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TESTIMONY

INFLATION IS LARGELY A DEMAND-SIDE PROBLEM

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Senate Committee on Banking, Housing, and Urban Affairs
Building a Resilient Economy: Shoring Up Supply

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Chair Brown, Ranking Member Toomey, and members of the Senate Committee on Banking, Housing, and Urban Affairs:

Thank you for the opportunity to testify today. My name is Veronique de Rugy, and I hold the George Gibbs Chair at the Mercatus Center at George Mason University, where I study tax and fiscal policy, the federal budget process, and the implications of government spending for economic growth.

I would like to offer the following three main takeaways:

1. The inflation Americans are experiencing today was to be expected. There were sufficient warnings that this inflation should not have been a surprise.
2. The inflation Americans are experiencing is the result mostly of expansive monetary and fiscal policy, rather than the result of global supply chain problems or other supply shocks.
3. Fiscal and monetary restraint are key to controlling inflation.

BACKGROUND

The Consumer Price Index in February 2022 showed its sharpest year-over-year spike in four decades,[1] catching the Federal Reserve (Fed) by surprise. After being slow to recognize the inflation, the Fed claimed that the inflation is transitory, , meaning that it would go away all on its own. When inflation persisted, the Fed said that prices are just catching up to prepandemic levels. When prices began to exceed prepandemic levels, the list of "causes" of inflation began to change with the circumstances, to the point that one could conclude that inflation can be caused by nearly everything (the restricted supplies of lumber, used cars, and other goods, as well as overall supply chain tangles).

Today, the argument that inflation is mostly the result of supply shocks such as the war in Ukraine or of global supply chain problems continues to be widespread.[2]

1. Bureau of Labor Statistics, "Consumer Price Index—February 2022," news release no. USDL-22-0145, March 10, 2022, https://
www.bls.gov/news.release/pdf/cpi.pdf.
2. Betsy Stevenson, "The Best Way to Tackle Inflation: Confirm Biden's Fed Nominations," *The Hill*, March 2022.

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None of these alleged causes, however, can explain the persistence of inflation or its scale compared with inflation in other countries. In particular, explanations about supply-shock-driven inflation seem to mistake inflation (i.e., an increase in the general price level—that is, of all prices and wages) with changes in relative prices (i.e., when only some prices rise, as when the price of cars rises relative to the price of other goods and to wages because of reductions in the supply of computer chips). In the end, excessive focus on the supply side of this issue causes people to fail to recognize the overwhelming role played by the demand side, in particular the role of deficit spending accommodated by the Fed's expansionary monetary policies. This is surprising, considering that many legislators, Fed officials, and many experts treated the pandemic and lockdown induced downturn as if it were a demand-side shock and have responded with measures meant to raise aggregate demand. They should not be surprised that this inflation is demand pull rather than cost push.

GLOBAL SUPPLY CHAINS ARE NOT THE PRIMARY CAUSE OF INFLATION

One of the most common talking points about the inflation is that it was caused by supply shocks in general and global supply chain weaknesses in particular. Fixing inflation therefore requires, among other things, pulling in supply chains behind national borders. This hypothesis is based on misconceptions about both supply chains and inflation.

According to the World Trade Organization, trade in intermediate goods continued to rise during the pandemic, albeit at a slower rate than before, in spite of port and shipping bottlenecks.[3] In other words, although there were chokepoints, supply chains were far from "cut off," as the president recently claimed on national television.[4] In fact, as I will show later, most of the supply chain issues had to do with the tremendous increase in demand rather reductions in the economy's ability to supply goods due to than supply-chain-specific issues. Economist Scott Lincicome has demonstrated repeatedly that "the nation's overall productive capacity and its medical goods industries are generally healthy and that domestic industries and their supply chains have adapted during the pandemic to meet extraordinary demand."[5]

Furthermore, it is at best unlikely that moving supply chains to domestic producers will lower inflation by reducing the cost of production. Global supply chains are global as they are because every other available mode of production and distribution is more costly. Were the government to forcibly constrain and alter these supply chains, it would increase costs further—and as costs go higher, so do prices. Undoing decades of globalization would also take similar decades.

