Inflation: Who Cares and
Should Bygones be Bygones?
December 16, 2023

In an Opinion piece in the *Wall Street Journal* (October 18, 2023), Alan Binder expressed puzzlement that the Biden administration was not getting more credit for the performance of the economy. The unemployment rate was very low and inflation had moderated substantially from the highs of 2022. He attributed public unhappiness to lags in perception, generalized grumpiness, and persistent economic inequalities. He acknowledged that some people were discontent because prices remained higher than before the pandemic, but he pointed out that most prices do not fall except in severe downturns, an outcome no one wants.

Subsequently, the *Journal* published several letters taking issue with Blinder. The details of their criticisms differed, but the general thrust was that Blinder was out of touch with how inflation affects regular people.

For me, this exchange highlighted two recurring issues in macroeconomics:
First, why do we care about inflation? And why does the public seem to care more than many economists?
Second, should central banks focus on inflation or the price level? Does it make a difference and why?

Terminology

Let me first clarify terminology. Inflation is a sustained rise in the overall price level. It is usually measured using the prices of goods and services purchased by consumers, weighted according to the items' shares of the consumption budget.

In the United States, the Consumer Price Index (CPI) produced by the Bureau of Labor Statistics (BLS) is the most familiar measure of inflation and is commonly used in contracts. However, the Federal Reserve favors the Personal Consumption Expenditures (PCE) chain-type price index. The PCE index draws on CPI price data but includes some expenditures made on behalf of consumers rather than by them; government-supported medical expenditures are the most important. The PCE index also is more reflective of shifts in the consumption basket and tends to show slightly less inflation than the CPI over time. In analyzing changes in each index, economists often exclude the volatile food and energy components, thinking that the remaining "core" measure provides a truer picture of underlying inflation trends.

Since the early 1990s, many central banks have seen achieving moderate rates of inflation as a critical mission, with moderate inflation considered to be 2 percent. Many adopted explicit inflation targets. Although the Federal Reserve did not formally announce a target until 2012, 2-percent inflation, together with full employment, had been recognized as the Fed's goal for some time.

Central bankers often speak of moderate inflation as "price stability." However, with low - even no - inflation, prices of individual goods and services move around. Price signals are critical to the efficient allocation of goods and services. But with low inflation, increases and decreases in prices tend to offset one another. Price stability refers to the overall price level.

Even the overall price level is not literally stable. With inflation of 2 percent per year, the overall price level will double over 35 years. Nevertheless, 2 percent inflation is thought to be low enough that it will not attract the public's attention or adversely affect the economy.

Why do we care about inflation?

People do not like inflation. Various polls, word counts, and other indicators show that the public becomes agitated when they judge inflation to be too high. They even seem to care more about high inflation than about high unemployment. Economists tend to be less concerned about inflation and more about the unemployment rate.[1]

Economists

Economists acknowledge inflation has costs. High rates of inflation make planning for the future more difficult. Resources are expended as households and businesses try to adapt to rapid increases in prices and to economize on their holdings of money and other assets that decline in value with inflation. Inflation can interact with the tax code to distort decision-making and to enlarge the government's take.

On the other hand, wages tend to rise with inflation. Transfer payments can be indexed to inflation. The tax code can be indexed to inflation or amended in other ways to make it less distorting and to limit rising tax burdens. In other words, many of the problems created by inflation can be addressed.

Additionally, economists see some benefits to inflation. Inflation can facilitate the workings of the labor market: lower real wages may be needed to reduce unemployment but cutting nominal wages is difficult. With inflation, a reduction in real wages can occur if nominal wages remain unchanged while prices rise.

Higher *expected* inflation means higher nominal interest rates, giving central banks more room to cut interest rates in a recession. Higher *unexpected* inflation reduces debt burdens to the degree that borrowers' incomes rise with inflation while their debt payments are fixed. Creditors lose, but creditors are often assumed to be better able to take care of themselves than borrowers. The federal government, as a net borrower, gains.

