EconoFact Chats: High Inflation: Causes, Consequences and Policy Responses

Karen Dynan, Harvard University

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Michael Klein:

I'm Michael Klein, executive editor of EconoFact, a nonpartisan 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:

Inflation was a major issue when I first started studying economics in the 1970s. In fact, for many people it was the major issue. Public opinion polls at that time identified inflation as people's biggest concern. Now after more than four decades, during which inflation was low and stable, we are seeing the highest inflation rate in 40 years. Correspondingly, inflation has once again climbed to the top of the list of the public's concerns. Last month the Pew Research Center reported that 7 in 10 Americans view inflation as a very big problem for the country, which is 15 percentage points higher than those who saw the affordability of healthcare or violent crime as a very big problem, and almost 20 percentage points higher than those concerned about gun violence or the federal budget deficit.

Michael Klein:

Why is inflation so high? What are the prospects for it coming down? What can be done? To answer these questions I'm very pleased to welcome back to EconoFact Chats Karen Dynan, a professor of the practice in the Department of Economics at Harvard University. Karen is very well qualified to speak to these issues. She's a prolific and influential scholar, and has had important high level policy experience having served as Assistant Secretary for Economic Policy and Chief Economist at the US Department of the Treasury from 2014 to 2017, and before that working as a staff economist for almost two decades at the Federal Reserve Board. Karen, welcome again to EconoFact Chats.

Karen Dynan:

Thanks, Michael, it's wonderful to be here.

Michael Klein:

It's great to have you again. Karen, what's happening with inflation in the United States and how does this compare to what's been going on in other advanced countries?

Karen Dynan:

Yeah, so over the past year inflation in the United States has climbed to very high levels, as you noted, the highest in 40 years. According to last Friday's Consumer Price Index report, overall consumer prices in May were 8.5% above where they were in May 2021, and core inflation, that's inflation excluding food and energy, was 6% on a 12 month basis. And we are seeing fairly similar patterns in many other advanced economies, for example, consumer inflation is almost as high in Europe and in the United Kingdom as it is in the United States. We are even seeing rising inflation in Japan where the level is still much lower than in the United States and Europe, but it's a striking development because Japan has struggled with low inflation for so long.

Michael Klein:

So struggle with low inflation, people now might not think that low inflation is a problem, but in an EconoFact memo that I published I explained why that is, although that memo, I guess, will have to be updated now, or I'll just rewrite it in Japanese, or something like that. Karen, inflation is defined as a rise in a price index, something that's supposed to capture prices throughout the economy. But if inflation was just adding an 8% increase to the price of food, the price of gas, rents, and wages and salaries, then it shouldn't really matter that much, it's just what economists call a nominal change, and in terms of hours worked, people are not paying more for things. But this isn't the case and inflation is clearly something that is very unpopular. Why is that?

Karen Dynan:

Yes, when people are asked why they don't like inflation, the first thing they typically mention is that it reduces their purchasing power, that the dollars that they earn every month just don't go as far because prices are higher.

Michael Klein:

So is this just a case of thinking about pay increases, or not thinking about pay increases due to inflation, but focusing on the cost of things that I'm purchasing instead?

Karen Dynan:

Well, it is the case that over longer periods of time, for example, over periods of maybe two or three or four years, wages and salaries tend to track price inflation. Some people come out okay, but this is not the case often over shorter periods, when inflation particularly is rising unexpectedly. So for example, various broad measures of wage growth right now show that earnings on the whole haven't kept up with inflation over the past year, and some industries, where worker shortages have been particularly acute, like in the leisure and hospitality industry, and in the retail and trade sector, wages have risen faster than prices, but even in those categories we're seeing some signs of slowing wages, even though price inflation isn't slowing. So that's a concern for people.

Karen Dynan:

The other thing about high inflation, if it's not expected, is that it can cause an arbitrary redistribution of purchasing power for people who are in longer term contracts. So you see this with workers on multi-year wage contracts, when they end up getting paid in dollars that have less purchasing power than they expected at the time when they negotiated their contracts. You see this with loans too, high inflation can be great for borrowers, and this was true for people who bought homes in the 1970s, because after we had inflation rise in the late seventies and early eighties, as borrowers got to pay back the loans in dollars that were worth less than they thought they would be, but it hurts the lenders who thought they'd get more real purchasing power back.

Michael Klein:

So you're describing inflation that has very different effects across the economy. Who tends to be hurt the most by inflation?

Karen Dynan:

Well, it depends on what else is going on in the economy, but I would say in general high inflation is hardest on low income households. So low income households, they're less likely to own homes and other types of assets that are hedges against inflation. For example, given the rise in home prices over the pandemic period, implicit rent for homeowners has risen a lot, but those homeowners also own an asset that has a much higher price, so that's helped offset the rise of implicit rent. But if you don't own a home, then you've just been stuck with higher rent. I would also say that lower income households typically have less financial reserves to insulate them from unexpected inflation. For example, it's a big deal right now for anyone who needs a car to get to work that gas prices are twice as high as they were a year ago. If you have extra money in your bank account, you can dip into that money to fund your gas, but if you don't have those kinds of reserves you might have to cut back on some other form of important spending.

