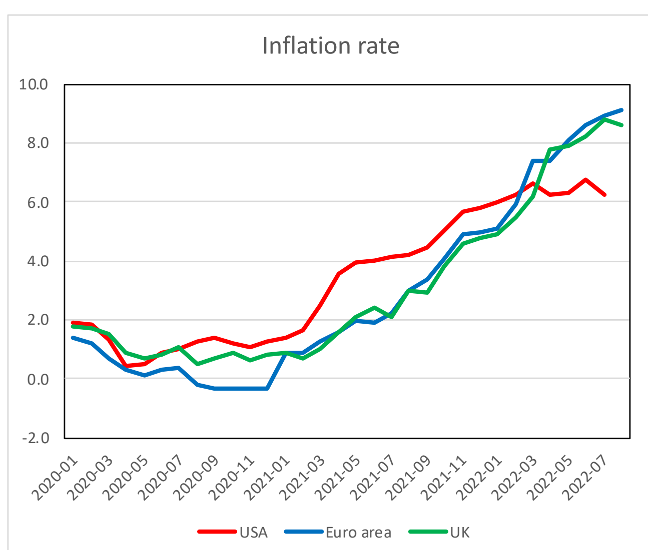
What happened to inflation? A hindsight view

September 30, 2022

By now, we all know that inflation is stubbornly high. As one of the most studied and forecasted variable in economics, it is surprising how long it has taken to reach that conclusion. As surprising is that there are still active debates about what to do about it. For the profession, it should be sobering to see that thousands (or much more) of scientific contributions, and untold amounts of money dedicated to this topic, did not result in reaching a rapid diagnosis and policy conclusions. We are reminded of 2008, when the late Queen Elizabeth assembled a distinguished group of economists and asked them why they did not see the global financial crisis coming. Predicting financial crises is arguably difficult – a few economists got it right in 2008, some even for the right reason – but inflation? Everything went wrong, and still does.

The figure below shows the inflation rate (relative to the previous year) for the US, the euro area and the UK. Throughout 2020, inflation moved slightly downward as demand fell a bit faster and deeper than supply. Things changed quite abruptly in early 2021. This is about when oil prices recovered their pre-Covid levels, following a trough in April 2019, and went on to more than double relatively to the latest peak. This is also when we started to hear about supply chain disruptions. Note that, at that time, Putin had not started to rattle his saber, and probably was not even thinking about invading Ukraine. (If he was, our political science colleagues deserve a big blame too.)



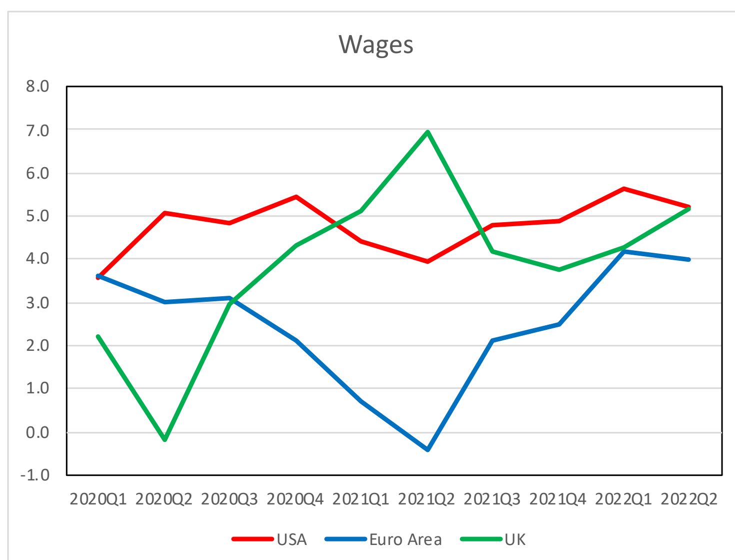
Sources: FRED, Eurostat and ONS.

