Inequality and inflation

ASSA Meetings

New Orleans

January 2023

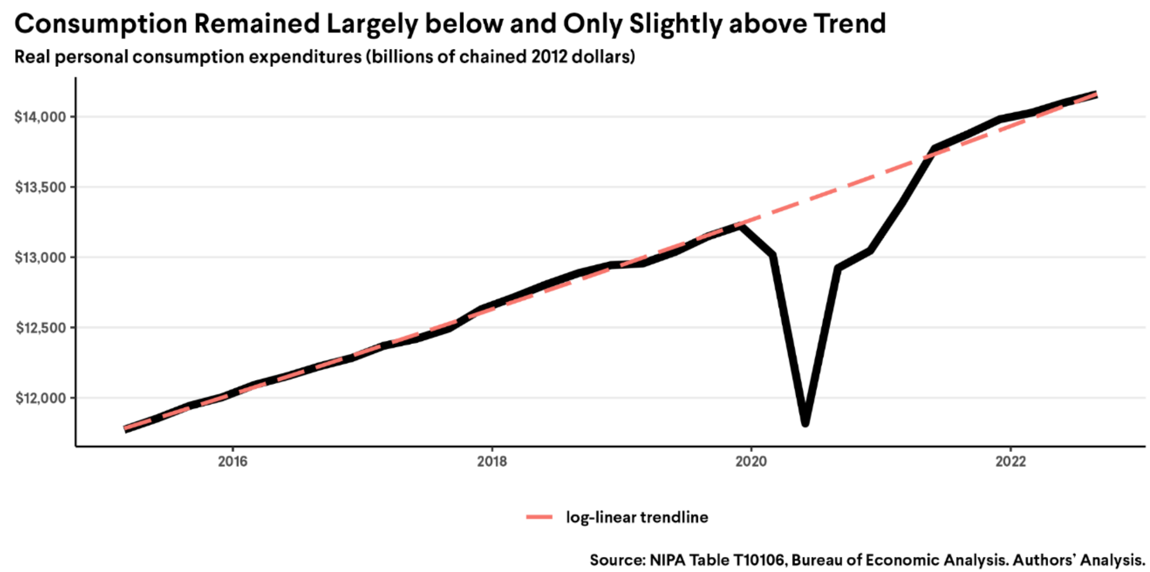
Outline

1. Understanding the underlying drivers—the disturbances to the economy—that are causing increased inflation *and* worsening inequality
2. Right question: How do we respond to these disturbances *and* their consequences?
3. Focus on monetary policy wrong. It will worsen inequality and do little to tame inflation, unless push to unacceptable levels, with long-run consequences
4. Host of better ways that (i) do a better job at taming inflation; (ii) reduce inequality; and (iii) regardless of model of inflation and estimate of its inertia, have positive effect on economy

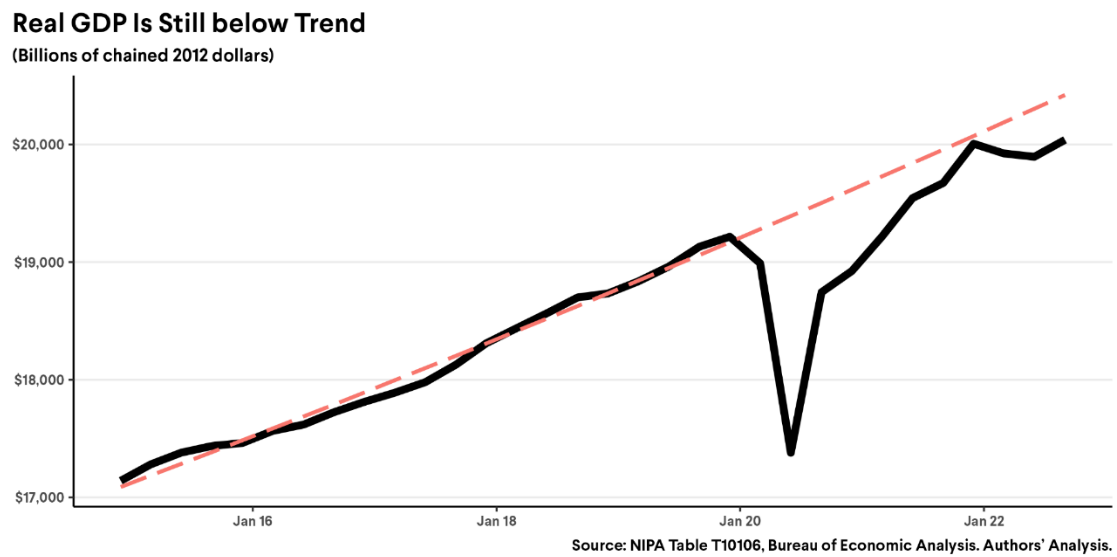
Underlying drivers

- Not excess demand
- Excess savings not caused by excess pandemic spending
- Excess savings not being spent down quickly

