IEO Webinar Series: Inflation Take-off: Transitory or Troubling?
Edited Transcript of Paul Krugman's Remarks
(November 30, 2021)

Loungani: Let's start with your November 14th tweet where you said: "I got inflation wrong I didn't see the current surge coming." Can you tell us why you had reached that conclusion? What has happened since and where do you stand now: are you still sort of the captain of Team Transitory or are your views starting to shift?

Krugman: Okay, so I guess Chairman Powell told us today that the use of the term 'transitory' is just a passing fad.

Let me describe where the debate was -- I think I find it helpful to think of it kind of in terms of how this has unfolded, where the debate was early this year and what has happened. So, this is a debate, you know, where people on either side are not stupid [and] not crazy, which is unusual these days.

Earlier this year we had in the United States the American Rescue Plan, which was a lot of money. And on one side of the debate, Larry Summers and Olivier Blanchard looked at the scale of it and said that is a huge amount of fiscal stimulus and we'll push the economy far above potential and lead to a lot of inflation. People like me took a look at it and said, yeah, that is a whole lot of money but it's very low multiplier. Things like aid to state and local governments will not be spent rapidly, and a lot of the checks individuals would probably be saved -- it would probably be a low multiplier event and wouldn't overheat the economy that much.

What actually happened, at least as I read it, is that the low multiplier analysis was correct in that if fact if you look at final demand -- if you look at C + I + G – it's up about 4% over the past 2 years, which is roughly in line with the normal growth of potential output. However, the economy looks overheated and inflationary. So, in some sense, neither side has been right about how the story would play out. We've actually had the low multiplier story but we've had the inflation.

I think, basically, nobody should be doing a victory dance in the end zone here. It hasn't come out the way anyone expected.

My read on what's happened --which I thought was uncontroversial, but I've got this slightly hysterical pushback from some people on the other side this debate in private – is that we've run into supply constraints that probably we should have seen coming -- or some of them we should have seen coming -- but we didn't.
I think there are actually two quite distinct supply constraint stories. One is the supply chain stuff that we all talk about. And the other is the Great Resignation, the surprise drop and persistence of low labor force participation.

The supply chain stuff is very much about the composition of demand because of the extreme skew towards goods, -- as opposed to services -- and durable goods in particular. And the numbers are really kind of eye-popping. It's faded a bit but at the peak durable goods consumption was 34% above pre=pandemic levels. So no wonder we have a problem with the supply chain. And that we should have seen coming but we didn't. It's a little bit like shadow banking -- once we understood what was happening it was obvious, but it wasn't obvious in advance.

The other is the Great Resignation and that has really been mind boggling, So we're still four million down from pre=pandemic employment in the United States. But all indicators are now pointing to a very, very tight labor market.

Okay, where I am now: The supply chain stuff should fade. The labor market stuff is very much up in the air. But the question has got to be: one-time overheating of the economy, whether it's because of demand or supply constraints, has historically not translated into sustained inflation, It takes a long period -- at least in the past it has taken a long period – of year after year of an overheated economy for it to get embedded in expectations. And so that's why, where I am right now is: we can talk about historical episodes, but right now this has not played out the way anyone expected, but it's not yet at the point where you want to say: hey, we have a fundamental prolonged overheating that is feeding into expectations.

Loungani: Yeah, so maybe let's talk about the kind of historical episodes that we could look back to try to guide us about what might happen in in the future. Folks of my age certainly worry about a replay of the 1970s and that's what Martin Wolf said in a FT article; he said we are making the same errors now. So I think that is the worry on the minds of many who've lived through the 1907s. Is that the right historical experience to draw on or are there others we could be guided by?

Krugman: I'm putting together a longish piece on inflation probably to be published in the *Times* and I start with Hamburger Helper because, when I was a student living on a limited budget, ground beef prices had gone crazy and meat extenders were a big part of life.

I thought it was a terrific insight by the Biden CEA that said that we really should be looking at the 1946-48 inflation after World War II, which was remarkable – CPI growth hit 20% and stayed really elevated and in double digits for almost two years. And it was clearly demand-pull inflation. It was a huge pent-up demand for durable goods after wartime rationing. What was striking about it from a modern perspective is that when the demand subsided, inflation fell quickly. The inflation did not get embedded into the economy – there was no stagflation following that.