Some fifty years ago, we had the first oil shock. Since then, again, thousands of scientific papers have been produced, so we should expect that an oil shock is a topic that first-year students well understand. In my textbook, my coauthor and I explain that oil shocks do not last

very long but that wage-price spirals may overtake base effects once oil prices eventually peak or even go in reverse. Here again, we have a huge literature on long-run effects of temporary shocks, including elaborate discussions of hysteresis. Yet, most of the profession declared that the inflation surge would be temporary. The central banks have taken much scorn for sticking to that view for one year, but the financial markets were going along and few voices were heard to the contrary. At the very least, we should have known that this was one possibility, but that not the only one, in fact the least probable one.
Which brings me to the current debates. On one side are the central banks and those who argue that monetary policy must be forceful to make up for delayed action. At this stage, they argue, only a significant increase in unemployment will stop the wage-price spiral. On the other side, it is argued that inflation is about to peak and to start declining. They note that, in many countries, wage increases have been muted. Betting on the absence of a wage-price spiral would be a serious mistake, however.

By mid-2021, inflation rate was on its way to reach 4%. What mattered was not that inflation was way above the usual 2% target. Most normal people, by which I mean non-economists, do not know that 2% is an important benchmark for central banks. But they well know that a 4% inflation rate is a measure of how much their purchasing power has shrunk, and they are most unlikely to accept such a loss. For inflation to stop rising on its own, normal people would have to follow the advice of the Governor of the Bank of England who (probably applying Oscar Wilde's advice that "to disagree with three fourths of the British public is one of the first requisites of sanity") invited employees to accept a reduction in their real incomes for the common good. They did not and inflation has kept rising. The train carrying the wage-price spiral has left the station.

This can be seen from the figure below. In the US and the UK, wages did not decline (except briefly in the UK) during the pandemic period. Actually, since they rose above the inflation rate while productivity growth was muted, they probably played a key role in triggering the inflation surge. The surge promptly eliminated real wage gains. With inflation now running at some 5% to 10% or more, in the developed countries, it is certain that wages will rise further to catch up. Wages are a lagging indicator, so current data are most surely misleading.



Sources: FRED, Eurostat and ONS.

They are further misleading because a number of governments have sought to contain the inflation rate by capping energy prices or by subsidizing energy. Such subsidies must have played a role in the euro area, but their effect is being eroded. In addition, normal people understand that price caps and subsidies cannot permanently remain in place, so they know that they face further losses as inflation is still trailing further upward. Anyway, the very sustainable cumulated price increase will not be undone, so the purchasing power loss is permanent. Wages will have to catch up, and this will happen faster the longer labor markets remain tight. Hoping to tame inflation without higher unemployment is just wishful thinking.

In fact, wishful thinking is another part of the story. When the FOMC finally started to raise its interest rate in March 2022, no member expected to reach 1.5% by end 2023 as evidenced by the celebrated dot plots (expectations of future interest rates by the FOMC's rate-setters). At their latest meeting, when they raised interest rates for the third time to reach 3%, they foresaw themselves hiking the rate to between 4% and 5% in 2023. Each time, the financial markets agreed, as they usually do. But if inflation stays around, say, 6%, the interest rate will have to rise above 6% for monetary policy to stop being expansionary. And what is true for the Fed applies to many other central banks. Even though the old myth of achieving disinflation without a recession – the soft landing hypothesis – is now dissipating, many believe that the interest rate increases enacted so far are enough. We do not have many examples where negative real interest rates have done the job.

The real challenge is that we just don't know what the path of inflation will be over the next 2-3 years. Economic forecasting – never the pride of economists – is now hopeless given the unprecedented shocks (Covid, Ukraine) that we face. Central banks have lost much credibility with the "temporary" debacle of last year and are naturally unwilling to risk more egg-in-the face by telling us where they plan to drive their interest rates. Most have now explicitly abandoned forward guidance, for good reason. Yet, the Fed's dot plots still convey a sense of confusion, which financial markets share and reinforce.

Going back to the first part of the title of this text, what happened to inflation, the answer is: the surprise is not that it rose fast and far, but that so many economists have been surprised. When monetary and fiscal policies are strongly expansionary, labor markets are tight and households sit on large savings accumulated during the pandemic, demand is strong and resilient. When the world economy recovers from a massive disruption, supply is slow to pick up. Expecting an inflation surge was not necessarily a safe bet, but it was a distinct possibility.

Finally, the second part of the title, hindsight, accepts that it is too easy now to tell a story of what happened and to play the blame game. Well, I am sure that many economists did not buy the mainstream story. Among many others, I did not, as can be seen in a previous blogpost from March 2021. The real question is why these warnings were summarily discarded.