Statement of William E. Spriggs

"The Fragility of the US Economy: Fiscal policy responses"

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"*Building a Resilient Economy: Shoring up Supply*"

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Thank you, Chair Brown for this invitation to give testimony before your committee today on the issue of improving the resiliency of the American economy. I am happy to offer this testimony on behalf of the AFL-CIO, America's house of labor, representing the working people of the United States; and based on my expertise as a professor in Howard University's Department of Economics.

The collapse in economic activity in the first quarter of 2020 in response to the COVID crisis unleashed a chain of events that disrupted normal economic activity. The global Pandemic, unlike other shocks, had a simultaneous affect on the world economies. Necessary precautions that delayed the spread of the disease and successfully mitigated worse loss of life, significantly altered consumption. So, while the initial impact was a drop in all consumption, the gradual reopening of some activity led to different patterns of consumption than before the Pandemic. But the responses of firms to the initial collapse in consumption also created difficulties responding to shifting demand patterns. What was clear is that our economy was not resilient.

It took the quick decisive steps of the Families First Act and the CARES Act to stabilize the economy. These initial steps addressed the obvious shortcomings of an inadequate

unemployment insurance system, the lingering effects of the Great Recession that left household balance sheets woefully weak and revealing the lack of resiliency among households to income shocks, the lack of paid sick leave, the difficulties of main street businesses in accessing liquidity even in a time of low interest rates, and the fragility of state and local government infrastructure. These necessary pieces did not anticipate the subsequent waves of COVID and how long the support proved to be needed. So, fortunately, the American Rescue Plan extended support to ensure the effects of COVID would not scar the economy. The American economy ended 2021 with its fastest growth in decades and the strongest recovery of the labor market on record.

But we began this year with the world still struggling with COVID and all the disruptions that have now revealed the scars and fragility of a global system. The continued disruptions to supply chains plaque all nations. All advanced economies face higher rates of price changes than in the pre-COVID era. This is a natural functioning of markets; price pressures appear every time there is a shock to supply and is not related to differences in fiscal responses.

There are specific reasons the US measure of prices has run higher than for other countries. The US product markets have been criticized for having higher levels of concentration than in Europe because of weaker anti-trust enforcement. (Covarrubias, Gutierrez and Philippon 2019) (Gutierrez and Philippon 2018) (Baker 2003) (Alemani, et al. 2013) (Karabell 2020) Higher levels of concentration make it easier for firms to raise prices, but also make an industry more vulnerable to supply shocks should one firm's workforce be hit harder by COVID.

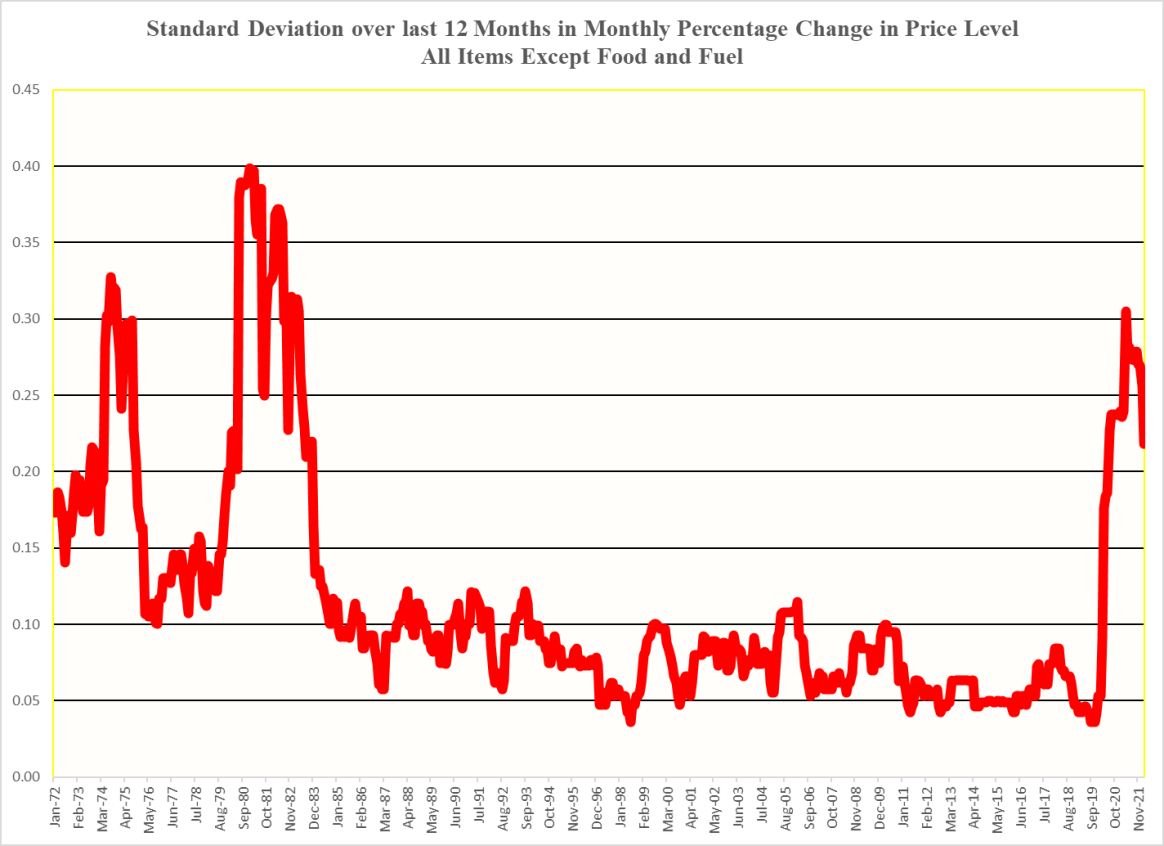
Most other nations' response to COVID was the aggressive use of job retention schemes. These programs directly subsidized firms keeping their workforces during COVID and lowered the frictions being experienced in the United States of trying to recruit workers that were sent to

