**EconoFact Chats: Understanding Current Inflation**

**Jay Shambaugh, George Washington University**

**Published on 26th July 2021**

Michael Klein:

I'm Michael Klein, Executive Editor of EconoFact, a non-partisan, web-based publication of the Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein:

I'm going to date myself here. These are some of the things I remember from the 1970s: disaster movies, disco, OPEC, Watergate, and inflation. Of these, the one that has raised concerns almost 50 years later is inflation.

Michael Klein:

The high and rising inflation of the 1970s shook people's faith in their economic security, raised fundamental questions about the government's ability to manage the economy, and caused macro-economists to doubt their theories. Now inflation seems to be emerging again. The big question is whether this is a transitory rise due to supply chain and stimulus issues related to the COVID-19 pandemic, or if we're about to be plunged into another era of disaster movies, disco, and high and rising inflation.

Michael Klein:

To consider the prospects for ongoing inflation and the ways in which inflation affects your economic well-being, I'm happy to welcome back to EconoFact Chats, Jay Shambaugh of George Washington University. Jay has made important contributions to economic research. He served as a member of President Obama's Council of Economic Advisers. And after that, he headed the Hamilton Project at the Brookings Institution. Jay, welcome to EconoFact Chats.

Jay Shambaugh:

Thanks, Michael.

Michael Klein:

Jay, let's start off with some basics. Can you give us a definition of inflation, and discuss the difference between inflation and high prices and why is that distinction important?

Jay Shambaugh:

So, if prices go up, that's inflation. It also means you'd have higher prices because they went up. But if the prices stay high and don't rise any further, that means you had that bout of inflation when the prices went up, but the inflation then is gone, the prices aren't changing anymore. So, I always think if gas prices go from $2 to $4, that's inflation. If they stay at $4, that may seem like high prices, but it's not more inflation. It's just high prices.

Michael Klein:

Dating myself again, back in 1974, when I was a teenager, I remember President Ford saying that inflation was the most pressing problem facing the United States. Not poverty, not inequality, not a range of post-Watergate political concerns, but inflation. But if inflation is an increase in all prices and wages, why isn't it neutral? That is, why doesn't my increase in my wage compensate me for say, a higher price of orange juice?

Jay Shambaugh:

Michael, it's a really good question. When I teach macro-economics, I sometimes try to get my students to explain what's bad about inflation, and it takes them a while because it's not obvious, just for the reason you said, if all the prices and wages and everything are going up at the same pace and everyone expects it to go up at that pace, it's not entirely clear what's wrong with that. The problem usually is not all the numbers change together, right? So in the end, not every price is moving up and down the same. Not all the wages are. So, you'll have some people's incomes, don't keep up with inflation, especially elderly people on fixed incomes, and especially people on minimum wages where those wages are staying fixed.

Jay Shambaugh:

So in that sense, you can have some people who really wind up losing from inflation. They lose purchasing power. Prices go up, but their wages don't. So, in particular, that issue shows up if that inflation's unexpected. So, some people might've made a contract or made a decision based on what they thought prices would be, and then they wound up going up a lot more.

Michael Klein:

Jay, who else is hurt or benefited by inflation?

Jay Shambaugh:

So, borrowers on fixed rates actually do very well with inflation. Going back to your 1970s example, if you took out a mortgage at fixed rates in 1973, before inflation took off, you did really well, right? Because suddenly your salary or wages start going up pretty fast as prices are rising with inflation, but your mortgage payment's actually getting cheaper and cheaper and cheaper in real terms. So, if you've got a fixed rate loan, great, it's very helpful for you as a borrower. On the other hand, if you're a lender, that generally means you wound up losing on the other side of the deal. So, that's basically where you'll see, we tend to think borrowers like inflation. Lenders, not so much.

Michael Klein:

When President Ford tried to rally people around inflation, he had this lapel pin that said win, W-I-N. And it stood for 'whip inflation now,' and that didn't work so well. In fact, people turn them upside down, so they read NIM, N-I-M, which they took to mean 'no immediate miracles.' Inflation was ultimately defeated more than five years after that through a recession. In fact, the deepest recession at that time, since the Great Depression. This was engineered by the Federal Reserve under its new chairman, Paul Volcker, and then we've had low inflation ever since pretty much, with a couple of short lived increases.

Jay Shambaugh:

Yes. So, after a decade-plus of elevated inflation, and after that deep recession, we had fairly low inflation for a number of decades. Former chairman, Ben Bernanke, he called this period the great moderation, where we had moderate but good growth, and moderate inflation. And what's really interesting is over the past decade or so, up until the last say three months, inflation had been too low. The Federal Reserve has a target of around 2% inflation, but inflation was persistently below that target, as you pointed out in an EconoFact memo.