So far this looks like that. It looks like an economy that hasn't restructured to meet the changes. In this case, it’s because of the pandemic. That time it was because of trying to convert a war-time economy back to peacetime. And a burst in demand -- although in this case actually the overall demand, as I said, is not all that high -- but given the apparent supply constraints that seems like a more likely model.

What we're all worried about of course is: does this get embedded in inflation, do we get a situation where a leapfrogging process – that is what kept inflation going during the seventies even during recessions -- gets re-established. If you're sure about what's happening, then you're not paying attention. What happened in the ‘60s and early-70s was year after year of indifference to inflation. It was ‘The Great Society’ plus Vietnam War, which went on for years; then a brief anti-inflation policy followed by politicization of the Fed and Arthur Burns generating a runaway boom to get Nixon reelected.

At this point the inflation story is about seven months old. That does not seem like enough to get it really burned into people’s expectations. Obviously, you have to be worried, but there's a reverse mistake too. At this point, the action is all in monetary policy. In a way the fiscal policy is all a debate about stuff that is in the rear view mirror and is a bygone. If we tighten monetary policy, what if it turns out that you’re tightening monetary policy just as the fiscal impulse is fading away and the economy is reverting to what appeared to be its normal state pre-pandemic, which was secular stagnation. You really don't want to be doing that. So it's not an easy call right now but I would say that there's isn't remotely enough evidence in there to pull the trigger on rate hikes. But that is the question.

Loungani: Your mention of ‘The Great Society’ made me think of another concern that is out there that we are passing ‘Build Back Better’ -- sort of the equivalent of the Great Society -- right now. Are you not worried that this would play the role that ‘The Great Society’ programs did in the ‘60s?

Krugman: No, not really, for two reasons. One, ‘Build Back Better’ at this point is not actually all that much money. It's not quite right to just do decade analysis but I think it's close enough – we have a CBO projection that cumulative GDP over the next decade will be $288 trillion and you have a $ 1.75 trillion spending plan which is largely -- not entirely but probably largely -- paid for with tax hikes. And even if you if you include the infrastructure [bill] -- it's kind of odd given the way people talk about these things: the infrastructure bill is basically paid for with smoke and mirrors, whereas 'Build Back Better' is pretty close to paid for -- the two of them together is still well under 1% of GDP and largely paid for -- it's just not that much fiscal stimulus. So I think that is not the real issue. There's no plausible set of parameters under which spending on that scale or deficits -- you know, net fiscal stimulus -- on that scale would make a significant difference to any of this.

Loungani: So let me ask you a little bit more then on what precisely you would want monetary policy to be doing. You say you're worried about the reverse mistake. I take it you wouldn't agree with Martin [Wolf]'s position on this: I think he said something like 'the current policy only makes sense in a depression and we are not in the depression'.

Krugman: I missed that column. But what I would say is in a lot of ways in the functional sense we've been in a depression since 2008, in the sense that the zero lower bound has been, if not actually binding, at least close to binding. If we're basically in a secular stagnation world, which I think we are and I see no reason why we won't be once COVID -- I don't think it goes away -- becomes part of the background noise. In that kind of world you're always in a situation where aggregate demand is consistently a problem and the possibility of not having at hand the tools to provide enough demand is always lurking. A couple of years ago, there was a lot of discussion about how we should be running persistent stimulative fiscal deficits being advanced by a guy named Larry Summers, right? I think that that argument still holds, that by 2023 we're likely to be back in that world. I'm not sure I know why we should still be doing QE at this point but should we be doing major retrenchment?

I think I saw flashing up there in the chat why fiscal policy is in the rear-view mirror in the United States. Nothing's going to happen. I mean it shouldn't be [that way] necessarily in terms of fundamental economic principles but realistically do you think that there will be a new spending bill beyond 'Build Bank Better'? Do you think there'll be a new tax hike? The most likely outcome of the political process is going to be divided government. And even if that doesn't happen, you know, we effectively on our fiscal policy have three parties, which is Republicans, Democrats, and ‘Manchinema’ [Manchin-Sinema]. Since that third party has veto power, we don't get anything. So, and this is just in general, fiscal policy is very hard to do in the modern in the modern political constellation.

So, it’s really all about monetary policy and the Fed has to always think in terms of what policy choices will be very difficult to undo later. And unfortunately that applies on both ends. If the inflation becomes embedded of course that's painful to undo. But if stagnation gets embedded, that's also very difficult to undo. And there really are risks on both sides.

