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Inflation: A Series of Unfortunate Events vs. Original Sin

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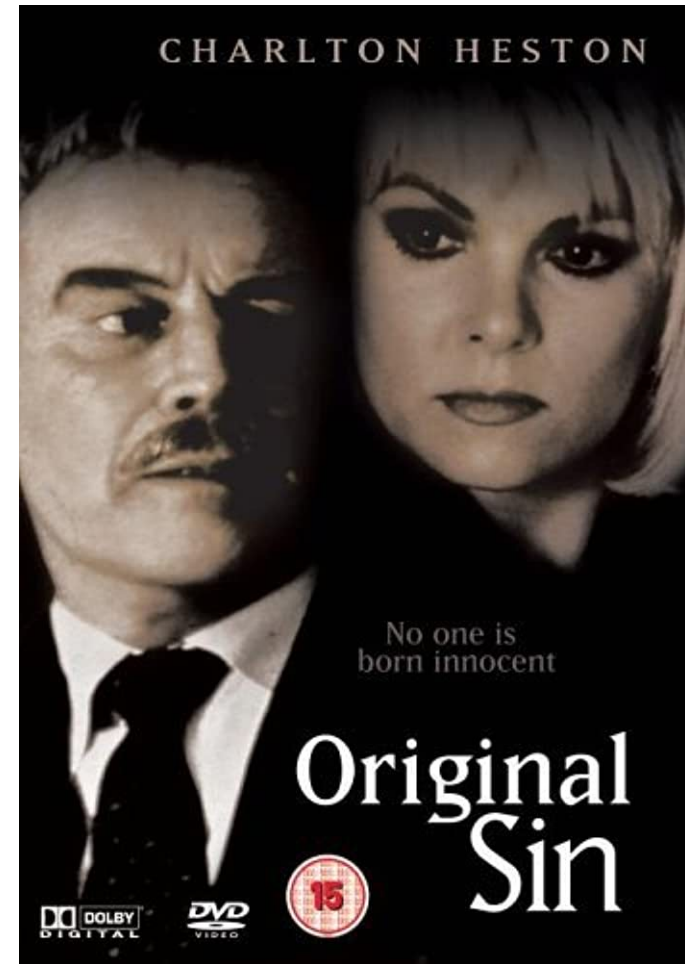
May 23, 2023