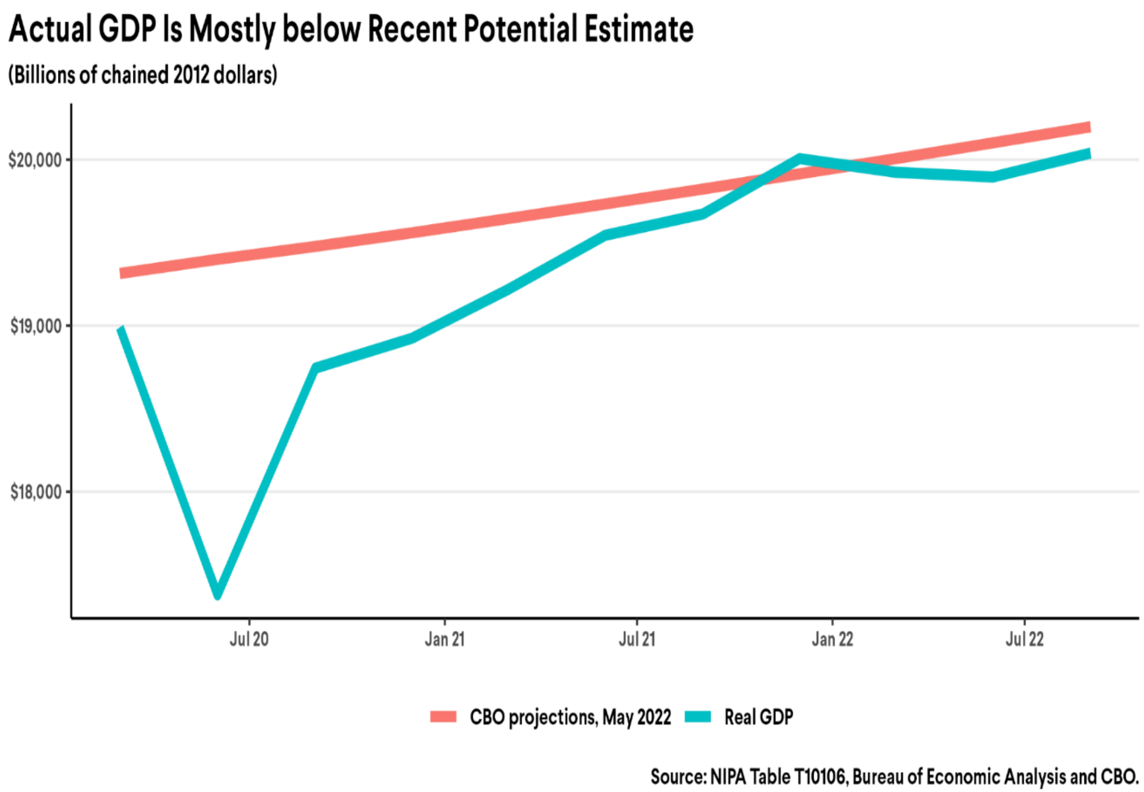
Excess consumption was not the problem



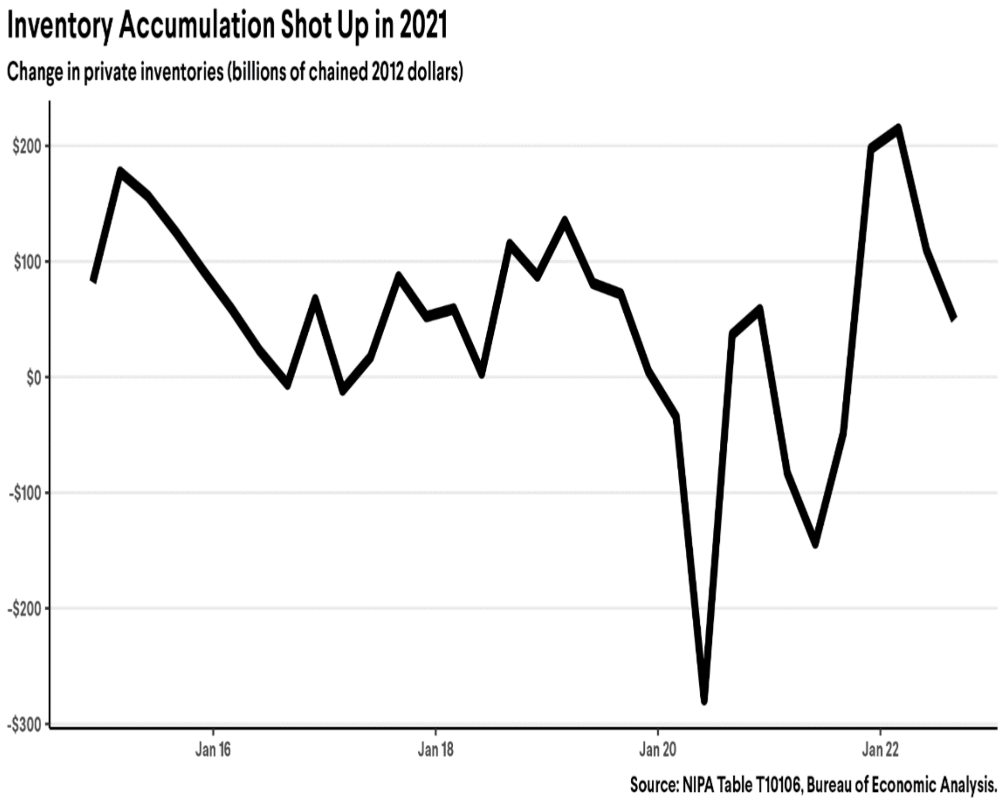
