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# Inflation Concerns Should Not Impede Enactment of Build Back Better

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Critics of the House-passed Build Back Better (BBB) legislation have argued that the recent rise in inflation is a reason to forgo or scale back the legislation's investments, which would cut poverty (especially among children), boost opportunity and productivity, advance racial equity, and fight climate change. This argument is misguided. BBB is unlikely to have any noticeable effect on inflation; more important, the long-term benefits from its investments are large while the risks of it generating inflation that the Federal Reserve cannot manage are small.

- **Build Back Better would add only moderately to deficits in the short term and reduce them in the longer term.** The House-passed BBB would increase the deficit by 0.6 percent of gross domestic product (GDP) in fiscal year 2022 and by diminishing percentages through 2026 before starting to reduce deficits in 2027, according to the Congressional Budget Office (CBO).[1]
- **The loss of fiscal stimulus as temporary relief measures enacted earlier in the pandemic have phased out will dwarf any inflationary pressure BBB would cause by increasing demand for goods and services in 2022**. Many relief measures that boosted consumption — such as stimulus payments and expanded jobless benefits — have ended, creating a drag on economic growth that will be much larger than the modest stimulative impact of BBB measures in the near term.
- **Current inflation stems primarily from COVID-related disruptions in the global supply chain and the unique characteristics of the pandemic economy, not from an economy that is broadly overstimulated.** During both the height of the pandemic and today, when infection rates are still significant, individuals and households consumed fewer services — from travel to dining out in restaurants to movies, concerts, and sports events — and shifted to consuming more of their income on goods. While this shift was largest during the early stages of the crisis, today consumption of services remains *below* pre-pandemic levels. The increased demand for goods put pressure on global supply chains, which were themselves

[1] CBPP calculations based on data from Congressional Budget Office, "Summary of Cost Estimate for H.R. 5376, the Build Back Better Act," November 18, 2021, https://www.cbo.gov/publication/57627, and fiscal year GDP from CBO's July 2021 ten-year economic projections, https://www.cbo.gov/system/files/2021-07/51135-2021-07-economicprojections.xlsx.

disrupted by the pandemic. Factories could not always operate at full strength during the pandemic, for example, and early in the crisis, concerns that demand for goods could plummet if the crisis was not well controlled led some companies to cut back production and orders by what turned out to be too much. The result was a flare-up of inflation starting in the spring of 2021, which will likely last well into next year for reasons unrelated to Build Back Better.

- **Addressing inflation and meeting the nation's investment needs are two separate tasks.** The Federal Reserve has primary responsibility for addressing inflation as part of its dual mandate from Congress to promote stable prices and maximum employment, and it has the tools to do that. Current Fed policy is still "accommodative" toward further expansion, reflecting the continued need to generate job growth and to protect the economy against continued uncertainties related to the pandemic itself. (See box, "Getting Virus Under Control Remains Critical for Strong Expansion and Lower Inflation.") But when necessary, the Fed can offset unwanted inflationary pressures by gradually tightening monetary policy, starting with reducing its holdings of Treasury and mortgage-backed securities acquired to support the economic recovery (it currently is tapering purchases and has signaled that it will likely speed up the tapering) and ultimately raising its short-term interest rate target gradually.

The major ratings agencies Moody's and Fitch both agree that BBB and the recently enacted infrastructure legislation would not add to inflationary pressures. Also, many leading economists have concluded that BBB would not make the Fed's task of controlling inflation more difficult and should not stand in the way of enacting the needed investments in BBB, which would expand the economy's capacity to produce goods and services in the longer term, strengthen economic growth, and ease future inflationary pressures.

### Getting Virus Under Control Remains Critical for Strong Expansion and Lower Inflation

The successive waves of rising and falling COVID-19 cases have heavily influenced the pace of the recovery by affecting leisure and hospitality industries like travel and dining out, the labor supply, and the prices of goods affected by supply chain disruptions. In 2021, leisure and hospitality jobs were a major source of employment growth when the virus appeared under control in the spring, but when the Delta variant hit and cases surged, economic growth and job creation slowed. Similarly, many people have returned to work, but continued concerns about possible school closures or the need for children to quarantine have led some parents to wait until the situation is more settled.

