The Way We Were

Why the price pressures caused by the pandemic will prove to be an anomaly.

By James E. Glassman

The rise and fall of inflation over the past couple of years reflects the biometrics of a supply-side dynamic that is very different from typical inflationary episodes. Most bouts of inflation have been the result of excess demand and an overheated economy. The supply-side nature of the pandemic era's inflation challenges, which has confounded policymakers and economists alike, implies that the credit for inflation's fall has little to do with monetary policies and more to do with the clearing of supply-side dislocations.

The facts speak for themselves. Inflation spiked to double-digit levels by early 2022 but now has fallen back to 2.5 percent annualized over the most recent six months. Inflation measures that exclude shelter rents, which had little to do with the pandemic and for many reasons are slowing more gradually than overall inflation, have collapsed to 1–2 percent annualized over the most recent six months, below the Fed's 2 percent longer-run target. Popular trimmed-mean measures of underlying inflation also confirm that the Fed's 2 percent longer-run goal is in focus.

Why is inflation retreating even as the economy remains fully employed? That's not usually how inflation behaves. A proper diagnosis has the answer. Prices respond to shifts in both demand and supply. Most inflation episodes have been caused by excess demand—a "hot" economy. And that's why central banks have taken center stage. Monetary tools are designed to manage demand, economic slack, and inflation. But these tools don't work well and can cause undue harm when supply-side disruptions like those resulting from the pandemic dislocations are the culprit. Supply-side

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THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
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Widely Repeated and Unconvincing

Over the decades, structural changes resulting from deregulation, globalization, and technological innovation have fostered greater pricing discipline. At the same time, the Digital Revolution has altered the labor-inflation dynamic. The shrinkage in the share of income accruing to workers since the 1990s—labor's share drifted even lower during the pandemic despite all—implies that labor cost trends are not the inflation threat that many assume. Wage increases did quicken but only to catch up with cost-of-living increases. In today's economy, wages are more likely to follow prices than the other way around. For that reason, the widely repeated claim that unemployment will have to rise to curb inflation is unconvincing.

—J. E. Glassman

pressures dissipate naturally when dislocations clear, regardless of the central bank's actions.

Popular opinions assume that massive federal support provided by many fiscal initiatives in 2020 and 2021 overheated the economy and drove inflation up. This doesn't square with facts, because inflation was a challenge around the world even though the policies of others were not as generous as those of the United States. Furthermore, although demand held up well after an initial collapse thanks to Washington's unprecedented policy response, the government's financial support merely replaced lost private income when social distancing lockdowns left more than thirty-five million people without a job. Demand only returned to where it would have been had there been no pandemic. In other words, the government's response was more akin to fiscal rescue than fiscal stimulus. Furthermore, in contrast to past fiscal responses to economic crises that typically outlive the need, the pandemic lifelines had a short expiration date.

The rise and fall of inflation during the pandemic had little to do with the Federal Reserve.

The generous support for consumers contrasts with more limited lifelines for businesses, other than the temporary help offered by the innovative Paycheck Protection Program. Businesses had to worry about survival and went on the defensive. And because production of goods is scattered around the world, lockdowns everywhere led to congested supply chains. The asymmetry of the policy response, providing more support for consumers than businesses, led to a gap between demand and supply—that is, to excess demand. But the culprit leading to excess demand was the shrinkage of supply, held back by the congestion in the global supply chains that now has cleared, not demand.

For the better part of a quarter-century, the behavior of inflation has puzzled economists.

Whether inflation was caused by demand or supply might seem academic, a distinction without a difference. After all, didn't the oil embargoes of the 1970s demonstrate that supply shocks too could be inflationary? Those shocks led to the "stagflation" idea when inflation worsened even as the economy struggled. The oil shocks forced economists back to the drawing board to incorporate supply shocks into the popular natural rate view of inflation. But the supply shocks of the pandemic era had nothing in common with the oil embargoes in the 1970s. Supply chain bottlenecks were not the result of efforts by foreign producers to ramp up prices.

