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Recent Inflation Is No Reason to Pare Back Needed Investments

By Chad Stone

Over the coming months, the President and Congress will work to finalize the emerging, bipartisan infrastructure bill as well as broader economic recovery legislation with the goal of addressing long-neglected needs, strengthening the economy, and expanding opportunities so that everyone shares in the prosperity that these investments will promote. Policymakers should not let overwrought concerns over the recent spike in inflation or fear of high future inflation deter them from enacting these needed investments even as they continue to monitor inflationary pressures.

Here's why:

- Much of the recent inflation spike reflects temporary factors that, going forward, aren't likely to significantly affect the more moderate underlying inflation trend.
- The following considerations mitigate the risk that the infrastructure and recovery measures, along with the substantial relief measures that policymakers enacted over the past year to address the pandemic-driven deep recession, will drive harmful inflation:
 - The investments in the infrastructure and recovery packages will come over a number of years, spreading out increases in demand that might contribute to inflation;
 - These packages will also include financing offsets to cover costs, which will reduce demand;
 - Many of these investments — such as in infrastructure, child care, and education — make the economy more productive over time and able to satisfy a higher level of future demand without generating inflationary pressures; and
 - Most important, Federal Reserve officials are fully aware of the issue and believe that the Fed has the policy tools to address any inflationary pressures without harming the economy.

In congressional hearings, Fed Chair Jerome Powell has repeatedly expressed his strong belief that current elevated inflation is transient and that the Fed has the tools to promote a strong and equitable recovery and prevent inflation levels like those of the late 1970s:

“I will say that these [recent inflation] effects have been larger than we expected, and they may turn out to be more persistent than we have expected...But the incoming data are very consistent with the view that these are factors that will wane over time, and inflation will then move down toward our goals and we’ll be monitoring that carefully.

“You have a central bank that’s committed to price stability and has defined what price stability is and is strongly prepared to use its tools to keep us around 2 percent inflation ... All of these things suggest to me that an episode like what we saw in the 1970s ... I don’t expect anything like that to happen.”¹

Jason Furman, the chair of President Obama’s Council of Economic Advisers, succinctly sums up why inflation fears should not stand in the way of enacting the full suite of measures in the emerging infrastructure bill and broader recovery legislation:

“I think the needs that this country has in terms of children, in terms of paid leave, in terms of infrastructure, in terms of climate change — they are so large, those numbers should not be dialed down. And I would separate the inflation debate. This year, we injected \$2 trillion in the economy in a single year with almost no notice. That’s a difficult thing for the economy to absorb. The legislation Congress is talking about — it’s spread out over ten years. A lot of it’s paid for. It would expand the size of the economy. And it would give the Fed as many years as it needs to offset it. So I wouldn’t worry about inflation at all in the context of the new proposals.”²

Recent Inflation

In June 2021 the consumer price index (CPI) jumped to 5.4 percent above its level of a year earlier — the largest 12-month increase in the CPI since January 1991. The measure that the Fed actually targets, the price index for personal consumption expenditures (PCE) in the national income and product accounts, which tends to grow a few tenths of a percentage point more slowly than the CPI, was 4.0 percent higher than a year earlier in June — its largest 12-month increase since August 2008.

This recent spike follows a long period of inflation running persistently below the Federal Reserve’s 2 percent target for meeting its mandate to maintain price stability, including a sharp drop in inflation during the pandemic-driven recession. The Fed does not view a temporary increase in inflation, causing it to rise above its 2 percent target, as cause for alarm. In fact, current Fed policy states that “following periods when inflation has been running persistently below 2 percent,

¹ Jeff Cox, “Fed Chair Jerome Powell says it’s ‘very, very unlikely’ the U.S. will see 1970s-style inflation,” CNBC website, June 22, 2021. <https://www.cnbc.com/2021/06/22/feds-powell-very-very-unlikely-the-us-will-see-1970s-style-inflation.html>.