Rachel Fefer, Andres Schwarzenberg, and Liana Wong, economists at the Congressional Research Service, write that

> the United States, in particular, was a driving force in breaking down trade and investment barriers across the globe and constructing the open and rules-based global trading system that has enabled [global value chains] to proliferate. . . . For example, stronger linkages to the global economy force U.S. industries and firms to focus on areas in which they have a comparative advantage, provide them with export and import opportunities, enable them to realize economies of scale, and

3. "Exports in Intermediary Goods Continue to Grow in Third Quarter of 2021," World Trade Organization, February 4, 2022, https://www.wto.org/english/news_e/news22_e/stat_04feb22_e.htm.
4. "ABC News Live Update: Biden's Exclusive Interview with George Stephanopoulos," interview by George Stephanopoulos, ABC News, video, accessed March 18, 2022, https://abcnews.go.com/US/video/abc-news-live-update-bidens-exclusive-interview-george-76510757.
5. Scott Lincicome, "The Pandemic Does Not Demand Government Micromanagement of Global Supply Chains," Cato Institute, February 24, 2021, https://www.cato.org/pandemics-policy/pandemic-does-not-demand-government-micromanagement-global-supply-chains.

encourage knowledge sharing and innovation. In addition, households have been able to enjoy lower product prices and a broader variety of goods and services—some of which may not be produced domestically.[6]

Global supply chain constraints or port bottlenecks do exist, and Congress can address them in several ways, some of which I will mention later in this testimony. Indeed, the United States could get much more out of global supply chains by removing the many government-imposed barriers that have intentionally diminished US supply chain capacity, efficiency, and flexibility and thus made the supply chain crisis far worse than it ever needed to be.[7]

Finally, this is not to say that global supply chain constraints cannot and have not led to an increase in the price level. However, one needs to differentiate between supply constraints, which increase the price of some or even many goods relative to other prices, and inflation, which occurs when the prices of everything, including labor, eventually rise. We are now seeing the price of everything go up, and wages also rising though for now at a lower rate. Supply shocks and constraints do not cause that broad-based pattern. Indeed, individual price increases show up in measurements of inflation, but these increases in relative individual prices should not be confused with inflation. In addition, price-level hikes caused by supply-side shocks (such as supply-chain chokepoints) are generally not ongoing, month-after-month price hikes. They are usually a one-time price-level jump, which eventually dissipates when the supply shock is over, , and indeed usually reverses resulting in a period of measured deflation. All prices are rising, the inflation is persistent, and there is no sign of a reversal.

Similarly, a shift in demand from services (restaurant means) to goods (TVs) can cause goods prices to rise, but it causes services prices to decline, with no effect on the overall price level. That is not what we are seeing.

By contrast, inflation, or a general increase in all prices including wages, and the associated fall in the dollar's purchasing power has a single source: the creation of too many dollars and the promise to print more dollars in the future.

THE MAIN CAUSE OF INFLATION

Government-induced demand is a key player in this burst in inflation. The US Department of the Treasury first issued $3 trillion of new debt, which the Fed quickly bought in exchange for $3 trillion of new reserves that the Treasury sent out as checks and other forms of payments to Americans. The Treasury then borrowed another $2 trillion or so to send out another round of checks and payments to Americans. Overall federal debt rose by almost 30 percent of GDP.

This action was the product of a misdiagnosis of economic problems on the basis of the belief that the pandemic-induced recession was mostly an aggregate demand shock, not one of aggregate supply. That means that sending money to people would have very little impact on output, especially because a large share of the economy was closed. It would, however, affect demand for durable goods.

The size of fiscal stimulus was also an issue. Even by Keynesian economics standards, the $5 trillion injected into the economy was larger than any plausible output gap, at any level of multiplier. The same can be said of the $1.9 trillion American Rescue Plan, which was passed in March 2021. Around early 2021, the

6. Rachel F. Fefer, Andres B. Schwarzenberg, and Liana Wong, "Global Value Chains: Overview and Issues for Congress" (report no. R46641, Congressional Research Service, Washington, DC, December 16, 2020).
7. Scott Lincicome, "American Sclerosis," *Dispatch*, November 10, 2021.

Congressional Budget Office projected that the output gap would be $700 billion through 2023,[8] the period when most of the $1.9 trillion in spending would take place. $1.9 trillion was two or three times more than needed to fill the gap.[9]

Whereas everyone from monetary experts to the Fed chairman to President Joseph R. Biden Jr.'s Council of Economic Advisers spent most of 2021 explaining this burst of inflation without any mention of the role played by fiscal and monetary policies, economists such as Larry Summers and Jason Furman, who had advised earlier Democratic administrations, and Olivier Blanchard of the International Monetary Fund were sounding the alarm. As some of the best Keynesian economists out there, they recognized that the $1.9 trillion American Rescue Plan was excessive and would cause an excessive increase in aggregate demand, followed by inflation.

A series of new studies confirm the demand-side effects on inflation.[10] The World Trade Organization's chief economist Robert Koopman also estimates that increased demand for goods was a major factor behind supply chain issues, accounting for anywhere between two-thirds to three-quarters of supply shortages.[11] In other words, there wouldn't be "supply chain" problems without the massive increase in demand for durable goods fueled by government spending.

The government has been borrowing money for decades and the Fed has been buying Treasury securities and turning the debt into reserves for a decade without causing inflation. What was different this time around? First, Americans have seen for a decade or so prices rise in assets from housing to land to the stock market, but the increase didn't spread to broader prices until now.