The emergence of the Omicron variant poses yet another new challenge, as Federal Reserve Chairman Powell stated in his latest congressional testimony:

> The recent rise in COVID-19 cases and the emergence of the Omicron variant pose downside risks to employment and economic activity and increased uncertainty for inflation. Greater concerns about the virus could reduce people's willingness to work in person, which would slow progress in the labor market and intensify supply-chain disruptions.[a]

Controlling COVID-19 remains key to getting the economy back on track, to bringing more people back into the labor market, and to returning consumption patterns to a more normal split between services and goods. Once the virus is under control, an expanding labor supply, faster growth in demand for services, and slower growth in demand for goods can help to resolve supply chain problem, which by itself would tend to lessen inflationary pressures over time (although a revival in services by itself would add to aggregate demand). The bottom line is that efforts to save lives and reduce disease are critical to the economic recovery as well.

[a] Jerome H. Powell, testimony before the Senate Committee on Banking, Housing, and Urban Affairs, November 30, 2021, https://www.federalreserve.gov/newsevents/testimony/powell20211130a.htm.

## Build Back Better Would Not Overstimulate the Economy

Unlike the large relief and recovery measures enacted earlier in the pandemic, BBB is not designed as an economic stimulus or emergency relief act. CBO estimates that the House-passed BBB legislation would increase the budget deficit by 0.6 percent of GDP in fiscal year 2022 and by diminishing percentages through 2026, before starting to reduce deficits in 2027 and subsequent years. (BBB would reduce deficits after 2026 because most of its investments are temporary but its revenue-raising measures and prescription drug savings are permanent.)

These projected near-term increases in deficits due to BBB are relatively small, especially in comparison with the large drag on aggregate demand and economic growth exerted by the waning of earlier stimulus measures. Those earlier measures contributed to stimulating demand and increasing the primary budget deficit (that is, the deficit apart from interest payments on the debt) by 10 percent of GDP in 2020, relative to the previous year, an August 2021 analysis by the President's Council of Economic Advisers (CEA) found; in 2021 the measures widened the primary deficit further but only by 2 percent of GDP.[2] With a much lower amount of stimulus remaining in 2022 than in 2021, the primary deficit is projected to *fall* by an amount equal to 9 percent of GDP, exerting a substantial *drag* on GDP growth.

The fiscal stimulus effects of BBB plus the recently enacted infrastructure legislation would only modestly reduce this drag in 2022, to a little under 9 percent of GDP according to CEA. After 2022, the change in the primary deficit — and hence any stimulus or drag on growth — would be small with or without BBB or the infrastructure legislation.

The change in the primary deficit is a rough-and-ready measure of fiscal stimulus or drag, not a precise measure of the contribution that enacted measures have on economic growth. A similar but more sophisticated fiscal impact measure published by the Hutchins Center at the Brookings Institution also shows a sharp shift from stimulus to drag between 2021 and 2022 as stimulus measures phase down or end.[3] (Both measures account for the initial impact of fiscal policy but not any subsequent multiplier, or "bang-for-the-buck," effects.) The relief and stimulus measures enacted in 2020 supported aggregate demand — which fell rapidly after the crisis hit early that year — and turned the economy around, putting it on the road to recovery. The measures enacted early in 2021 were not as large because the economy was recovering and private demand for goods and services was growing. As the recovery continues into 2022, growing private demand will replace the lost fiscal stimulus and be the major source of GDP growth.

## Inflation in the Pandemic Economy

The 6.2 percent rise in the consumer price index (CPI) between October 2020 and October 2021 was the largest 12-month increase in over 30 years. The increase in the price index for consumer expenditures (PCE), which is the Federal Reserve's preferred inflation measure, was 5.0 percent. Higher food and energy prices are partly responsible for the increases, but so too are temporary shortages associated with global supply-chain bottlenecks and the dramatic shift in consumption from services to goods in the recovery from the 2020 recession.

The sharp contraction in economic activity and employment associated with the outbreak of COVID-19 in early 2020 was the deepest but shortest U.S. recession on record.[4] April was the cruelest month, with nonfarm payroll employment falling below its February 2020 level by 22.4 million jobs (a drop of nearly 15 percent) and the official unemployment rate rising to 14.8 percent. A more realistic unemployment measure, which accounts for the misclassification of some unemployed workers as employed and the sharp drop in labor force participation as many job losers stopped looking for work, showed unemployment rising well above 20 percent.

