this time the West went all-in with sanctions and what are the long-term implications of this foreign policy approach.

Our second speaker will be Ruth Wisse who is an Emeritus Professor of Yiddish and Comparative Literature at Harvard. Ruth will speak about anti-Semitism, the growing intolerance of Zionism on college campuses, the failures in Holocaust education, and why Jews need to focus on achievement and abstain from being the victim.

If you are interested in listening to a replay of today's What Happens Next program or any of our previous episodes or if you wish to read a transcript, you can find them on our website [Whathappensnextin6minutes.com](http://Whathappensnextin6minutes.com). Replays are also available on Apple Podcasts, Podbean and Spotify.

Thanks to our audience for your continued engagement with these important issues, good-bye.