EconoFact Chats: Directions for Economy Policy in the Current Macroeconomic Environment

Binyamin Appelbaum (The New York Times)
Megan Greene (Financial Times and Kroll)
Scott Horsley (NPR)
Greg Ip (The Wall Street Journal)

Published on 9th October 2022

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:

This is our sixth EconoFact Chats episode that features a panel of distinguished economic journalists. Binyamin Applebaum of the New York Times, Scott Horsley of NPR, Greg Ip of the Wall Street Journal, and joining us for the first time, Megan Greene, a columnist for the Financial Times, and also the Global Chief Economist at Kroll.

Michael Klein:

We last spoke in May 2022. Since then, inflation has persisted. The Federal Reserve has aggressively raised interest rates, as have other central banks. The dollar has strengthened. We averted a railway strike a few weeks ago that threatened to disrupt supply chains. The Inflation Reduction Act was passed into law. The longest reigning monarch in British history has died, and Britain went through a mini short crisis when new fiscal plans were announced but then reversed.

Michael Klein:

Binyamin, Scott, Greg, and Megan, I'm very interested in hearing your take on most of these issues, maybe not the queen's passing as much, but these other economic issues. And thanks for joining me today.

Megan Greene:

Thanks for having us.

Greg Ip:

It's good to be here.

Michael Klein:

Inflation remains the dominant economic issue in the United States, but information about inflation can be confusing. There's a difference, for example, between core inflation and headline inflation, and the inflation rate looks different if we consider how prices have changed over the past year as compared to how they've changed over the past month, at an annual rate. How do we make sense of these different indicators and are they telling us divergent stories? Greg?

Greg Ip:

Well, you're right. There's almost as many inflation indicators as there are economists and there are a lot of economists. So you can basically come up with the inflation rate you want, but the one that most people are familiar with is what we call the total Consumer Price Index, which tells us inflation in the last 12 months was around 8%. But we also know a lot of that was because of rising food and energy prices and we have seen indication that on average, both have started to move down.

Greg Ip:

So to try and get a better sense of underlying inflation trends like what will the inflation rate be when all these other sort of cross currents wash out, you can look at the core rate, which excludes food and energy. And the Federal Reserve actually looks at a different index altogether called the Index of Personal Consumption. And if you look at that index, it kind of tells the same story whether you look at it a three month, six month, or 12 basis. Inflation is running in the 4% to 5% area. So I think that's kind of what the bottom line is, that once all the supply chain disruptions and the energy stuff has basically washed out, we're looking at a rate of around 4%. Not nearly as bad as 8%, but roughly double the Federal Reserve's 2% target, and that's why the Fed is still committed to raising interest rates to try and get that number down.

Michael Klein:

Scott?

Scott Horsley:

We did get a little break in July and August with falling gasoline prices, which kind of helped to pull down the headline number on inflation. And we know that gas prices also have sort of an outsized psychological effect on the way people feel about inflation. So the Fed pays attention to those inflation expectations as well. Unfortunately, this past week we had OPEC and its partners, namely Russia announcing a big production cut in crude oil, which could send gas prices higher in the months to come. And we were already seeing retail gas prices rising in the latter half of September because of refinery outages on the West Coast and in Ohio. So that temporary reprieve we were getting from the really high gas prices of the spring could at least partially reverse, and that's not going to help things either.

Michael Klein:

Megan?

Megan Greene:

Yeah, I would just say that we economists like to look at core inflation because it strips out the really volatile energy and food prices, but actually, energy and food is something most people consume, and can't not consume. And so we kind of conveniently remove them from the equation, but that's what people are really paying attention to. I don't even own a car and I know what gas prices are. I think people are highly attuned to that. And also, inflation's just a deeply personal experience. We come up with this basket and provide weights to figure out what inflation is, but your experience with inflation depends on what you actually buy. And so if you're spending a lot on healthcare, then healthcare inflation matters a lot to you. If you own a home, then that might matter a lot to you. So whatever the headline figure says, I think people's experience with inflation is very different.