Michael Klein:

So earlier you mentioned core inflation, which is inflation stripping out the rise in the price of food and fuels, and the price of food and fuels has risen faster than other prices. I imagine low income houses are also hurt by the fact that they spend a bigger proportion of their budget on food and fuels than richer households.

Karen Dynan:

Yes, that is certainly true, and with food and fuels rising, particularly right now, at a higher pace than even the rest of other goods and services, it has been, I think, felt particularly sharply by lower income households.

Michael Klein:

So that's the effects of inflation. Karen, how did we get to today's high inflation? Is it a situation of bad luck, or is it a situation of bad policy? Or is it some combination of the two?

Karen Dynan:

I would certainly say bad luck, and I would say there's a role for policy, although it's complicated as to whether you want to say bad policy, because some of the policies that boosted inflation have had other types of benefits. But anyway, the first piece of the story, and this is the component that's most related to policy, is strong consumer demand, with the story being that people saved a lot during the early part of the pandemic. So even though we had this massive job loss in 2020, incomes really held up across the income distribution for lower income households and higher income households, because we had these generous government support policies that replaced income. And at the same time we had consumption that was constrained, particularly in 2020, by people not wanting to engage in activities that might expose them to the virus. So by the end of 2020 people had accumulated larger than usual amounts of saving, which for people lower on the income distribution, who tend to not save very much, it really could make a big difference.

Karen Dynan:

But then you get to early 2021, and finally people were getting vaccinated in large numbers, and people were ready to get out there and spend and make up for lost ground. So we had this strong consumer demand, which is still with us today, putting upward pressure on prices.

Michael Klein:

So economists are trained to think about demand and supply, sometimes people say we're trained to think about very little else than demand and supply, but demand, I imagine, is only one part of the story supply also matters, especially in the era of COVID, right?

Karen Dynan:

Yeah, so supply constraints have also been a very important part of the story, and in fact failure to anticipate the size and persistence of those constraints helps explain why monetary policy didn't act sooner to address inflation. But basically it turned out that one can't restart a giant complicated economic machine overnight. And you've probably seen pictures of ships stacked up at west coast ports last fall, because ports had limited capacity to bring in all the goods that were being demanded. If you've tried to buy a new car you know that auto makers have not been able to make as many cars as they have wanted to because they haven't had enough semiconductors. You may have heard scary stories about medical devices that can't be completed because there's one critical part from Asia that's still missing.

Karen Dynan:

So these are all types of bottlenecks and supply chain issues, and they matter because it has meant that supply hasn't been able to rise to meet this strong demand, which has put more upward pressure on prices. The other thing I should mention on the supply side is the worker shortages. So when the economy was heating up in the late 2010s, an important reason we didn't see inflation rise was that the economy was able to ramp up production with just a modest increase in wages, because that was enough to bring people back into the labor force. And in 2021 I think policy makers were surprised by the reluctance of people who had been laid off during the pandemic to come back into the labor force, for reasons that we still don't entirely understand, whether it's fears of the virus, trouble getting childcare, or people taking time out because they have the money to fund it. But this worker shortage has basically exacerbated the effects of the supply chain issues and the other types of bottlenecks.

Michael Klein:

I think the issue of labor market is really important here. Somebody we both know, Julia Coronado, was on television recently, and the interviewer asked, "why is the economy doing so poorly?" And she said, "well, unemployment is very low." And so while people are really focused on inflation, it is striking that unemployment is what, 3.6% or so in its most recent report. So in this period of very high inflation we also have low unemployment. Karen, going back to the fact that different prices rise at different rates, supply and demand shocks over the past few years have meant very different rates of inflation across categories of goods and services, and you alluded to some of that before. Are we seeing inflation becoming more broad based now?

Karen Dynan:

Yes, we are seeing inflation becoming more broad based. Initially the upward pressure on prices was concentrated in goods, because there was a lingering reluctance to consume high contact services, and that meant that people were instead concentrating their spending on goods. And this created these pockets of acute pressure in terms of supply and demand, imbalances, particularly because of the supply chain problems that were constraining production or delivery. But that was early in the period of rising inflation. One of the most concerning developments over the past nine months or so is that inflation has got much broader, it's gone beyond these certain categories that we can tell special stories about in terms of demand and supply.

Karen Dynan:

So one way to gauge underlying inflation, broader inflation, is to look at measures that strip out the big increases where you think special factors are probably at play. So for example, the Dallas Fed publishes a series called trimmed-mean inflation, and that series, it didn't do much over the summer of 2021 when broader inflation was being pushed up by these special factors, but this series then took off in the fall of 2020 and is now at its highest level in three decades.