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[2] Jared Bernstein and Ernie Tedeschi, "President Biden's Infrastructure and Build Back Better Plans: An Antidote for Inflationary Pressure," Office of Management and Budget, August 23, 2021, https://www.whitehouse.gov/cea/blog/2021/08/23/president-bidens-infrastructure-and-build-back-better-plans-an-antidote-for-inflationary-pressure/.

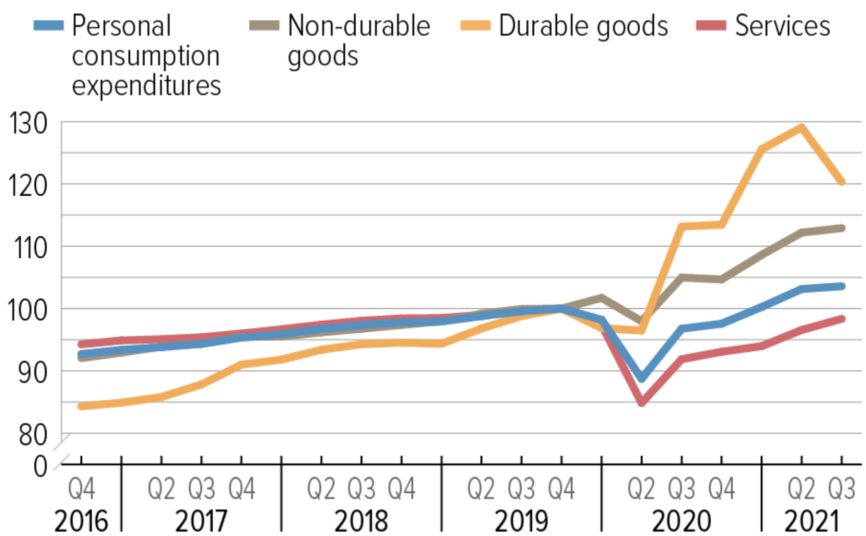
[3] Brookings Institution, "Hutchins Center Fiscal Impact Measure," November 2, 2021, https://www.brookings.edu/interactives/hutchins-center-fiscal-impact-measure/.

[4] National Bureau of Economic Research, "Business Cycle Dating Committee Announcement July 19, 2021," https://www.nber.org/news/business-cycle-dating-committee-announcement-july-19-2021.

FIGURE 1

**Pandemic Distorted Consumer Purchases Toward Goods, Away From Services**

Personal consumption expenditures and components




Note: Each line is the level of real (inflation-adjusted) personal consumption expenditures or its components indexed to its level in 2019 (Q4=100).

Source: CBPP analysis of Bureau of Economic Analysis data

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Due to the steep decline in demand for goods and services, the CPI in April 2020 was over 1 percent *lower* than its February 2020 level — a *deflation* rate of nearly 6 percent at an annual rate. Real (inflation-adjusted) gross domestic product was 10 percent lower when the recession bottomed out in the second quarter of 2020 than when the previous expansion peaked in the fourth quarter of 2019.

This sharp contraction in economic activity was driven largely by the actions taken by governments, households, and businesses to limit face-to-face interactions in response to the outbreak and spread of COVID-19. Voluntary and mandatory social distancing limited both the aggregate demand for goods and services and the aggregate supply, especially for services. The leisure and hospitality sector and low-paid workers were particularly hard hit by both the virus and the recession.

Federal policymakers responded to the pandemic and recession by enacting the Coronavirus Aid, Relief, and Economic Security (CARES) Act in March 2020, which provided stimulus payments to households plus substantial support for businesses, unemployed workers, and state and local governments as their income or revenues fell sharply. By supporting aggregate demand for goods and services, these CARES Act fiscal stimulus measures kept the recession from being even worse and helped generate an unexpectedly strong (though incomplete) recovery through the summer of 2020. Because social distancing sharply limited purchases of services, *goods* purchases took up a larger proportion of total spending than normal, and household saving increased sharply.

