# 012422 Ford aud

### fspp-webmaster@umich.edu

[](https://scribie.com/files/859fa5c7ca4642d593769f9a0e922fc169147041)https://scribie.com/files/859fa5c7ca4642d593769f9a0e922fc169147041

[music]

0:00:26.3 Luke Shaefer: Good evening. I'm Luke Shaefer, Associate Dean for Research and Policy Engagement and Kohn professor of Social Justice and Social Policy here at the Ford School. I'm delighted to welcome you to this timely event, Road to Economic Recovery, Inflation, Wages and the Changing Labor Market presented as part of the Ford School's Policy Talk series in partnership with the Center on Finance, Law and Policy. As a scholar of social welfare policy, I've watched closely the impact of the expanded social safety net during the COVID-19 pandemic on the well-being of Americans in the form of reduced poverty and hardship in 2020 and 2021. But like many Americans, questions about the state of the economic recovery going forward, and particularly about inflation, have been on my mind. Americans are feeling the effects of rising prices every day at the grocery store, at the gas pump, and in their online retailer checkout carts. I also know the economy has added millions of jobs in the last year, but at the same time, there are millions more open jobs. I must confess, I don't completely understand what all of these things add up to. Luckily for me, I happen to work down the hall from some of the nation's leading economists studying these questions, so I thought I might just ask them. And if I wanted to hear from them, I thought the Ford School community might be interested too in what they had to say.

0:01:57.6 LS: So here we are. I'm delighted to be joined by Kathryn Dominguez, a Professor of Public Policy and Economics at the Ford School. She has worked as a research consultant for the Federal Reserve System, the International Monetary Fund, and the World Bank, among other entities. Josh Hausman is an Associate Professor of Public Policy and Economics here at Ford. He also served as a staff economist at the Council of Economic Advisors during the Obama administration. John Leahy, he is the Allen Sinai Professor of Macroeconomics and Public Policy. He has consulted with the Federal Reserve Banks of New York, Philadelphia and Kansas City, and is currently co-editor of the American Economic Review. And finally, Betsey Stevenson is a professor of Public Policy and Economics here at Ford. She served as a member of the Council of Economic Advisors during the Obama administration and chief economist for the Department of Labor in 2010 and 2011. So I'm gonna kick some things off with some of the questions on my mind, but we encourage you to engage and ask questions on the YouTube chat box or tweet your questions to #policytalks. There will be time at the end of the live event for these audience questions, including those received in advance.

0:03:18.9 LS: So first, let me welcome our panelists. Thanks everyone for being here. Josh, I'm wondering if you could kick us off. What are the facts about rising inflation at the start of 2022, what does it mean for American households, and what kind of prospects do we have for getting worse or getting better in the coming months?

0:03:42.8 Josh Hausman: Thank you so much. I'm so pleased to be part of this panel. Thank you for organizing it. Maybe the place to start is just to remind us what inflation is. So inflation is the growth rate of the price level, where the price level is the weighted average of prices in the economy. It's weighted because changes in some prices matter a lot more to households than changes in other prices. It matters more to households if rents go up than if the price of candy bars goes up. The average of prices that is most often looked at is the consumer price index, or what we'll call the CPI. So here we see CPI inflation, the price... The change in the CPI over a 12-month period, and you can see at the very end here that CPI inflation is currently 7%, which is the most rapid inflation since 1982.

0:04:30.7 JH: Now it's reasonable to ask why this matters, and in fact, economists often start with the baseline that it shouldn't. Generally, when prices go up, so do wages. So on average, workers aren't left worse off. Still, there are very good reasons to worry about inflation. First, at least in the short run, wages may not rise as fast as prices. At the same time as prices rose 7% between December 2020 and December 2021, average hourly earnings rose only 4.7%. Second, even if their real wage isn't any lower, people simply really dislike inflation, and that is a cost. Third, since not all prices adjust at the same time, inflation generally means quite uneven changes in prices, which can lead to economic inefficiency. So inflation has real cost, and we'd like to understand what's causing it. The place to start is to look at some other measures of inflation. Here the green line is what we saw on the previous graph, the overall CPI with that inflation rate at 7%. The purple line is what economists call core inflation. It's inflation without energy and food prices, the rationale being that food and energy are often quite volatile. You can see that core inflation has also risen a lot, although not quite as much. It's now at 5.5%.

0:05:48.2 JH: The two measures below attempt to adjust for unusually volatile prices in a couple of different ways. I'll simply highlight the orange line, which is median inflation. It's the inflation rate of the median item in the CPI, and you can see that that's up although by much less than the overall CPI. So the conclusion I take from this graph is that no matter how one measures it, inflation is up substantially over the past year, though the headline 7% rise in the CPI probably reflects some unusual price increases in things like energy and used cars. This unlikely accounts for much of overall... Of why overall CPI inflation is higher than median inflation. I do wanna highlight the role of durable goods. The pandemic led to a dramatic shift in demand from services to goods. As people stopped eating out, going to movie theaters and so on, they shifted a lot of consumption towards buying durables, things like equipment for their kitchen, and the consequence was much higher durable prices. Here we see the 12-month change in the durable goods component of the CPI, and remarkably, this is higher than at any time since the 1950s. Even in the 1970s when there was double digit overall inflation, durable goods inflation was lower than it is now.

0:07:04.1 JH: So what is the outlook for inflation going forward? Now, the Federal Reserve is quite optimistic. They see inflation back below 3% by the end of 2022. The Fed knows a lot more than I do, so take the following with a large grain of salt. But I think this Fed forecast is over optimistic for three reasons. First, the Fed itself plans to do very little to rein in inflation. As perhaps we'll talk about more, the Fed plans to raise interest rates by about 0.75 percentage points this year, it's hard to see that doing very much to slow inflation. Second, there's a technical reason to expect inflation to persist, and that is that reflecting its importance in families budgets. One-third of the CPI is shelter, meaning both direct spending by households for rent, and the amount that households who own their houses would be paying for rent if they didn't own their houses. This is measured as the weighted average rent being currently paid. It's not the amount you'd pay if you signed your rental contract today. So with house prices rising rapidly, these average rents will go up as people sign new rental contracts, and that will feed slowly into the CPI.