their best devices. Among OECD nations, the US unemployment rate spiked significantly higher than for other countries, and while US unemployment rates have settled near their pre-COIVD level as they have on average for the OECD, total labor hours in the US still have not recovered as they have on average in the OECD—this reflects lower labor force participation rates in the US. The US has low female labor force participation because it lacks the infrastructure of policies to support the care economy present in most OECD nations. Protecting individuals, through beefing up the coverage and generosity of unemployment benefits helped to facilitate shifting workers to sectors that faced rising demand during the initial stages of the COVID crisis but has now slowed the recovery of those sections that had initially faced the greatest spikes in unemployment. And the lack of protection from the virus, and weak paid sick leave coverage in the United States, meant several industries faced greater losses of workers than other OECD countries. (Chen, et al. 2021) (Bureau of Labor Statistics 2021) Fewer workers died in other OECD countries.

The shocks to markets have come from many directions. Price volatility is at an astonishing level compared to previous periods. Over the last 50 years, only the oil crisis of the mid-1970s and the late-1970s coincide with a similar spike in price volatility. In both those cases, a shock in the supply of oil, and overlapped with hurricanes Eloise in 1975 and Frederic in 1979, the Yom Kippur War of 1973, the Iran Hostage Crisis of 1979, and the Lebanon War of 1982, created price volatility. The similarity in massive supply shocks and rising prices have people wanting to invoke rising inflation expectations and excess demand.

Figure 1 shows price volatility, measured as the standard deviation in monthly changes in prices (excluding food and fuel) over the previous 12 months. It spikes in the early and late 1970s. This period also spikes but at a lower level and has already started to recede. The decline

from the spike in the late 1970s was engineered by massive interest rate hikes from the Federal Reserve that caused the greatest recession since the Great Depression to that date. Prices have now started a path to stability this time without interest rate hikes, though they will clearly continue to face the head winds of potential climate events, COVID and now war related supply shocks.



Because price volatility is high, it means there is a lot of noise in the actual signal. Comparing prices one month to the last month or the last 12 months will give wildly different views. And, unlike the buildup to prices in the late 1970s, this price volatility came after a period of price declines for many items and a deceleration in inflation as measured by the CPI in