These developments put pressure on global supply chains and created pent-up demand for goods and services while supply was still sharply restricted due to pandemic-related limits on businesses' ability to remain open or operate at full capacity, leading to higher inflation as the economy began reopening in 2021. The first notable increase in inflation was in April 2021, when the CPI rose to 3.6 percent above its level a year earlier and the 12-month change in the PCE price index was 3.1 percent. Most analysts, including Federal Reserve Chair Jerome Powell, saw this as a transitory increase — reflecting technical measurement issues and global supply chain bottlenecks confined to a few sectors — that would dissipate relatively quickly, rather than as an indication of an overhearing economy. In fact, however, supply chain issues have proven to be more stubborn and increases in volatile food and energy prices have added to near-term inflationary pressures.

Although inflation likely will remain elevated longer than was anticipated when it first broke out in the spring, anything like the spiraling inflation of the 1970s remains highly unlikely. It may take longer than expected for supply-chain issues to be resolved, but in the sectors where prices surged due to supply shortages, prices will come back down as shortages clear up. Getting the virus under control is critical: an easing of the pandemic would bring workers back into the labor force and redress the imbalance between goods and services that is still evident. The Federal Reserve has the tools to address remaining inflationary pressures to the point where prices are rising at a stable, predictable rate. (Trying to reverse the increase in the price level that has already occurred in the pandemic would be a recipe for recession.)

## Federal Reserve Has Primary Responsibility for Addressing Inflation

The Federal Reserve has the primary responsibility for addressing inflation as part of its dual mandate from Congress to promote stable prices and maximum employment.[5] For over a decade preceding the jump in the inflation rate this spring, the Fed struggled unsuccessfully to *raise* inflation to a rate averaging 2 percent, which it judged to be the rate most consistent over the longer run with its statutory mandate.[6] By and large over this period, the expansionary monetary policy that the Fed followed in pursuit of its maximum employment goal was consistent with the Fed's effort to raise the inflation rate to achieve its inflation goal.

The larger-than-expected jump in inflation this year to a rate well above the Fed's 2 percent target range has presented a new challenge. There is now a potential tension between the monetary policy actions appropriate for promoting further employment growth in an economy that continues to have slack in the labor market and the actions potentially needed to fight unwanted inflation. Acknowledging this tension, Fed Chairman Powell stated last month:

[5] The Fed's mandate from Congress is to promote "stable prices" and "maximum employment." Operationally, the Fed says that "inflation at the rate of 2 percent, as measured by the annual change in the price index for personal consumption expenditures, is most consistent over the longer run with [its] statutory mandate." Board of Governors of the Federal Reserve System, "Statement on Longer-Run Goals and Monetary Policy Strategy," January 24, 2012, https://www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf.

[6] The Fed has chosen 2 percent as its inflation target rather than zero because "inflation that is too low can weaken the economy. When inflation runs well below its desired level, households and businesses will come to expect this over time, pushing expectations for inflation in the future below the Federal Reserve's longer-run inflation goal. This can pull actual inflation even lower, resulting in a cycle of ever-lower inflation and inflation expectations." Board of Governors of the Federal Reserve System, "Why does the Federal Reserve aim for inflation of 2 percent over the longer run?" August 27, 2020, https://www.federalreserve.gov/faqs/economy_14400.htm.

> Managing through that process [of meeting both our inflation and employment goals] over the next couple of years is . . . going to be very challenging because we have this hypothesis that inflation is going to be transitory. We think that's right. . . . But we are concerned about underlying inflation expectations remaining stable, as they have so far.[7]

Build Back Better would not materially affect either inflation (as explained above) or the Fed's ability to address it. Rather, the challenge to the Fed's ability to meet its stable prices and maximum employment goals stems mostly from uncertainties about getting the virus under control and about the time needed to resolve the supply-chain bottlenecks largely responsible for the initial jump in inflation, as Powell explained in recent congressional testimony:

> Most forecasters, including at the Fed, continue to expect that inflation will move down significantly over the next year as supply and demand imbalances abate. It is difficult to predict the persistence and effects of supply constraints, but it now appears that factors pushing inflation upward will linger well into next year. In addition, with the rapid improvement in the labor market, slack is diminishing, and wages are rising at a brisk pace.
>
> We understand that high inflation imposes significant burdens, especially on those less able to meet the higher costs of essentials like food, housing, and transportation. We are committed to our price-stability goal. We will use our tools both to support the economy and a strong labor market and to prevent higher inflation from becoming entrenched.[8]