0:08:15.7 JH: Finally, a lot of optimism about inflation over the past year, the persistent view that it would be temporary and fall in the future has been based on the view that supply-side disruptions would abate. Ports would become unsnarled, schools would return to normal, so parents could go back to work, COVID would fade away so those who left the labor force out of fear of the virus would return. All these bets have proven wrong thus far. I'd like nothing more than for them to be proven right in the future, and of course, it's possible, but it's not what I would think of as my baseline scenario. In particular, even if the COVID situation in the US improves, there are other possible supply shocks on the horizon. For instance, China's effort to maintain zero COVID in the face of Omicron could well lead to disruptions of production in China, increasing prices for Chinese-made goods in the US, and if Russia invades Ukraine, that can increase energy prices. So let me stop there, and I hope my colleagues can convince me to be more optimistic.

0:09:21.6 LS: Well, before we maybe look too much into the future, let's look into the past. And Kathryn, I'm wondering if you could offer some thoughts on why inflation jumped the way it did, especially in United States over the last year or two.

0:09:35.4 Kathryn Dominguez: Sure. And that was a great introduction, Josh. But, really, I'm just gonna start with the pandemic. The pandemic is the reason that inflation is so high. The pandemic and the policy responses to the pandemic, which we'll talk a lot more about, and then also the reactions of individuals and firms, those all three together are actually what caused inflation to go up. But let me talk about the demand side and the supply side just really briefly. So on the demand side, Josh already started us off with the discussion that people couldn't go to the movies, the restaurants, they couldn't travel so they bought stuff. They bought consumer goods, and particularly durable goods, and those goods are the ones that are often involved in complicated supply chains. On the supply side, global disruptions in production and supply chains, and lower labor force participation, which I know Betsey's gonna talk about, have combined to reduce the supply of the very goods that people are demanding more of. So economists have a supply and demand model that says, higher demand, lower supply, that's gonna lead to higher prices, and that's exactly what we're seeing. On top of that, as Josh sort of also described, higher prices lead workers to demand higher wages, which then in turn lead to higher prices and so on.

0:11:13.2 KD: So one of the things economists and policy makers are very worried about is that this wage price spiral might actually continue far beyond when we think if and when the pandemic actually abates. So the pandemic started this off on this trajectory, but now the question is, will behavior on the part of individuals and firms lead us to this ever increasing level of prices and wages? So that is the backdrop. Just a couple of other things, just to start us off, the pandemic and the very extraordinary policy responses and behavioral responses were quicker than we've ever seen before. The only times that we've seen these dramatic changes are typically after... During and after war time. So this is really a very unusual circumstance where we had a very large shock, the pandemic, which then led to very dramatic, extraordinary changes in policy and very dramatic changes in behavior. So one of the reasons why inflation surprised us all is in part because these shocks came so quickly, and then the reactions to the shocks in turn were very large. So I'll stop there.

0:12:40.3 LS: Betsey, tell us about the labor market side of this and what will that explain.

0:12:50.9 Betsey Stevenson: Yes. So let me start by... You asked me about the labor market side, addressing Kathryn's point about wage price spirals, and I think I wanna be really clear that I don't think we're seeing that yet. It is absolutely what every economist is fearful of, but if you look at price growth and wage growth, they are completely uncorrelated across 110 industries. So we don't see that it's wage growth that is right now being the big contributor to inflation. If you look at the things that have been driving inflation, there are things... The autos, the energy, those are not coming out of high labor market costs. If we're pointing back to something that Josh has said, why is it that inflation can be painful, and he said, well, sometimes we just might not keep up right away, I think it's really that inflation redistributes. There are winners and losers from inflation, and typically economists talk about how people in debt tend to be winners from inflation and lenders tend to be the losers from inflation. But we can also see redistribution across the labor market that right now is partially reflecting some reallocation that's going on. The winners right now are the young and the restless, those are the people getting the real wage gains.

0:14:12.3 BS: So young people at the lower end of the wage spectrum, we're seeing real wage gains. So if people entered the bottom third of the labor market are continuing to see real wage gains despite the higher inflation rates. And then the people who are getting real wage gains are the people who are changing jobs, who are taking advantage of this period of time where we're seeing a lot of re-allocation in the economy. Consumers are changing what they wanna buy, people are changing where they wanna work, everybody's sort of shuffling around. What we're seeing is that some people are able to use that shuffle to get higher wages for themselves, and other people who are staying put are seeing that their wages aren't keeping up with inflation. So we're seeing some of that redistribution going on. The last point I wanna make about what we see going on with inflation is... The United States, when we look at the private sector economy, about a fifth of the economy is in that goods producing sector where we're seeing all of these high prices really coming from in terms of our workers. About a fifth of our workers in the private sector work in the goods producing economy. The other four-fifths work in the service sector.

0:15:19.9 BS: The service sector has never really been hit so hard by a recession. It's usually the goods producing sector that gets hit by a recession. In this recession, it was the service sector, and the service sector has also been the slowest to recover from that recession. That's also a place where we're not seeing a lot of inflation right now. Looking at the things where we used to be worried about inflation like healthcare inflation to not seeing that be a particularly big problem, but I do have a lot of concern. So one of the... The concern I have for why we might have ongoing inflation is whether or not consumers finally... We sort of moved past the pandemic, and people decide they do wanna go to the movies again, they do wanna go out to dinner again, they do wanna travel again, they do wanna go for those cosmetic or elective procedures and to the consumer health care, all of that is gonna require a huge demand for workers. And the big question that I think no one could really answer right now is, will the forces that caused demand for those services to shift out also cause labor supply to shift out so we get some more of our workers back.