Michael Klein:

Megan, in fact, you had a recent column in the FT about that. You talked about food insecurity and the way that is affecting people.

Megan Greene:

Yeah, that's right. I think for all the attention that we've paid to rising energy costs, there's been relatively less attention paid to rising food prices. And I think that a food insecurity crisis, which seems to be abating a bit as food price inflation is coming down globally, but it has severe political and social effects, particularly across emerging markets, those countries that are heavily reliant on imports for food. We've already seen how it plays out in Sri Lanka, for example. Food insecurity crisis arguably kicked off the Arab Spring a number of years ago. And in both cases, in both the energy crisis and the food crisis, there was already a crisis before Russia invaded Ukraine. There were underlying problems that were exacerbated by the war. And I think that globally in policy terms, we're trying to do a lot to pivot on energy. There's relatively less being done to address the underlying fundamental drivers of the food insecurity crisis. And so I think that's going to be a problem that's going to be impacting a lot of people globally.

Michael Klein:

And part of what's happening in emerging markets and developing countries is that the price of commodities is linked to the dollar. And so the strength of the dollar has been raising food prices in these countries as well. One of the issues with inflation is 'what do people expect.' Because we know from our experience in the 1970s that high inflation expectations can actually lead to a dynamic that itself leads to high inflation. And it does seem that inflation expectations are linked to gas prices. And Scott, as you mentioned, gas prices had been falling, but now with this new shortfall or cut by OPEC+, gas prices might be rising again. What do you think the evidence is on what people expect inflation to be, and does that portend a more difficult or a less challenging effort by the Federal Reserve to bring down inflation? Binyamin?

Binyamin Applebaum:

Yeah. Inflation expectations are important because people's expectations inform their behavior, their demands for wage increases, the amounts that they're willing to pay for goods and services. Their planning for the future at both the individual and the corporate level, are all influenced by basically our expectations about where we think inflation is going to be over time. And the good news from the perspective of The Fed is that inflation expectations in the United States have remained remarkably constant, and remarkably low, even in the face of this period of inflationary pressure. People on the whole are still planning for a future in which inflation gets back down to something close to where it's been historically around that 2% number, that's the Fed's target. And that's really interesting because it suggests in part, that people have confidence that The Fed means it when it says that it will tighten the screws on the economy until inflation does get back down there. In part, it may just be the case that this hasn't been going on long enough to really reshape expectations. In the 1970s when inflation expectations became a really important driver in the persistence of high inflation, it took about a decade to really do that work, or at least it took a significant number of years before people really started behaving like high inflation was here to stay, and that created a problem that required a much more forceful response from The Fed. But in this case, we're still somewhere in the two year range for this surge in inflation. And at least to this point, it has not reshaped long-term expectations.

Michael Klein:

Megan?

Megan Greene:

Yeah. So I agree on the importance of inflation expectations. I would just highlight how difficult they are to measure. We have market based measurements of inflation expectations, but of course, the markets often don't get things right. There are consumer based measurements for inflation expectations, but people

don't get things right either. In fact, there was recently a survey that came out asking people what would happen to inflation when The Fed hikes rates, and the majority of people actually thought that inflation would go up. So there's a lack of understanding generally about how monetary policy works, where inflation even is; and so they're important, but they're really difficult to measure.

Michael Klein:

So that idea, when you have higher rates, you have higher inflation, that's what President Erdogan of Turkey claims is the case, and that's why he's been trying to say that cutting interest rates will lead to lower inflation, something that almost nobody agrees with. So the Fed is raising interest rates and the hope is that there can be, in fact what is called a soft landing, rather than a sharp, difficult recession. Greg, does the recent evidence, you think, show that there is going to be a soft landing?