Revised following delivery at the conference

The big question



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

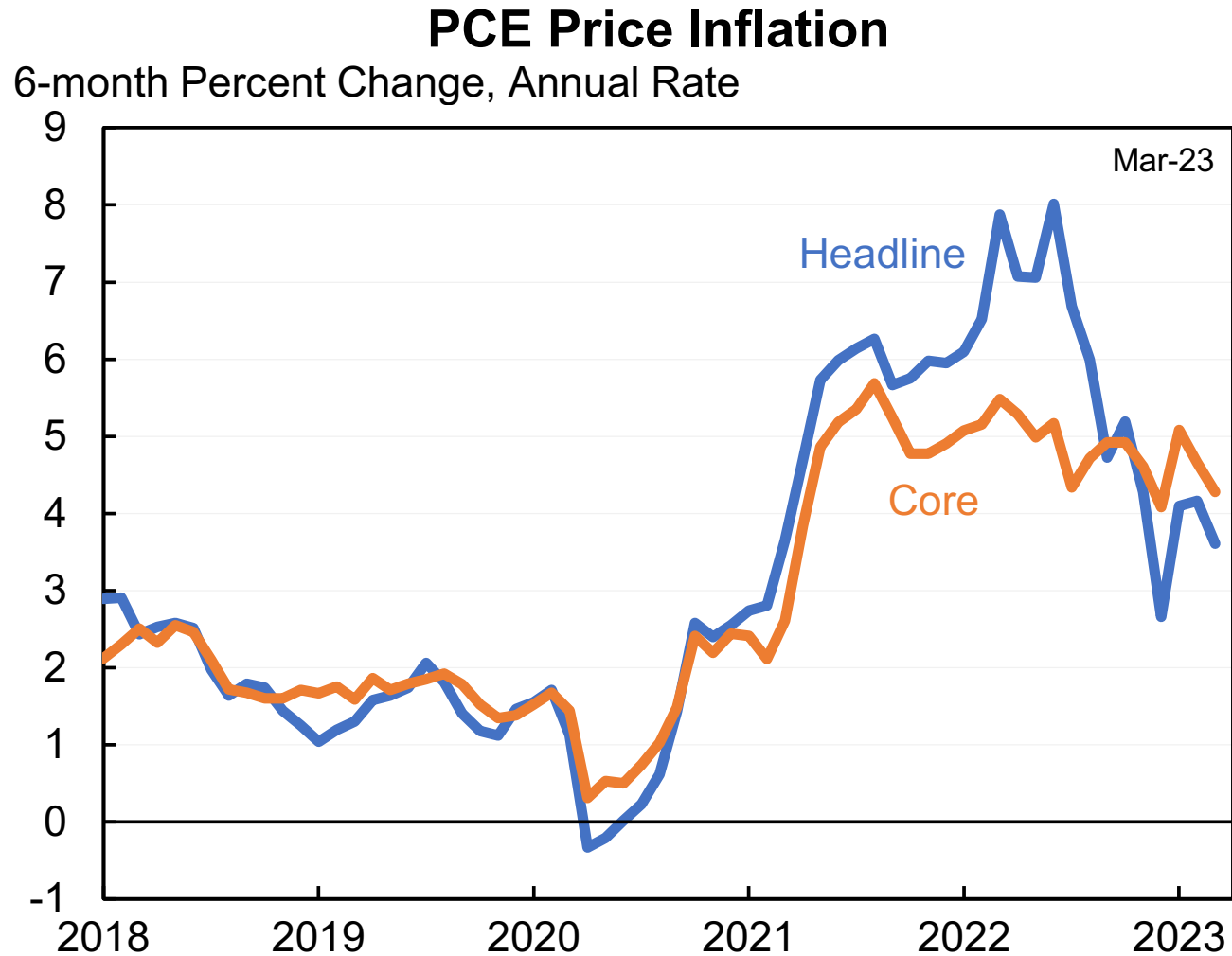


Fiscal policy & monetary policy

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



Outline

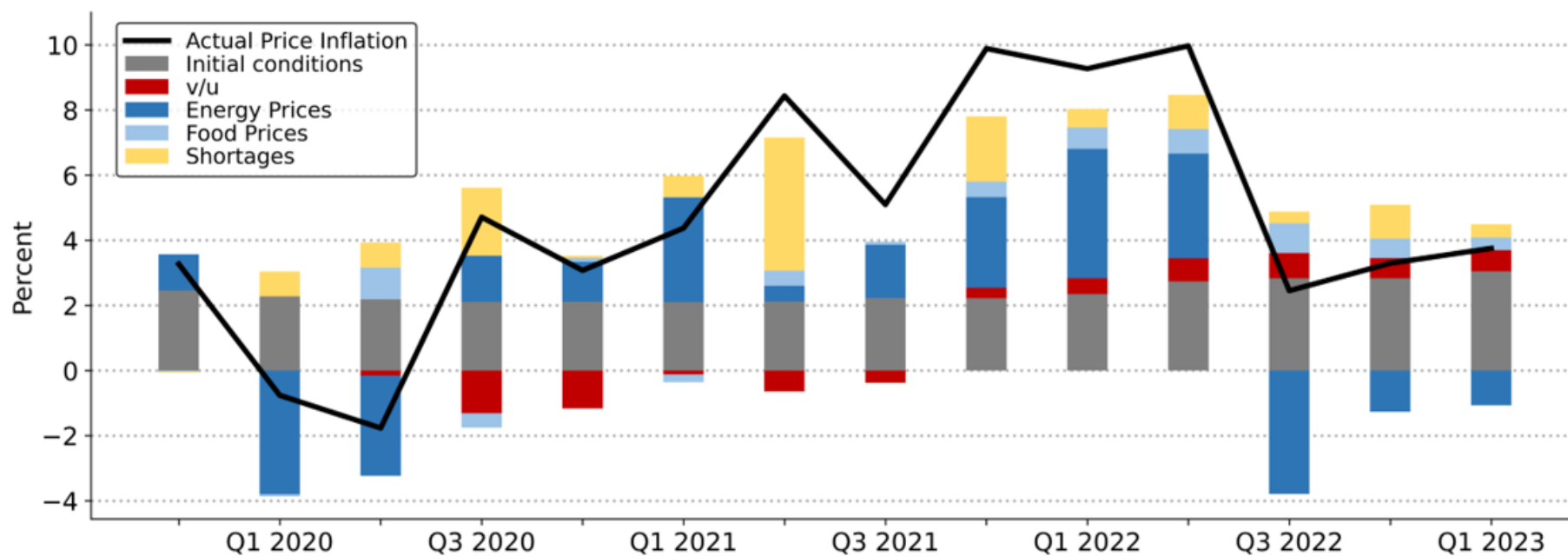