Total Real Aggregate demand below trend



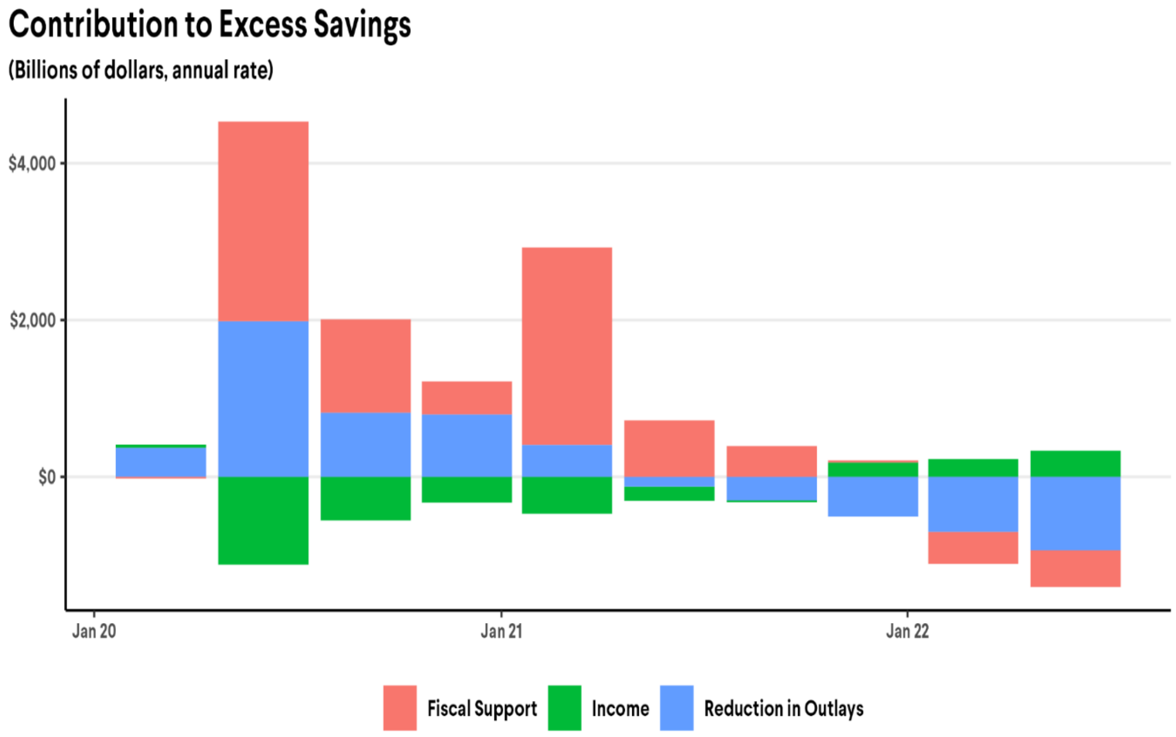
Real Aggregate Demand below CBO estimate of potential output