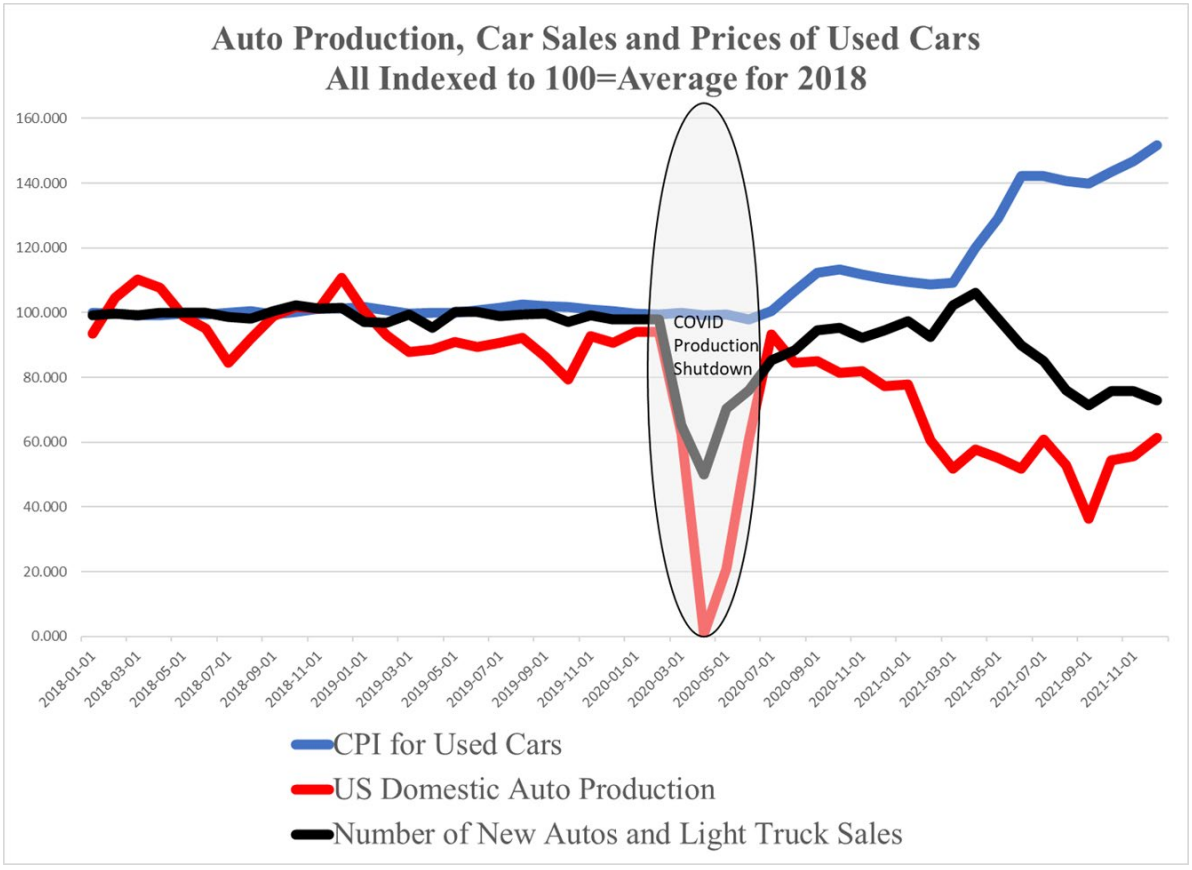
2020 and early 2021. So, the base years for this level of price instability include a period of prices rebounding to pre-COVID price levels.

What is important though is that prices become unstable from supply shocks because households and businesses must seek substitutes for items that become scarce or suppliers that fall off. Households shift demand outward for substitutes, and businesses find other suppliers, most of whom had been rejected before because they were higher cost providers. Early on, COVID induced collapsing demand with shifts to new items. For example, unable to go to gyms, households shifted demand for in-home gym equipment. The drop in demand for gyms lowered prices for gyms and was offset by rising prices for in-home gym equipment. This explains the great moderation of prices from spring 2020 to fall 2021.

