Supply shocks are fueling much of today's inflation

By Steve Chapman

Apr 15, 2022

Inflation was in witness protection for many years, but it has finally come out of hiding, accompanied by a brass band. Prices have risen by 8.5% in the past 12 months, the biggest jump since 1981. The price increases that many (including me) thought would be a passing headache show no sign of abating.

Two people have gotten the bulk of the blame: President Joe Biden and Federal Reserve Chairman Jerome Powell. Biden's contribution came in the form of a big pandemic relief spending bill that spread $1.9 trillion around. Powell's sin was keeping interest rates low and the money supply growing, to encourage us all to get out, or stay in and spend.

Those policies, however, have been reversed. The staggering increase in federal spending that fueled the economy in 2020 and 2021 has ended, which means that this year, fiscal policy will actually be a brake on inflation. The Fed has begun a series of increases in interest rates, while selling bonds to sop up excess cash.

But those changes don't mean inflation is on the way out. On the contrary, it is likely to persist, even in the face of sober fiscal and monetary policy. The chief cause of rising prices is one that is beyond the control of the president or the Fed.

Fed critics often quote economist Milton Friedman, who wrote, "Inflation is always and everywhere a monetary phenomenon." But they rarely quote what he added: that it "can be produced only by a more rapid increase in the quantity of money than in output." Inflation, he argued, results from too much money chasing too few goods.

He was right. But what is going on right now is not just too much money, it's also too few goods. The money supply has grown faster than output partly because output has lagged. Supplies of goods and services have been curbed by the pandemic and the disruptions it has caused. Even if the money supply were fixed, supply shocks could cause prices to rise across the board.

Imagine a very simple economy in which there is $100 to spend and only one way to spend it — on the 20 hamburgers the economy can produce. Those burgers would cost $5 apiece. Now imagine that restaurants can manage to turn out only 10 hamburgers. They would each cost $10. Too much money? No — too few goods.

Something similar has been going on with the U.S. and the global economy. Supplies have declined or stalled even as demand has grown. In 2019, automakers worldwide produced 92 million vehicles. Last year, they made only 80 million.

One Pittsburgh auto dealership owner told The New York Times, “If I could get 100 Toyotas today, I would sell 100 Toyotas today.” But she had only three. With cars and trucks scarce, prices were bound to climb.

Likewise with oil. The war in Ukraine has scrambled the market, pushing prices up. The International Energy Agency said the world could lose 3% of total output — “the biggest supply crisis in decades.” The war has also curtailed the availability of food, because Russia and Ukraine have long been major producers of wheat, corn and cooking oil.

In the U.S., housing construction was lagging behind population growth even before COVID-19 came along. The pandemic, however, made it harder to get lumber, appliances, windows and doors, without which buildings can’t be built. The number of homes for sale has hit a record low.

Something else is needed to produce houses or just about anything else: human beings. But COVID-19 pushed a lot of Americans out of their old jobs, and labor-force participation remains well below what it was before.

On top of that, an important source of labor, immigration, has dried up. Alex Nowrasteh and Michael Howard, analysts at the libertarian Cato Institute, calculate that if our foreign-born population had continued growing at its pre-2016 pace over the past five years, we’d have 4.8 million more workers than we have today.

A price jump in one sector is common even in noninflationary times, because of shifts in supply and demand. But when supplies can’t keep up with demand in many sectors, you get broad inflation. That’s our current predicament, and it has no simple or quick solutions.

A previous generation figured out how to conquer inflation in the 1980s: by squeezing the money supply till it screamed. But yesterday’s solution won’t suffice today.