Large inventory accumulation sign of weak aggregate demand

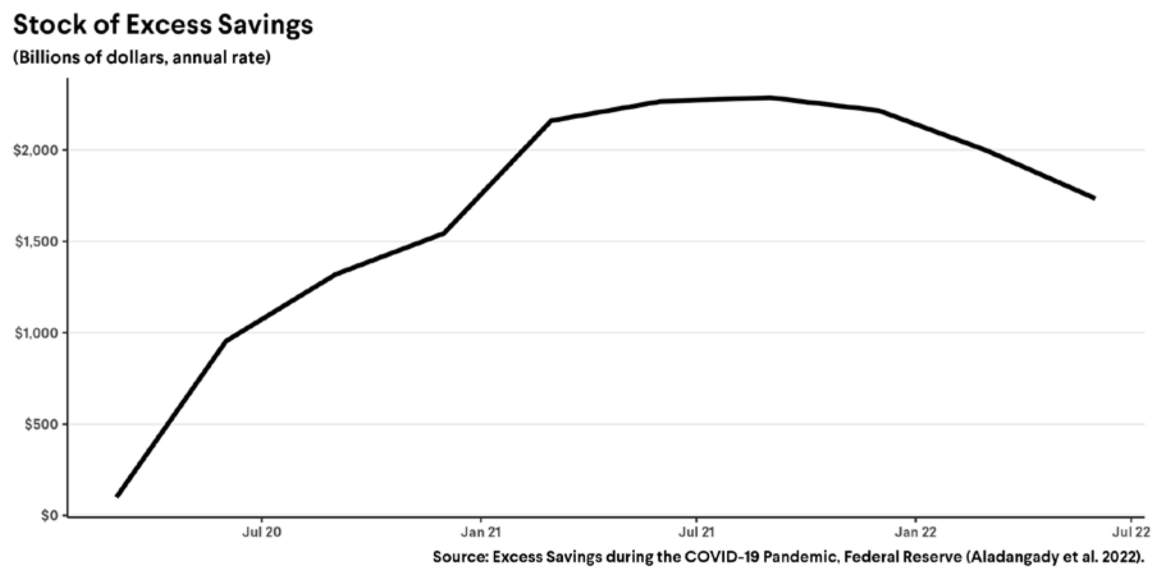


High fiscal spending only part of cause of excess savings

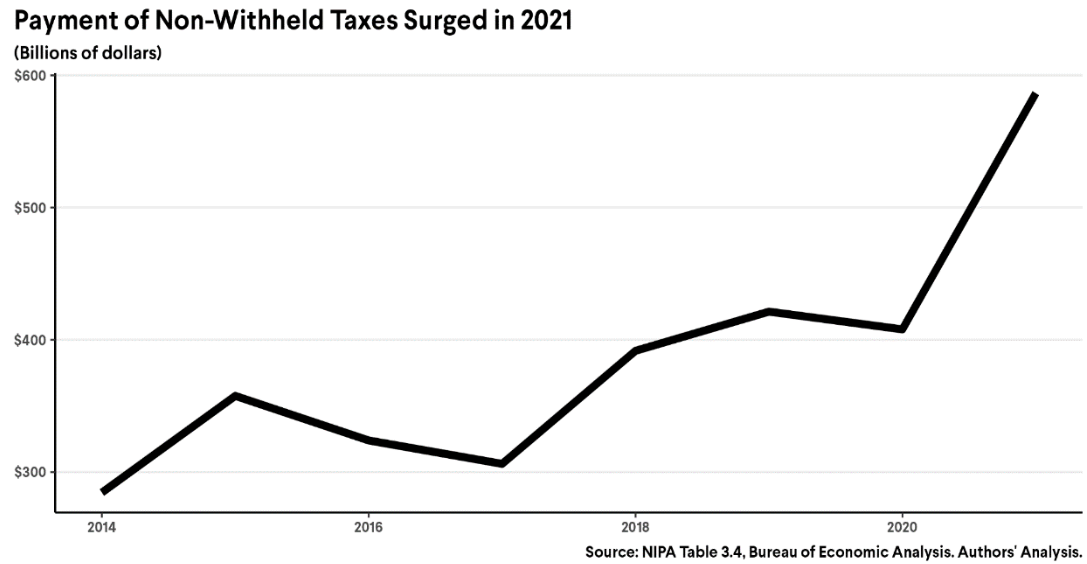


Source: Excess Savings during the COVID-19 Pandemic, Federal Reserve (Aladangady et al. 2022).