1. Core Inflation & Limited Food/Energy Passthrough
2. Were Shortages Due to the Peloton Economy?
3. An Alternative Macroeconomic Approach

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The Bernanke-Blanchard decomposition

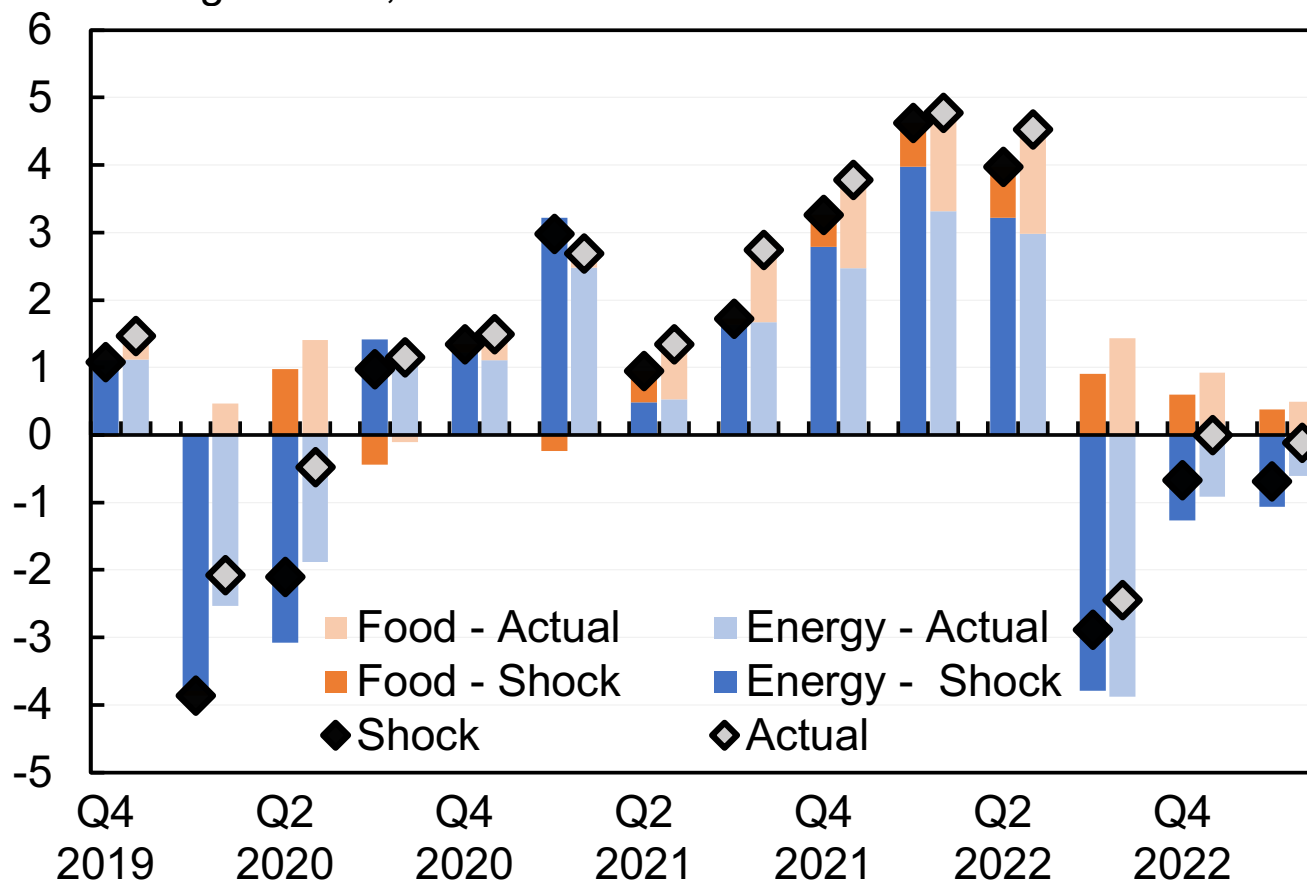
FIGURE 12. THE SOURCES OF PRICE INFLATION, 2020Q1 to 2023Q1