But supply shortages are different. Manufacturers unable to get smart chips from their old suppliers had to hunt down chips from new suppliers, and that raises costs and cuts supplies from manufacturers. To see how one supply shock can echo with price increases, motor vehicles are a key example. The shortage of chips, the necessary part of new cars, reduced domestic automobile production in September 2021 to a low of 39% of its January 2020 production level. It has since been slowly building up, but in January 2022 remained only at 58% of its January 2020 capacity. (The last major disruption to US domestic auto production was the September to October 2019 strike by the UAW against General Motors. During that two-month period, domestic production dropped to 86% of its August 2019 capacity.) In February, the price of new cars rising from 2021 to 2022 levels, contributed 0.5 points of the 7.9 percentage point rise in the Consumer Price Index. The rise in the price of new cars from the collapse in automobile production, of course prompted households to increase their demand for used cars, the next best substitute. That shift in demand contributed 1.7 points of the 7.9-point rise in the CPI. An

additional boost came from increased demand for auto repairs, among those who could not afford a new or used car, and 0.06 more points added to the CPI. In all, the sustained record low in auto production contributed 2.3 points in the 7.9-point rise in CPI, or 29% of the price rises. Similar shocks play out throughout the market and into the CPI.

Figure 2 traces out changes in US domestic auto production (in red), sales of vehicles (in black) and the CPI for used cars (in blue). The surge in sales in early 2021 appears as mirror to the collapse in sales in 2020. It should not be thought of as demand running too high, since it subsequently recedes after returning to just above its average during 2018, but as a smoothing of demand over a two-year period. The rising CPI for used cars climbs after the collapse in the production of new cars.



Attempts to roll back demand, in the case of automobiles, to align with current capacity would need to be a very drastic drop in aggregate demand levels. Only the demand shock of the Great Recession approximates the current collapse of auto production. The drop in domestic vehicle production from July 2008 to December 2008 was to 64% of July's capacity. That took removing 2.8 million jobs from the economy. That makes policies aimed at aggregate demand untenable.

Throughout 2021 various shocks disrupted supplies including Vietnam needing to shut major factories to control the spread of COVID, six days of blockage in the Suez Canal from a ship run aground, the need to preserve oxygen for the rise in COVID cases in India that slowed production where oxygen was used interrupting the production of active pharmaceutical ingredients, an outbreak of COVID that China had at its third largest container ports lowered shipment capacity to 30% in late spring 2021, and Hurricane Ida in August slowed US production and shipments. These are just some of the shocks that make the prices of various items jump, causing everyone to seek substitutes and put more pressure on the broader measure of prices. Lowering aggregate demand in the face of widespread supply constraints can only lead to lower levels of output and stalled or falling labor market conditions.

Instead of focusing on aggregate demand as the Federal Reserve is mistakenly doing, Congress should take this as another moment to reflect on lessons we are learning during the Pandemic. Clearly, we do not want an economy that is vulnerable to computer chip scarcity. While issues of economy of scale in the production of chips has led to the dominance of a few firms, the chips are too essential to be forced to rely on a small set of firms that are too centrally located and vulnerable to geopolitical or global warming shocks. The economies of scale make

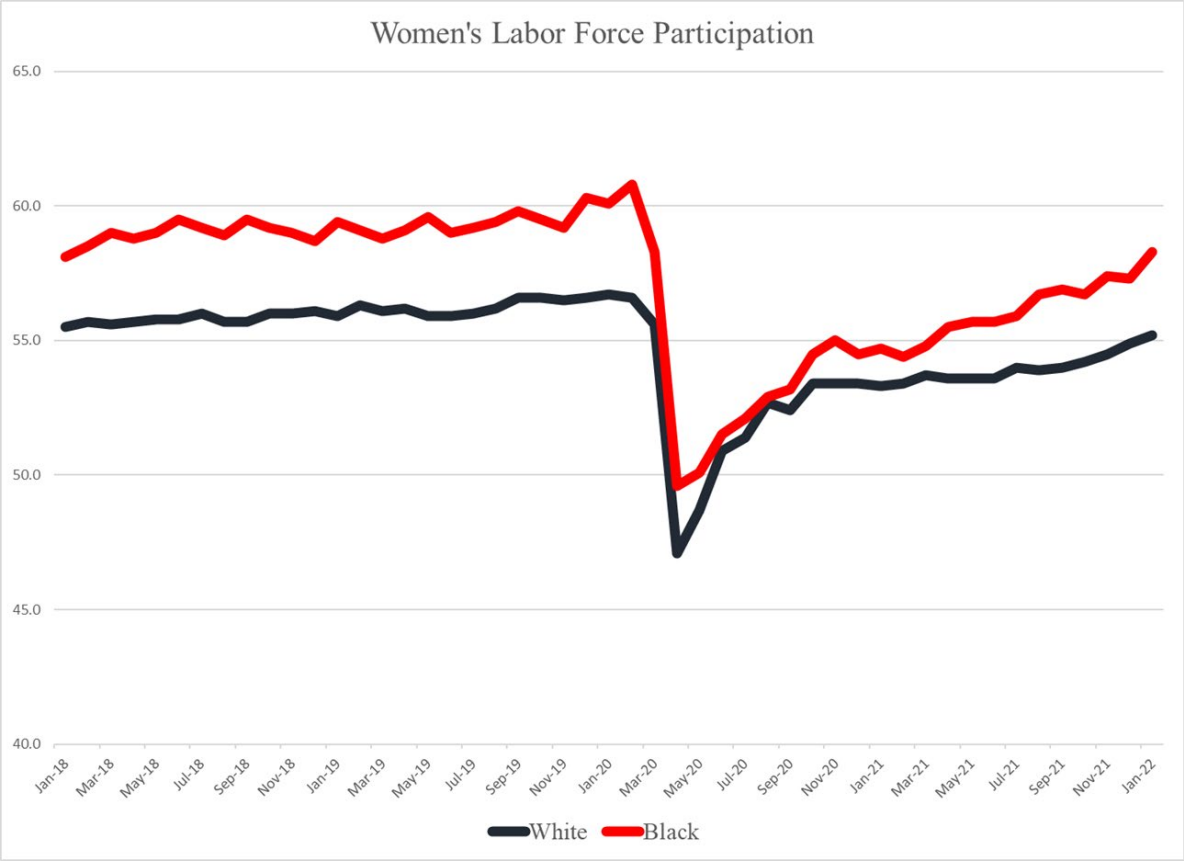
for real entry barriers. A policy, like the CHIPs Act, would help level the playing field for those seeking to make computer chips in the US, where they were initially invented.