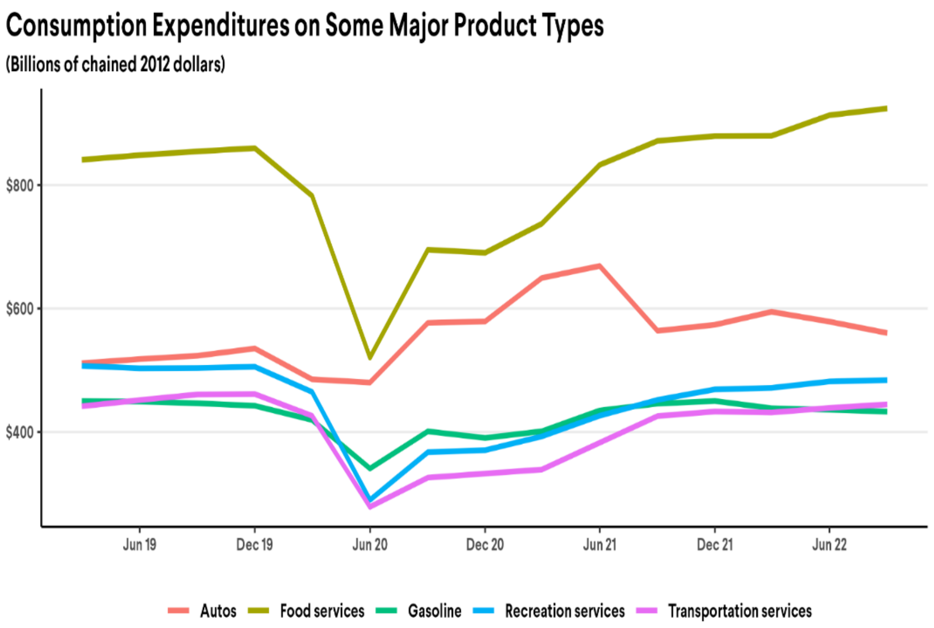
Excess savings has only been spent down slowly



Much of spending down of excess savings went for taxes not withheld

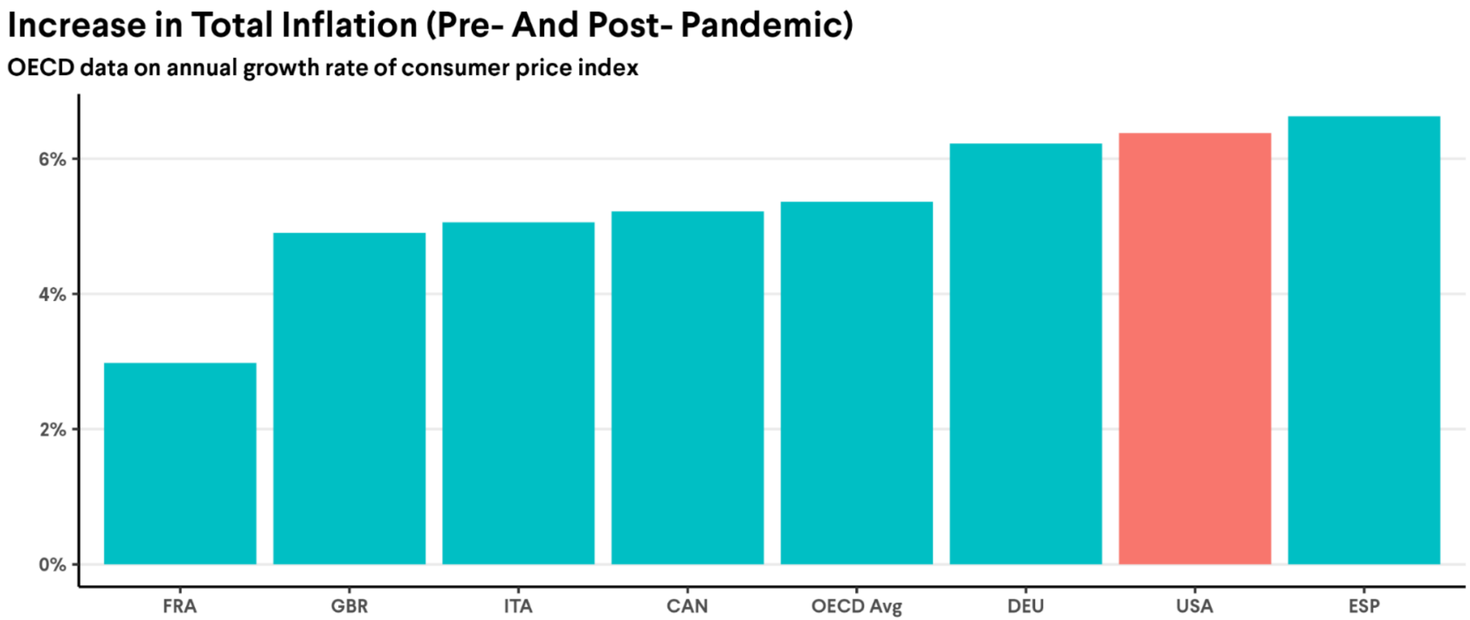


Even consumption of non-traded goods (sector where prices most likely affected by excessive pandemic spending) did not surge



Source: NIPA Table T20306, Bureau of Economic Analysis.