0:16:29.0 BS: If we don't get more workers back when the demand for services increases, we're gonna see higher inflation in the service sector and I think that that's why I would agree with Josh in terms of pessimism about where inflation could be going, but I think that that's what would be driving it. I think that the goods producing sector, we're gonna see the inflation there die down very quickly.

0:16:56.1 LS: So Betsey, you talked about needing to get more workers back, and I wonder if you could tell us a little bit more about that. So we saw this huge just fall in the number of jobs at the start of the pandemic. And then over... Especially 2021, we regained a lot of those jobs but there remain a lot more jobs open. So how do you make sense of that? Are we just seeing huge numbers of people on the sidelines, are we just seeing way more open jobs as part of the outcome of these huge shocks to policy that Kathryn was talking about and we just can't keep up with it? How should I make sense of the labor market and the role it plays here?

0:17:41.5 BS: We cannot ignore the pandemic. So I'm gonna tell you a scary number. At the end of December, beginning at January, census pulse data revealed that 14 million people were not at work because they either had COVID, were caring for somebody with COVID, or were at home because their kids got sent home from school because of COVID-related closures. So that's the highest number we've ever had during this entire pandemic of people not being in work because of direct COVID-related reasons. So you can't work if you have COVID. And I'm also gonna say another really grim reality, one of the reasons we're seeing inflation is we tried to keep demand up when the real potential of the economy fell. And the real potential of the economy fell because we have premature deaths due to COVID, that's one reason. It's not the only reason, but we shouldn't ignore that. We've also had people who've developed long-term chronic health problems due to COVID. They're not coming back. We continue to have people who are not coming into the labor force because they're fearful of COVID. So labor force participation for people over the age of 55 is a lot lower.

0:18:58.0 BS: It's not actually because people were retired at much higher rates due to COVID, it's because normally people retire and then they un-retire. Retirement is kind of boring, and people like to go out and do things where they engage in the world. And so maybe the truck driver decides to then drive school buses, or maybe the person who retires from their teaching job takes a part-time job working at an after-school program. People take on other jobs. That is what has declined. So it's actually the labor market entry of older workers that has slowed, not that the labor exit of older workers sped up, and it's paying attention to where these pain points are. Are they at the entry point of the labor market or the exit point that really helps try to shape what's gonna happen with the labor market. And I think... Turning to Fed policy, I think the Fed has been trying to keep the economy going so that people would stay in the labor market and we wouldn't see that sort of speed up in labor market exit rates, we wanna keep people in jobs, but I think right now where in the labor market with so much churn, it's not sure... It's not clear... And so much illness, and so much disruptions due to child care that it's not clear that Fed policy alone can keep people in these jobs.

0:20:19.4 LS: So in a minute, I wanna turn to John and start talking about the Fed policy. Just before we go though, I wanna try to summarize for myself as a non-expert. So we... Josh, from your slide it looks like we had a lot of years of very low inflation, and then as Kathryn was saying, as a result of this unprecedented pandemic and then an unprecedented policy response, and that has to do with fiscal monetary policy as well as labor market dynamics, we've seen the surge in inflation, and it sounds like none of you are particularly positive that... At least it's... I shouldn't expect it to recede next month or any time in the next half year. And maybe by the end of 2022, maybe we would see some progress. But Josh, sounds like you don't even think by then.

0:21:19.2 JH: Well, I think, as Betsey was saying, the goods prices could reverse very quickly, and so exactly it's always hard to know how to parse month to month changes. And you could imagine that there could be sufficiently rapid reverse of goods prices that you would see some months with quite low inflation readings. I don't think that sort of underlying trends of inflation, things like the median measure, are going to have substantially fallen by the end of the year. But, again, the Fed disagrees and the Fed knows more than I do.

0:21:50.4 BS: I think... Can I just... I just have one more thing. What I was saying, the potential output has declined, and I give you the labor market aspects, but there are a bunch of other things that I think has caused at least a temporary decline in potential output, and some of those are those supply chain disruptions, I think that's temporary. We've also seen immigration around the world decline, and I think that's a big challenge that's kept our... What we can produce down. And there's also been a deferred capital investment that I think is meaning... It means that we're not able to get the supply people want. So we've kept people's demand high, but companies just are not producing enough to be able to meet all of that demand right now, and I think that's what is going to continue going on. I don't think all of a sudden... The only way this changes is, if all of a sudden tomorrow, we just decide we want less, so demand goes down, or something happens that reduces demand, or if we have some miracle increase in supply. And I think it's the miracle increase in supply that we're all hoping for. I'm still waiting for a dishwasher that I've been waiting for for eight months, and so I'm hoping for a miracle any day now.

0:22:58.5 LS: Well, it's not just that our ability to produce is going down, but the responsiveness, that's where the supply chain disruptions come in. Supply has become, you can't get your dishwasher. You want a dishwasher. You'd pay a lot for a dishwasher, they still can't get you a dishwasher. So whereas five years ago, they would have found some way to get you a dishwasher from Malaysia.

0:23:23.0 KD: One thing, Luke, just to be a little bit more positive is... And John's just about to talk about this. But policy is unwinding. So there's less stimulus and maybe not as much contraction on the Fed's part as some on the panel would like, but policy is sort of withdrawing or normalizing relative to what we saw before. So that is likely to have some implications for prices as well in the more... Bringing them down. So just to get a little bit of optimism in there.

0:23:58.1 John Leahy: Let me take that as an invitation to talk about policy a little bit.

