Inflation: Transitory or Persistent?

From today's Signal:

It started growing in the spring, crept up in the summer, and exploded in the fall. Inflation now dominates the political conversation in many countries. COVID-related disruptions to supply chains are considered the primary cause, but economists also argue about other factors like too much stimulus spending. ...

On December 16th two noted economists provided their current opinions. Team Transitory Krugman, who writes for the NYT, and whose opinions we rarely share, comes as close to admitting that he may be wrong as we've seen. Team Persistent Summers writes for the WP. If you have read what we have previously shared on the subject, our view should be clear:

The Year of Inflation Infamy

By Paul Krugman

I will always associate inflation with the taste of Hamburger Helper.

In the summer of 1973 I shared an apartment with several other college students; we didn't have much money, and the cost of living was soaring. By 1974 the overall inflation rate would hit 12 percent, and some goods had already seen big price increases. Ground beef, in particular, was 49 percent more expensive in August 1973 than it had been two years earlier. So we tried to stretch it.

Beyond the dismay I felt about being unable to afford unadulterated burgers was the anxiety, the sense that things were out of control. Even though the incomes of most people were rising faster than inflation, Americans were unnerved by the way a dollar seemed to buy less with each passing week. That feeling may be one reason many Americans now seem so downbeat about a booming economy.

The inflation surge of the 1970s was the fourth time after World War II that inflation had topped 5 percent at an annual rate. There would be smaller surges in 1991 and 2008, and a surge that fell just short of 5 percent in 2010-11.

Now we're experiencing another episode, the highest inflation in almost 40 years. The Consumer Price Index in November was 6.8 percent higher than it had been a year earlier. Much of this rise was due to huge price increases in a few sectors: Gasoline prices were up 58 percent, used cars and hotel rooms up 31 percent and 26 percent respectively and, yes, meat prices up 16 percent. But some (though not all) analysts believe that inflation is starting to spread more widely through the economy.

The current bout of inflation came on suddenly. Early this year inflation was still low; as recently as March members of the Fed's Open Market Committee, which sets monetary policy, expected their preferred price measure (which usually runs a bit below the Consumer Price Index) to rise only 2.4 percent this year. Even once the inflation numbers shot up, many economists — myself included — argued that the surge was likely to prove transitory. But at the very least it's now clear that "transitory" inflation will last longer than most of us on that team expected. And on Wednesday the Fed moved to tighten monetary policy, reducing its bond purchases and indicating that it expects to raise interest rates at least modestly next year.

Inflation is an emotional subject. No other topic I write about generates as much hate mail. And debate over the current inflation is especially fraught because assessments of the economy have become incredibly partisan and we are in general living in a post-truth political environment.

But it's still important to try to make sense of what is happening. Does it reflect a policy failure, or just the teething problems of an economy recovering from the pandemic slump? How long can we expect inflation to stay high? And what, if anything, should be done about it?

To preview, I believe that what we're seeing mainly reflects the inherent dislocations from the pandemic, rather than, say, excessive government spending. I also believe that inflation will subside over the course of the next year and that we shouldn't take any drastic action. But reasonable economists disagree, and they could be right.

To understand this dispute, we need to talk about what has caused inflation in the past.

Inflation, goes an old line, is caused by "too much money chasing too few goods." Alas, sometimes it's more complicated than that. Sometimes inflation is caused by self-perpetuating expectations; sometimes it's the temporary product of fluctuations in commodity prices. History gives us clear examples of all three possibilities.

The White House Council of Economic Advisers suggested in July that today's inflation most closely resembles the inflation spike of 1946-1948. This was a classic case of "demand pull" inflation — that is, it really was a case of too much money chasing too few goods. Consumers were flush with cash from wartime savings, and there was a lot of pent-up demand, especially for durable goods like automobiles, after years of wartime rationing. So when rationing ended there was a rush to buy things in an economy still not fully converted back to peacetime production. The result was about two years of very high inflation, peaking at almost 20 percent.

The next inflation surge, during the Korean War, was also driven by a rapid increase in spending. Inflation peaked at more than 9 percent.

For observers of the current scene, the most interesting aspect of these early postwar inflation spikes may be their transitory nature. I don't mean that they went away in a matter of months; as I said, the 1946-1948 episode went on for about two years. But when spending dropped back to more sustainable levels, inflation quickly followed suit.

That wasn't the case for the inflation of the 1960s.

True, this inflation started with demand pull: Lyndon Johnson increased federal spending as he pursued both the Vietnam War and the Great Society, but he was unwilling at first to restrain private spending by raising taxes. At the same time, the Federal Reserve kept interest rates low, which kept things like housing construction running hot.

