Statement to the Committee on Banking, Housing, and Urban Affairs, U.S. Senate

Committee Hearing On: "Higher Prices: How Shrinkflation and Technology are Hurting Consumers"

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Statement

Chairman Brown, Ranking Member Scott, members of the committee: thank you for the invitation to discuss with you today how price increases, shrinkflation, and technology may be harming consumers. I am a senior fellow at the Manhattan Institute, where I research fiscal and monetary policy and financial markets. I am also a columnist at Bloomberg Opinion.

The high inflation environment we are in is a terrible economic burden for American households—especially those living paycheck to paycheck, who are struggling to afford groceries, let alone enjoy the occasional meal out with their family. It has also proven more persistent than policymakers hoped. It is tempting to blame whoever raised the prices we see, the firms we buy goods and services from, who appear to be getting rich from our rising bills. But they are not at fault; they are merely reacting to the realities of the high and uncertain environment we are all facing.

Firms can increase prices several ways: they can simply increase the prices we all see—the sticker price, they can reduce volume of what we buy but still charge the same price—shrinkflation, or they can practice dynamic pricing—charging only some customers a higher price. All of these feel unfair to many consumers. But it is the high inflation environment that's harming consumers, not how firms respond to it.

In order to bring inflation down, we need to understand it, how it started, and why it persists. History has shown that misdiagnosing the problem and then implementing misguided policies will create more harm for American households.

Inflation accelerated coming out of the pandemic, when the economy faced constrained supply, from pandemic related shortages, and high demand, the result of people emerging back into the economy after being at home with nowhere to spend money, and extremely accommodative fiscal and monetary policy. Some of that policy could be justified at the height of the pandemic, and it was a lifeline for many Americans who were unable to work. But the expansionary policy was too large and went on for far too long and ultimately contributed to inflation. Economists estimate expansionary fiscal policy contributed as much as 4 percentage points of our excess inflation. Today inflation is lower, down to about 3 to 3.5% from the high of 8.6%.

The fact that inflation is still high in the service sector—and wage growth is more than 4%—suggests that it may stick around for the foreseeable future. In short, the supply constraints have largely been resolved, but demand remains elevated, and the higher inflation has permeated into our economy. Our current fiscal policy stance is not helping. While monetary policy has become more restrictive, fiscal policy remains very loose, with continued infrastructure spending, subsidies to industries such as chip manufacturing, clean energy, and student loan forgiveness. This loose policy worsens inflation by adding more demand to the economy and adding further to the debt.

Greedflation

Inflation cannot be blamed on greedy corporations. First, there is no reason to think corporations have suddenly become greedy. It is natural to increase prices when facing a period of high demand. This can feel unfair sometimes, but it is an important part of market functioning.

Take the example of an umbrella salesman in the rain. It may feel unfair that he increases his price when it rains, but if he didn't increase prices when it started to sprinkle, there would be no umbrellas left when there is a downpour. Or, if he can't make more money in the rain—why would he bother selling umbrellas and sitting in the rain himself?

We see a similar story playing out in other markets today. Prices are increasing because demand is still high: consumer spending is still up, there is a vigorous labor market, and GDP is growing. And prices tend to rise more when demand is high. This price adjustment is how the market rations goods.

It is true that there was an increase in corporate profits in 2021 when inflation first spiked. But profits peaked in 2022 and have decreased and leveled off since then.

One way to understand what happened is that, initially, firms raised prices in response to increased demand and limited supply, just like the umbrella salesman. They did so because:

1. The high demand environment pushed prices up, and consumers were willing to pay more because there was more money in their pockets coming out of the pandemic.
2. Firms rightly anticipated a higher inflation environment that would also increase the costs of their inputs, including labor, and they needed to increase prices to stay in business.

This is why profits initially increased. At first their costs of inputs did not go up as much as prices because many firms had previously locked in wage and input costs. But as inflation continued, firms renegotiated those contracts and gave their workers wage increases, which eroded profit margins.