Greg Ip:

Let's first of all define what we mean by a soft landing. So a recession is typically when the economy actually contracts and the unemployment rises materially. A soft landing is when economic growth slows, unemployment is roughly stable, or goes up a little bit, but the economy doesn't actually contract, and yet it's still slow enough for inflation to ease. Typically, in the past, soft landings have occurred when The Fed starts to raise interest rates to prevent inflation from going higher, but it's a situation where they're not actually committed to trying to get the inflation rate lower than it already is. That's different today. Inflation right now is too high for The Fed. It's, depending on how you measure it, 4%, 8% and the Fed wants it down to 2%. And every single time in the past when The Fed set out to try and push the inflation rate lower, it's always ended in a recession.

Greg Ip:

So based on that historical pattern alone, the odds of a soft landing do not look very good right now. But you might want to make a few special points about why this time is different. First of all, as Binya was saying a few minutes ago, if people's expectations of inflation are still really, really low, that suggests that they don't need a lot of convincing to adjust their wage and price behavior, so that low inflation actually comes about relatively painlessly. Another reason to be optimistic is that the inflation this time around seems to be heavily caused by disruptions to supply chains, even to the labor market. People who left the labor market because they were afraid of COVID or they changed where they live or they changed their type of job. As a result, we see an extremely high level of vacancies; of employers unable to fill jobs. It would be interesting if you had a softening in the labor market that showed up as employers simply not filling vacancies as opposed to laying people off. And indeed, some recent data is consistent with that story. In August, we saw a fairly significant decline in vacancies, and yet the employment report for September showed a nice increase in employment. It also showed a slowing in wage growth, which is exactly the kind of thing that The Federal Reserve wants to see. So you might say the data of the last month or two is consistent with a soft landing. I would add a word of caution though, which is that every hard landing starts out by looking like a soft landing. And the fact of the matter is we have a lot of Fed tightening in recent months that has yet to show itself on the economy. So I would not pop the champagne just yet.

Michael Klein:

Okay. We'll hold off on the champagne. Binyamin?

Binyamin Applebaum:

I guess I'd just make two points in addition to what Greg just said. The first is that one interesting difference between the current moment and some of the recent Fed induced recessions like Volcker's decision to crash the economy in the late 1970s, or Greenspan in the early 1990s, is that in those

instances, The Fed really set out quite explicitly and intentionally to crash the economy for the purpose of bringing inflation back under control. They said that they recognized that they needed to impose significant pain in order to reshape inflation expectations, and we're hearing The Fed talk differently this time. Now, I don't know whether that means we'll get a different ending to the story, but Fed officials have been much more cautious in talking about what they want to accomplish. They have suggested that they see a different balance than their predecessors did between the imperative of bringing down inflation and the danger of driving up unemployment. We've heard people like Mary Daly, the President of the Federal Reserve Bank of San Francisco, talk about the importance of not moving from the pain of inflation directly to the pain of unemployment, and punishing lower income families twice. Now, whether they're able to thread that needle, whether that actually delivers a soft landing, I think is a very open question, but it is a difference in mentality among the people who are trying to pull off that landing.

Binyamin Applebaum:

And then the other thing I'd mention is that it has been a surprisingly long time since The Fed did something like this. Our recent recessions have had different causes. The financial crisis was not a monetary policy induced recession, and the economy has changed a lot since then. And the way that monetary policy filters out through the economy and the structure of the economy, there is some interesting research suggesting that the impact of interest rates on economic activity is less direct, and less powerful than it was in say, the Volcker era. And I think there too, we don't know how exactly that's going to play out. So I have questions about... I think anybody would be right to be skeptical about the likelihood of a soft landing, but things are different this time in some important ways.

Michael Klein:

Scott?

Scott Horsley:

It's also important just to keep in mind the starting point here. We're starting from a point of very, very low unemployment. As of last Friday, it was 3.5% matching a half century low. So even if we were to see an uptick in unemployment, painful as that might be, you could have a modest rise in unemployment and still be at the very low end of unemployment by historical measures. So we've got a lot of runway here to try to engineer at least a soft-ish landing. Fed officials have said if they could manage to keep the unemployment rate say under 5%, they would count that as a win, even if though that might not qualify as a true soft landing.

