CROWE

Center for Research On the Wisconsin Economy

University of Wisconsin- Madison

Causes and Consequences of the Rise in Inflation

Noah Williams

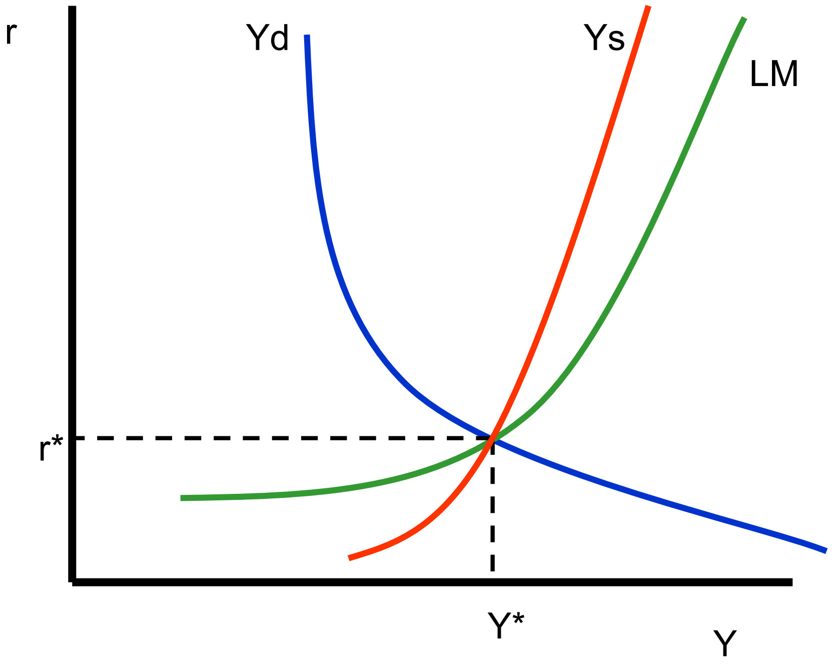
August 10, 2021

https://crowe.wisc.edu

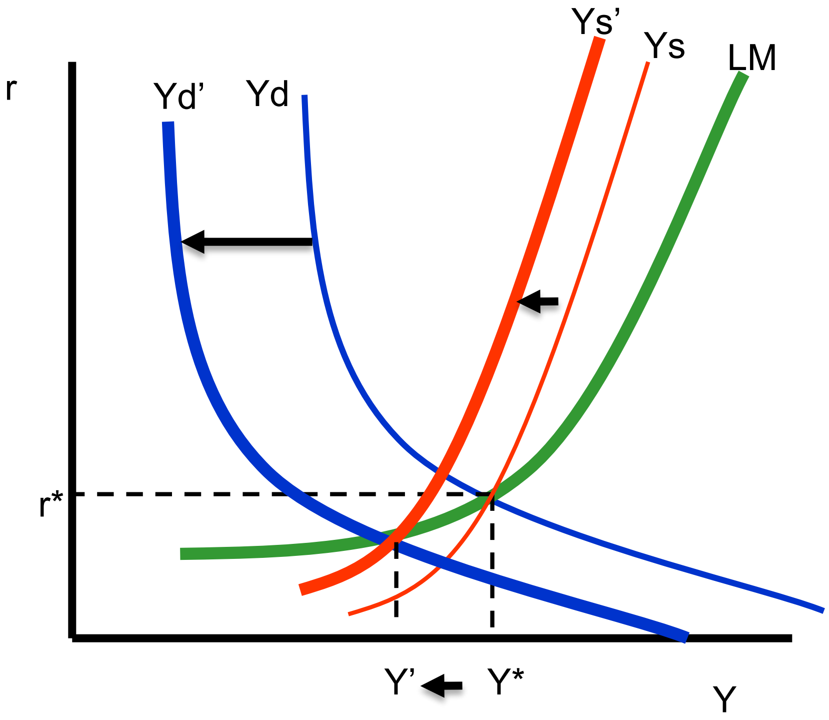
Policy Lessons and the COVID Recession

- Fiscal policy (government taxes and spending) and monetary policy (interest rates, asset purchases) can offset **demand**-side recession
- **"Lesson of 2008":** Better to do too much (and risk inflation) than too little (and face persistent unemployment)
- Unprecedented fiscal stimulus: $5.2 trillion with more on the way
- Continued monetary policy stimulus: low rates and asset purchases, including intervention in mortgage market
- But: fiscal & monetary policy less useful for offsetting **supply shocks**