Second, as economist John Cochrane explains, the large money printing and deficit spending alongside the absence of discussion about paying down the debt once this crisis is over is what produced this inflation:

> Inflation comes when government debt increases, relative to people's expectations of what the government will repay. If the Treasury borrows, but everyone understands it will later raise tax revenues or cut spending to repay the debt, that debt does not cause inflation. It is a good investment, and people are happy to hold on to it. If the Fed prints up a lot of money, buys Treasury debt, and the Treasury hands out the money, as happened, but everyone understands the Treasury will pay back the debt with future surpluses, the extra money causes no inflation. The Fed can always soak up the money by selling its Treasury securities, and the Treasury repays those securities with surpluses (i.e., taxes less spending).

8. Calculations of the Committee for a Responsible Federal Budget based on Congressional Budget Office, *An Overview of the Economic Outlook: 2021 to 2031*, February 2021. "America Faces a $380 Billion Output Gap," Committee for a Responsible Federal Budget, February 1, 2021.
9. Veronique de Rugy, "The Not-So-Stimulative $1.9 Trillion Package," *National Review*, March 19, 2021.
10. Francois de Soyres, Ana Maria Santacreu, and Henry Young, "Demand–Supply Imbalance during the Covid-19 Pandemic: The Role of Fiscal Policy," VoxEU, Center for Economic Policy Research, March 1, 2022, https://voxeu.org/article/demand-supply
-imbalance-during-covid-19-pandemic; "Global Supply Chains: Risk, Repair and Restructuring," Morgan Stanley, February 17, 2022, https://www.morganstanley.com/ideas/supply-chain-disruption-outlook; "Demand Shock behind Global Bottlenecks Should Ease in Months-WTO," *Reuters*, February 14, 2022. A recent study by the International Monetary Fund estimates that, in the second quarter of 2021, in the United States, about 45 percent of changes in producer prices were driven by supply shocks and 55 percent were driven by demand shocks. Oya Celasun et al., "Supply Bottlenecks: Where, Why, How Much, and What Next?" (working paper no. WP/22/31, International Monetary Fund, Paris, February 2022).
11. "Demand Shock behind Global Bottlenecks Should Ease."

> The 2020–2021 borrowing and money episode was distinctive because, evidently, it came without a corresponding increase in expectations that the government would, someday, raise surpluses by $5 trillion in present value to repay the debt.[12]

Most economists believe that the Fed has the tools to control inflation today by raising interest rates. However, one needs to face the fact that the amount of America's debt may make fighting inflation harder than in the past. A few fiscal facts are important to bear in mind. Federal debt held by the public is now $23 trillion, or 100 percent of GDP, and a large share of that debt is short term (30 percent has a maturity of a year and over 60 percent a maturity of four years). Therefore, any increase in interest rates sufficient to fight inflation would quickly lead to large increase in interest payments.

In addition to being politically unpopular, if the additional interest payments are paid for with borrowed money rather than higher taxes, the borrowing may add fuel to the inflation fire. Cochrane explains:

> This consideration is especially relevant if the underlying cause of the inflation is fiscal policy. If we are having inflation because people don't believe that the government can pay off the deficits it is running to send people checks, and it will not reform the looming larger entitlement promises, then people will not believe that the government can pay off an additional $1 trillion deficit to pay interest costs on the debt. In a fiscally driven inflation, it can happen that the central bank raises rates to fight inflation, which raises the deficit via interest costs, and thereby only makes inflation worse."[13]

REFORM IDEAS

First, the Fed needs to fully step back from its expansionary policy. It needs to raise interest rates significantly to tame inflation. With inflation at 7%, even the Fed's promise to raise interest rates to about 2% leaves the real, after-inflation, cost of borrowing at a stunning negative 5%. The usual rule of thumb is that to tame inflation, the Fed must raise the nominal interest rate by more than the inflation rate, so the real inflation rate rises. Current Fed policy will only achieve that goal if almost all of today's inflation miraculously melts away on its own.

But Congress needs to do its part too. Without fiscal consolidation, the government's interest costs on the debt. Unless fiscal policy tightens to pay those interest costs, raising interest rates just makes deficit-induced inflation worse. As economist Eric Leeper states, "fiscal responses are fundamental, even indispensable to monetary policy impacts on inflation." They are "the difference between a Brazilian-style interest rate and inflation spiral and a successful reigning [*sic*] in of inflation,"[14] he adds.

Empirical work confirms that fiscal contraction is a key element to reducing persistent inflation. For instance, legislators implemented fiscal consolidation (by raising revenue, decreasing spending, or both, and passing pro-growth tax and regulatory reforms that increased the tax base) during each of the three latest victories over inflation: in the late 1940s, after the 1980–1982 Recession, and in the late 1980s and mid-1990s. Unfortunately, this link between fiscal and monetary expectations is too often overlooked in conventional inflation debates, with fiscal authorities acting as though inflation outcomes are independent of fiscal policy.