² “Inflation Is Out Of Control In Lebanon And Venezuela. Could It Happen Here?” NPR, July 18, 2021, <https://www.npr.org/2021/07/18/1017366910/inflation-is-out-of-control-in-lebanon-and-venezuela-could-it-happen-here/>.

appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time.”³

While the June CPI increase was larger than expected and inflation could remain elevated for several months before moderating, as Powell has acknowledged, he anticipates that it will moderate.⁴ Many experts agree, pointing to three phenomena that have caused inflation to rise temporarily: (1) a technical “base effect,” arising from a very sharp drop in prices in early 2020; (2) pandemic-driven supply bottlenecks and shortages of materials in some sectors, leading to very large but temporary price increases in those sectors; and (3) pandemic-driven labor shortages that similarly limit businesses’ ability to satisfy demand with the workforce they have or lead them to raise wages to attract more workers, passing at least some of their increased labor costs on to their customers through higher prices.

Base effects

While inflation was close to but still below the Fed’s 2 percent target on the eve of the recession in February 2020, it fell sharply in the recession and remained well below that target from March 2020 through February 2021. Part of the spike in inflation in recent months arises from the fact that the CPI fell below its February 2020 pre-recession-trend level in the recession and has had to grow faster than that trend rate just to return to the original pre-recession trajectory.

President Biden’s Council of Economic Advisers (CEA) calculated that the average annual rate of increase in the CPI from February 2020 through June 2021 was 3.5 percent, compared with the 5.4 percent annual rate from June 2020 to June 2021.⁵ By looking over a slightly longer time period, the CEA analysis yields an average annual change that is less affected by the temporary, very depressed price levels in March through June of 2020. A Center on Budget calculation that’s similar to the CEA’s finds that the average annual rate of increase in the PCE price index was 2.9 percent from February 2020 to June 2021, compared with 4.0 percent from June 2020 to June 2021.⁶ These large base effects are now mostly in the past.

Supply bottlenecks and shortages

CEA analysis also found that a large part of June’s 5.4 percent increase in the CPI is due to pandemic-impacted services and the market for cars.⁷ These, too, are temporary sources of higher recent inflation that won’t likely have a significant effect on future inflation. As the CEA explained, services affected by the pandemic and especially automobile-related sectors (new cars, used cars, parts, and rentals) played a significant role in boosting the CPI in the last three months. Semiconductor shortages arising from the pandemic have slowed new car production and this, coupled with rising demand for cars coming out of the pandemic, including demand by rental car

³ Federal Reserve, “State Statement on Longer-Run Goals and Monetary Policy Strategy,” adopted effective January 24, 2012; as reaffirmed effective January 26, 2021, https://www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf.

⁴ Statement of Jerome H. Powell before the House Financial Services Committee, July 14, 2021, <https://financialservices.house.gov/uploadedfiles/hhrg-117-ba00-wstate-powellj-20210714.pdf>.

⁵ Council of Economic Advisers, July 13, 2021, <https://twitter.com/WhiteHouseCEA/status/1414940741399457792>.

⁶ CBPP calculation based on Bureau of Economic Analysis data.

⁷ Council of Economic Advisers, July 13, 2021, <https://twitter.com/WhiteHouseCEA/status/1414940727088402438>.

companies, raised prices for both new and used cars. But these shortages are not permanent and an increased supply of new cars should ease the price pressures in automobile-related services. The recent surge in lumber prices also captured attention, but lumber prices have already returned to pre-pandemic levels.

Also, services affected by the pandemic have experienced substantial price swings since the onset of COVID-19. A CEA-constructed price index for certain pandemic-related services (airfare, lodging away from home, and admissions to recreation services) fell 14 percent from February to May 2020.⁸ After modest increases over the next six months, that index fell to 16 percent below its level of a year earlier in February 2021. Substantial increases in the last four months closed that gap to 2 percent in June, temporarily raising inflation further.

Labor shortages

Temporary labor shortages are part of the recent increases in inflation as well. Job openings are at record high levels, and employer complaints about hiring difficulties are widespread, though hiring in June and July were quite strong, easing fears about the labor market that arose after lower hiring numbers were reported in April. In some sectors of the economy that were re-opening rapidly, employers faced more demand for their products than they had workers to meet that demand, which led to prices that were higher, at least temporarily, than they will be as employers are increasingly able to hire enough workers to operate at full capacity.