The difference between Vietnam War inflation and Korean War inflation was what happened when policymakers finally acted to rein in overall spending through interest rate increases in 1969. This led to a recession and a sharp rise in unemployment, yet unlike in the 1950s, inflation remained stubbornly high for a long time.

Some economists had in effect predicted that this would happen. In the 1960s many economists believed that policymakers could achieve lower unemployment if they were willing to accept more inflation. In 1968, however, Milton Friedman and Edmund S. Phelps each argued that this was an illusion.

Sustained inflation, both asserted, would get built into the expectations of workers, employers, companies setting prices and so on. And once inflation was embedded in expectations it would become a self-fulfilling prophecy.

This meant that policymakers would have to accept ever-accelerating inflation if they wanted to keep unemployment low. Furthermore, once inflation had become embedded, any attempt to get inflation back down would require an extended slump — and for a while high inflation would go along with high unemployment, a situation often dubbed "stagflation."

And stagflation came. Persistent inflation in 1970-71 was only a foretaste. In 1972 a politicized Fed juiced up the economy to help Richard Nixon's re-election campaign; inflation was already almost 8 percent when the Arab oil embargo sent oil prices soaring. Inflation would remain high for a decade, despite high unemployment.

Stagflation was eventually ended, but at a huge cost. Under the leadership of Paul Volcker, the Fed sharply reduced growth in the money supply, sending interest rates well into double digits and provoking a deep slump that raised the unemployment rate to 10.8 percent. However, by the time America finally emerged from that slump — unemployment didn't fall below 6 percent until late 1987 — expectations of high inflation had been largely purged from the economy. As some economists put it, expectations of inflation had become "anchored" at a low level.

Despite these anchored expectations, however, there have been several inflationary spikes, most recently in 2010-11. Each of these spikes was largely driven by the prices of goods whose prices are always volatile, especially oil. Each was accompanied by dire warnings that runaway inflation was just around the corner. But such warnings proved, again and again, to be false alarms.

How 2021 happened

So why has inflation surged this year, and will it stay high?

Mainstream economists are currently divided between what are now widely called Team Transitory and Team Persistent. Team Transitory, myself included, has argued that we're looking at a temporary blip — although longer lasting than we first expected. Others, however, warn that we may face something comparable to the stagflation of the 1970s. And credit where credit is due: So far, warnings about inflation have proved right, while Team Transitory's predictions that inflation would quickly fade have been wrong.

But this inflation hasn't followed a simple script. What we're seeing instead is a strange episode that exhibits some parallels to past events but also includes new elements.

Soon after President Biden was inaugurated, Larry Summers and other prominent economists, notably Olivier Blanchard, the former chief economist of the International Monetary Fund, warned that the American Rescue Plan, the $1.9 trillion bill enacted early in the Biden administration, would increase spending by far more than the amount of slack remaining in the economy and that this unsustainable boom in demand would cause high inflation. Team Transitory argued, instead, that much of the money the government handed out would be saved rather than spent, so that the inflationary consequences would be mild.

Inflation did in fact shoot up, but the odd thing is that overall spending *isn't* extraordinarily high; it's up a lot this year, but only enough to bring us more or less back to the prepandemic trend. So why are prices soaring?

Part of the answer, as I and many others have noted, involves supply chains. The conveyor belt that normally delivers goods to consumers suffers from shortages of port capacity, truck drivers, warehouse space and more, and a shortage of silicon chips is crimping production of many goods, especially cars. A recent report from the influential Bank for International Settlements estimates that price rises caused by bottlenecks in supply have raised U.S. inflation by 2.8 percentage points over the past year.

Now, global supply chains haven't broken. In fact, they're delivering more goods than ever before. But they haven't been able to keep up with extraordinary demand. Total consumer spending hasn't grown all that fast, but in an economy still shaped by the pandemic, people have shifted their consumption from experiences to stuff — that is, they've been spending less on services but much more on goods. The caricature version is that people unable or unwilling to go to the gym bought Pelotons instead, and something like that has in fact happened across the board.

Here's what the numbers look like. Overall consumption is up 3.5 percent since the pandemic began, roughly in line with normal growth. Consumption of services, however, is still below prepandemic levels, while purchases of durable goods, though down somewhat from their peak, are still running very high.

No wonder the ports are clogged!

Over time, supply-chain problems may largely solve themselves. A receding pandemic in the United States, despite some rise in cases, has already caused a partial reversal of the skew away from services toward goods;

this will take pressure off supply chains. And as an old line has it, the cure for high prices is high prices: The private sector has strong incentives to unsnarl supply chains, and in fact is starting to do that.

In particular, large retailers have found ways to get the goods they need, and they say they're fully stocked for the holiday season. And measures of supply-chain stress such as freight rates have started to improve.