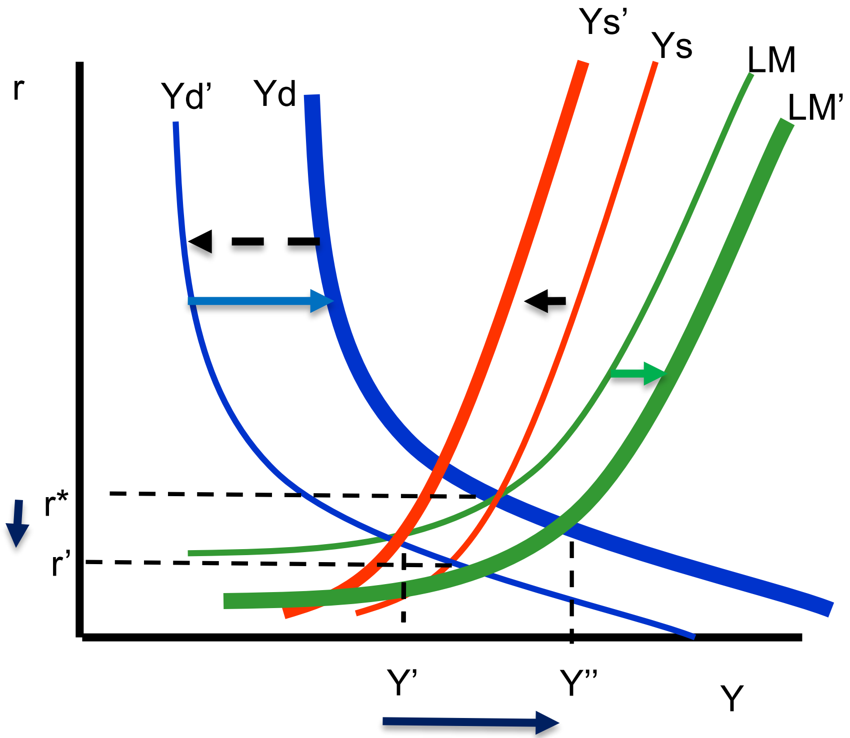
A Stylized View of Pre-COVID Economy



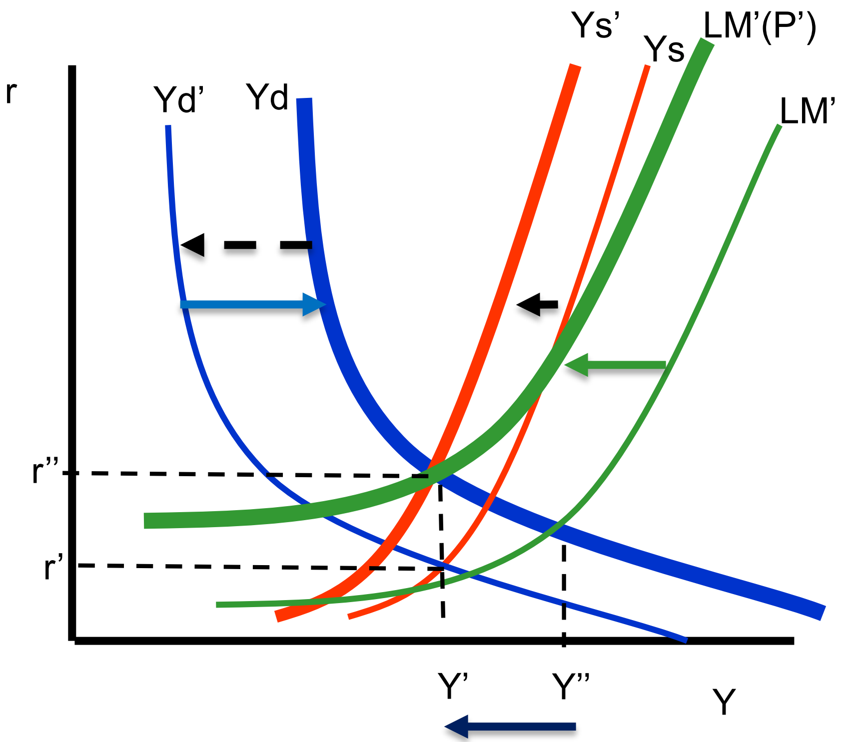
Long-run equilibrium pre-COVID



COVID shock caused demand, supply shifts



In response: Increase in government spending, loosening of monetary policy



Problem: Demand outstripping supply.
Leads to price increases

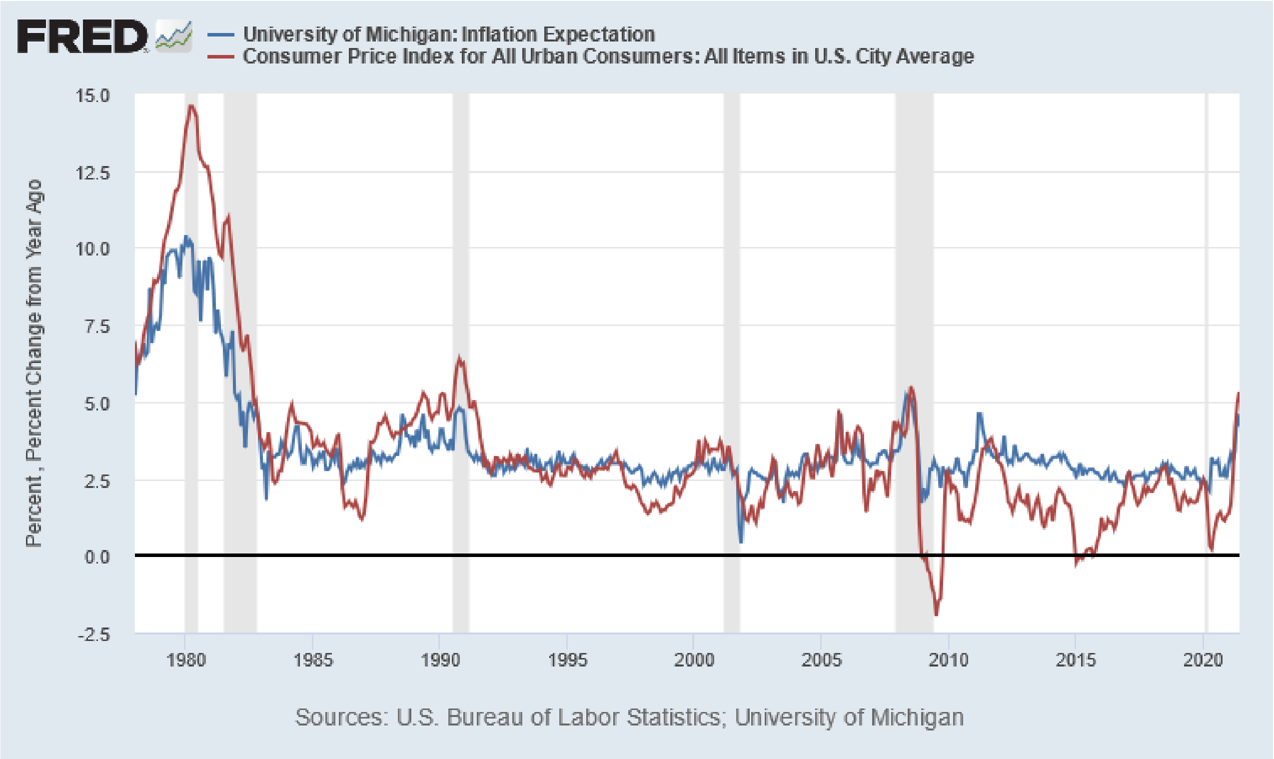
Inflation not Necessarily Persistent

- The adjustment process in response to policy means increases in prices (one-time inflation) but not necessarily ongoing higher inflation
- Inflation can become persistent if:
  - Policy continues on this path. Possibly sets up a game of chicken between fiscal & monetary policy
  - Households and businesses build higher inflation in to long term expectations. Require greater rates of return, higher wages.
- **Deflationary trends:** productivity improvements, global price pressure, declining population, falling real interest rates