Shrinkflation

In addition to higher prices, many consumers are getting less for their money—for example: fewer potato chips in a bag. This so-called shrinkflation is just another way for firms to increase prices. This isn't a driver of inflation - it a manifestation of it.

Rather than increase the price consumers pay, they might shrink the size of their product instead. Again, this can be extremely frustrating for consumers because they are getting less and paying more. But it is another way for firms to deal with price pressures from increased demand. The alternative is to simply increase prices, but whether one approach is better than the other is hard to say. Charging more may price consumers out of the market entirely.

Dynamic pricing

Another way that firms can respond is not increasing prices for everyone, but only for consumers who use goods or services in high demand times or are willing to pay more. This is known as dynamic pricing—and it is another frustration for many consumers.

Wendy's recently attempted this when they floated the idea of charging more during peak times. Technology is aiding this effort because firms can collect data on potential customers and gain insight into their willingness and ability to pay.

An example of dynamic pricing that predates our current inflation era is airlines. They charge more for peak time flights or by charging for services that were once included in the quoted airfare, such as checking a bag or picking your seat. This is another way of passing on higher costs to some customers. This is especially attractive for airlines who face pricing pressure to keep fares low because of technology that enables consumers to comparison shop.

Believe it or not, dynamic pricing can be better from a consumer welfare point of view than increasing prices for everyone. For example, airlines may price discriminate, but the cost of flying has fallen and it has become more accessible. In the 1980s, about 30% of Americans had flown in the last year; now it is more like 50%—in large part because lower income Americans have a cheaper option, even if it means worse service.

The same is true for Wendy's, who can either increase prices for everyone in response to higher input costs or can increase them only for customers who value convenience more and thus put a higher premium on eating at peak times. The result is more people can go to Wendy's, because a price increase for everyone excludes more people from the market. It may feel unfair, but economists generally agree that including more people in a market is beneficial for consumers.

We can probably expect more firms to dynamically price in the future. Technology empowers firms to target individuals, to show them ads for the goods they want and charge them more than other consumers. Artificial Intelligence has the potential to turbo charge this practice, in the not-too-distant future we may all see different goods and prices when we shop online.

But while technology can make dynamic pricing easier for firms, it also can empower consumers. Algorithms can help customers find products they most want and best suit their needs. Technology also facilitates comparison shopping and allows consumers to post reviews, a very valuable resource for future shoppers. Online marketplaces may mean more complex pricing, but they also enable more price comparison for consumers, compared to visiting a brick-and-mortar store. Research suggests that this technology contributed to the low inflation environment before the pandemic.

It feels unfair, because it is different to what consumers have become used to—though everyone paid different prices when people haggled for goods. But a more personalized shopping experience may end up creating a more inclusive marketplace where more people can afford to participate and it is easier to find the goods and services that best suit their needs.

Conclusion

We remain in a high inflation environment; this is what is harming consumers—not greedy corporations who also face pricing pressures. This is largely the result of a still growing economy, and it is made worse by government policies that continue to stoke demand. We are still increasing the debt and giving households handouts. One benefit of this environment has been rising nominal wages (something many of us wanted), especially for lower earning Americans. But it also means inflation is still high—and it means rising costs for goods and services for these same people and the rest of the population.

There is no way around the fact that this elevated demand will increase prices. Firms can increase prices in in a number of ways: increasing the sticker price, providing less for the same price, or dynamic pricing. All provide understandable frustration for consumers, but these are the results of a high and uncertain inflation environment—not the cause.

Past attempts to keep companies from raising prices, such as price controls, have proved counterproductive. They create shortages, reduce the incentives to sell or produce, and worsen inflation. The best way to fix this is to not undermine the Fed's attempts to control inflation and pull back on spending, stop handouts, especially to higher earners who don't need them, and to reduce the debt.