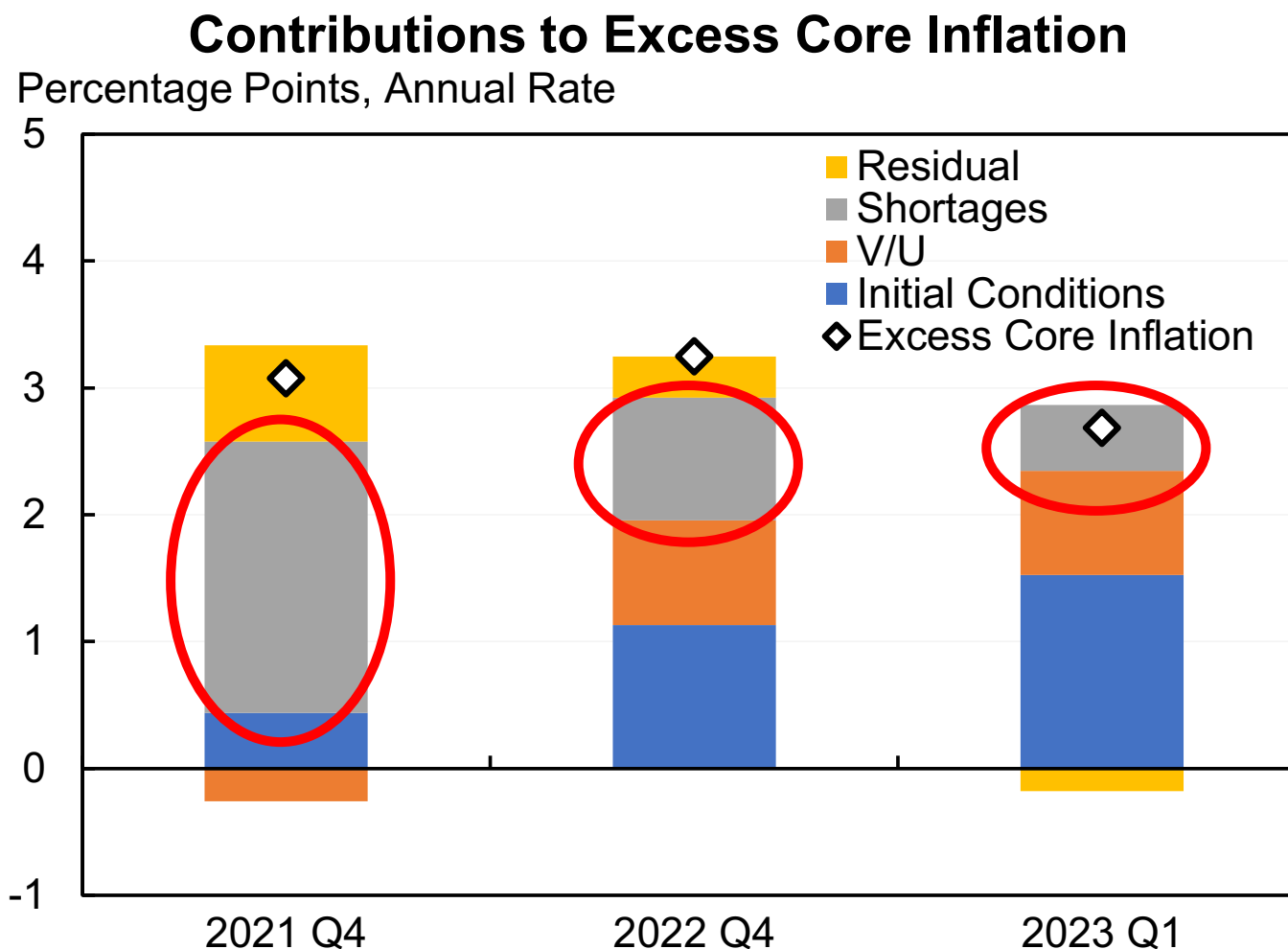
The food & energy shocks \approx contributions, implies little passthrough to core inflation