Increase in US inflation only slightly higher than other advanced countries



Turkey as an outlier was dropped from OECD average. Change in inflation is determined by calculating the annualized rate of change in CPI from (Dec 2020 to May 2022) and subtracting that from the annualized rate of inflation from December 2017 to December 2019.

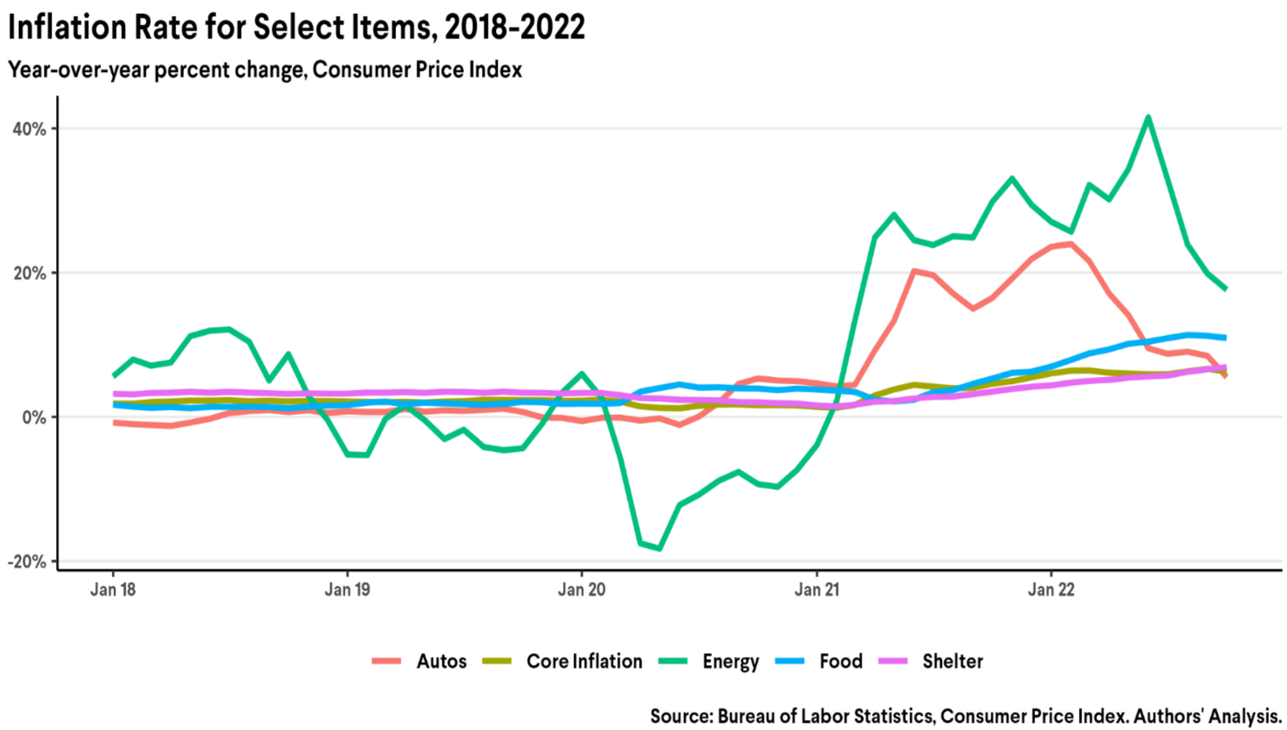
Multiple differences in policies

- Much higher pandemic spending
- Much worse pandemic labor policies (higher unemployment rate)
- Much worse working conditions and job protections
- Much poorer health policies