0:24:02.6 LS: And, John, if you don't mind... Yeah, starting with the person who doesn't know anything about macroeconomics in mind...

0:24:10.4 JL: No one knows anything about macroeconomics...

[laughter]

0:24:13.8 JL: That's probably a good place to start. So like Kathryn said at the beginning, and Josh did, that inflation's basically when too much money chases too few goods, when demand outpaces supply. And as Betsey said, this is a very strange inflationary episode because it's not driven by a ton of people suddenly rich buying stuff. It's because this pandemic happened, and the pandemic means we can't produce stuff. And so it's just fewer goods to buy and, at the same time, policy kept demand strong. So if you look at personal income, and one of the striking things about the last three years is that personal income hasn't fallen, even though unemployment rate shot up, even though production fell. The policies of the Trump administration and the Biden administration kept money in people's hands and people kept ability to keep going, and that was a huge victory. But what it meant was that there was a lot of demand for very few goods. Then you throw on top of that that the Federal Reserve has been following very, very loose monetary policy.

0:25:28.1 JL: They kept interest rates low throughout this entire process. Now, one thing that's interesting about the Fed is that it changed its policy procedures just in 2020. So up until 2020, the Fed had been proactive. Whenever they thought there might be inflation, they would raise interest rates. So it's kind of like shoot first, ask questions later. And so we would start raising interest rates when unemployment was at 5% or at 6% in some episodes, and this was very tremendously successful. You saw Josh's picture, and inflation has been pretty much flatlined at 2% for over 20 years. Now, but it left in the back of your mind that maybe we were being too aggressive. Maybe we were ending the party before it really started getting going, and that maybe unemployment could have fallen a little further, and maybe people could have seen their wages rise a little more, and maybe disadvantaged groups could have enjoyed more in the boom. So the Fed shifted from a proactive policy to a reactive policy, that instead of trying to keep inflation from ever going above 2%, they kinda tried to keep it averaging around 2%. So let it go above and then push it down, let it go below and push it up, but try to keep it... Wait until you see the inflation before you start tightening. Now in most...

0:27:04.5 BS: John, I was just gonna say, you called this successful. I just have to say it was definitely successful in keeping inflation down.

0:27:11.7 JL: Oh, yeah, no, no, that's exactly what I meant. I meant successful, and it's...

0:27:15.5 BS: But...

0:27:15.6 JL: When you think of the monitoring authorities, most monetary authorities in the world, the only thing they think about is inflation. By that metric, it was very successful. But the reason they shifted was to even out the two pillars. The Fed is supposed to look at unemployment, and it's supposed to look at output... I'm sorry. Inflation and unemployment and try to put those a little bit more on even footing. Now, the strange thing that happened... And most people expected when the inflation got to 3%, the Fed would start tightening, 4% it would start tightening. But they're still behind mortgage-backed securities and throwing fuel on the fire, and basically calling the price increases temporary, and they still haven't taken contractionary action. The actions Kathryn talked about are all slowing the stimulus. The interest rates... They've talked about raising interest rates, but we still haven't seen a rise in interest rates. And one of the interesting things about the inflation interest rate dynamic is that a rise in inflation is similar to a fall in interest rates. So when inflation goes up, you're paying back your loan in cheap dollars. The dollar that you're paying in the future isn't worth as much as the dollar you borrowed. So a 1% rise in interest... In inflation, is similar to a 1% cut in interest rates.

0:28:42.9 JL: So this entire year in which the Fed basically didn't raise rates, and interest rates... Inflation rates rose to 7%, was as if the Fed was cutting rates every month. And this was very stimulatory, and this, I think, is why Josh is so pessimistic, that 75 basis points over the next year seems like a little too little too late to counteract an increase in inflation from 2% to 7%. Most economic models would say you need to raise rates to 6, 7, 8% in this situation, which is... I don't think anybody is contemplating at this stage, and... But past that proactive Fed would have rates that are much, much, much higher than they are right now.

0:29:37.5 BS: John, there you mean... They focus on core PC, not CPI, so...

0:29:42.3 JL: It's at 4% so they should be at 6%.

0:29:43.9 BS: But also...

0:29:45.9 JL: You wanna get at the region of 1.5 is a good one. So every increase in the interest... In the inflation rate should be about 1.5 increase in the federal funds rate.

0:30:00.2 KD: But, John, here's the... We might have coalesced around a different conversation, which is why are we in recession if the Fed had put on the brakes too hard. There are...

0:30:10.3 JL: Oh, I think we're in for very rocky next year, because the Fed doesn't have a great track record of stopping booms. Booms are very hard to stop, especially because policy takes time. Fed interest rate rises take, generally, about a year to a year and a half before they fully influence the economy. So if they're not raising rates until the middle of next year, March say, we're gonna see the contractionary effects sometime in 2023. How do you fine-tune that? It's not something that's easy to find-tune. So we're probably gonna see some rises, falls. We could have a recession if the Fed over tightens. We could have higher inflation if the Fed under tightens. But basically, it's like... Imagine driving a truck that turns a year and a half after you turn the steering wheel, and that's just gonna be really... It's really kinda hard.

0:31:11.8 BS: But, Kathryn, that's not what I thought you were saying. I thought you were saying is, the counterfactual is we could be in a recession right now 'cause they might not have taken strong enough action early on.

0:31:21.8 KD: Exactly. We can applaud them for not allowing the US economy to be in worse shape than we would have otherwise during the pandemic, but then at the same time, we've got this, I don't know, hangover that we're talking about where there is this additional stuff out there, which we need to sop up. And I'm a little bit more optimistic, truthfully, that they will figure out a way to do this and actually not have to slam on the brakes, but tap the breaks and slowly get us there. I'm a bit more optimistic, but I agree overall...