Contributions to CPI Inflation from Food and Energy

Percentage Points, Annual Rate



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



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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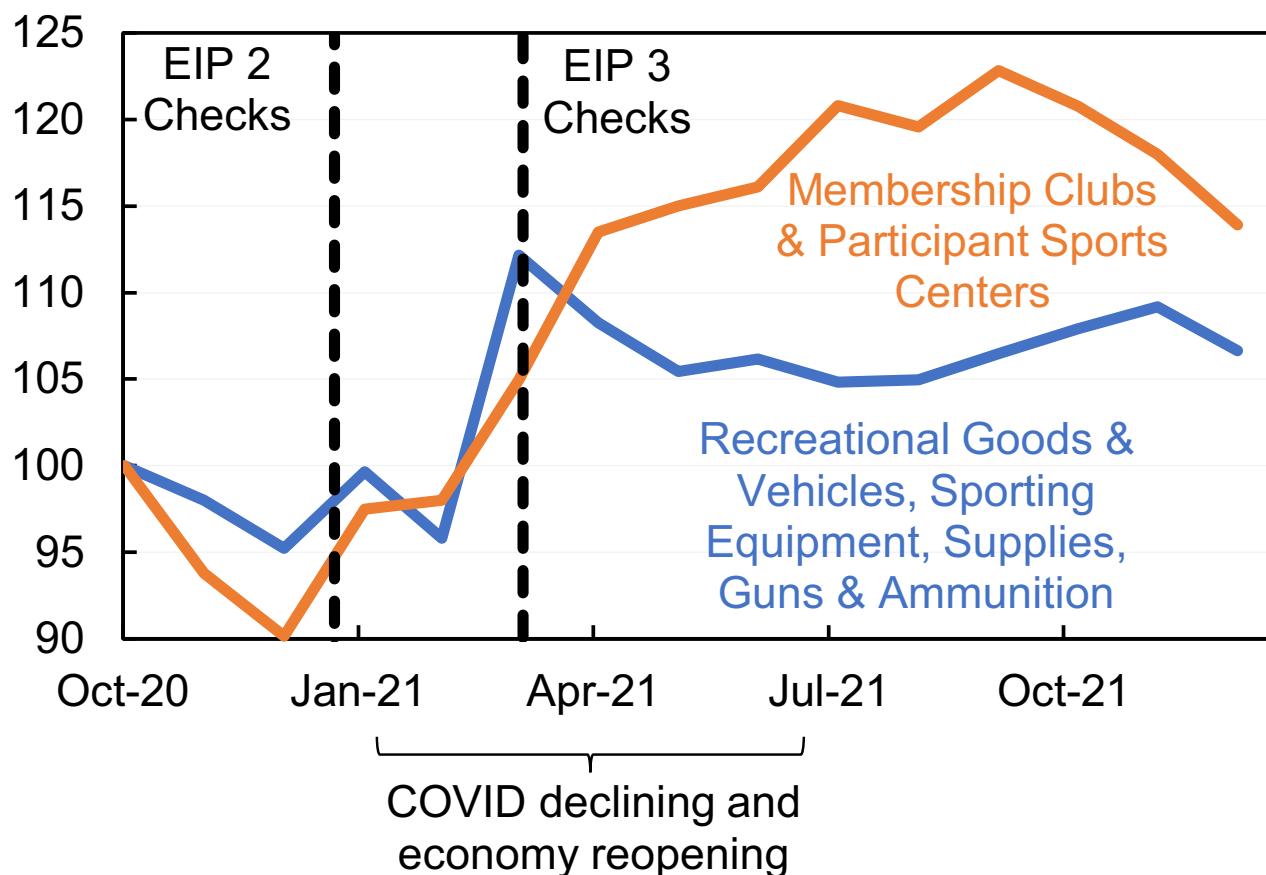
The Peloton economy thesis

1. COVID caused people to shift spending from services to goods
2. The supply of goods was more inelastic so this raised inflation

Spending on gym equipment and gyms

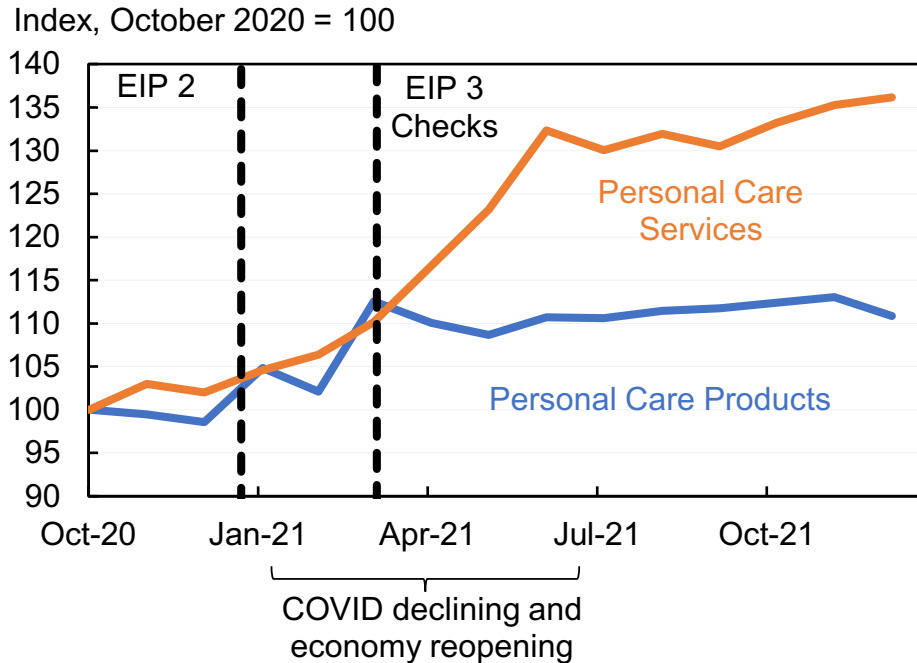
Real Personal Consumption Expenditures Sporting Goods and Gyms

