Inflation: A Series of Unfortunate Events vs. Original Sin

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Revised following delivery at the conference
The big question

Vaccines effective, vaccines ineffective, microchip shortage, ports clogged, Russian invasion, & etc.

Fiscal policy & monetary policy

Source: Google.
The Bernanke and Blanchard’s model and estimates (if correct)

- Rule out monetary and fiscal policy (aka demand) operating through the labor market as a major channel for inflation in 2021 or even a large one thereafter.

- Is agnostic on the big questions:
  1. Did monetary and fiscal policy operate through other channels, like shortages, food or energy shocks?
  2. Was inflation the result of unpredictable shocks (i.e., unfortunate events) or was it predictable (i.e., original sin)?

- To settle these issues we cannot use the Bernanke-Blanchard model and estimates but instead need to bring other evidence to bear on whether their shocks were caused by supply and demand—something they do (in part) in their paper as well.
My view: core predominantly original sin but excess of headline was due to an unfortunate accident.

Source: Bureau of Economic Analysis; author's calculations.
Outline

1. Core Inflation & Limited Food/Energy Passthrough

2. Were Shortages Due to the Peloton Economy?

3. An Alternative Macroeconomic Approach
Outline

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The Bernanke-Blanchard decomposition

FIGURE 12. THE SOURCES OF PRICE INFLATION, 2020Q1 to 2023Q1

Source: Bernanke and Blanchard (2023).
The food & energy shocks ≈ contributions, implies little passthrough to core inflation

Contributions to CPI Inflation from Food and Energy
Percentage Points, Annual Rate

Rough decomposition of excess core inflation: how should shortages be interpreted?

Contributions to Excess Core Inflation

Percentage Points, Annual Rate

Note: Baseline core inflation assumed to be 2.3 percent and is subtracted from initial conditions. Q4/Q4 for 2021 and 2022. Source: Bernanke and Blanchard (2023).
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1. Core Inflation & Limited Food/Energy Passthrough

2. Were Shortages Due to the Peloton Economy?

3. An Alternative Macroeconomic Approach
2. Were Shortages Due to the Peloton Economy?

The Peloton economy thesis

1. COVID caused people to shift spending from services to goods

2. The supply of goods was more inelastic so this raised inflation
2. Were Shortages Due to the Peloton Economy?

Spending on gym equipment and gyms

Real Personal Consumption Expenditures
Sporting Goods and Gyms

Index, October 2020 = 100

- EIP 2 Checks
- EIP 3 Checks
- Membership Clubs & Participant Sports Centers
- Recreational Goods & Vehicles, Sporting Equipment, Supplies, Guns & Ammunition

COVID declining and economy reopening

Source: Bureau of Economic Analysis; Macrobond; author's calculations.
The same pattern was true w/ most other durable goods as well

Source: Bureau of Economic Analysis; Macrobond; author’s calculations.
Many countries had more lockdowns in 2021 without increases in goods spending

Real Durable Goods Expenditure

Index (Q4 2020 = 100)

Source: Organisation for Economic Co-operation and Development; Eurostat; Macrobond; author’s calculations.
2. Were Shortages Due to the Peloton Economy?

BB argument: goods up inelastic supply & services down the elastic supply
Is it more plausible to think of the demand for services as increasing on the inelastic portion?
Outline

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(Polemical) Linear policy analysis of a $1m/household fiscal stimulus plan

- 514% of GDP in fiscal stimulus
- Using a multiplier of 0.8, real GDP up 412%
- Unemployment rate falls to 0%
- Using a Phillips curve with a slope of 0.15, the inflation rate rises to 2.6%
What might actually happen—and how a linear analysis would interpret it

**Actual Results**

- Real GDP growth a little above the baseline
- Massive inflation

**Clearly a “Shortage” Shock**
The BB approach to quantifying macro policy operating through the labor market

Monetary/fiscal $\Rightarrow$ real GDP $\Rightarrow$ labor market $\Rightarrow$ inflation

- Fiscal multiplier & monetary impulse response
- Okun's Law
- Phillips Curve

In the BB model monetary and fiscal policy may also operate through other channels including:

- Shortages
- Food and energy shocks
An alternative approach that drops the intermediate step

Monetary/fiscal $\Rightarrow$ nominal GDP $\Rightarrow$ real GDP $\Rightarrow$ inflation

- Treat monetary and fiscal multipliers as applying to nominal GDP
- Estimate the possible increase to real GDP (e.g., in this case being above pre-COVID forecast was implausible)
- The price increase is the residual
Real GDP did as well as could be expected, what was unusual was prices/nominal GDP.
Summary and conclusion

• An elegant paper but it does not answer whether inflation was “a series of unfortunate events” or “original sin”.

• The paper does suggest that food and energy shocks do not explain core inflation.

• Shortages are consistent with demand increases—and demand supporting higher overall consumption.

• It may be more fruitful to ignore the labor market in assessing large non-linear shocks.

• Regardless, we all agree about the present situation--and the unlikelihood of a soft landing to 2% inflation.
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