Generally, to compete for workers in a tight labor market, employers have to offer better wages, benefits, and working conditions in some combination that attracts workers. A more satisfied and productive workforce can offset some of the costs of providing better pay and working conditions, but inflation could temporarily rise to higher levels as the boost in compensation takes effect. The inflationary effects would be temporary because higher wages would push up the price *level* as they phased in but not inflation (the *rate of increase* in the price level) thereafter. And while these higher wages can raise prices, they are important for boosting the earnings of workers, particularly in low-paid jobs.

Worker compensation (wages plus benefits) has, in fact, been rising as the economy has been opening up (although not enough to keep up with the spike in inflation).⁹ An open question has been how the pandemic experience has affected people's decisions about what kind of work and working conditions they want or are willing to accept. With the strong jobs reports in June and July, it is clear that hiring is picking up overall. If some workers remain hesitant to work in certain sectors, like restaurants and hotels, that have challenging working conditions and low pay and in which demand could fall again based on rising cases of COVID-19, wages could be pushed up in those parts of the labor market. In recent months hiring has been strong in leisure and hospitality, though jobs in the sector remained down about 10 percent in July compared to pre-pandemic levels.

The effect of unemployment insurance (UI) on labor shortages has attracted considerable attention, but its importance remains unclear, particularly given the strong hiring gains made in June

⁸ Council of Economic Advisers, July 13, 2021, <https://twitter.com/WhiteHouseCEA/status/1414940733656678403>.

⁹ Jason Furman and Wilson Powell III, "US Workers are getting large raises, but not enough to keep up with higher inflation," Peterson Institute for International Economics, <https://www.piie.com/blogs/realtime-economic-issues-watch/us-workers-are-getting-large-raises-not-enough-keep-higher>.

and July. A host of governors used complaints from businesses and others about hiring difficulties as an excuse to prematurely cut off fully federally funded emergency unemployment benefits, including the \$300 federal supplement to weekly UI benefits and the emergency benefits for individuals who did not meet the restrictive criteria needed to receive *any* regular state UI benefits, that are supposed to be available through September 6.¹⁰ While research shows unemployment benefits can result in somewhat longer spells of unemployment as workers can afford to look for work somewhat longer to try to find a job that is a good fit, research also shows that these benefits keep unemployed workers attached to the labor force (that is, looking for suitable work), leading to better job matches that raise productivity as well as wages over the longer run.

Analysts find no evidence that the \$600 federal supplement to weekly UI benefits, which was in effect through July 2020, had any significant effect on the willingness of UI recipients to take jobs — which isn't surprising since at that time there were substantial health risks to taking a job and job opportunities were scarce. Conclusive evidence is lacking on the \$300 weekly boost to benefits that's currently in effect in states that are still providing federal benefits. There are more job openings per unemployed worker now, but the preliminary data from a study that compares employment effects in states that cut off federal benefits prematurely with those that haven't provides no support for claims that UI has been a major deterrent to employment.¹¹ There *is* evidence, however, in that same analysis that the loss of UI benefits has increased the self-reported hardship that jobless individuals face in paying for regular expenses.

Many of the complaints about the role of expanded jobless benefits in the tight labor market came in the spring, after the federal government reported sluggish job growth numbers for April. But since April, job growth has been strong, though overall the economy still faces a sizable jobs deficit from pre-pandemic levels, suggesting that factors other than jobless benefits are largely driving hiring.

Looking Ahead

While no one should dismiss inflation concerns out of hand — Fed Chair Paul Volcker's policies from 1979 to 1981 to end double-digit inflation *did* precipitate a major recession — neither should one accept higher inflation as inevitable or view it as a reason to oppose or pare back the pending recovery and infrastructure bills.