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[1] The comments in this section reflect my own observations and experience. However, someone looking for a more authoritative source might consult Robert Shiller's "Why Do People Dislike Inflation?" The survey, done in the mid-1990s, highlighted the contrasting views of economists and the general public. https://cowles.yale.edu/sites/default/files/2022-08/d1115.pdf

Economists also associate declining prices with the Great Depression and other severe downturns. This is territory they do not wish to re-visit.

The Public

The public sees inflation as reducing the standard of living. While wages and other income generally rise with inflation, the increases are not automatic or universal; some people are left behind. Also, workers whose wages do keep pace with inflation may see these increases as attributable to their individual strong performance or merit, rather than to cost-of-living adjustments or generalized competition for employees. Indeed, corporate communications with employees may stress the merit-based nature of pay increases. To have what is presented as a reward for performance eaten up by higher prices does not sit well.

The public views inflation as a tax – a sneaky underhanded tax that was not voted. They also seem to see high inflation as an indicator of general government incompetence. If the government cannot control inflation, can it do anything well? Other policies and programs are likely to be misguided and poorly executed.

The public also tends to be skeptical of economists' focus on core inflation, as prices of food and energy are highly visible, and these items are critical to consumers' well-being. In defense of economists, over long periods, such as ten years, differences between total and core inflation measures cancel out and the average inflation rates are almost the same.

Inflation vs Price Level Targeting

The current situation highlights important differences between a focus on inflation and a focus on the price level.

Since inflation is the change in the price level over time, you might think it would not matter whether the central bank is trying to achieve a particular inflation rate or reach a particular price level. And if the central bank always hit its target – whether inflation or price level – there would be no difference.

But central banks do not always hit their target. They do not have perfect foresight or control. Other factors influence prices and forecasts can be wrong. Thus, inflation and the price level frequently deviate from their targets – sometimes substantially. And depending on whether the target is inflation or the price level, the central bank's response will be different.

As noted, many central banks, including the Federal Reserve, target a rate of inflation of 2 percent. For the ten years, 2009 to 2019, inflation in the United States averaged 1.5 percent using the PCE index – below target.[2] Inflation slowed early in the pandemic, but as

[2] Using the CPI, inflation averaged 1.7 percent. All numbers in this section are the author's calculations using the PCE price index taken from the FRED data base maintained by the Federal Reserve Bank of St. Louis in

activity recovered, rebounding demand collided with supply bottlenecks and inflation increased sharply. Prices in September 2021 were up 5 percent from the previous year and by September 2022, they increased another 7 percent. The Fed was slow to react to the rise in inflation, not increasing interest rates until March 2022. But once it began, the Fed raised interest rates aggressively. By the fall of 2023, inflation had moderated. Prices in September 2023 were about 3 ½ percent above September 2022.

Inflation Targeting

So, what next? If the target remains inflation at 2 percent, then the central bank will keep policy tight until its forecasted rate of inflation over the next couple of years is close to 2 percent. It will not take account of the more rapid inflation that occurred in 2021, 2022 and 2023. As long as the outlook for inflation is 2 percent, the central bank is on track to its objective. Bygones are bygones.

If they are wrong and inflation is higher than expected, policy will remain tight or even tighten; the date when the target will be achieved will be pushed out; but the goal remains the same – 2 percent inflation. If inflation is lower than expected, the central bank will be more stimulative, hoping to raise actual and forecast inflation to 2 percent. No account is taken of history.

Inflation targeting is relatively straightforward and generally understood by the public. Part of its appeal is that it has – or seemed to have – an element of self-fulfilling prophecy. If households and businesses know the inflation target is 2 percent and believe the central bank will act to achieve it, price- and wage-setting will take this into account and tend to deliver the desired outcome.