Michael Klein:

Yeah. That memo was published almost four years ago. And in fact, more recently, last fall, when I spoke with Greg Mankiw of Harvard, he said that it's been a real puzzle for economists, why didn't inflation go up more than people thought it would during this period of strong growth in the 2000-teens? What about right now?

Jay Shambaugh:

Well, so in the last few months we haven't been worried about low inflation, right? We've been worried about suddenly prices rising. So, in 2020, price growth was really low as part of the pandemic, but in the last few months it's been picking up. And so, the headline that people probably have seen is that CPI inflation over the last 12 months ending in June, was 5.4%. We mentioned the Fed's target is around 2%. So, that's clearly a much bigger jump than we're used to seeing.

Michael Klein:

You pointed out, Jay, in a recent publication that you did for the Hamilton Project, that part of this recent rise comes from what economists call the base effect. Can you explain what that means?

Jay Shambaugh:

Sure. So as I said, what we'll talk about is how much did prices change over 12 months? Right? And so, one part of that is then what were prices 12 months ago? And if we think of where we are today, 12 months ago was June of 2020, we're in the middle of a shutdown, in the middle of a pandemic. Prices had actually gone down quite a bit. And so, you're comparing off an odd base when you compare it today to exactly 12 months ago.

Jay Shambaugh:

And so, one thing that I've liked to do over the last few months is look at inflation over a two-year period, because in that case, you can skip over the pandemic, both the crash in prices and the bounce back. And just say, what was the annual rate of inflation over that two-year period? And there, it turns out for what we call headline CPI, it's around 3%. And for core, where you strip out some of the noisy series, it's around 2.8%. So, nowhere near as shocking as that 5% looks, but also clearly above that 2% target.

Michael Klein:

Jay, can you describe the difference between what you've called and others call, core inflation and headline inflation?

Jay Shambaugh:

Sure. So, core inflation is we strip out series that are typically very volatile, right? And so, energy and food prices often bounce around a lot. They're a commodity set in markets where the prices can change quite a bit. And so, often people will strip those things out and just look at all the other prices. So, that headline that we talk about is a basket of all prices and core strips out those more volatile series.

Michael Klein:

And the reason that's done is because if you're thinking about the macro-economic determinants of inflation, core seems like a better indicator because you're having, as you say, these volatile prices not entering into it, isn't that right?

Jay Shambaugh:

That's exactly right. And so, if there's some sort of spike in oil prices because of a conflict in Libya, like in 2011, you wouldn't want to mistake that and think there is runaway inflation in the economy. It was a very specific shock leading to one particularly important price series going up a lot. And so, core inflation tends to be looking at things that are just more stable, and it's a better way to get a handle on whether prices overall are rising at a rapid pace.

Michael Klein:

Also, continuing on this topic, while inflation is measured for a basket of goods, it's not the case that all prices are rising together. That never happens. And sometimes, it's really quite different. You pointed this out in your Hamilton Project paper from April. At that time gas prices were rising faster than other prices and more recently used car prices have skyrocketed and they accounted for pretty big part of the rise in inflation that we saw. Lumber prices, for example, after rising a lot, have come back down. What do these disparate movements say about the prospects for continuing overall inflation?

Jay Shambaugh:

So, I think if the price increases we're seeing are primarily from very particular goods, that there is something unusual happening where supply and demand just aren't matching for that particular good, then you tend not to think of that as something that is likely to trigger ongoing inflation. So, lumber is I think the great example because we saw the prices spike as there was a lot of demand for both home building and home improvements, and there just weren't as many sawmills active, but fairly quickly, those prices turned around because a lot of saw mills just started operating on three shifts instead of one, to push more supply into the market.

Jay Shambaugh:

Autos has been a really important issue, as you note. In fact, a large chunk, I think 40% or maybe half of the price increase in the core CPI lately has been about autos, and a lot of that being used cars. And this is again where you can see some very unusual things happening. Auto production has been hampered by a supply of computer chips, which is partly pandemic related, and actually, partly goes back to the Trump Administration trade war with China, where we don't have as many chips flowing into the United States right now.

Jay Shambaugh:

And so we don't have as many cars being made, but it's also just in the used car market, you can get these odd things where there are fewer defaults right now because of the support during the pandemic to a lot of households, not as many people defaulted on their cars and those become used cars. And rental car company dynamics. And then, you combine that with people have some money now and they want to buy cars. And so, the prices for used cars have just gone up a lot, but it's less clear that we want to think about that as clearly something driving the overall economy or price level.