Michael Klein:

So shifting a little bit from monetary policy to fiscal policy, and from the United States to the United Kingdom, a couple weeks ago we had this very dramatic event in the United Kingdom where Liz Truss, and the Chancellor of the Exchequer, Kwasi Kwarteng, released what they called a mini budget, which led to a near crisis in the United Kingdom. It was revealed recently that the Bank of England had to step in to prevent a meltdown of financial markets, and we saw the pound dip to almost parity with the dollar. What does this tell us, if anything, about fiscal policy more broadly or perhaps about fiscal policy in the United States, where we're reaching record levels of national debt. Greg, your thoughts on this?

Greg Ip:

So here's my take on what we have learned from the UK fiscal debacle. If you go back to pre-pandemic times, we were in a world where supply always seemed to be ample and demand was always constrained, investment was too low. In that world, inflation and interest rates were always low. Indeed, they were arguably too low. And so in that environment, central banks kept interest rates low and they almost welcomed deficit spending because deficits helped counteract excessively weak demand and low

inflation, low interest rates. That's not the world we're in any longer. We're in a world now of constrained supply, whether it's the supply of energy or the supply of labor, and a fairly strong demand bumping up against that supply. And that manifests itself as persistent inflation problems, not just in the United States, but almost every country. And central banks understand that we're in a new world, which is why they're moving to raise interest rates as quickly as they are. But it doesn't look like elected leaders and budget makers have realized that we're in a new world, and in most countries, not just UK, they still continue to borrow as if there are no limits on what they can borrow. And I think that lesson from the UK situation is that's just not true. Now, we know that part of the selloff in British markets was because of derivative positions that pension funds had entered into, which then amplified the selloff as they were forced out of those positions. But that is not the only market where a lot of people have been assuming that long rates will last forever. So I would expect those dynamics to recreate themselves elsewhere.

Greg Ip:

And the Americans really should not be looking smugly at the British as if that can't happen to them, because it can. And in fact, Joe Biden, for all his rhetoric about being for lower inflation, has borrowed, I think about $5 trillion since he became president through things like the Stimulus Act, through things like the Infrastructure Law, through executive actions, which expanded food stamps. And now he wants to forgive anywhere from half a trillion to a trillion dollars of student debt. It is not that different from exactly how much Prime Minister Liz Truss intends to borrow in the UK. So it looks to me like you look around the world, you still have government leaders who do not yet realize that we're in a different world when it comes to deficits.

Michael Klein:

Binyamin?

Binyamin Applebaum:

So I agree with Greg's analysis. I guess I'm relatively less concerned about America's fiscal situation. I don't think we're comparable with Britain in some important respects, but I do think that fiscal policy makers are still very much in an old mindset, and I will hazard the prediction that we are going to see a couple of countries have much more painful experiences than Britain just did, before that mindset shifts. There are going to have to be some examples made before people learn the lesson.

Michael Klein:

Binyamin, picking up on what Greg mentioned about supply constraints, you had a recent editorial in The New York Times about what's happening with housing in California. Now, we know that there are real difficulties with the supply of housing and then this spills over to other issues like labor markets because it becomes difficult for people to move from one place to another. Can you talk a little bit about what you raised in that article and what's happening in California?

Binyamin Applebaum:

Yeah. If you sort of take a big picture look at inflation dynamics in the United States, one of the interesting things that's happened in recent decades is that even before this current period of intense inflationary pressure brought on by the pandemic and its aftershocks, we had this long-term trend in which we have been constraining the supply or failing to adequately supply some of the things that people need and want and spend the most money on. And so we've seen over time, the cost of healthcare and the cost of education, and most of all, the cost of housing going up, up and away as a share of household expenses relative to other goods and services. These are hugely undersupplied things in our society, and housing is really perhaps to my mind, the most outrageous example. What you have is a situation in which we've inverted the long standing pattern. It used to be the case that the most prosperous areas