0:32:01.5 JL: I'm a bit more pessimistic just because if you do the proactive things, you naturally raise rates higher than inflation. But if you do the reactive thing, then you've gotta move faster because you gotta catch up for what you missed in the past. And I don't see any... I think this Fed thinks it's gonna do exactly what it did in 2004, and it's gonna be too little too late.

0:32:27.9 BS: Can I just remind you of what the costs are though of what they did in the 2008 recession, which is we saw prime age employment declining all the way until around 2015, and we didn't really see a labor market recovery until the 2015 through 2019. So it took us seven years after the recession began before we really turned the labor market around. That's a very, very long time. For some people, that's a lifetime, that's the end of their career. And what they did was turned this economy around so rapidly. And I think if we think about the scarring effects on workers, they have minimized the amount of scarring effects on workers. It's not their fault they can't get job care back. And they can't do anything about that, but what they can do is produce a hot economy. That means the second your job here comes back and you're ready to go into the workforce, you're gonna be able to find a job. I guarantee you that right now even if you do have eight months of non-work on your resume, which I'm telling you in 2015, if you had a gap of a year on your resume, it was gonna be really tough for you to find a job.

0:33:34.9 JL: Are you telling me that raising interest rates a little bit this summer and in the fall would have sent us into recession?

0:33:42.6 BS: No, I'm not saying that I'm just saying...

0:33:43.8 JL: They would have thought of a little bit of a... A little bit of insurance against the inflation, and you still had fiscal policy, you still had the monthly checks.

0:33:53.9 KD: John, I think there was a lot of uncertainty. In hindsight, we can look back and say, "Gee, they should have done that." I agree with you. But in the moment, there were a lot of conflicting pieces of information that didn't necessarily say that we were zooming ahead...

0:34:11.4 JL: So you have a bunch of theories on the table and they went with the one which was most optimistic, which was this is all gonna disappear in six months, whereas most policies where I said you would have said, "Okay, there's this one thing where inflation seems to be taking off. There's this other thing where maybe it'll go away." Why am I putting out all of my eggs in the hopeful basket? I think an optimal policy would have weighed these two things a little bit and maybe not raised interest rates as much as the models, say, one for one with inflation, but you wouldn't have stayed at zero, and you wouldn't still be at zero even today. Hopefully... We'll see what they do Wednesday, there'll be possibly an announcement. But I would have thought the policy would have been taken in the different possibilities and said, "Okay, 7% inflation is a pretty bad outcome too," and done a little bit earlier.

0:35:10.0 JH: Another way of putting why I'm puzzled by the Fed's action is that Fed policy is much more expansionary now than it was in the spring, because the real interest rate, I would argue, is the right measure. And so it seems like if you think that policy is appropriate now, you have to think that it should have been much more expansionary in the spring. And it doesn't seem like the Fed thought that, so I'm confused about what their motto was that said they were doing the right policy in the spring and the right policy now, given that they have much more expansionary policy now with a much lower unemployment rate and a much higher inflation rate.

0:35:41.0 LS: So, Josh, if you could go back in time to last summer and fall, would you raise the interest rates? Are you with John on this one?

0:35:52.8 JH: I think certainly by fall, I would have raised the interest rate some and at least seen what happened as insurance that John says. I think... My sense, and I might be wrong, is that the Fed, and perhaps the government, the Biden administration a bit more generally, really was sort of betting on the pandemic receding and, thus, a lot of the supply disruptions disappear. And that wasn't a crazy bet, when I was...

0:36:18.8 JL: I think Delta, it wasn't a crazy bet.

0:36:23.0 JH: Right. But it was also not a sure bet by any means, and I think certainly by July, August, it was clear that that bet was not going to be... That you weren't gonna win that bet, and so I think at that point, you needed to rethink things somewhat.

0:36:37.8 BS: I think we're all in the same... Josh your point about monetary policy has what looks to be unintentionally become more accommodative as inflation has risen and they've done nothing. I think we're all in agreement that that's probably not the right thing. The question is, could they... When should they have moved, how could they've communicated that, did they... Could they have better seen that coming, could they have somehow moved quicker? They've got this problem that they have to slow their purchase of mortgage backed securities before they actually raise rates. Could they have started to slow that a little bit sooner?

0:37:17.5 JL: Housing prices were booming in the fall, and it's... That seemed like the appropriate time to be slowing with mortgage backed security purchases.

0:37:27.0 BS: I do think that there was a hope, and honestly, I still have this hope, which is that other policies will do something to help us increase supply. Because at the end of the day, what families are looking for is not for the Fed to make them to want to buy a car less. What families want is for more cars to show up on our shores so that they can afford to buy cars. And so all the Fed can do is reduce our demand by making cars essentially more expensive, by making money today expensive relative to money in the future, and so that's just another way of things becoming more expensive. And families are not like, "Hey, why isn't the Fed doing that?" They're like, "Why aren't we getting more cars on our shores?"

0:38:10.2 KD: I do think there was too much optimism about that. But also really hard... This is the first time we've been in this complicated global supply chain world where it was really unclear how quickly things would actually start moving. I think the auto industry had stronger forecasts of how quickly they'd be able to get cars out there than has been the case.

0:38:34.6 JL: So Kathryn...

0:38:37.0 BS: I agree with that. And I would say I was surprised to see... I wasn't surprised to see how big of a decrease there was in the number of new cars available in 2020 compared to 2019, but we didn't see much of an increase between 2020 and 2021. So they've just sort of been stuck at this lower level of cars that are available, and people are ready to get out and they don't wanna be on public transit, and so you put all that together, and the next thing we know, car prices are exploding with used car prices up 30-35%.

0:39:08.7 LS: John, you wanna get in?