Higher real interest rates would also increase household wealth through lower inflation (increasing the real value of wealth) and higher interest receipts (raising household income flows). Thus, although the central

12. John H. Cochrane, "Fiscal Inflation" (paper presentation, Cato Institute 39th Annual Monetary Policy Conference, Washington, DC, December 22, 2021), https://static1.squarespace.com/static/5e6033a4ea02d801f37e15bb/t/61d3c86e0797d1326136230b/1641269358431/Cochrane_Final_12.pdf, 4.
13. John H. Cochrane, "Fiscal Inflation," *Grumpy Economist*, January 3, 2022.
14. Leeper, "Shifting Policy Norms," 2.

bank is aiming to lower inflation, its efforts could backfire by boosting demand for goods and services. Higher levels of debt work to amplify these (demand-driven) inflationary pressures if there are no plans for fiscal consolidation (e.g., tax hikes to offset the wealth effect).[15]

Second, Congress needs to get its fiscal house in order above and beyond the need to tame inflation. Inflation comes when people lose faith that the U.S. will eventually repay its debts. Perpetual deficits and the looming entitlements crisis undermine that faith. The good news is everyone knows what types of fiscal adjustments are effective at reducing the US debt-to-GDP ratio. Alberto Alesina and others have shown that fiscal adjustment packages based on spending cuts—preferably reforms to programs that are the drivers of future debt: Social Security and Medicare—rather tax increases are the most effective way to reduce the debt. Such packages are also less likely to cause short-term recessions and, if they do cause short-term recessions, those recessions are mild and short, unlike those caused by adjustments based on tax increases.[16]

Third, many of the long-term structural problems with the global supply chain are legislative, and Congress should fix them. Here are a few:

- Eliminate the Jones Act (Merchant Marine Act of 1920).[17]
- Reform the Foreign Dredge Act, which requires that dredging barges comply with the Jones Act.[18]
- End punitive tariffs, duties, and quotas, which inflate costs and reduce the supply of goods that are essential for alleviating supply constraints.[19]
- Ease immigration restrictions.[20]
- End the ban on Mexican trucking companies' operation on US roads.[21]

These are some of the things that Congress can do specifically to alleviate some of the restrictions imposed on global supply chains.

Finally, there is a temptation to offset inflation with subsidies, to have the government borrow more money to pay for gas, housing, childcare, and more at subsidized prices. Since fiscal largesse is the source of the problem, and since these efforts make the affected markets more inefficient, this approach threatens a

15. Eric M. Leeper, "Shifting Policy Norms and Policy Interactions" (paper presentation, Jackson Hole Economic Symposium: Macroeconomic Policy in an Uneven Economy, Federal Reserve Bank of Jackson Hole, WY, September 8, 2021), https://www
.kansascityfed.org/documents/8357/Leeper_JHPaper.pdf.
16. Alberto Alesina and Veronique de Rugy, "Austerity: The Relative Effects of Tax Increases versus Spending Cuts" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, March 2013).
17. Under the act, all freight moved between US ports must use US-built, US-crewed, and US-flagged ships to move all freight between US ports. This requirement makes shipping more costly and puts more pressure on inland transit (trains and trucks). Thomas Grennes, "An Economic Analysis of the Jones Act" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, May 2017); Nita Ghei, "The Jones Act and the Growth of Regulatory Barriers in the US Shipping Industry," Mercatus Center at George Mason University, April 4, 2017; "Project on Jones Act Reform," Cato Institute, accessed March 18, 2022, https://www.cato.org/project-jones-act-reform.
18. This significantly inflates the costs of dredging US ports, preventing expansions that could accommodate more and larger ships. There has been no container terminal expansion since 2009 (Charleston).
19. For example, section 301 tariffs have drastically reduced the supply of truck chassis in the United States, worsening truck shipping bottlenecks. "Tariffs Could Be Part of Why We're Short on Chassis," *Flexport*, October 28, 2021.
20. Immigration restrictions have "removed at least 1 million potential (and lawful) workers from the U.S. labor market, putting acute pressure on labor-intensive industries like warehousing. (And backed-up warehouses make it more difficult to clear containers that are stacked up at various ports.)" Lincicome, "American Sclerosis."
21. The ban keeps "'the largest and closest supply of potential US truck drivers' out of the country *and* reducing the number of *American* trucks available for inland work because they're picking up cargo at the border from Mexican truckers who have to drop it there." Mark Szakonyi, "Western Countries Waking Up to Freight Infrastructure Needs: DHL CEO," *Journal of Commerce*, October 14, 2021, quoted in Lincicome, "American Sclerosis."

greater stagnation spiral. Making a good cheaper for some consumers by subsidies makes it more expensive for the economy as a whole.