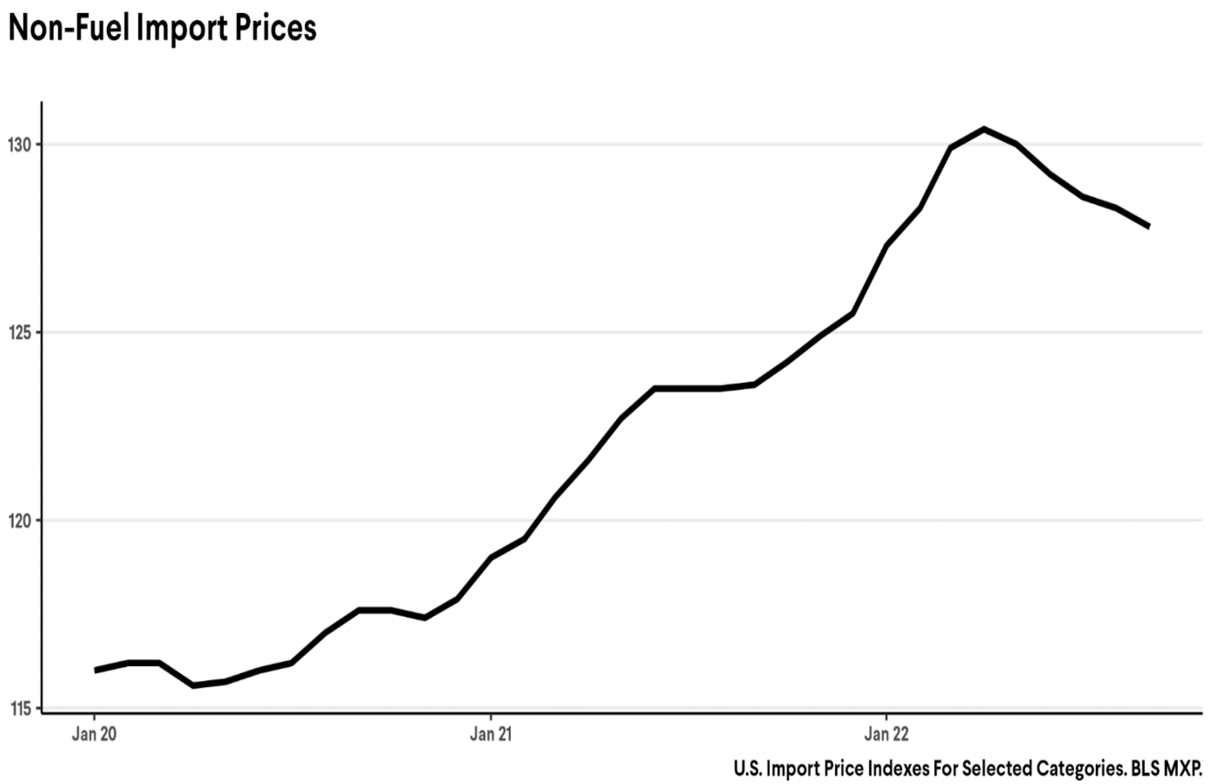
Source of inflation

- Pandemic-induced supply side shortages
- Demand shifts, partly induced by pandemic, partly induced by large changes in relative prices, partly induced by supply shortages in other sectors
  - Asymmetric price responses—with shortages leading to greater price increases than excess demands leading to price decreases
  - Exemplified by rental market
- Unexpected lack of resilience of markets to shocks—consequence of short-sightedness
- Exercise of market power—with prices going up more in sectors and with firms with more market power
  - Phelps/Winter/Greenwald/Stiglitz model predicts greater uncertainty leading to higher mark-ups
  - Contributing to lack of resilience—baby formula
- All exacerbated by war

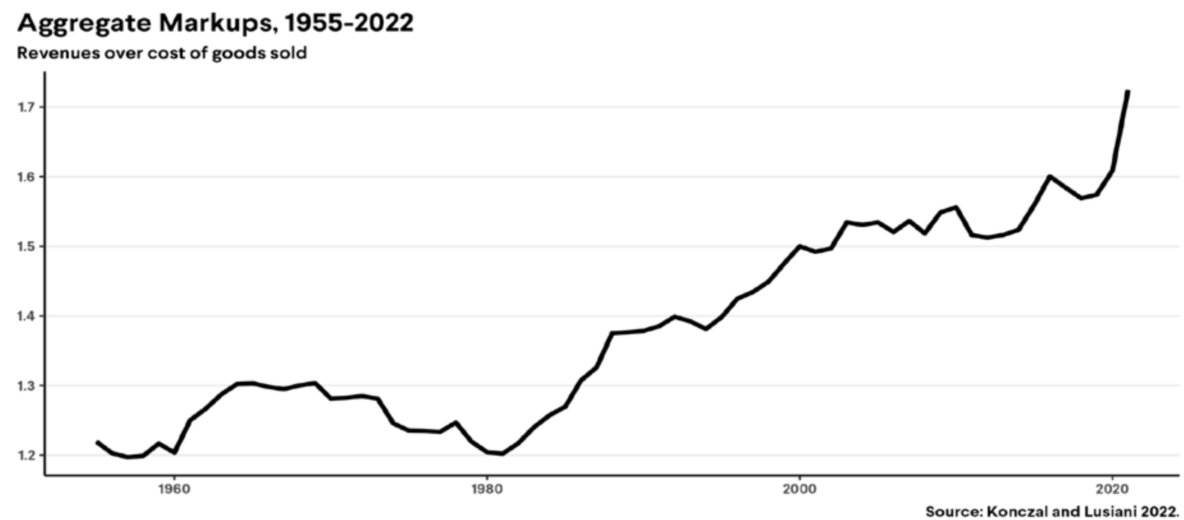
Price increases centered on certain sectors and timing not related to gap between aggregate demand and potential output



