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ECONOMIC VIEWPOINT

Notes by Danny Leipziger, Professor of International Business

How Real is the Threat of Inflation?

The latest barrage of punditry deals with inflation in the United States and calls by some to get out ahead of it and adjust monetary and fiscal policies. By way of background, it is worth recalling that the American economy is coming out of the worst decline in GDP in over a century and that the impact of the Covid-19 pandemic and the ensuing and necessary lockdowns have scarred the economy. That said, there are reasons to examine price rises over the past few months.

Some price increases are due to temporary supply shortages in key industrial component areas, while others reflect pent-up demand. In the case of the former, most supply chain problems should work themselves out. In the case of the latter, a one-time demand shock could occur, although many households are rebuilding savings and paying down debt.

The Federal Reserve has shifted to an inflation target that averages 2 percent, and it is willing to accept an over-shooting of that target if it is temporary in nature, which the Fed is betting will be the case.

The alarm bells being rung by some economists, Larry Summers prominent among them, are based on the view that the economy is closer to full-employment (as measured by the elusive concept of output gaps) and the new spending packages will add dramatically to aggregate demand and spur inflation into unacceptable territory.

Factors to keep in mind in making these judgments include the reality that many businesses have shuttered for good, that unemployment relief will end by mid-summer, and that historical economic relationships may not be as telling in a post-pandemic environment. Specifically on the jobs front, we are significantly below full-employment if it is properly measured.

Moreover, some lower-skill jobs are vacant, meaning wages may need to be bid up. That is both good for low-income workers as well as an additional impetus to raise productivity and efficiency.

Anti-inflation efforts can also be assisted by more effective policies toward uncompetitive practices, a largely ignored area in past years.

When considering the size of new fiscal expenditures, one needs first to look at the extent to which they will be financed by increased taxes on those who can afford to pay and those who have avoided paying in the past. Many of the most successful corporations in the U.S. economy fall into this category, as do the ultra-rich.

Second, it is important to realize that funds earmarked for infrastructure, unlike cash transfers, take a number of years to be spent. Since these decisions are political, the actual level of spending will need to be negotiated.

The ratio of national debt to GDP has risen because of both structural factors and fiscal stimulus programs enacted to fight the pandemic. This implies that there is need for broader spending, for tax reforms, and for actions that will raise GDP growth closer to a 3 percent average than the historical 2 percent.

The most controversial aspect of economic policy—and one that may not get as much attention—is the continuation of Quantitative Easing, the Federal Reserve's bond-buying program that adds $120 billion of new liquidity to the system each month. There are good reasons to think that this is excessive and soon will be unnecessary as the economy expands.

Fear of how markets will react is, in my view, misplaced: Markets will react whenever this policy is curtailed. The bond-buying program is no longer needed at its current level, and a pre-announced reduction of $10 billion per month in this program would be well advised and should start soon.

Should inflation persist above targets, the Fed will need to tighten up and the shock will be greater coming from the current expansionary stance than it would be from a neutral stance. On this point, pundits like Professor Summers are correct.

Whether there is too much pressure on inflation rates or not will be seen in the pace of recovery and end-year results. To the extent that tightening is required, the Fed will need to be in a position to respond. In the event that inflation isn't a dominant concern, the Fed still needs to try and contract its balance sheet in a deliberate manner.

It is widely acknowledged that central banks did yeoman's work in helping keep economies from collapsing further. Now however, with fiscal stimuli in place and recovery underway, they need to embrace a more modest pace of monetary emissions. Will this cause interest rates to rise? Yes, but those rates have been holding close to zero for many years and this is abnormal.

A return to monetary normality is a good thing.