Loungani: Hearing you now and reading what Larry Summers has written about what he thinks the Fed should do, I'm not sensing a huge difference. I mean, Larry says there should be accelerated tapering of asset purchases; I think I heard you say that's okay. Larry said you should stop mortgage-related purchases given the housing price boom; would you go along?

Krugman: Yeah.

Loungani: Would you say we are now talking nuances about the pace at which this should happen, rather than a disagreement or policy.

Krugman: Well, I'm finding a little bit hard to know I'm engaged in a lot of discussion publicly and through back channels with Jason [Furman]. On asset purchases: it is hard to see why we should be doing this. But the issue that's on the table that matters is actually conventional monetary policy. Should we have a rate hike? And since that is a real possibility I can imagine -- I would put it as less as the less likely outcome – but it's certainly possible that some time in the next six months there might be data that would make it clear even to Team Transitory that it's time to have a rate hike. It would be embarrassing to be engaging in long term asset purchases at the same time that you're raising rates. So it's not clear to me why you should be doing that, except that I think they [Fed] just don't want to do anything suddenly. I think the best justification for continuing this is just not to have a sudden stop in the program. But it is interesting that I don't think that Larry [Summers] or Olivier [Blanchard] or Jason [Furman] have actually said definitively we should raise rates now. I don't think anybody has said we should raise rates now and they haven't even definitively said that we should raise rates by March or April [2022]. But there seems to be it's more a difference about what should be your presumption. And that is tricky. Actually, it's maybe that I put the presumption of innocence on inflation and I think they would put a presumption of guilt. But it’s still more nuanced than we would like given the amount of heat in this debate.

Loungani: So maybe we can end on that note: What indicators are you looking at to judge your position and calibrate your position. And what would it take for you to say, ‘well, inflation now should be our central concern’?

Krugman: So what I'm looking for is any hint that inflation expectations are starting to get embedded in price and wage setting, which is unfortunately really hard to measure because we don't have a direct measure of inflation expectations except from the bond market. For what it's worth, the bond market is still on Team Transitory. But the bond market doesn't set wages and prices. We have consumer expectations of inflation, but we know from lots of evidence that when you ask consumers ‘what do you expect inflation to be?’ they actually respond by talking about what the price of gasoline is. So consumer expectations are not actually very helpful. So you're looking for subtler clues about whether anybody is raising prices not because demand is high or supply is constrained, but because they expect everybody else to be raising prices. So you read the Beige Book. It would be great – actually Joe Wiesenthal from Bloomberg had a very good suggestion just today that we really should have an ongoing survey of workers, in addition to all these surveys of businesses and, you know, we should have a Beige Book-like thing where they talk to 100,000 workers instead of a few thousand businesses. We don't have that and it’s not clear it would quite give you what we want. So you're looking for clues that that this is happening. I mean, part of the problem is that the thing that we're so worried about – which is the expected rate of inflation might be rising -- I'm not clear that there even is really anything such thing as an expected rate of inflation. For wage and price setting what people actually do is they have rules of thumb. If you ask people 'what's your number for the expected inflation rate?' they probably don't really have such a number. What they have is a pattern of behavior and that pattern of behavior changed in the '70s as people began to behave as if we were going to be living in a 10% inflation economy for the foreseeable future. But what we're looking at is very squishy.

The other thing I'm very curious to watch is to see whether the labor force participation starts to recover. We don't really know quite why that happened; it clearly wasn't the incentive effects of unemployment benefits because those went away and nothing happened, but it might still be the cash cushion from the previous rescue programs. If labor force participation really starts to recover, then I would say, 'well, let's not hike' but it's going to be a very anxious, very knuckle biting year or so.

Loungani: Quickly, on supply constraints, going away, are there particular indicators you look at or trust.

Krugman: Well, labor force participation is the main one. I actually think that all of this other stuff – the container ships and the ports -- that all, in some sense should be part of the stuff you exclude from core inflation. Conceptually, core inflation is supposed to be stuff that isn't moved by short-run fluctuations in supply and demand. And so -- except to the extent that that supply constraints might start to get built into some kind of wage-price spiral -- I'm mostly actually looking at labor market, looking at labor force participation and to some extent compensation – so LFPR and ECI, that's what I'm looking at.

Loungani: Okay, well, thanks very much, this was a very good exposition of the Team Transitory position.