produced the most housing because the most people wanted to go and live there. That is the story of the growth of New York in the 19th and 20th centuries. And what we now have is the situation in which the most prosperous places produced the least housing, and make it the hardest to live there, and California is the outstanding example of this. It's a place where there are lots of good jobs, but nobody can afford to move there and live there and prosper there. The state produces nothing like the amount of housing that it needs because it has handed power over to local governments to control the supply of housing, and those local governments are basically private cubs of individuals who benefit from rising home prices and they fiercely resist any development. And so California ends up with less housing than it needs. That column was about a small bit of good news in terms of California's approach, but more important than those changes is the broader pattern which persists, which is that we are underproducing housing, massively underproducing housing.

Michael Klein:

So this is an example of NIMBY, right Binyamin? Not in my backyard, keep housing constrained, Keep the value of your house higher.

Binyamin Applebaum:

Yeah. That's the term people throw around for the mentality of people in many of these communities, who to the extent that they're willing to acknowledge that a problem exists, are pretty consistent in suggesting that it should be solved by building housing somewhere else.

Michael Klein:

Scott?

Scott Horsley:

Well, and ideally, you'd like to have a situation where people can move to the places where their opportunities are greatest. And before the pandemic, we'd seen a pretty sizable slowdown in mobility in the US for all sorts of reasons. There was some hope that with the rise of remote work during the pandemic, maybe that there'd be more opportunities for people to move to more affordable places, but now we have this sort of perverse situation where you have a lot of folks who are going to be perhaps locked in by the sort of golden handcuffs -- folks who own homes with low mortgage rates now are going to have a disincentive to move elsewhere, and have to pay a much higher mortgage rate if they move. So that could really constrain our ability to take advantage of opportunities of mobility.

Michael Klein:

I'd like to turn to another topic for a moment, the Inflation Reduction Act, which wasn't so much really about inflation perhaps, but more about moving the country towards a more green future. Do you think that this could in fact have a measurable impact on the carbon footprint of the United States? Greg?

Greg Ip:

It definitely will. There are calculations that, for example, it gets the US materially closer to its Paris commitments to reduce emissions. But I would venture to say that's actually not the most significant accomplishment of this law because most of those near-term reductions will simply come through the greater diffusion of technologies that are already relatively mature, like wind and solar and to a certain extent, battery storage technologies that are more or less competitive, cost competitive with fossil fuels. To me, the more exciting part of this law is the stimulus it gives to frontier technologies like hydrogen and carbon capture and storage, and direct air capture. These are technologies that are really just at the frontier and they're not really commercially viable yet, but if we see those technologies following the

same path that solar and wind did, then as they get built out and there is more... the manufacturing base grows, we start to see economies of scale and learning by doing kicking, and those costs start to fall. And the reason that's exciting is that those technologies are essential to really get at really hard to decarbonize sectors like cement and steel and agriculture.

Michael Klein:

So one of the points that Greg brings up is that there's a role perhaps for the government in trying to foster innovation at a point where it might not be commercially viable yet, but it's sort of a jumpstart for it, and we also see this with chip technology. I recently interviewed a colleague of mine, Chris Miller, who wrote a wonderful new book called Chip War, where he talks about the role of government. What do you think the government should be doing for semiconductors and for microchips and for advanced technologies? Is there a role for the government to do this? And initially, it was through the Defense Department, and then it went through other agencies as well. What do you see as the government's role in advancing these kinds of high technologies outside of green technologies? Binyamin?

