Tim Phillips [00:00:00]:

Welcome to VoxTalks Economics recorded live at the PSE CEPR Policy Forum, the Paris School of Economics, my name is Tim Phillips.

In this episode; What caused the COVID era inflation in the United States? And can we say it's behind us yet? Inflation in the US, many other places as well, took off in 2021 and 2022 and is only now beginning to come under control. But was it caused by overheated labor markets, pushing up wages, commodity price rises, changes in demand, supply chain disruption? There are many reasons given. At the conference, Olivier Blanchard of the Peterson Institute has just given a keynote called; The Inflation Burst: An Anticipatory Autopsy, based in part on a paper with Ben Bernanke that evaluates these potential causes. He joins me now. Olivier, welcome.

Olivier Blanchard [00:01:07]:

Thanks for inviting me.

Tim Phillips [00:01:08]:

Olivier, many economists at the time, 2021, thought that inflation burst would be small, short lived. That was a misjudgment. How damaging has that misjudgment been?

Olivier Blanchard [00:01:21]:

I think you have to distinguish between misjudgment on the fiscal side and misjudgment on the monetary side. I think that there was definitely misjudgment on the fiscal side. There's absolutely no question that the various spending programs, both from the Trump administration in 2020 and the Biden administration in 21, were too large. They were well intended, they tried to protect people, but they were, from a macroeconomic point of view, too large. I think that's the original sin. Now, given this, what about the monetary policy? I think first it should have been clearer when these fiscal spending programs were put together about what it fought and that they were too large. But leaving this aside, clearly they were a bit late in reacting. They didn't do anything in 20, they did little in 21. And that was a mistake. Is it a big mistake? I'm not sure. I'm not sure. I think it has complicated things a little bit, but it would not have made a gigantic difference upon, again, was too much demand coming from the fiscal side?

Tim Phillips [00:02:28]:

You distinguished between the reaction of two types of economists at the time. There were some that worried that inflation might come because the federal rescue plans would overheat the economy. How does that happen? That's basically just too much money chasing too few goods.

Olivier Blanchard [00:02:47]:

Yes.

Tim Phillips [00:02:47]:

Others that this would not be a problem. The Phillips curve had become flatter. It had shifted down over the previous decade, so the COVID stimulus would not be inflationary. Did you find that credible at the time?

Olivier Blanchard [00:03:02]:

No, and I wrote about it at the time. I think the meta issue is that the amount of spending implied, potentially implied by the fiscal programs was so large that it would show up somewhere. Now, the more specific discussion was about the effects through the labor market. And it's true that if you took the Phillips curve, which had been estimated over previous 20 years, you said, yes, there may well be overheating. But again, the slope of a Phillips curve is flat. Or another way of saying, this is not going to lead to a lot of wage inflation, so maybe it's good for the economy and yes, we'll get a bit more inflation, but nothing. That was the view of the optimists and it's probably represented 95% of relevant economist population. There were a few people who disagreed, of which I was one, and another one was Larry Summers. And we said, no, something is going to happen. You cannot trust relations which have been estimated in a very quiet environment, which was the previous 20 years, what's known as great moderation. And the slope of the Philips curve is going to be much steeper when we get to really low unemployment. It's just going to put a lot of pressure on inflation and expectations are going to de anchor people who say, well, there is inflation now, there's going to be inflation in the future, and so don't kid yourself, it's going to lead to more inflation. These were the two views.

Tim Phillips [00:04:32]:

We will get to what happened to both of those. But first of all, the story initially was just dominated by these enormous price spikes we had in used cars was a really surprising one. Energy prices, of course. Why was it such a shock that this would show up in the data? Why were we surprised by that?

Olivier Blanchard [00:04:53]:

So we have to go back to this distinction between the two groups. And in my presentation I said both groups were largely wrong and Ben Bernanke, in a presentation he's giving tomorrow, say both groups were partially right, which is true. So what happened is that the pessimists, namely Larry and I, among others, were right about inflation, was very big. But where we were wrong was in thinking that it would happen through the labor market. We thought that there would be this enormous wage pressure and there was not a whole lot of wage pressure. There was overheating by any variable you can look at. But the wage equation to be nerdy about it remained very stable. And the action came, as you said, from the rest, from the prices given wages. And I think we had not, and here I use a global we, we had not anticipated how much commodity prices would go up and the size of price spikes to two shortages. So that's where the action came from. That's what led to inflation. I think it was due to too strong demand, but for a different channel from the one that I had anticipated.

Tim Phillips [00:06:08]:

Now, your model, your empirical analysis is attempting to disentangle what happened, what influences, at which times, it's not the only autopsy that's being done into this spike in inflation at the moment. How is your approach different? What have you done here?