Yet supply-chain problems aren't the whole story. Even aside from bottlenecks, the economy's productive capacity has been limited by the Great Resignation, the apparent unwillingness of many Americans idled by the pandemic to return to work. There are still four million fewer Americans working than there were on the eve of the pandemic, but labor markets look very tight, with record numbers of workers quitting their jobs (a sign that they believe new jobs are easy to find) and understaffed employers bidding wages up at the fastest rate in decades. So spending does appear to be exceeding productive capacity, not so much because spending is all that high but because capacity is unexpectedly low.

Inflation caused by supply-chain disruptions will probably fall within a few months, but it's not at all clear whether Americans who have dropped out of the labor force will return. And even if inflation does come down it might stay uncomfortably high for a while. Remember, the first postwar bout of inflation, which in hindsight looks obviously transitory, lasted for two years.

So how should policy respond?

To squeeze or not to squeeze, that is the question

I'm a card-carrying member of Team Transitory. But I would reconsider my allegiance if I saw evidence that expectations of future inflation are starting to drive prices — that is, if there were widespread stories of producers raising prices, even though costs and demand for their products aren't exceptionally high, because they expect rising costs and/or rising prices on the part of competitors over the next year or two. That's what kept inflation high even through recessions in the 1970s.

So far I don't see signs that this is happening — although the truth is that we don't have good ways to track the relevant expectations. I've been looking at stories in the business press and surveys like the Fed's Beige Book, which asks many businesses about economic conditions; I haven't (yet?) seen reports of expectations-driven inflation. Bond markets are essentially predicting a temporary burst of inflation that will subside over time. Consumers say that this is a bad time to buy many durable goods, which they wouldn't say if they expected prices to rise even more in the future.

For what it's worth, the Federal Reserve, while it has stopped using the term "transitory," still appears to believe that we're mostly looking at a fairly short-term problem, declaring in its most recent statement, "Supply and demand imbalances related to the pandemic and the reopening of the economy have continued to contribute to elevated levels of inflation."

Still, an unmooring of inflation expectations is possible. Given that, what should policymakers be doing right now? And by "policymakers" I basically mean the Fed; political posturing aside, since, given congressional deadlock, nothing that will make a material difference to inflation is likely to happen on the fiscal side, inflation policy mainly means monetary policy.

I recently participated in a meeting that included a number of the most prominent figures in the inflation debate — a meeting in which, to be honest, those of us still on Team Transitory were definitely in the minority. The meeting was off the record, but I asked Larry Summers and Jason Furman, a top economist in the Obama administration, to share by email summaries of their positions.

Summers offered a grim prognosis, declaring, “I see a clearer path to stagflation as inflation encounters supply shocks and Fed response than to sustained growth and price stability.” The best hope, he suggested, was along the lines of what the Fed has now done, end its purchases of mortgage-backed securities (which I agree with because I don’t see what purpose those purchases serve at this point) and plan to raise interest rates in 2022 — four times, he said — with “a willingness to adjust symmetrically with events.” In other words, maybe hike less, but maybe hike even more.

Furman was less grim, saying, “We should not drop the goal of pursuing a hot economy,” but he wanted us to slow things down, to “get there by throwing one log on the fire at a time.” His policy recommendation, however, wasn’t that different. He called for three rate hikes next year, as the Fed said on Wednesday that it was considering.

Where am I in this debate? Clearly, a sufficiently large rate hike would bring inflation down. Push America into a recession, and the pressure on ports, trucking and warehouses would end; prices of many goods would stop rising and would indeed come down. On the other hand, unemployment would rise. And if you believe that we’re mainly looking at temporary bottlenecks, you don’t want to see hundreds of thousands, maybe millions of workers losing their jobs for the sake of reducing congestion at the Port of Los Angeles.

But what both Summers and Furman are arguing is that the inflation problem is bigger than temporary bottlenecks; Furman is also in effect arguing that tapping on the monetary brakes could cool off inflation without causing a recession, although Summers doesn’t think we’re likely to avoid at least a period of stagflation when bringing inflation down.

The Fed’s current, somewhat chastened, position seems almost identical to Furman’s. The latest projections from board members and Fed presidents are for the interest rate the Fed controls to rise next year, but by less than one percentage point, and for the unemployment rate to keep falling.

Perhaps surprisingly, my own position on policy substance isn’t all that different from either Furman’s or the Fed’s. I think inflation is mainly bottlenecks and other transitory factors and will come down, but I’m not certain, and I am definitely open to the possibility that the Fed should raise rates, possibly before the middle of next year. I think the Fed should wait for more information but be willing to hike rates modestly if inflation stays high; Furman, as I understand it, thinks the Fed should plan to hike rates modestly (in correspondence he suggested one percentage point or less over the course of 2022, matching the Fed’s projections) but be willing to back off if inflation recedes.