Supply-side dislocations have cleared on their own. That's why inflation has fallen back. The behavior of commodity prices is telling. Commodity inflation, which spiked in response to supply chain congestion, accounted for virtually all of the doubling of consumer inflation since 2019. But prices of consumer goods have flattened since summer 2022 as supply chain bottlenecks vanished. Time and actions by the business community to work around bottlenecks deserve the credit for falling inflation.

Monetary authorities have little ability to control supply shocks. The rise and fall of inflation during the pandemic had little to do with the Federal Reserve. The proof lies in what didn't happen when the Fed hiked interest rates. Central banks control inflation by managing demand and economic slack with (conventional and unconventional) interest rate tools. This is why the Federal Reserve's policy committee assumes (predicts) that unemployment will have to rise as high as 5 percent, well above the natural rate, in order to keep inflation in check.

Fortunately, the Fed's actions have not sent the economy into the recession expected by many, have had little impact on aggregate demand, and have not touched unemployment. And yet inflation has retreated, counter to the textbook description of how monetary policy works. The economy has slowed, of course, but it would have slowed regardless of the Fed's actions as the economic damage from the pandemic lockdowns healed and the economy reached cruising altitude (its potential output level).

Inflation was a challenge around the world even though the policies of others were not as generous as those of the United States.

Of course, there is a role for Fed action even in the face of supply shocks, if they lead to a deterioration in inflation expectations. Many believe that a worsening of inflation expectations exacerbated the stagflation caused by the 1970s oil shocks. During the pandemic, however, inflation expectations were well-behaved. Inflation expectations reflected in interest rate markets and in surveys of professional forecasters conducted by the Federal Reserve Bank of Philadelphia held steady well before the Fed began to raise rates, implying that investors and professional forecasters anticipated no lasting inflation problem. Inflation expectations remained anchored close to the Fed's 2 percent long-run target, a testimony to the credibility of its long-run strategy.

Some say that monetary policy should still tighten in response to a supply shock in order to prevent transitory jolts from sparking a wage-price spiral, particularly when labor markets are tight and businesses are struggling to find workers. This idea was more relevant long ago when businesses were shielded from competition and prices tended to be automatically marked up over costs relatively. But over the decades, structural changes resulting from deregulation, globalization, and technological innovation have fostered greater pricing discipline. At the same time, the Digital Revolution has altered the labor-inflation dynamic. The shrinkage in the share of income accruing to workers since the 1990s—labor's share drifted even lower during the pandemic despite all—implies that labor cost trends are not the inflation threat that many assume. Wage increases did quicken but only to catch up with cost-of-living increases. In today's economy, wages are more likely to follow prices than the other way around. For that reason, the widely repeated claim that unemployment will have to rise to curb inflation is unconvincing.

The pandemic shocks are unlikely to leave a permanent mark on the economy, work habits, globalization, reshoring, or inflation. It might be a different story if pandemics occurred frequently. But the pandemic likely will come to be seen as a once-in-a-lifetime event. And the economic incentives shaping the way we were—the ambitions of developing economies that are driving globalization, the cost advantages and rising global living standards that encourage production offshoring, the limited availability of domestic workers that challenge efforts to re-shore manufacturing, the disruptive nature of technology and transforming power of the Digital Revolution that is breaking the wages-inflation nexus, and the business advantages associated with work in the office—remain compelling.

What about inflation? For the better part of a quarter-century, the behavior of inflation has puzzled economists. It has been less responsive to the ups and downs of business cycles than predicted by popular inflation models. The reasons for this are not entirely clear but are believed to be a result of growing competition and policy commitment to low inflation. The pandemic has done little to quell these forces. For that reason, the price pressures caused by the pandemic probably will prove to be an anomaly.

Why is inflation retreating even as the economy remains fully employed? That's not usually how inflation behaves.

With the inflation storm passing, economic life will slowly return to the way we were. ◆