The inflation risk is real

larrysummers.com/2021/05/24/the-inflation-risk-is-real

Larry Summers, May 24, 2021

The covid-19 chapter in U.S. economic history is coming to a close more rapidly than almost anyone expected, including me. Within weeks, gross domestic product will reach a new peak, and it is likely to exceed its pre-covid trend line before year's end, as the economy enjoys its fastest year of growth in decades. Job openings are at record levels, and unemployment may well fall below 4 percent in the next 12 months. Wages and productivity growth are increasing.

This is both very good news and a tribute to the aggressive covid-19 containment policies of recent months, as well as to strong fiscal and monetary policies since the onset of the pandemic. Our economy has outperformed those of other industrial countries. U.S. policymakers can take satisfaction from that.

But new conditions require new approaches. Now, the primary risk to the U.S. economy is overheating — and inflation.

Even six months ago, it was reasonable to regard slow growth, high unemployment and deflationary pressures as the predominant risk to the economy. Today, while continuing relief efforts are essential, the focus of our macroeconomic policy needs to change.

Inflationary pressures are mounting from the boost in demand created by the $2 trillion-plus in savings that Americans have accumulated during the pandemic; from large-scale Federal Reserve debt purchases, along with Fed forecasts of essentially zero interest rates into 2024; from roughly $3 trillion in fiscal stimulus passed by Congress; and from soaring stock and real estate prices.

This is not just conjecture. The consumer price index rose at a 7.5 percent annual rate in the first quarter, and inflation expectations jumped at the fastest rate since inflation indexed bonds were introduced a generation ago. Already, consumer prices have risen almost as much as the Fed predicted for the whole year.

"We are seeing very substantial inflation," Warren Buffett recently observed in remarks typical of business leaders throughout the country. "We are raising prices. People are raising prices to us, and it's being accepted."

Fed and Biden administration officials are entirely correct in pointing out that some of that inflation, such as last month's run-up in used-car prices, is transitory. But not everything we are seeing is likely to be temporary. A variety of factors suggests that inflation may yet accelerate — including further price pressures as demand growth outstrips supply growth;

rising materials costs and diminished inventories; higher home prices that have so far not been reflected at all in official price indexes; and the impact of inflation expectations on purchasing behavior.

Higher minimum wages, strengthened unions, increased employee benefits and strengthened regulation are all desirable, but they, too, all push up business costs and prices.

It is possible that the Fed could contain inflationary pressures by raising interest rates without damaging the economy. But in the current environment, where markets around the world have been primed to believe that rates will remain very low for the foreseeable future, that will be very difficult, especially given the Fed's new commitment to wait until sustained inflation is apparent before acting. The history here is not encouraging. Every time the Fed has hit the brakes hard enough to slow growth meaningfully, the economy has gone into recession.

How much does it matter whether inflation accelerates? In general, increases in inflation disproportionately hurt the poor and are associated with reductions in trust in government. Progressives might consider the role that inflation played in electing Richard M. Nixon in 1968 and Ronald Reagan in 1980.

Jason Furman, chairman of President Barack Obama's Council of Economic Advisers, recently said that the American Rescue Plan is definitely "too big for the moment," stating: "I don't know of any economist that was recommending something the size of what was done." Excessive stimulus driven by political considerations was a consequential policy error that would be tragically compounded if valid concerns about the economy overheating prevented Congress from making the types of necessary public investments that are the focus of President Biden's Jobs and Families Plans.

So how best can we contain overheating risks and promote sustainable growth while also making necessary investments in infrastructure, greening the economy and helping low- and middle-income families?

First, starting at the Fed, policymakers need to help contain inflation expectations and reduce the risk of a major contractionary shock by explicitly recognizing that overheating, and not excessive slack, is the predominant near-term risk for the economy. Tightening is likely to be necessary, and it is critical to set the stage for that delicate process. Meanwhile, the administration needs to continue to respect the independence of the Fed as it changes course. Clear statements that the United States desires a strong dollar will also be helpful in anchoring inflation expectations.

Second, policies toward workers should be aimed at the labor shortage that is our current reality. Unemployment benefits enabling workers to earn more by not working than working should surely be allowed to run out in September; in some parts of the country they should end sooner. Re-employment bonuses should be considered, and a major focus should be on promoting mobility and training workers for occupations where labor is short. Where “made-in-America” requirements exacerbate labor shortages and raise prices, they should be reconsidered.

Third, it is essential to make long-term public investments to increase productivity and enable more people to work. It would be a grave error to cut back excessively on public-investment ambitions out of inflation concerns. That is not because of the immediate jobs they create, but because of the long-term increases they generate in productive potential, sustainability and inclusivity. But where possible, infrastructure investments should be financed by reprogramming of Rescue Plan funds, such as those now being used by some states to finance tax cuts. Additionally, current spending financed by future taxes might further stimulate an already overheated economy. The opposite — revenue increases ahead of spending, or at least parallel to spending — can ensure more sustainable growth.

The winding down of the covid-19 crisis provides a historic opportunity for taking the next step toward providing for all Americans in an ever more effective and inclusive way. But to avoid squandering the opportunity, policymakers need to accept economic reality. The moment has come to move past emergency policies and fight for our country’s long-term future.