Binyamin Applebaum:

I think that it is interesting to look at research and development spending in the United States over the last half century, because the total amount of money that the nation invests in R&D has increased a little bit over that period, but the composition has shifted dramatically. If you go back to the beginning of the period, more than two-thirds of that investment was government spending, and that's basically flipped now, and investment comes predominantly from the private sector. And I think that's consequential because we have seen a pattern in which corporations are more interested investing in late stage or market ready technologies and improving existing technologies or finding variations on a theme, and that it is government funding that has long provided the basis for significant innovation for new areas, that there are kinds of projects that are unlikely to be funded at the level that will ultimately be optimal for society unless the government provides those resources. So I think that is a legitimate area in which the government has a role to play and probably a larger role than it's playing at present. Where I think things get much more controversial is when we move into the realm of what's often called industrial policy, which is the question of whether the government should be subsidizing in various ways, the production of market ready technologies. There are a growing number of economists and advisors to the Biden administration who strongly favor those kinds of approaches, but I think there's still a lot of questions about how that works, at what cost, what are the trade offs. And that, I think is where the debate gets a lot more complicated.

Michael Klein:

Yeah. I think that is going to be a big issue of debate as we move forward. Scott?

Scott Horsley:

Yeah. Industrial policy was kind of a dirty word in this country for a long time, and there was a sort of consensus that the government was not very good at allocating resources to successful enterprises. Maybe at the basic research stage, there was a role to play, but when it came down to market ready technologies, there wasn't a role. We've seen a real turnaround now with the CHIPS Act piece of the Inflation Reduction Act. The government's putting a lot of money into mature technologies to encourage the development of computer chips in this country as opposed to in Taiwan or overseas. We'll see how that plays out. We'll see if ultimately that's judged to be successful. It's not necessarily all driven by economics. It's partly driven by geopolitics, and some of the supply chain disruptions we saw during the pandemic, but whether the government is ultimately a good venture capitalist, we'll see.

Binyamin Applebaum:

Yeah. If I can just say one more thing about that. The reason that semiconductors are made primarily in Taiwan and in South Korea, at least the advanced ones, is because those governments engaged in industrial policy. They bought those advantages. They invested heavily in securing their market leading positions. And I think the two questions... so that's absolutely true. And then the two questions one needs to ask is how good has that been for them? And how bad has it been for us? Do we suffer if we're buying our semiconductors from Taiwan? What does it mean that we rely on trading partners and make other things instead? So that's where it gets complicated. But there's no question that the location of semiconductor manufacturing has been determined by government policy.

Michael Klein:

Yeah. Chris Miller's book does a really nice job of explaining that, and also explaining how incredibly complicated it is to make these things. At one point, I was laughing because you have to have these nano size pieces of tin shot with a laser 500,000 times a second in order to produce enough...it just seems like magic that it actually works. So it's incredibly advanced technology, and there are only a few places in the world that can actually do this. Greg?

Greg Ip:

I would actually go a bit further than Scott did, and I would say that we haven't got any good evidence that governments are any better at picking winners today than they were in those days when nobody thought industrial policy was smart. We are pouring all this money into semiconductor manufacturing at a time when semiconductor prices and the share prices of semiconductor companies are plunging because there is currently actually a glut of the most advanced chips. So why are we doing it anyway? I think it's because, well, we don't buy fighter jets from other countries even when it's cheaper because we think that's dangerous for our national security. We now think of semiconductors as similar to fighter jets. We do not want to end up in a situation where we depend on countries like China for something so important. So in some sense, we willingly subsidize something knowing that it's not actually economically very efficient, because there's a larger principle at stake, which is that we need not to be dependent on adversaries for this. In economics, we call these externalities. These are costs that emerge from market transactions that are born by society. If we ended up in a situation where we depended entirely unstable or adversarial places for these key technologies, that would impose a cost that we may only come to realize at a time when we are at war.

Michael Klein:

Yeah. Chris points out in his book how Russia really failed in developing this, and so the weapons systems, for example, that Ukraine is now using are much more advanced, and we have these smart bombs and things like that. So I want to thank you once again for this really interesting conversation. There's so many things that are going on now, from semiconductors, to the inflation problems facing the United States and other countries, and fiscal problems, and I really appreciate that you were able to share your insights on this today. Thanks again for joining me.

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. EconoFact is a publication of the Fletcher School at Tufts University. Thanks for listening.