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Why Economists Disagree on Whether Inflation Was a Supply or Demand Problem

By Ryan Bourne

February 1, 2022 6:30 AM

Last year, U.S. consumer price inflation was recorded at 7 percent — the highest annual rate since 1982. But economists seem divided over why the price level rose so sharply.

Put aside the baseless suggestions from politicians about the role of corporate greed or market concentration; economists such as Larry Summers and John Cochrane confidently claim that the problem was primarily too much macroeconomic stimulus being pumped into the economy. Others, including James K. Galbraith and even, until recently, Fed Reserve chairman Jerome Powell, have suggested that the culprit was the severe Covid-lockdown-related disruption to the supply of goods and services. If the profession can't agree on the source of such a profound macroeconomic phenomenon, what faith can the public have in their pronouncements?

In broad terms, economists do agree on what causes inflation. As Milton Friedman famously said: "Inflation is always and everywhere a monetary phenomenon. And [inflation] can be produced only by a more rapid increase in the quantity of money than in output." The vast majority of economists understand that a sharply rising price level results from too much money chasing too little output. The problem is that querying whether it's the aggregate supply or aggregate demand that's responsible is like asking which blade of the scissors cuts the paper.

Ascribing blame means judging a baseline of what you'd expect to happen and then explaining why matters deviated. That requires a view on what macroeconomic policy should target and whether government institutions are delivering those objectives. The great demand-vs.-supply debate, then, is as much a proxy war among economists about the mandate and effectiveness of the Federal Reserve as anything else.

Let's suppose you think that the Fed should have a pure inflation mandate: targeting consumer price inflation at an average rate of, say, 2 percent. In 2020, the inflation rate was 1.3 percent. To achieve a price level at the end of 2021 consistent with its target would have required a 2.7 percent inflation rate in 2021. Instead, it was 7.1 percent, which amounts (under this framework) to a serious macroeconomic policy error: an economy awash with too much money given the economy's potential to produce goods and services.

At the time of Joe Biden's American Rescue Plan, in fact, former treasury secretary Larry Summers warned that the combined macroeconomic stance of fiscal and monetary was producing a stimulus well beyond what one would expect to close any shortfall in production from its output potential. In his view, a sharp rise in price levels was a predictable consequence of a demand-side stimulus that was far too big. This view is bolstered by evidence that U.S. inflation and our stimulus have been far higher here than in Europe.

True, some domestic supply factors — such as slower population growth, certain supply-chain disruptions, government welfare programs that disincentivize labor supply, and ongoing pandemic work-from-home lockdown arrangements — might have reduced the economy's productive capacity by more than the Fed envisaged, whether through reducing the availability of inputs or by weakening productivity growth.

But at best, the Fed failed to foresee that supply would be less responsive to new demand than usual given the pandemic; at worst, policy-makers knowingly kept money too loose. Either way, in retrospect, Fed errors on the demand-side are to blame for above-target inflation.

How, then, can other economists conclude that last year's inflation was a supply-side phenomenon?

One answer is that not all economists believe that central banks should target inflation. For a whole range of reasons — including the fact that it's difficult to estimate the "output potential" of the economy — economists such as George Mason University's Scott Sumner have argued that the Federal Reserve's mandate should be to target a consistently rising level of nominal GDP each year as the least damaging means of generating macroeconomic stability. Under this framework, the Fed should simply concern itself with the overall level of aggregate demand and not worry about the consumer price level in particular.

This line of thinking leads to very different conclusions about 2021. Suppose you see the job of the Fed as aiming to deliver a level of nominal GDP consistent with maintaining its growth rate from the five years before the pandemic (averaging 3.9 percent per year). Then you'd conclude that through the third quarter of 2021, the Fed almost perfectly hit its catch-up-level target. Demand, in other words, for most of last year, was right on point.

If one accepts this, then it stands to reason that the fact that 2021's nominal GDP growth consisted of higher-than-expected inflation and weaker-than-expected real output growth must be the fault of supply-side conditions. After all, the Fed did its job on demand! It has no levers that will increase the supply of semiconductor chips, increase the population, or unlock port capacity for any given demand level. All it can do is guarantee that demand continues to rise consistently each year.

In this view, then, pandemic-related supply-side problems are self-evidently to blame for the inflation we've seen. It would have been wrong and damaging to have run tighter policy (although now that the NGDP trend is running slightly above target, modestly tighter monetary policy was probably appropriate even under this framework).

The real Fed neither has a simple inflation mandate, nor targets levels of nominal GDP. Instead, it has a dual mandate that incorporates both inflation and employment. But if you're looking for a reason that economists can look at the same facts and come to the opposite apparent conclusions, there's one simple explanation: It's because they disagree on what the Fed's mandate should be.

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