Price Level Targeting

Price level targeting is more complicated. What is the price level that should be targeted and how long should the central bank take to get there? Assume we want prices back to "normal." And we decide that normal is fall 2019 - before the pandemic. The price level then was about 15 percent below what it is today, meaning prices would have to fall 15 percent to get back to the level in 2019. But if 2 percent inflation per year was our earlier goal, perhaps "normal" should include an increase in the price level of 2 percent per year for the four years from 2019 to 2023. Then our target price level would be higher and the desired reduction from the actual 2023 price level would be 7 percent.

How quickly should the central bank try to get back to the targeted price level? Cuts in the overall price level of 7 percent over a short period, say two years, would require very restrictive policy or a very severe negative shock to the economy. As Blinder said, such a price reduction would almost certainly involve a deep recession. However, as the time period for returning to "normal" lengthens, achieving the target price level becomes more

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November 2023. Changes are measured from September to September. Thus, inflation from 2019 to 2023 is actually September 2019 to September 2023.

feasible, at least on paper. If the desired price level is 2 percent per year above the level of 2019, this could be achieved by 2031 if actual inflation between now (2023) and 2031 averages 1 percent per year.

Of course, we would be starting from an inflation rate well above 1 percent and many things affecting prices will happen over eight years. And the desired path to the target price level will change as unforeseen developments push the economy off course. In addition to assessing whether deviations from the desired price level path require correction or whether they are transitory, central banks will be challenged to explain what they are trying to achieve to the public. What is the target? Is it the price level of 2019 plus 2 percent per year? Is it the price level of 2023 plus 1 percent? As we move forwards, is it the current price level plus yet another rate of change? Are they making progress towards their target or not? As noted, each deviation from the desired price level path requires drawing a new path. Adding a base year and a longer time horizon to the desired inflation rate makes a more complicated narrative. Public understanding and hopes for a self-fulfilling prophecy are likely to suffer.

An average rate of inflation has some of the features of a price level target. Averaging takes account of history. If applied rigidly, however, it can commit central banks to excessively aggressive actions. The averaging period is important. Shorter introduces more volatility, while longer means more can change in the world. If "average" is interpreted loosely and simply means some consideration is given to whether inflation was too high or too low in the recent past, it may have merit. The Fed introduced an averaging approach in August 2020, with the intention of compensating for the below-target inflation rates of the 2010s by allowing inflation to be modestly above target for an unspecified time. The timing was bad, however, as shortly thereafter inflation shot up much more than expected.

Interestingly, the high rates of inflation from 2021 to 2023 have, in a way, given the Fed what it wished for: offset the low inflation of the 2010s. If you take the price level in 2009 as the base (rather than 2019) and assume it increased 2 percent per year for 14 years, the target price level for 2023 would be only 3 percent below the actual price level. In other words, fairly close to where we might have thought – back in 2009 – we wanted the price level to be in 2023. Inflation averaged 2.2 percent per year from 2009 to 2023.

<u>Concluding thoughts</u>

Many economists, not just Alan Blinder, are probably surprised that the public viewed the economy so negatively in the fall of 2023, given the low unemployment rate and the reduction in the inflation rate from the peaks of 2022. Many economists would probably be content if both the unemployment rate and the inflation rate continued at roughly 3 ½ percent. While inflation has costs, economists tend to think these costs can be managed by indexation and other measures.

The public, on the other hand, seems to view inflation as an unfair tax and the unexpected surge in inflation in 2021 and 2022 as a sign of central bank and government ineptitude. Indexation would only involve the government more deeply in economic affairs. Moreover,

dismissing the surge in inflation as due to supply chain bottlenecks and the war in Ukraine feeds the sense that the government is not in control of events.

Nevertheless, rolling back prices to levels before the spike in inflation would be highly risky and likely to entail a severe recession. Ignoring history and attempting to return to 2 percent inflation seems a more feasible approach. Even that will be a challenge, in light of long-term upward pressures on inflation that are likely to come from aging populations and from replacing a functioning energy system with one thought to be more climate friendly.