Increased scrutiny must be taken by the Department of Justice and the Federal Trade Commission to combat growing market concentration. Bottlenecks in production, especially of food, appeared throughout COVID. They have hurt farmers and consumers, and the workers in those plants. (Puzzanghera 2022) This experience demonstrates an extra element of consumer surplus must be the risk factor of over reliance on a few producers, especially in a time of crisis. In meat production, especially, this can be crucial as increasing threats of disruptions from global warming events can make us too reliant on the lack of supplier diversity.

Energy independence must now be taken to include our ability to rely on fuels like solar and wind that do not trade in the global marketplace. We cannot simply rely on the fallacy of domestic oil production as insulation from global force since its price is set by global forces. Electric cars and reliable electricity sources are better insurance for price volatility.

Our labor market is slowly healing from its greatest collapse in the spring of 2020. Policies aimed at slowing aggregate demand will make the recovery slower than necessary and create scarring in the labor market that will leave more workers vulnerable because the slow recovery leaves the most scarred the most likely to take precarious jobs and lower earnings. Figure 3 shows the recovery underway in women's labor force participation. For the sake of clarity, I only show it for Black and White women. Black women are significantly more sensitive to labor market conditions to increase their labor force participation. The more rapid rise for Black women shows that employment prospects have finally picked up, because their figure is driven by increases in actual hiring. On the other hand, the slower increase for white women's labor force participation is because we must still drive policies that can get their labor