This seems like a fairly nuanced distinction. It is, of course, possible that bad inflation news will force far more draconian tightening than the Fed is currently contemplating, even now.

Maybe the real takeaway here should be how little we know about where we are in this strange economic episode. Economists like me who didn’t expect much inflation were wrong, but economists who did predict inflation were arguably right for the wrong reasons, and nobody really knows what’s coming.

My own view is that we should be really hesitant about killing the boom prematurely. But like everyone who’s taking this debate seriously, I’m hanging on the data and wonder every day whether I’m wrong.

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From December 16th's WP:

The Fed's words still don't measure up to the challenge of inflation

By Lawrence H. Summers

The Federal Reserve's recognition that inflation is not transitory, that the U.S. labor market is very tight and that priority now must be given to price stability is welcome, if belated. Without this pivot, entrenched inflation followed by a recession would be likely.

A recognition of the need to change direction, as manifest in the Federal Open Market Committee statement and Chair Jerome H. Powell's news conference Wednesday, was necessary but not sufficient for successfully achieving price stabilization and sustained growth. I see grounds for substantial concern in both the intrinsic difficulty of the task at hand and in misconceptions that the Fed still seems to hold.

There have been few, if any, instances in which inflation has been successfully stabilized without recession. Every U.S. economic expansion between the Korean War and Paul A. Volcker's slaying of inflation after 1979 ended as the Federal Reserve tried to put the brakes on inflation and the economy skidded into recession. Since Volcker's victory, there have been no major outbreaks of inflation until this year, and so no need for monetary policy to engineer a soft landing of the kind that the Fed hopes for over the next several years.

The not-very-encouraging history of disinflation efforts suggests that the Fed will need to be both skillful and lucky as it seeks to apply sufficient restraint to cause inflation to come down to its 2 percent target without pushing the economy into recession. Unfortunately, several aspects of the Open Market Committee statement and Powell's news conference suggest that the Fed may not yet fully grasp either the current economic situation or the implications of current monetary policy.

The Fed forecast calls for inflation to significantly subside even as the economy sustains 3.5 percent unemployment — a development without precedent in U.S. economic history. The Fed believes this even though it regards the sustainable level of unemployment as 4 percent. This only makes sense if the Fed is clinging to the idea that current inflation is transitory and expects it to subside of its own accord.

In fact, there is significant reason to think inflation may accelerate. The consumer price index's shelter component, which represents one-third of the index, has gone up by less than 4 percent, even as private calculations without exception suggest increases of 10 to 20 percent in rent and home prices. Catch-up is likely. More fundamentally, job vacancies are at record levels and the labor market is still heating up, according to the Fed forecast. This portends acceleration rather than deceleration in labor costs — by far the largest cost for the business sector.

Meanwhile, the pandemic-related bottlenecks central to the transitory argument are exaggerated. Prices for more than 80 percent of goods in the CPI have increased more than 3 percent in the past year. With the economy's capacity growing 2 percent a year and the Fed's own forecast calling for 4 percent growth in 2022, price pressures seem more likely to grow than to abate.

This all suggests that policy will need to restrain demand to restore price stability. How much tightening is required? No one knows, and the Fed is right to insist that it will monitor the economy and adjust. We do know, however, that monetary policy is far looser today — in a high-inflation, low-unemployment economy — than it was about a year ago when inflation was below the Fed's target and unemployment was around 8 percent. With relatively constant nominal interest rates, higher inflation and the expectation of future inflation have led to dramatic reductions in real interest rates over the past year. This is why bubbles are increasingly pervasive in asset markets ranging from crypto to beachfront properties and meme stocks to tech start-ups.

The implication is that restoring monetary policy to a normal posture, let alone to applying restraint to the economy, will require far more than the three quarter-point rate increases the Fed has predicted for next year. This point takes on particular force once it is recognized that, contrary to Powell's assertion, almost all economists believe there is a lag of about a year between the application of a rate change and its effect. Failure to restore policy neutrality next year means allowing two more years of highly inflationary monetary policy.

All of this suggests that even with its actions this week, the Fed remains well behind the curve in its commitment to fighting inflation. If its statements reflect its convictions, this is a matter of serious concern.

To be fair, though, there is another possibility. Perhaps the Fed's restraint reflects less conviction about what ultimately will be necessary than a desire to avoid being itself a source of economic shocks. We should hope that what we have seen is just the first part of what will be, if necessary, a more radical policy redirection. Time will tell.

Lawrence Summers is a professor at and past president of Harvard University. He was treasury secretary from 1999 to 2001 and an economic adviser to President Barack Obama from 2009 through 2010.