Why Inflation Has Declined

By Robert Shapiro

Energy, supply chain disruptions, and labor costs.

Inflation has declined sharply because its principal sources—energy prices and supply chain disruptions—weakened substantially. The data show that the large initial run-up in energy prices and the large initial costs of supply chain disruptions were followed by substantial declines in both energy prices and shipping costs. Two other popular candidates for blame, federal fiscal policy and employee costs, have fallen steadily for two and a half years contributing mainly to the disinflation.

The largest single factor in the acceleration of inflation starting in early 2022 was energy prices. The real price of U.S. oil imports drives domestic oil prices—and those prices declined sharply with the onset of the pandemic: The real price of a barrel of crude fell from $63.46 in January 2020 to $19.95 in April 2020 and averaged $41.52 from April to December 2020—down 53 percent from January. These falling prices directly followed the collapse in global demand, with the real GDP of advanced countries contracting 2.8 percent in 2020.

Oil prices recovered with global demand, averaging $73.48 in 2021. They became an important factor for inflation in late 2021 and early 2022, when OPEC constrained supplies to offset its depressed revenues from 2020 and Russian President Vladimir Putin reinforced rising energy prices by disrupting energy supplies to Europe. The result was sharp increases in the real price of oil imports, which peaked at $113.63 in the second quarter of 2022 and averaged $95.86 for the year, even as real GDP growth in the United States and other advanced countries fell

Robert Shapiro is Chairman of Sonecon and formerly served as U.S. Under Secretary of Commerce for Economic Affairs.

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

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by about half. Consequently, inflationary pressures in the United States were first concentrated on prices for gasoline and home heating and cooling, which jumped more than 50 percent, and goods with energy-intensive production and/or transport, including prices for food, automobiles, and large appliances that rose 9 percent to 18 percent.

The disinflation came when OPEC and Putin couldn't sustain their interventions in worldwide energy markets. So as global growth eased in 2022, real oil import prices fell from the high of $113.63 in the second quarter to $80.21 in the fourth quarter and an average of $71.32 in the first half of 2023, or virtually the same price as 2021 before inflation took off.

A similar pattern is evident in the supply chain disruptions, first triggered by the pandemic's impact on global transportation networks and sustained in 2021 as producers struggled to rev up production again. We can use international freight transportation costs to gauge the inflationary impact of those disruptions. For example, the index of U.S. import air freight prices jumped 80 percent in 2020 even as demand fell sharply and continued to rise another 20 percent in 2021. Moreover, the pressure from transport prices eased and then reversed as supply chains normalized in late 2021 and early 2022: The index fell 6 percent in the first six months of 2022, another 30 percent in the second half of 2022, and 14 percent more in the first seven months of this year.

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Inbound air freight costs followed the same pattern, jumping 48 percent in 2020 and 14 percent in 2021, and then declining 5 percent in the first six months of 2022, another 14 percent in the second half of 2022, and 17 percent in the first seven months of 2023. By July of this year, air freight costs had returned to pre-pandemic levels of January 2020. As with energy, the supply chain disruptions helped drive inflation and their resolution helped drive disinflation.

Next up is fiscal policy, which the data show played a supporting role in the inflation of 2022 but a larger role in the subsequent disinflation. The deficit soared in the first year of the pandemic by an astounding 283 percent, up from $984 billion in 2019 to $3,132 billion in 2020. However, that increase had little effect on prices or interest rates, since most of the shortfall came from the collapse in federal revenues and the first round of emergency spending and checks for businesses and 90 percent of households that offset the enormous increase in the personal savings rate. Personal savings jumped from 8.8 percent of disposable income in 2019 to 26.4 percent in the second quarter of 2020 and averaged 17.0 percent for the year.

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In the view of economist Larry Summers and others, the real culprit was the third round of checks and emergency spending passed in March 2021. They are certainly correct that those checks along with the buildup in personal savings and the extraordinary job gains in 2021 restored people's confidence to spend again. But overall, fiscal policy cannot be blamed for sparking inflation in 2021, since the deficit declined 17 percent from $3,132 billion in 2020 to $2,775 billion. Moreover, fiscal policy from that point on contributed to the unwinding of inflation as the deficit fell another 50 percent in 2022 to $1,376 billion, even as growth slowed sharply.

This acute fiscal tightening also reinforced the monetary tightening by the Federal Reserve, starting with the March 2022 increase in the federal funds rate and followed by ten additional rate increases. However, the higher interest rates have undercut the fiscal tightening by increasing the costs of federal debt service, and the deficit for 2023 is expected to rise this year by 2.6 percent to $1,412 billion.

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Finally, we turn to the recent gains in real wages and household income cited by many commentators as a new source of inflation or at least a counterweight to disinflation. The labor market measure that matters most for inflation, however, is not wages but changes in total compensation paid by employers, also including benefits and salaries. By that metric, changes in total labor costs simply have not contributed to inflation.

Here, we consult the index of total compensation in constant dollars paid by employers across all industries and occupations issued by the Bureau of Labor Statistics. Those data show that total employee compensation, adjusted for inflation, increased from the fourth quarter of 2019 to the fourth quarter of 2020. Since then, however, the index has declined steadily. It fell 3.0 percent in 2021 as inflation began to take hold, declined another 0.5 percent in 2022 as inflation first heated up and then began to cool, and fell another 0.4 percent in the first half of this year. We have to conclude that labor costs borne by employers have lagged inflation since 2021 and continue to contribute to the current disinflation. ◆

Two other popular candidates for blame, federal fiscal policy and employee costs, have fallen steadily for two and a half years.