Olivier Blanchard [00:06:28]:

Well, we have a model, as opposed to the kind of informal discussions which you find elsewhere. It's hard to say and we basically thought, what is the kind of model that would explain the facts, would be understandable to policymakers and allow us to actually look at the data in some formalized way. I would say this was not done, as far as I can tell, by anybody else. It may have been done within central banks, I do not know. But we made a number of choices which I think made the paper more successful in terms of visibility, which is we wrote a really simple law as opposed to the tendency these days to write laws based on microfoundations which policymakers don't understand and don't care much about. And then it turned out that it was a really nice descriptive device, if you want, but I think the room was there to do that. We did it and I would say it worked.

Tim Phillips [00:07:24]:

And coming out of that, what has it described, what have we discovered about what was driving inflation and is driving inflation now?

Olivier Blanchard [00:07:33]:

So I think we've learned a number of things. We've learned that most of the action, quarter to quarter, was due to large price shocks. We beat the usual ones, energy or food, but also price of cars because there was a shortage and so on.

Voiceover [00:07:51]:

Supply chain, the prices for cars and trucks soaring…

Olivier Blanchard [00:07:56]:

What we learned in this was that these were very big, they dominated the news when they came out.

Voiceover [00:07:59]:

Prices have risen for lots of foods.

Olivier Blanchard [00:08:02]:

But the effects didn't last.

[Voiceover] [00:08:04]:

The most in the last year.

Olivier Blanchard [00:08:05]:

So when we actually simulate our model, we find that they have a very strong effect in the quarter in which they happen. And then it's gone in terms of inflation, other shocks gone, that's terribly important because there was the opposite in the 1970s, which is you'd have a price of energy shock. It would lead workers to say oh, inflation is going to be high. It would lead unions to have indexing walls which would say well, we want our money back. And this would lead not to just a one time shock, but a long difficult shock to handle that just hasn't happened at all, which is good news, I think, it says that the credibility of central bank has remained very strong. The fact that there hasn't been catch up, or at least we have not been able to detect catch up, which is the ability of workers to get back some of the real wage losses is more surprising because we have fairly tight labor markets and we think that workers might be in a position to ask for more, but they haven't. So I think this is the lesson. The other lesson is that although each month for each quarter the news was about these shocks, what was behind the scene was a much less visible low frequency movement, which is that there was overheating in the labor market and there was pressure on wages, wage inflation. And now that the price shocks are largely gone, at least we can hope so, those shortages are coming to an end, energy prices have often decreased. What is now visible is that looking forward, it's a fairly different type of inflation. It's inflation from the labor market. What I had predicted would happen at the beginning, and unfortunately, what was very useful on the way up, which was not much effect of a heating on wage inflation, is extremely nasty on the way down because you need a lot of unemployment in order to actually slow down wage inflation. And that's the situation in which I think many central banks are. So the future is a bit tough.

Tim Phillips [00:10:04]:

Their focus is now very much back on watching what the central banks are doing and how they are reacting, something that those of us who aren't in the business got used to not doing very much. We didn't care very much for a few years. Does what you've discovered here imply that so far the Fed's reactions to what have been going on with inflation have been appropriate?

Olivier Blanchard [00:10:24]:

So again, I think that they should have moved probably a year earlier and even earlier. They should have told the administrations that this was a no no. But leaving this aside, I think when they woke up, they acted right, and they have acted right again. The notion that you increase the interest rate and then magically, three months later unemployment is 1% higher is something that only people who are young enough not to have lived through previous inflation believe. It's a very random process, and we tend to think that you increase the interest rate, it starts doing things to the financial market. Some people take decisions, but maybe they have these large cushions of excess savings and so it doesn't work. And then you have financial systems. If I stress, it's good, but too much stress is bad. And so the Fed is navigating this. Given that if I were in Jay Powell's shoes, I would do probably roughly what he's doing. My sense is that there might be enough in the pipeline, although real interest rates are still not incredibly high, again, people have forgotten the 70s and the 80s. So my sense is they have to navigate the waters more or less as they are. So at this stage, I would not criticize the Fed at all.

[Voiceover] [00:11:46]:

In December 2022, Larry Ball and Daniel Leigh explained what had caused shortages of goods in the US. And estimated the effect on the prices that consumers were paying. Listen to our episode titled Understanding US. Inflation.

Tim Phillips [00:12:06]:

Turning the model around and looking at the future and what it projects. What does it tell us about the likely future path of inflation?