Index, October 2020 = 100

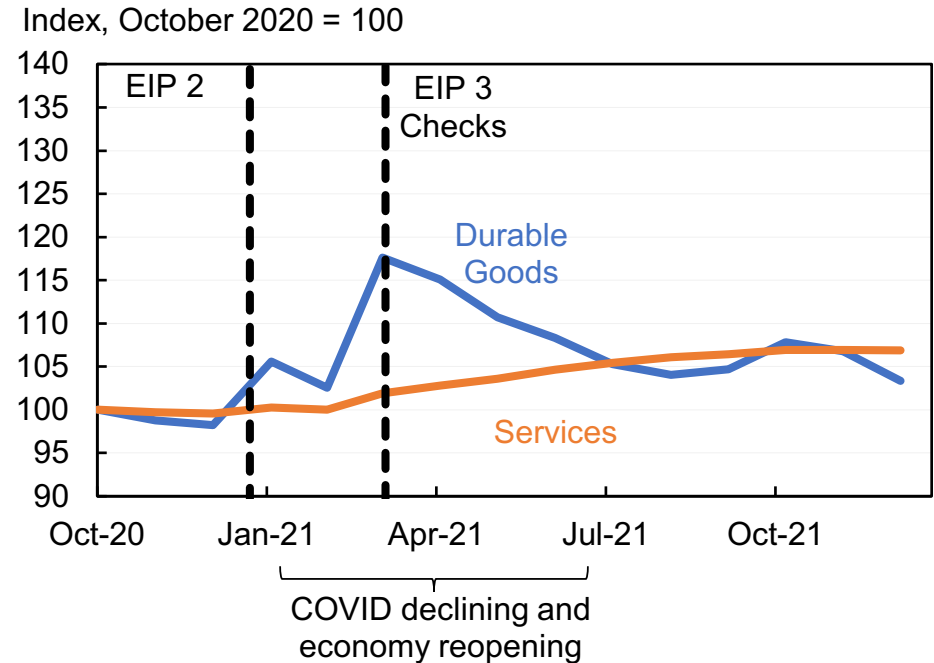


The same pattern was true w/ most other durable goods as well

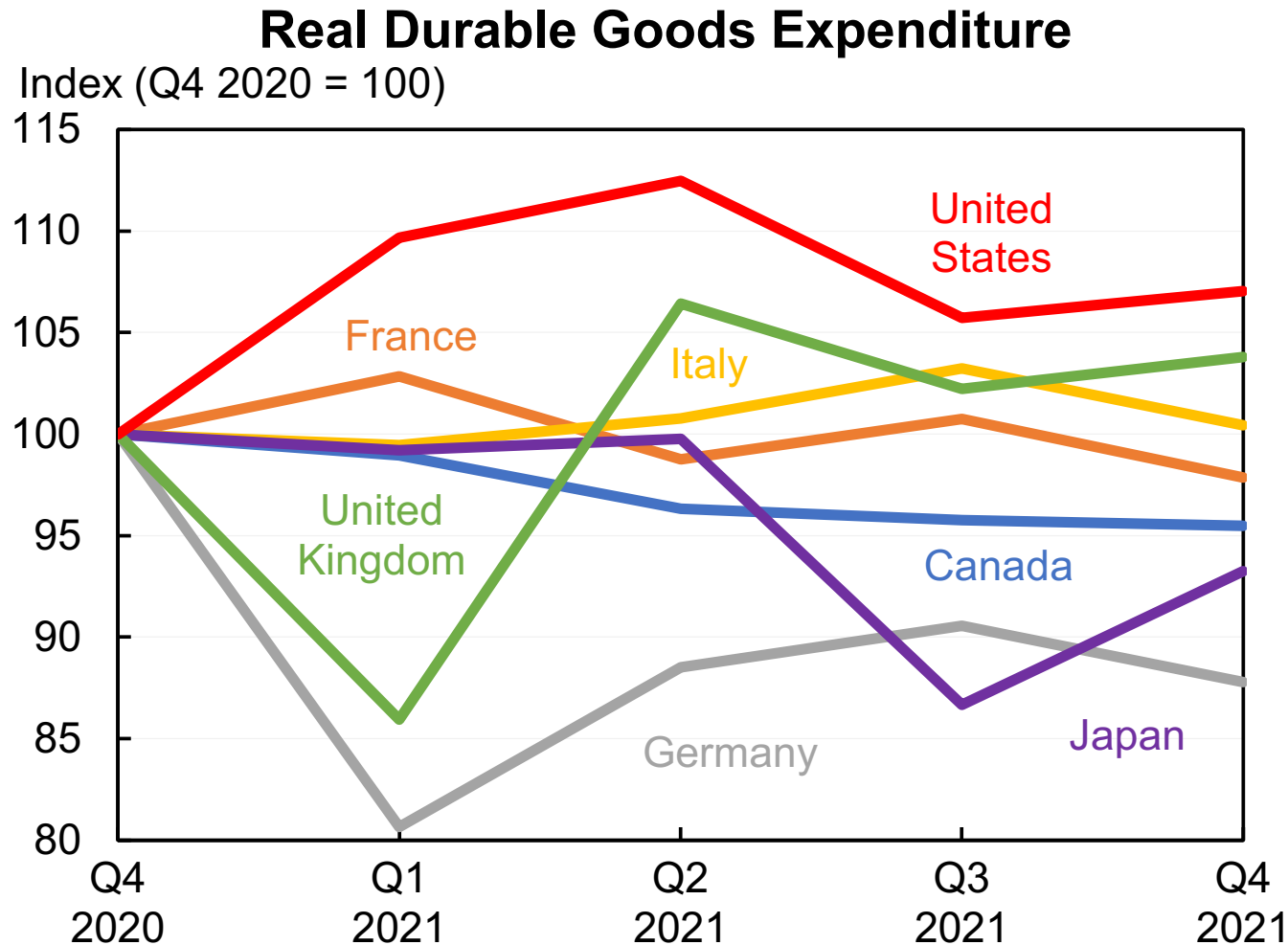
Real Personal Consumption Expenditures Personal Care