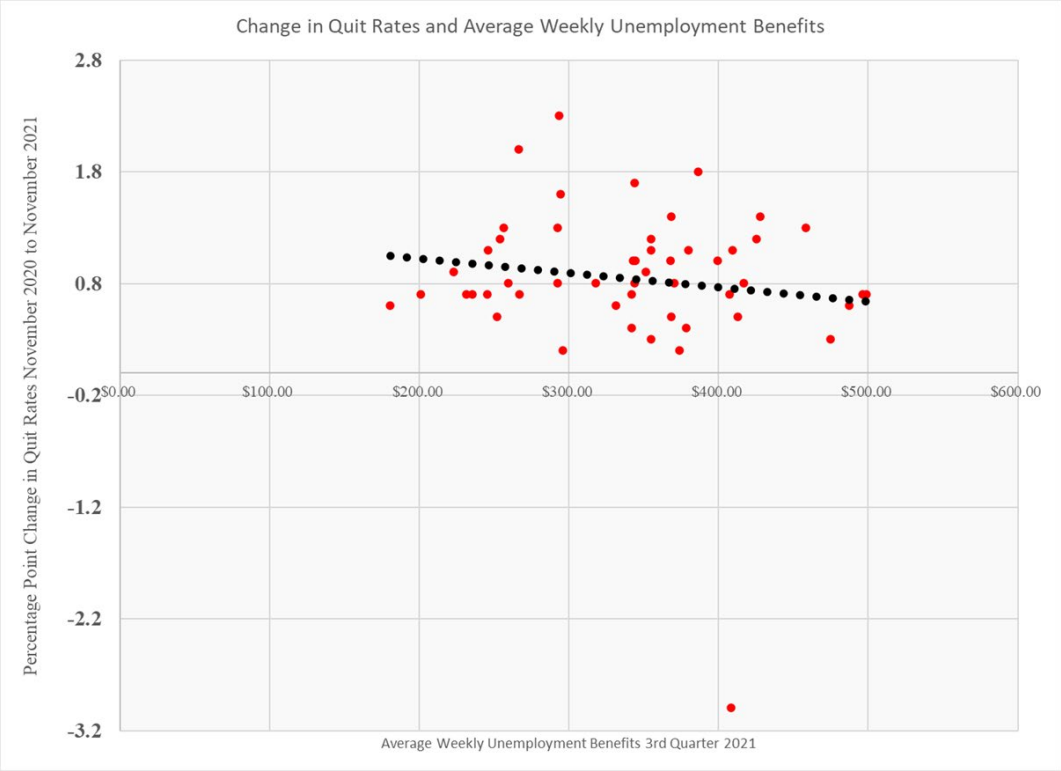
force participation to rise. Frictions in the labor market that cause barriers for women are costly. They lead to higher search costs for employers, and weaker good job matches for women. We need to adopt the proven policies that other nations in the OECD have in place which put a higher share of their women in the labor force and produce lower gender pay gaps. Those policies include paid sick leave, paid maternity leave, and public childcare. They constitute the infrastructure needed to increase our labor capacity and are as essential in a modern economy as good roads and ports to moving products.



A key component of the Build Back Better Act is to put in place the essential elements of labor market infrastructure that goes with the 21st century. As we saw from this crisis, firms do not benefit if we favor policies that weaken the ties between employers and employees. Women

need a labor market framework that protects their careers. And we need women's labor force participation to prosper as a nation.

Our unemployment insurance system was woefully lacking in 2020. That was clear from the onset of the COVID crisis. Instead of moving forward, unfortunately, too many states are in the process of de-investing in their labor market systems. They are making them weaker. Some of their actions are exacerbating the poor job matches going on now. Figure 4 shows the relationship between state unemployment benefit levels and the rising quit rates. Those states with the lowest benefit levels force workers to search for jobs while on the job, with the result being greater labor turnover. Instead of getting workers to make good matches with employers, employers in those states with low benefits get workers that start the job trying to go elsewhere.



The falling share of unemployed workers who are eligible for unemployment benefits weakens the automatic stabilizer that unemployment insurance is supposed to provide. A lesson from this crisis is that there is more uncertainty than we appreciated. With rising risks, we cannot afford to be under-insured. Congress must look at unemployment insurance before the next economic downturn.

We also must encourage the private sector to be more aware of risks. Too great levels of entanglements with countries that can cause geopolitical threats, and issues of managing risks from thin supply chains in the face of rising global warming threats must get factored in. Congress should think of policies that ensure the private sector incorporate those risks. Some of that can come from weakening the hold of financial markets and short-term thinking on corporate decisions. Short term gains lead firms to hold thin inventory, which are just-in-time until they aren't. When stock buybacks get rewarded on Wall Street, they are cringe worthy when firms prove to lack the liquidity to be resilient in a world of high risk. Rather than spend time shifting incomes to create different tax bases in low-tax countries, firms need to be making investments that make them more resilient.

Going forward, just as we often talk of personal responsibility, we must also talk about policy responsibility. Policies should not put high risks on the weak and low risks on the powerful. Just as firms need infrastructure to plan long-term investments, workers also need labor market infrastructure to ensure reliable paths to work. We should expect price volatility given the rising risk of global warming related events and think of ways to help cope with them. The risks are greatest on food prices, and automatic triggers for expanding the protections of the Supplemental Nutritional Assistance Program should be in place. Being policy responsible means learning lessons from what goes wrong.

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