Olivier Blanchard [00:12:16]:

I have no doubt about the commitment of central banks to decrease inflation. I think that can be taken as a given. The question is how long it takes. I think there is a decision, which is that if you want to do it quick because you're worried that expectations are going to de anchor, they haven't, but that may well be very costly in terms of unemployment. If you're more relaxed and you decide that you're going to do it and you watch like a hawk how expectations are moving but if they're not moving and you say well, maybe the end of 24, 25 fine, then you probably need more unemployment, I have no doubt about that in the US. How much, we really do not know, but some, no question. So I would expect interest rates to continue to increase a bit and unemployment to increase slowly is my best guess. But it's a bit fan shot.

Tim Phillips [00:13:08]:

Yeah. I was looking at the graphs that you put up and to get back down to 2% it turns out that ratio of vacancies over unemployment is the one that does a lot of work and it would have to the denominator would have to go up quite a lot.

Olivier Blanchard [00:13:22]:

So here there's a nerdy part to this which is, yes, the vacancy unemployment ratio would have to be very low. What this implies for unemployment itself is not obvious, but yes, it would imply substantially higher unemployment. I think now there's a way out which is maybe we don't need to run the last mile. We can walk the last mile or we cannot walk at all and we can decide that maybe 3% target inflation would be a really good number. And I continue to think that this, in the absence of history, would be the right number. No question. I understand the issues of credibility so I think we have to get to 3 before the discussion takes place. But I wouldn't be unhappy if when we get to 3 central banks are more relaxed. That issue will come back for sure.

Tim Phillips [00:14:10]:

Is there much chance of that, do you think? Because you've been pushing this idea for a few years now and it didn't take on with the European Central Bank?

Olivier Blanchard [00:14:18]:

Never despair. No, but I think there's a difference which is that when we were below 2% and I was talking about three or four, the notion, well, this is an inflation lover that really just wants inflation to be higher. And it was felt that this would destroy credibility of the central banks. Now, what's ironic is that they did things which are 100 times more exotic, like QE in any dimension you can think of, or negative rates and so on, and they didn't lose credibility. So retrospectively it could have been done but now it's different because it's on the way down. Right? And so the question is, I'm not asking for an increase in inflation, I'm asking for stopping the decrease to some level. So politically it's a bit easier whether it happens or not. I'm nearly sure it will not, at least not anytime soon, but they may well slow walk. They may say we have a dual mandate and we don't want at this stage to have too much unemployment. We don't like 3%, but we'll accept it and go slowly to two. I think that discussion they cannot have now, but when they are there, they could have it.

Tim Phillips [00:15:27]:

I just mentioned Europe. This paper was specifically about the US economy. Does it tell us about the economy in Europe and the path of inflation in Europe?

Olivier Blanchard [00:15:37]:

It surely has lessons. Does it imply exactly the same thing? Probably not. I have this project with the teams at the bank of England and the ECB and BOJ Bank of Japan to do the same exercise and to see whether the decomposition is similar. My guess I mean, I have some results, but nothing I can really show yet. My guess is that the general story will be similar. The big question will be the degree of overheating. The UK looks very much like the US. With worse shocks but the same dynamics. The Eurozone, I think the big issue there is whether the labor market is overheated, because the challenge of the Fed is that the labor market is overheated for sure. Now, does the ECB have the same challenge or not? Cannot tell yet.

Tim Phillips [00:16:26]:

It's comforting to hear that the UK might have the same dynamics. I live there and inflation seems extremely stuck, and the worry at the moment is that expectations will shift.

Olivier Blanchard [00:16:36]:

My sense is you have bigger shocks. One of the results in the preliminary report of the team at the bank of England is that your measure of shortages plays much more of a role than it does in the US. One wonders whether it has anything to do with Brexit, but I'm not going to...

Tim Phillips [00:16:56]:

That's another podcast.

Olivier Blanchard [00:16:58]:

I'm not going to go there. But it is striking, so I don't know if it's an accident. It's true, we have to look, but if it is, then I think a good part of what's happening comes from there. That should go away eventually. And yes, I don't think the situation is as dismal as some people put it on that front.

Tim Phillips [00:17:19]:

Olivier, thank you for talking about what seems to be like a very fruitful piece of work, that there is a lot of potential for finding out a lot more, not just about what's happened, but about how inflation is working now in the economy that we have today. Thanks for talking about it.

Olivier Blanchard [00:17:36]:

I hope so. We'll see.

Tim Phillips [00:17:47]:

The paper is called; What Caused the US. Pandemic era inflation. You can find it all over the place, and it's very short, very interesting to read, and as I said, it comes to a lot of very interesting conclusions. The authors: Ben Bernanke and Olivier Blanchard.

[Voiceover] [00:18:05]:

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