0:39:09.8 JL: No, I just was gonna add to what Kathryn said earlier about the question about why people didn't perceive all this happening. And I think one thing people don't understand is that macroeconomics is not a big data type of field. We haven't seen inflation like this for 40 years. And so if you think about where do you generate your theories of what's happening? Well, one of the things you do is you look at recent experience, and it just hasn't been any inflation. And our models of inflation, frankly, aren't very good, partially because the Fed is controlling inflation. If the Fed is controlling something, it's very hard... If they're trying to hit 2% every year, the variations are gonna be their mistakes, which are gonna be hard to predict and hard to model. So none of our economic models were doing very well at modeling inflation. They didn't have an experience like this in them. So actually, it probably wasn't surprising that most industry economists, most Federal Reserve Bank economists, figured inflation would go back to 2% because that's what it's done the entire time in the last 40 years.

0:40:25.8 KD: Just to add to that, John. Just to add to that, all our models would have suggested inflation should have been higher before the pandemic, so...

0:40:35.2 JL: Basically, our models have been missing inflation. The last big inflation discussion was in the last recession was all about missing inflation...

0:40:42.5 KD: Exactly.

0:40:43.9 JL: Of why inflation didn't happen. And all the models [0:40:46.2] \_\_\_\_...

0:40:46.3 KD: Because we had all those years where inflation never appeared even when unemployment got really low...

0:40:52.6 JL: And then suddenly it happened this time.

0:40:55.5 KD: Exactly.

0:40:56.3 JL: Now it happened for exactly the reasons the models would have predicted, which is excess demand, but we've had excess demand before and hadn't seen a ton of inflation. The other thing is that all the models that are used by the Central Banks have built in that everything returns to normal in three or four years. It's like an assumption. Why? Because over the last 40 years, everything has returned to normal, and you model what you've seen, you don't model what you haven't seen. It's very similar to how we were surprised by the financial crisis. We hadn't had a bank run since 1929, and so we didn't have bank runs in our model, and is surprised that that happened. And now every model has a bank run in it, and going forward, every model will have a little more serious inflation sector in it.

0:41:46.9 BS: Well, I think...

0:41:48.4 KD: Everyone's gonna model... Everyone's gonna model supply chains.

0:41:50.8 JL: Exactly. Then you won't miss it anymore.

0:41:55.6 BS: And I think there's supposed to a sort of optimistic story and a not optimistic story, which is the fiscal policy worked really well. And, in fact, we had realized we're putting 2.5 trillion in fiscal support in the economy in 2021, what's that gonna do to demand? We would have forecasted inflation. And now is when Larry Summers is running victory laps around because when the fiscal support came, he said, "Boy, that's a lot of fiscal support." I think fiscal policy works. I think when we give people money, they spend it, and if you believe that, then you needed to be a little bit worried about inflation. And if you didn't believe that, then why were you doing fiscal policy in the first place? I think we now know fiscal policy works, that's great. The next time we see a big recession, let's spend some money 'cause it works. But we do actually need to think about whether there's the supply there to produce the goods that we're giving people money to buy.

0:42:49.4 LS: So let's talk about fiscal policy for just a few minutes. So when I think about that, I'm thinking about the economic impact payments. We have three rounds of those that go out to the large majority of Americans. We have expanded unemployment insurance that provided $600 for a few months, expanded access to unemployment insurance like we've never done before, and then a $300 supplement later on, and then a modest Child Tax Credit that started this last summer. And from my standpoint as someone who studies poverty, nothing has ever worked like these things. We see poverty just plummet in 2020, food insecurity doesn't go up, which is unheard of in a recession. We see people are less likely to be delinquent on their mortgages. We didn't see a tsunami of evictions. But now we have inflation. So I wonder how... Tell me how I should be thinking about those things. Is it just that we should do more on the supply side to make sure there are the dishwashers for people to buy.

0:44:00.6 JH: Or I'd say... A lot of our models would say you have expansion in fiscal policy, you accompany that by higher interest rates. Arguably, that would actually be a benefit of expansion in fiscal policy, that the US economy would be better off of someone higher interest rates so that the Fed could cut rates if there was a recession in the future that perhaps, for some behavioral reasons, people like getting interest on their bank account. So you could argue this is actually exactly what should happen, that fiscal policy is good, and that then gets us out of what people like Larry Summers have called secular stagnation. But then that's accompanied by higher interest rates. If you don't raise the interest rate in response to it, then you get inflation.

0:44:38.4 KD: We've always known that you need to coordinate monetary and fiscal policy, but somehow it didn't quite work this time around. They were both pumping into the economy in all the positive ways, Luke, that you just suggested. But I think there was a little bit less of a coordinated view of how this would work together with the lower labor force participation and the supply chain issues. One other thing that there's a lot of research being done on, which we'll probably learn more and more about, is higher prices are really affecting different groups differently. And, Luke, whereas a lot of the policies were really helpful for low-income people, high prices can be really tough on low income-people. So it's like they got the positive benefits of many of these programs, but they may very likely have the largest negative impacts of higher prices, especially on gas, shelter and food, so it's... It's a little hard to know overall what to think of all this, because they are actually gonna be hit harder by these higher prices than higher income people.

0:46:00.5 LS: So we talked about, if we would go back in time, would we start raising interest rates a bit earlier on. What about... Oh my goodness. What about the fiscal policy of this? If you had to go... It sounds like everybody is on board with the fiscal policy. Would you do 100% of what we did? Would you do 80%? Would you do 50%?