Fed policy is currently still accommodative, consistent with efforts to raise overall employment in an economy in which employment is still several million jobs below where it was at the start of the recession. The Fed's move in November to begin "tapering" its purchases of long-term Treasury securities and mortgage-backed securities will slow but not reverse the large-scale purchases of long-term assets ("quantitative easing") that it re-introduced in March 2020 in order to stimulate demand in a weakening economy. To offset unwanted inflationary pressures, the Fed could reverse course, unwinding those purchases and raising its short-term interest rate target. But the Fed can and should take such steps in moderation to avoid tightening too fast and derailing the recovery.

## Ratings Agencies, Leading Economists Agree BBB Poses Few Inflation Risks

Build Back Better is an investment in the nation's future. Recent inflation complicates the Fed's task of meeting its inflation and unemployment goals in the short term. These are two separate phenomena. Given the scant evidence that BBB would significantly affect aggregate demand even in the short run or make the Fed's task more difficult, inflation concerns should not stand in the way of enacting BBB.

The major ratings agencies Moody's and Fitch both agree that BBB and the infrastructure act will not add to inflationary pressures. The two measures "should not have any real material impact on

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[7] Nick Timiraos, "Fed Worried About Inflation Risk as It Firmed Up Tapering Plan," *Wall Street Journal,* October 12, 2021, https://www.wsj.com/articles/fed-signals-asset-purchases-could-end-by-mid-2022-11634148001.

[8] Powell, *op. cit.*

inflation," according to Moody's Vice President William Foster, while Fitch Ratings Senior Director Charles Seville said they "will neither boost nor quell inflation much in the short-run."[9]

In an open letter, 17 winners of the Nobel Prize in Economics explained why enacting BBB remains a priority:

> Build Back Better would provide vital public investments in the nation's physical and human infrastructure, as well as in our tattered safety net. These investments are long overdue — they were needed before the COVID-19 pandemic, and their necessity has been highlighted by the virus and the economic shock that came with it. . . . Because this agenda invests in long-term economic capacity and will enhance the ability of more Americans to participate productively in the economy, it will ease longer-term inflationary pressures.[10]

Nobel laureate Joseph Stiglitz, who organized the letter, said in an accompanying statement:

> Some . . . have invoked fears of inflation as a reason to not undertake these investments. This view is short-sighted. These are importantly *supply* side measures, increasing the ability of more Americans to participate productively in the economy, helping to improve our low employment-working age population ratio. Significantly reducing the fraction of children growing up in poverty and giving these children access to pre-K and college education will reap large dividends in years to come.[11] [Emphasis in original.]

Similarly, Jason Furman, CEA chair under the Obama Administration, explained that Build Back Better and fighting inflation are not in conflict:

> Even if . . . Build Back Better puts modest upward pressure on inflation, it would happen gradually. The Fed would have more than enough time, space and tools to keep inflation at whatever target it chooses. The potential short-term effects of Build Back Better on inflation are dwarfed by the good it would do.[12]

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[9] Kanishka Singh, "Rating agencies say Biden's spending plans will not add to inflationary pressure," Reuters, November 17, 2021, https://www.reuters.com/world/us/exclusive-rating-agencies-say-bidens-spending-plans-will-not-add-inflationary-2021-11-17/.

[10] Economic Policy Institute, "Open letter from Nobel Laureates in support of economic recovery agenda," https://www.epi.org/open-letter-from-nobel-laureates-in-support-of-economic-recovery-agenda/.

[11] Joseph Stiglitz, "Seventeen winners of the Nobel Prize in economics sign letter in support of the President's Build Back Better package," Economic Policy Institute, September 20, 2021, https://www.epi.org/press/nobel-laureate-economist-joseph-stiglitz-issues-statement-in-support-of-build-back-better-agenda/.

[12] Jason Furman, "Biden Can Whip Inflation and Build Back Better," *Wall Street Journal,* November 15, 2021, https://www.wsj.com/articles/biden-can-whip-inflation-and-build-back-better-stimulus-prices-infrastructure-reconciliation-11636991676.