Real Personal Consumption Expenditures Overall

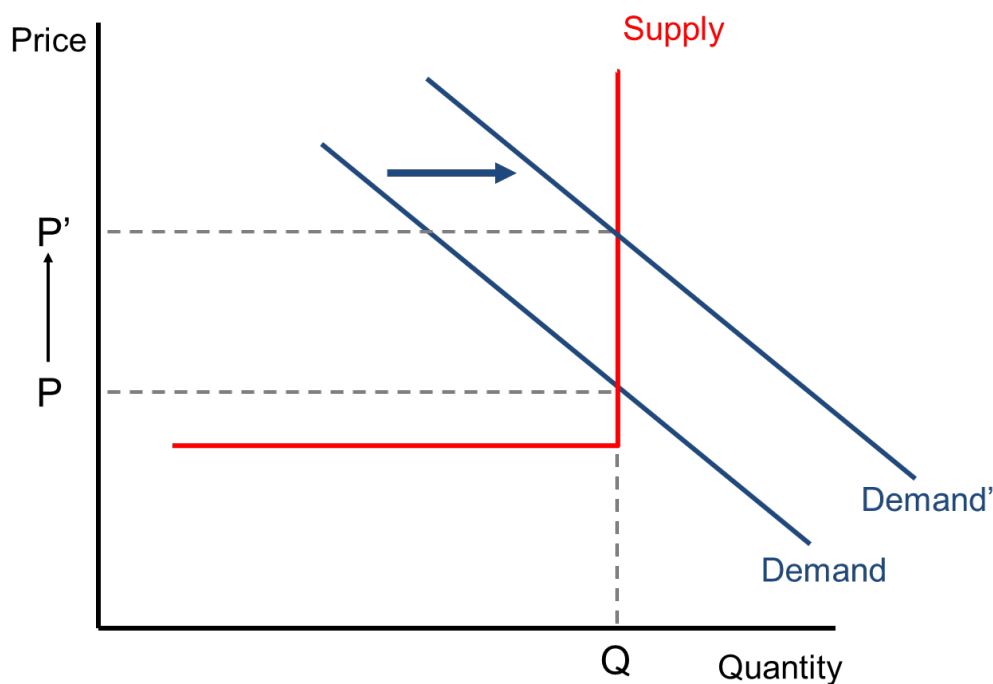


Many countries had more lockdowns in 2021 without increases in goods spending

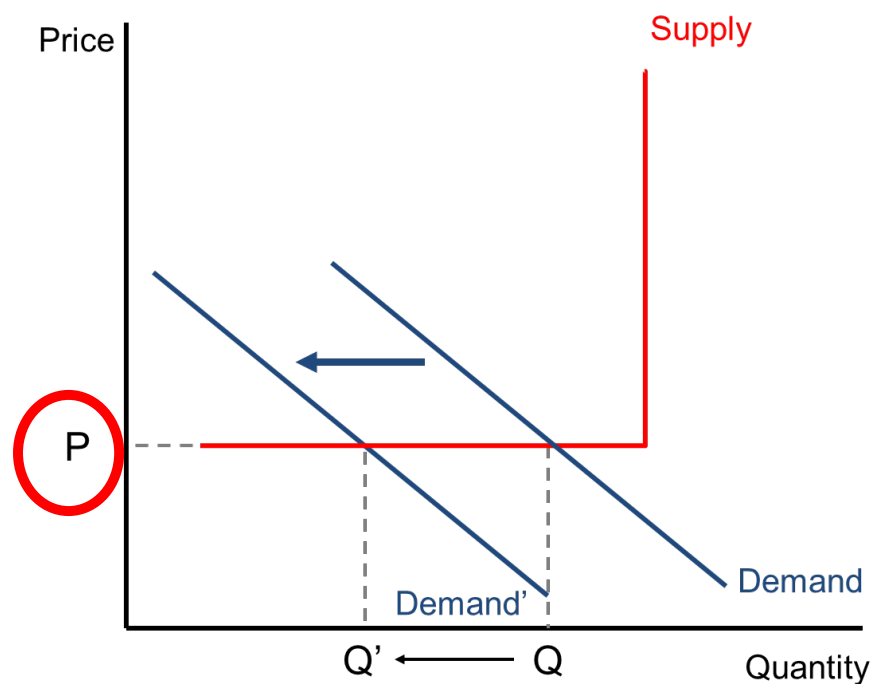


BB argument: goods up inelastic supply & services down the elastic supply

Durable Goods

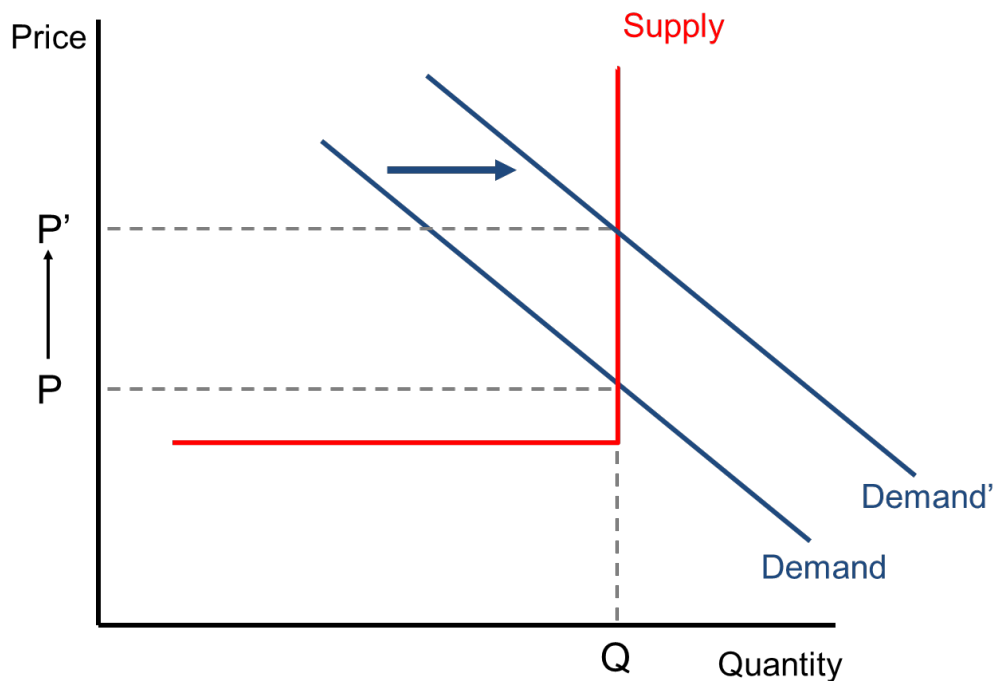


Services

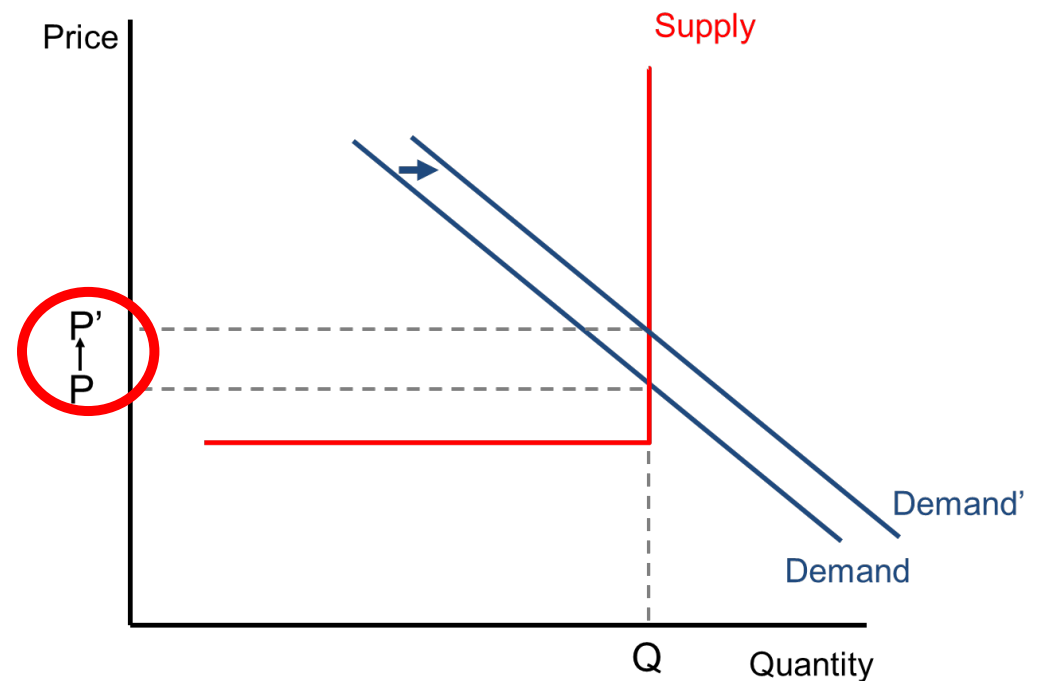


Is it more plausible to think of the demand for services as increasing on the inelastic portion?

Durable Goods



Services



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

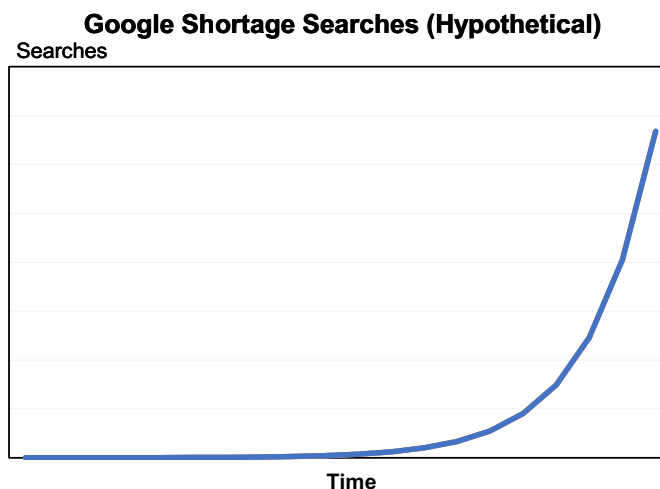
- 514% of GDP in fiscal stimulus
- Using a multiplier of 0.8, real GDP up 412%
- Unemployment rate falls to 0%
- Using a Phillips curve with a slope of 0.15, the inflation rate rises to 2.6%