0:46:24.9 BS: I think fiscal policy was exactly what we needed. We wanted to get... Inflation is re-distributory. It redistributes in the way Kathryn suggested. But let's also think about, there are some families that lost their incomes during the pandemic. If they're not buying food, the price of food might not rise as high. But they don't have any food, so giving them money to buy food might push up the price of food. But then it's gonna be shared across all the people who buy chicken, not just the families who lost their jobs and couldn't chicken anymore. And so I would still say the Child Tax Credit, expanding the benefits that allowed people to put food on the table, that kept them in their houses, that prevented evictions, no, these things are all worth it. Did we do too much? I agree with everything that's been been said so far about it's really hard to have predicted. So should the Fed have done more? Maybe. Should fiscal policy have done less? There's only one thing that I will say that I question, and that was the last round of economic stimulus payments.

0:47:37.6 BS: And that's because they weren't targeted, we were already at a point where we sort of knew there was a lot... We knew we were looking at $2.5 trillion in excess savings, and then we're thinking, "I know, let's give everybody in the United States another payment." Maybe we should have just stuck with the targeted stuff like unemployment insurance, the Child Tax Credit and the things that were really targeting people who needed the help.

0:48:03.5 BS: John, and then Josh.

0:48:05.0 JL: The fiscal policy wasn't that far off from what a utilitarian would have done. A utilitarian would have said, "Okay, there's half of the population's working, and half of the population, through no fault of their own, is suffering shutdowns and has to go home," and they would have divided what there was between the two groups, taken a little bit for the people who are working and given money to the people who weren't working so everyone could enjoy a consumption, and you've got insurance against this random shock. Now, they didn't do it the way a utilitarian would have done it, take it away from the front of the people who did well and give it to the people who did poorly, but that's the way it worked. Because the people who did well saved it all, lent it to the government, the government then borrowed it, and gave it to the people who experienced the shock. So the allocation was pretty darn close to what a utilitarian would have done, except for...

0:49:02.6 BS: Well, John, I thought what you were gonna say is, "And now they're paying higher prices... "

0:49:06.5 JL: And now, the thing that is now... Since they saved it, the demand of the well-off didn't diminish when things started getting better. They could spend their savings and buy houses and things like that, but... It wasn't that bad. Monetary policy is where I think the ball was dropped. But fiscal policy, as Betsey said, that last round, you might have ended it a little bit sooner, but we're starting to quibble I know the world of uncertainty.

0:49:39.3 LS: Josh, did you wanna get on this?

0:49:41.7 JH: Oh, I agree with all of that. I agree. I agree with Betsey that the last round of checks, it was the one you might question. But, broadly, I think what Betsey and John were saying that I think I have more quibbles with monetary policy than fiscal policy. I think we saw fiscal policy doing what, as Betsey said, it should do in recessions more generally perhaps.

0:50:04.9 LS: So I've got two questions from the audience. One is from Ryan Fogerty who's asking, "Have artificially low interest rates, going back to the 2008 recession, caught up with us here as well?" Have we had artificially low interest rates?

0:50:21.6 JL: [0:50:21.6] \_\_\_\_ the word artificial means. [chuckle]

0:50:23.7 KD: I don't know about artificial, but I think maybe what the question is asking is, and maybe has something to do with what happened today in the stock market, but interest rates have been really low, and that has led to potentially a bubble in some asset prices. And so one storyline is that that was in the background all along, and that that should have been tapped down well before this shock hit. I think it was... It would have been hard to be as focused on... Or put another way, I don't think people thought necessarily that interest rates were too low right after the great recession, but they... It was very hard for the Fed to raise them. That's what John brought up, this issue of normalization. It's just very hard to... It's been very hard to do. Maybe, it'll be easier to do in the current circumstances, but I don't know about the concept of artificially low. John?

0:51:34.0 JL: I think historically low is probably a better... Unusually low. We're living in a very, very, very strange time in which a dollar tomorrow is worth more than a dollar today. Not a dollar, but a unit of output. Like if you gave me a pizza tomorrow, it was worth more than the pizza today. So that companies that earn in the future are incredibly valuable. You can be losing a ton of money, in the short run with your internet start-up or Uber or that thing, but you'll be worth billions because you might give money in the far off future, and with negative interest rates, that money is worth more than the current money. And this is, I think, thrown off financial market somewhat. It makes it hard to value things. And you're using your expectations a lot more than you would be normally looking at the current profitability of businesses, and... But this is a different issue. Interest rates are low because of demographics. Interest rates are low because growth is slowing. There is a lot of a... That's another policy talk for another evening.

0:52:47.3 LS: Okay. Alright...

0:52:48.3 BS: Now I was... Luke, I was just gonna jump in and say, I think that brings us back to what was causing secular stagnation to begin with, why were interest rates kept so low. I don't think we actually still know the answer to that, but I do think we were a tiny bit asleep at the wheel because secular stagnation led us to expect inflation to stay low going forward. And I think we didn't really understand why inflation was stuck to low in the past. And so I wouldn't say artificial though. It was what it was, and we're still trying to really understand what's going on in the economy that kept inflation so low, and in that...

0:53:37.2 JL: And the Fed didn't seem like it could raise inflation, trying to push it for 20 years. It seemed like supply was increasing, our ability to produce was increasing, electronic prices were falling, our ability to deliver goods anywhere in the world was falling, and this was keeping inflation like...

0:53:56.2 BS: And we would be having a debate about was inflation actually even above zero if you actually appropriately adjusted for quality improvements and all these types of things. We had inflation so low, and the question was, why isn't the Fed doing more because we could tolerate higher inflation.

0:54:14.9 JL: The fear three years ago was we'd turned into Japan.

0:54:17.3 KD: Exactly.

0:54:19.5 JL: The fear three... It seems like we all...

0:54:21.5 LS: What does that mean?

0:54:23.7 JL: The exact opposite happens of what we fear. But we feared we're gonna be Japan, that supply was gonna exceed demand, and then we'd be in deflation and prices would be falling, and that would lead to...

0:54:37.0 BS: Stagnant growth.

0:54:37.6 JL: Exactly the opposite happened.