Michael Klein:

So, let's talk a little bit more about the determinants of inflation. We have a recent memo by Menzie Chinn and he mentions three factors, supply, demand, and expectations. Supply and demand as you've indicated, have been clearly affected by COVID, and the government's response to it.

Jay Shambaugh:

Yes, that's right. And so, we can think about the supply shocks being some of these that we just talked about, whether it's lumber or autos, as being clear issues where there's something with supply. And if the whole point is prices are set between supply and demand, if supply can't match demand, then you're going to see prices respond. Part of the point is, that's supposed to also cure the problem, right? So, the higher prices lead to more incentive to supply and may also make some people choose not to buy at the time. And so, we've clearly seen some issues on the supply side, especially in these particular areas.

Michael Klein:

That's like the sawmill example that you had, where they moved from one shift to three.

Jay Shambaugh:

Exactly. The saw mill or the used cars, and those are probably the most notable examples that we've got right now.

Michael Klein:

Yeah. Maybe I should sell my car now. Could make a killing out of it.

Jay Shambaugh:

You could help the problem, Michael, because you'd help push the prices back down if you sold.

Michael Klein:

I'd do it for the public good, of course.

Jay Shambaugh:

That's right.

Michael Klein:

What about-

Jay Shambaugh:

Go ahead.

Michael Klein:

What about the demand issues? People are pointing to the big government handouts to shield people from COVID recession as having this effect on prices because people have all this money hanging around.

Jay Shambaugh:

Yeah. And there's some truth to that. In a normal recession, people lose jobs, that reduces their income. They cut back on spending and that can make the recession even worse. This time, the government really stepped in with sizable support, so much that personal income is actually higher today than it was before the crisis. And so, that's a very unusual setup despite the fact that we're still millions of jobs lower than we were before. An added issue is that not everyone could spend that support or spend their own income, right? There were a lot of people, you weren't going to restaurants or movies or traveling or all of these other things for the last year, it's just built up a large block of savings in the economy. And now as the economy opens up, now as more people are vaccinated and feel like they can go out and spend safely, they've got money to do it.

Jay Shambaugh:

And so, that's that demand side. Where they're ready to go out and spend. I think some of this we've seen in what I would call bounce back inflation. So, prices for things that are just actually rebounding to where they used to be. So, if you look at airfares or hotel prices, they've gone up a lot in the last three months, but they're actually still below where they were two years ago. Right? And so in that sense, they're not surging in an unusual way. They're just saying, "Hey, we're no longer shut down. People have money and they feel safer going out and spending it." And so, that demand side is certainly showing up as well as the supply side.

Michael Klein:

The thing that really worries people about inflation is that it gets embedded. And Menzie talks about expectations, and that could cause inflation to stay high or even rise. This is clearly something that took hold in the late 1970s and it fueled inflation at that time. What do you think are the prospects for inflation expectations, bringing us back to the era of disco?

Jay Shambaugh:

Well, I think that is the legitimate fear and not just the fear of the disco, but the fear of expectations getting embedded. The idea is, it gets embedded in how people make decisions. And so, if I'm a firm and I need to set a schedule of prices over time, I might just build in and say, "Hey, I think prices are going to go up a lot more than 2% a year and I'm going to build that in." Or if I'm going to sign a new contract for rent with someone I'm going to, when I have a opportunity, bump the price a lot, because I think prices are going to rise over time. Or unions or workers might demand to build higher wage increases into their contracts because they expect higher inflation. And so, all of those things can build together in a way that pushes up prices.

Jay Shambaugh:

And I think one thing that's important there is if you look at both the 1990s and in the years right before the pandemic, the Federal Reserve was in some sense, able to push unemployment really pretty low and keep interest rates really low, in part because low inflation expectations were really embedded in the economy, in a way that people didn't see their actions as risking lots of inflation. And so, the concern is, do they become unmoored? Do we worry that we lose that? I would say this, that I think financial markets suggest that's not happening. Long bond rates are really low, they're down in the 1.2% to 3% to 4% range, they've actually fallen over the last few months even.

Michael Klein:

And that matters because long bond rates embed in them a protection against inflation. So, if inflation is expected to be higher, the long bond interest rate will be higher as well.

Jay Shambaugh:

That's right. And it also embeds in it, what people think the Federal Reserve might have to do. So, if they think the Federal Reserve is going to raise interest rates to combat inflation, then they would expect rates to rise over time and they would want a higher interest rate on long bonds than they on something say for 30 days. But we're not seeing that, we're not seeing in other financial market measures of inflation expectations, any kind of real jump, or for that matter in the Survey of Professional Forecasters, much of a huge jump.