Michael Klein:

So trimmed-mean inflation, I guess they don't really want to use the acronym TMI because that has another meaning, so maybe they want to think of a different name. So I said economists think about demand and supply and that's about all, but for inflation we know there's another really important variable, and that is people's expectations. If people expect inflation to be higher, that can become a self-fulfilling prophecy because they'll ask for higher wages, which feeds into higher prices, which causes people to ask for higher wages, and so on. Is this currently something to worry about?

Karen Dynan:

Yes, it's something we should be keeping an eye on. Inflation expectations do appear to have an important influence on wage and price setting, as one would expect, and people have taken comfort in the fact that long-term inflation expectations, so what people expect over the next 5 or 10 years, they haven't risen that much, and even at their somewhat higher values now they aren't notably out of the range that we've seen over the last 20 years or so. But I think that view is probably too optimistic for several reasons. The first is that expected inflation over shorter horizons has moved up much more, so for example, the New York Fed's one year measure of inflation expectations, how much people expect prices to rise over the next 12 months, that's now gone over 6%.

Karen Dynan:

The second reason for concern is that people in businesses, they aren't just forward looking when they think about what wage and price increases they'll need to keep up with broader inflation, they look backward too, to what happened in the past. Perhaps not so much when inflation was low and boring in the decades before the pandemic, but now you can't turn on the news in the morning without seeing some stories about how much prices are rising. So the fact that we've already seen a bunch of inflation, that is influencing the wages and prices that people are targeting now.

Karen Dynan:

And I would say that the third reason for concern is that we are starting to see more action even in the longer term measures of inflation expectation. So last Friday the Michigan survey measure of long term inflation expectations popped up by 0.3 percentage points, which doesn't sound like much, but it was a large movement by the historical standards of the series, which has made analysts start to worry that this might be a signal that people are losing confidence in the Fed's ability to control inflation, and that inflation expectations, once they become unanchored, could rise much more in coming months.

Michael Klein:

So Karen, I'd like to ask you a bit about the policy response so far. Has your old employer, the Federal Reserve been doing a good job? We hear some people saying that the Fed dropped the ball, and other people saying that complaints are Monday morning quarterbacking, that at the height of the pandemic and the dislocations the Fed acted appropriately, and it would've been irresponsible for them to start raising rates as early as some other people requested. What do you think about that?

Karen Dynan:

Well, the Fed has started raising interest rates, and they have put unconventional monetary policy, so that's quantitative easing, which I'm sure you've talked about on past podcasts, they've put quantitative easing into reverse with the goal of taking the stance of monetary policy from being supportive of demand, where it still is now, to basically back to neutral, and then beyond neutral such that monetary policy is actually in tight territory and it's weighing on demand, and therefore correcting the imbalance between supply and demand. Those are certainly steps in the right direction.

Karen Dynan:

The other important thing the Fed needs to do is to maintain the credibility of the institution. The public needs to know that the Fed is on top of the situation and committed to bringing inflation back to acceptable levels in order to keep inflation expectations, as we just talked about, in check. And this is where I come to your question about whether the Fed misstepped or not. Yes, I think most people believe they were behind the curve in 2021, and they have acknowledged in hindsight that they were behind the curve, and I think recognizing that misstep is important to maintaining credibility. Chair Powell has also telegraphed that they're going be nimble and humble going forward, and I think that will help as well.

Michael Klein:

So humility's always good, I imagine. So far I've asked you relatively easy questions, I'm going to end with an unfair hard question. Karen, what are the prospects for the Fed to engineer a reduction in inflation without cratering the economy? You knew it was coming.

Karen Dynan:

I think it is a hard question. I think we're all looking for a soft landing, that's where economic growth slows, but we don't actually slip backwards in terms of growth, we don't actually go into recession, and that weakening of demand is enough to bring inflation gradually back to target. And I think that's certainly a possible outcome, but we really can't be certain. The good news is that economic activity does seem to be cooling, for example, we saw in the last labor market report that job growth seemed to be abating somewhat, we can see that housing demand is starting to be curbed by higher mortgage interest rates. So that's the good news. We need to recognize though that it's a long journey back to 2% inflation from where we are now.

Karen Dynan:

So there's certainly a role for tighter monetary policy, and at this point we don't know how much tighter monetary policy is going to have to be, in order to curb inflation, we just don't know if it's going to take a recession to sufficiently reduce inflation. So at this point I think the odds of recession, they're certainly elevated above the normal risk of inflation, but I think it's also important to keep in mind that going into recession does not necessarily mean unemployment nearing the double digit range that we saw in the early 1980s when the Fed sharply tightened in order to bring inflation down. I think given the underlying health of the US economy, we talked about the savings that people have, I think given that underlying health, I would expect any recession to be mild and short lived.

Michael Klein:

Well from your mouth to god's ear, as they say. Thank you once again for joining me on EconoFact Chats to talk about what has become one of the central economic and political issues of the day. I always learn a lot from our conversations, Karen.

Karen Dynan:

You're welcome, it was my pleasure.

Michael Klein:

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