0:54:38.0 BS: Stagnant growth and just sort of stuck in this world that's sort of not moving.

0:54:43.2 KD: Japan would be happy to take a little bit of our inflation.

0:54:47.2 JL: We have a little bit.

0:54:48.9 KD: Just ship it.

0:54:50.2 LS: Well, it seems like, as my grandmother said, all things in moderation here.

0:54:55.6 BS: Yes.

0:54:55.7 LS: We've got five minutes. I'd just like to do a lightning round. You're talking with policy makers. I'm just gonna go down my screen. John, what's the number one...

0:55:02.3 JL: Raise interest rates by 25 basis points on Wednesday.

0:55:08.0 LS: Alright, that's a good lightning round. Kathryn?

0:55:11.6 KD: I actually wouldn't be against raising interest rates right away, but I actually think that it could be that things normalize faster than we currently think they will. And so I would be data-driven and wait and see how things go, but be ready to do more interest rate increases than probably they have signaled so far.

0:55:39.6 LS: So are you raising interest rates on Wednesday, or you're...

0:55:42.8 KD: I'm cool with that as well as the... I think it would be a surprise to the markets, and the markets have been already very volatile, so I'm guessing it won't happen. But if we wanted to actually get out in front of the situation that we're in, they're gonna need to start doing that fairly soon. But I don't expect it to happen this week.

0:56:12.0 LS: Josh?

0:56:13.6 JH: Well, I guess first, I would actually think more important than the Fed is I would tell the administration to try to get a strategy for controlling COVID and living with it, some way to try to limit its supply side effects on of the economy. I've been quite disappointed there that we haven't seen more of that. For the Fed, I would actually probably raise interest rates by 50 basis points, or a whole percent on Wednesday. I think that this notion that you have to move in tiny 25 basis point increments, I'm not sure that's... There's a lot of data for that. It would certainly surprise financial markets, but I think the concern with volatility of financial markets is too much from the Fed. It would still leave real interest rates very negative, very expansionary for the real economy. I think that you would see some volatility, and financial markets doesn't seem to me like it should necessarily weigh super heavily on the Fed's decisions.

0:57:05.8 LS: Josh, you have an article on The Atlantic that talks about something that's called COVID Has Broken the Economy, and you mentioned that...

0:57:12.2 JH: Well, that wasn't my title, but I actually like the title better than my article. It's a summary of a lot of what's going on at the...

0:57:19.6 LS: And The Atlantic editor [0:57:20.1] \_\_\_\_. Yeah, so could you just say one more minute and then we're gonna give Betsey the final word. But sort of like, why would having access to rapid tests and other things, what else would that other be, be inflationary, anti-inflationary policy?

0:57:37.0 JH: Well, I think a big thing that's happened... Arguably a reason a lot of forecasts got things wrong is that the labor force is two million smaller now than it was before the pandemic, and you would have expected on trend for it to be larger. And so, I don't know that we know exactly why all those people have left, Betsey was... I was learning some from that, but certainly you want people not to be scared to go to work and things like rapid tests in so far as they both reduce transmission of the virus and reassure people that's the kind of thing that could get people back to work.

0:58:08.9 BS: Luke, I woke up this morning, both my kids told me they had a sore throat. I gave them both a rapid test. They were both negative and they went to school. Without rapid tests, I would have had to keep them home, and I think that is happening all over the economy. So I think Josh is exactly right. Number one thing is you gotta get the pandemic under control, and you gotta help people learn to live with it. And that means they've gotta have masks, they've gotta have tests, they've gotta be able to make smart decisions based on balancing risks and benefits. And the only way we could do that is if we can increase the amount of knowledge people have, and that really comes down to tests. And I've been saying that for two years. And it's banana pants that I'm still saying that two years and we haven't solved the test problem. But the other thing I think... The main policy thing I would say is we gotta figure out how we're gonna increase labor supply, and I do think we're gonna have to solve the childcare problem. Right now, the average wage of childcare workers is below just about any other job in the economy, because wages have pushed up in almost all other low-end jobs. And what we saw between 2015 and 2019 was an enormous growth in childcare workers, and we saw the employment of mothers hit an all-time high.

0:59:28.9 BS: And if we wanna get mothers back, we're gonna have to get the childcare workers back. We're gonna have to figure out how we can afford to get the childcare workers back. And the same thing is true with healthcare workers. We've got an impending crisis with healthcare workers. In 80 years of growth in education in health services, we have never seen declines in healthcare workers during a recession. And what we're seeing now is ongoing declines in education... Private sector education in healthcare workers. I'm really worried about this. And if you take a look at even people trying to enter those fields or leaving because they're burnt out, I think we're gonna see ongoing problems with labor supply in a service sector that's really important for people. And when we turn around and don't have enough work in education in health services, I think that's gonna spark a new and different kind of inflation. And if I was giving policy advice, it's get a handle on that right now by passing policy that will ensure that more workers return to those jobs, and you see expansion rather than contraction in the labor supply in those important service industry jobs.

1:00:35.5 LS: John, Kathryn, Josh and Betsey, thanks so much for spending the hour with me and with the Ford School community. I know I have learned a lot, and I'm sure many others in the community have learned a lot too. And we'll look forward to seeing if we can... We should do more policy talks to weigh in on the big economic issues of our times. So thank you all.

1:00:57.3 JH: Thank you.

1:01:00.2 KD: Thank you.

1:01:00.5 JL: Thank you.

1:01:01.5 BS: Thank you.

1:01:01.6 LS: And thanks to everyone for tuning in.

### Thank you for choosing Scribie.com

Cross-check this transcript against the audio quickly and efficiently using our online Integrated Editor. Please visit the following link and click the Check & Download button to start.

<https://scribie.com/files/859fa5c7ca4642d593769f9a0e922fc169147041>