Jay Shambaugh:

There's a little bit of an increase in consumers' expectations of inflation, but honestly, those really tend to track gas prices. And it's not a surprise why. You drive down the street, you see the price in huge numbers everywhere you go. When you see it go up, inflation becomes more salient to you. I mean, I will admit, there is some research that does point out that bond markets don't always do a great job of predicting some upsurge in inflation that's coming. So, I don't want to put too much stock in it, but I think it is an important data point to hold onto. This idea that people who are putting their money where their mouth is, are not expecting a huge surge in inflation.

Michael Klein:

One of the things you just mentioned, Jay, voices the real concern about inflation, that if it does in fact start to get out of control, the Fed will have to respond the way they did in October 1979, by engineering a deep recession.

Jay Shambaugh:

Yeah. And I think that is really the big fear. Is that again, does the world end if inflation is 3% instead of 2%? No, it doesn't. And it might have some bad impacts on some people at the margin, but the real concern is, do we see inflation rising in a way that the Federal Reserve decides to raise rates really quickly, faster than the market was anticipating, faster than businesses were anticipating and we wind up back in a recession to try to choke off that inflation? I don't think anyone wants to see a repeat of the late '70s, but they don't want to see a repeat of the Volcker recession, where the Fed tried to deliberately slow down the economy to choke off demand, to try to push inflation back down.

Jay Shambaugh:

And so, I think that at least is the best reason to be afraid of inflation. On the one hand, you could worry that it goes up faster than wages and that there are real wage declines for some groups. But I think really what you're also most worried about is you get one of these bad outcomes where prices rise, the Fed tries to choke it off, and we wind up with a recession.

Michael Klein:

So, Jay, I apologize for this, we've been friends for a long time, but I'm going to put you on the spot nonetheless. What do you think is going to happen to inflation and how concerned should we be? Or maybe to make it a little bit easier, are there thresholds that you're looking at and when we reach or even breach that threshold, then you would be more concerned?

Jay Shambaugh:

So, the Fed has taken the view that the uptick in prices is temporary. That's what they keep saying. And personally, right now, I think that still seems like a very reasonable view. The bulk of the increases we've seen have seemed to either be these rebounding prices, like airfares, or these things that very much seem like clear temporary shocks like used cars or lumber, which has already reversed. That said, we've never really tried to push the economy out of a recession this fast before, where both monetary and fiscal policy are working really aggressively to get the economy going this quickly. And we've never really seen a modern economy emerge from a pandemic recession before. So, I think some humility is really an order when people are making their forecasts. My own is that inflation will slow. I think 2021 will be above what the Fed had hoped, but 2022, it will start to slow down.

Jay Shambaugh:

I think we do still have evidence that expectations are anchored. I think fiscal support is slowing and that those supply and demand across sectors will start to normalize. And lastly I guess, I would just add to that, we still have a huge hole in the job market, right? There's still millions of people are not employed today who were employed in February of 2020. And the unemployment rate is still elevated from where it was, by quite a bit. And economists used to talk a lot about something called the Phillips curve, where inflation is higher when unemployment is lower. I think that relationship's a lot weaker than people used to think it is, and partly it's weaker because of anchored expectations, but we're still a long way from overheating in the labor market. It's not that there are no unemployed people to reemploy if firms want more workers.

Jay Shambaugh:

I don't think there's evidence we're far above our potential output as an economy. So, when you ask, what are the things that would change my view in these things? One would be if there was more evidence of those expectations getting deanchored in the financial market, that financial markets thought they were, that would worry me some. I think also, once we get to the fall, if the summer of sorting things out and reallocating and all of these things, as people re-emerge into the real world, as all of those things are over, if in the fall we're still seeing really rapid inflation, that we're not slowing down heading back towards 2022 being lower than '2, but in fact, seeing evidence that it might be even faster, then that would start to worry me a lot.

Michael Klein:

Well, here in New England things cool off in the fall, so I hope the same will be true of price increases. Jay, thank you very much for this interesting conversation and for your views on this issue, which has really taken on a very high importance these days.

Jay Shambaugh:

Thank you, Michael.

Michael Klein:

This has been EconoFact Chats. To learn more about EconoFact and to see the work on our site, you can log into www.econofact.org. You can subscribe on our site, to our newsletter, that will let you know when we publish new memos and new podcast episodes. Please feel free to share this podcast and our memos with friends, colleagues, and on social media. EconoFact is a publication of the Fletcher School at Tufts University. Thanks for listening.