What might actually happen—and how a linear analysis would interpret it

Actual Results

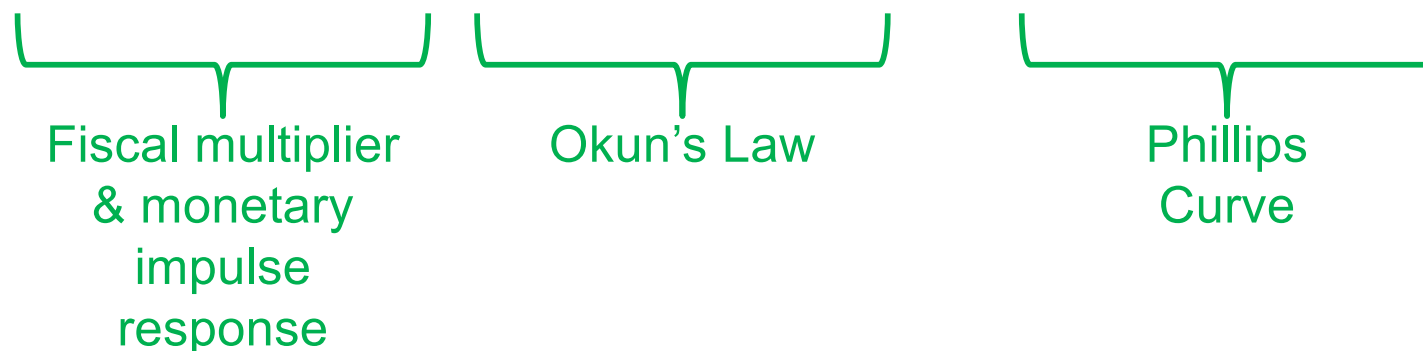
- Real GDP growth a little above the baseline
- Massive inflation

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



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

- Shortages
- Food and energy shocks

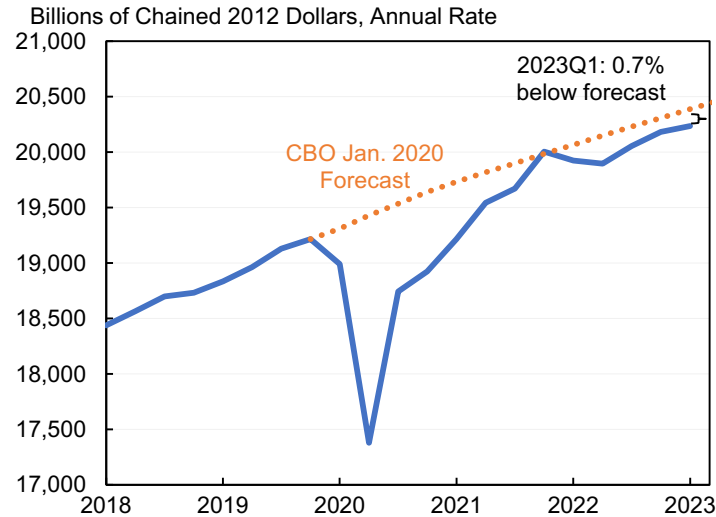
An alternative approach that drops the intermediate step

Monetary/fiscal \Rightarrow *nominal* GDP 

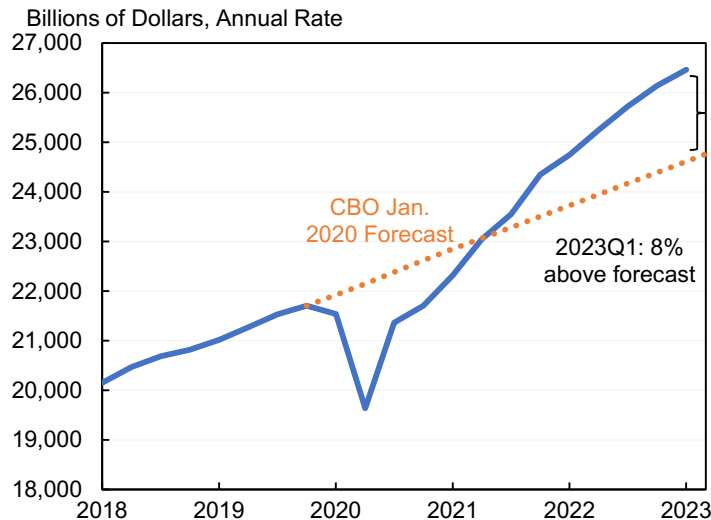
- Treat monetary and fiscal multipliers as applying to nominal GDP
- Estimate the possible increase to real GDP (e.g., in this case being above pre-COVID forecast was implausible)
- The price increase is the residual

Real GDP did as well as could be expected, what was unusual was prices/nominal GDP

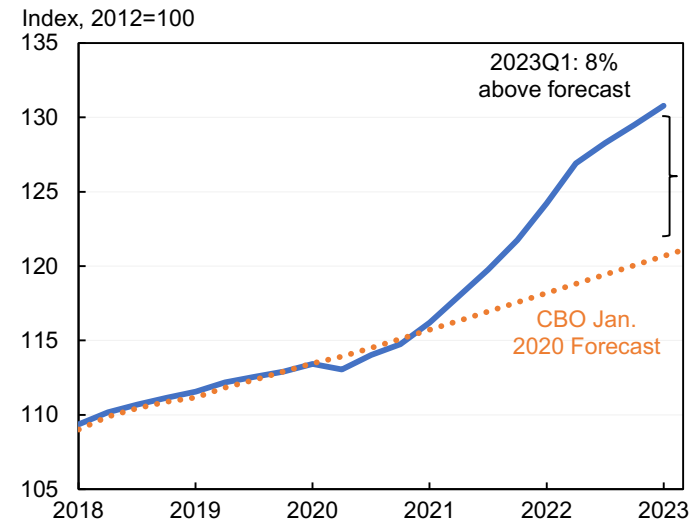
Real Gross Domestic Product



Nominal Gross Domestic Product



GDP Price Index



Note: CBO forecast rebased to match latest value for 2019Q4

Source: Bureau of Economic Analysis via Macrobond; Congressional Budget Office; author's calculations.

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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