As Powell observed in recent testimony, “Conditions in the labor market have continued to improve, but there is still a long way to go.” Even after substantial gains of 938,000 jobs in June, and 943,000 in July, payroll employment is still 5.7 million jobs lower than in February 2020 and even further behind what employment would be if the trend in pre-pandemic job growth had continued. Moreover, Powell said, “Despite substantial improvements for all racial and ethnic groups, the

¹⁰ Arindrajit Dube, “Early impacts of the expiration of pandemic unemployment insurance programs,” July 18, 2021, <https://arindube.com/2021/07/18/early-impacts-of-the-expiration-of-pandemic-unemployment-insurance-programs/>.

¹¹ Arindrajit Dube, “Early impacts of the expiration of pandemic unemployment insurance programs,” July 18, 2021, <https://arindube.com/2021/07/18/early-impacts-of-the-expiration-of-pandemic-unemployment-insurance-programs/>.

hardest-hit groups still have the most ground left to regain.” As history shows, only a very strong labor market will bring real gains for low-paid workers and workers of color.¹²

The measures that Congress is now considering that will improve our infrastructure and invest in children, education, health care, and technologies to address climate change will improve people’s lives and promote a more equitable economy. They will also increase demand for goods and services while the economy is still short of full employment, hastening the recovery, strengthening the labor market, and over time expanding the economy’s productivity and capacity to supply goods and services. To be sure, a somewhat higher risk of unwanted inflation comes with the rewards that such a high-pressure economy generates. But several factors mitigate the risk.

First, unlike the earlier spending, which was focused on relieving hardship and supporting an economy that was more than 10 million jobs short of full employment by getting money out the door that would be spent relatively quickly to meet immediate needs, the packages under consideration now would spread the spending over a longer period of time and offset much of the cost with measures — like revenue increases and savings in health care — that would also mitigate some of the spending’s demand stimulus. Second, while some of the investments in these packages, such as investments in children, would take decades to increase productivity and expand the economy’s capacity to produce goods and services, others, like child care and infrastructure, would have a more immediate effect over the next decade, reducing longer-term inflationary pressures and the degree to which the Fed would have to tighten monetary policy to prevent demand from outrunning supply.

Finally, as Powell has emphasized, the Fed has tools to address inflation. In the Great Recession of 2008 and 2009, the Fed expanded its toolkit for accommodating an expansion of economic activity to meet its dual mandate to achieve high employment and stable prices, and it has largely continued its accommodative policies as inflation has been persistently below its target. To offset unwanted inflationary pressures, the Fed would have to reverse course, raising short-term interest rates and unwinding the large-scale purchases of longer-term assets (“quantitative easing”) that it introduced when it was trying to stimulate demand after it had lowered its target interest rate as much as it could. It also would need to clearly convey its intentions to the public and financial markets so that they don’t come to assume ongoing inflationary pressures that they then build into their expectations of future inflation, prompting businesses to raise prices and workers to increase wage demands.

The Fed understands all of this, and it believes that it has the tools to accommodate a robust recovery while preventing worrisome inflation, as the quotes from Powell above attest. Prominent economists agree, as illustrated by the earlier assessment from Furman.

Conclusion

Predictably, opponents of the recovery legislation have seized on the recent inflation increase to argue that we cannot afford the measures in that legislation that would make critical investments in long-unmet needs like investments in children, health care, clean technology, education, paid leave,

¹² Chad Stone, “Robust Unemployment Insurance, Other Relief Needed to Mitigate Racial and Ethnic Unemployment Disparities,” Center on Budget and Policy Priorities, August 5, 2020, <https://www.cbpp.org/research/economy/robust-unemployment-insurance-other-relief-needed-to-mitigate-racial-and-ethnic>.

and housing because such investments would generate unacceptably high inflation. Too often, opponents make these arguments without any discussion of the value of these investments against a realistic assessment of inflation's risks and costs and the tools available to combat inflation should they be needed.

In fact, most experts, including those at the Federal Reserve, recognize that recent price spikes reflect temporary factors that should dissipate this year. It will be up to the Fed to keep inflation at rates consistent with its inflation target, and the Fed believes it has the tools to do so. Together, the proposed recovery legislation and the emerging, bipartisan infrastructure bill constitute a package that's the right size to address the nation's long-unmet needs and provide benefits that, if the Fed remains vigilant, will far outweigh inflationary risks.