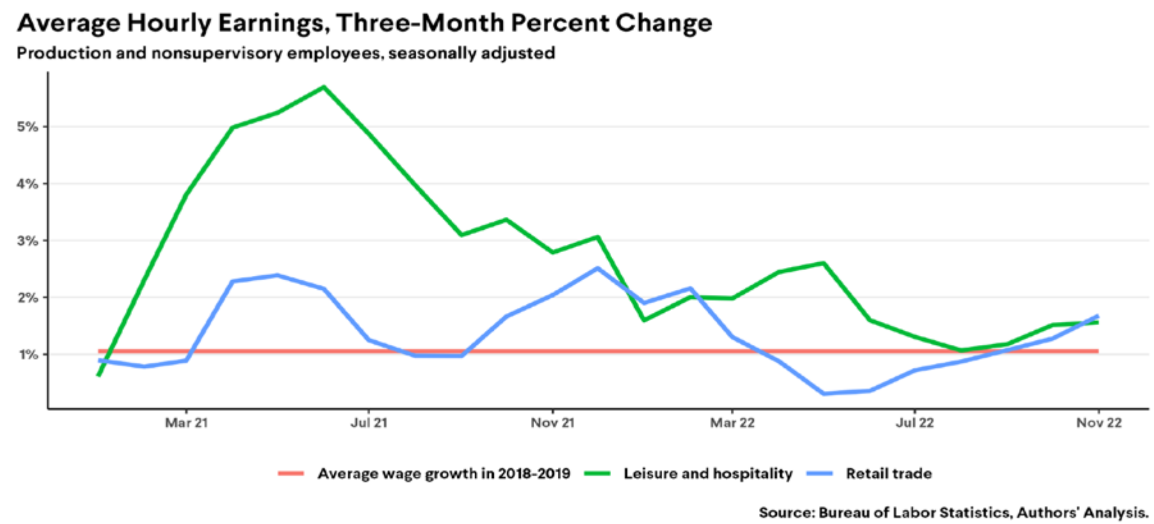
Including imported goods other than fuel



Large increase in mark-ups



Short-run correction in low wages in some sectors



Picture today

- Inflation is being tamed, as pandemic and its effects weaken
  - Bottlenecks being resolved
  - Disinflationary forces at play (oil, cars, etc.) as sectoral prices normalize
- Inflationary expectations remain tame
- Wages not keeping up with prices—not a sign of tight labor market; in any case, no evidence of out-of-control wage price spiral
  - Limited bargaining power of workers
- Wages can and should increase at pace faster than is in long run sustainable
  - To increase real wages
  - Mark-ups can and should decrease
- Inflation has seeped into core, there is some price-price inflation, and overall disinflationary process may be slow
  - 2% target totally arbitrary, time to get to target even more arbitrary
  - And cost of getting their quickly may be very high

Why monetary policy is not the right instrument

- Problem not caused by excess of aggregate demand
- Monetary policy doesn't address underlying source of problem—won't resolve supply bottlenecks
- May make matters worse
  - Will discourage investment required to resolve them
  - In "customer markets" (Phelps/Winter/Greenwald/Stiglitz) increases in interest rates induce firms to raise prices
  - Some evidence that higher interest rates get passed on in rents

Monetary policy increases inequality

- Increased unemployment
  - Hitting hardest at marginalized groups
  - Significant hysteresis effects
- Globally even more adverse
  - New form of "beggar-thy-neighbor policy"
  - Recessions in Europe, elsewhere will be worse
  - Global debt crisis
    - Increased value of dollar
    - Higher interest rates
    - Slower global growth

There are alternative policies

- Real supply side policies
  - Increasing green energy
  - Increasing food production
  - Increasing labor supply
    - Better childcare, family leave policies
    - Increased wages
    - Immigration reform
  - Stronger and better enforced anti-trust policies
- Better protective policies, partially financed by windfall profits tax
  - Can be designed to discourage price increases
- These policies have long term benefits, even if inflation turns out to be more transitory that seems to be the case now