Some Movement in Expectations of Inflation

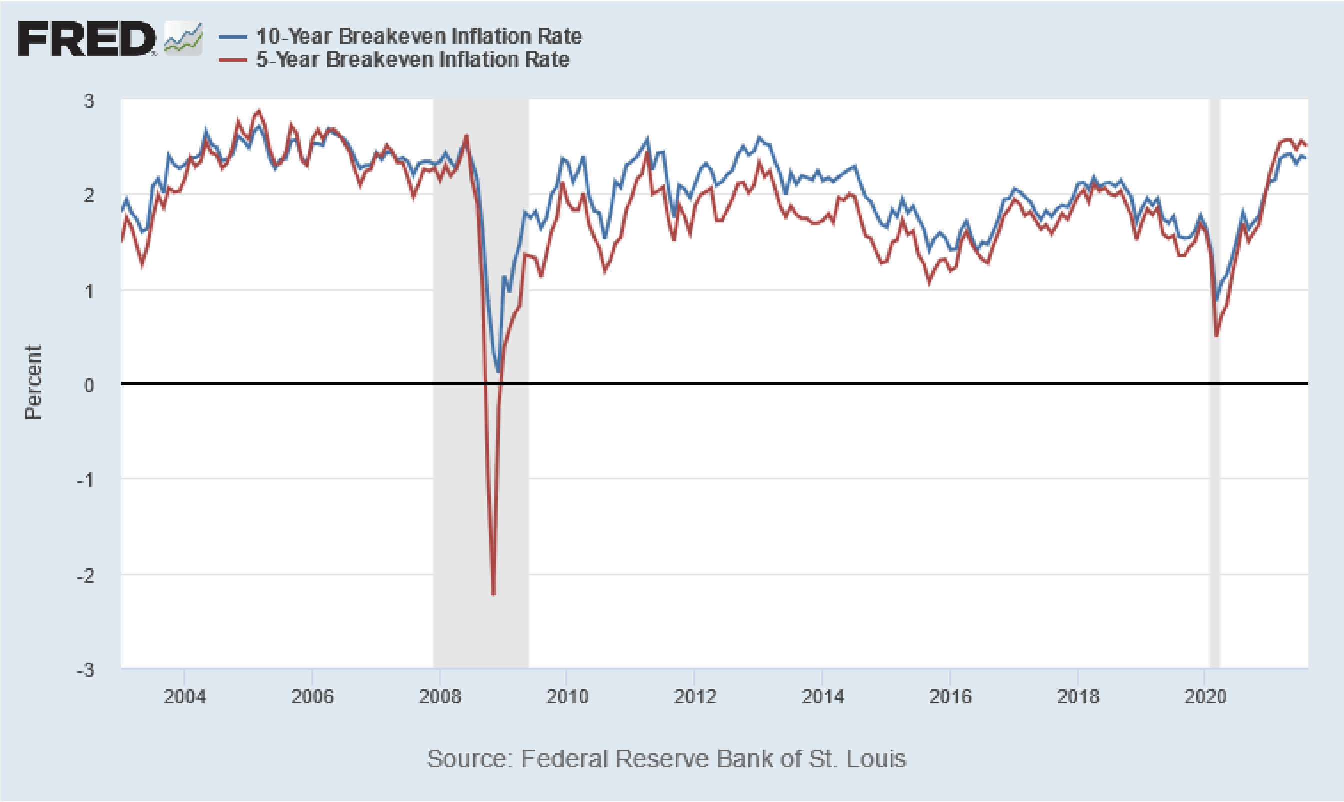
Latest NY Fed Survey: 4.8% 1-year ahead, 3.7% 3-years ahead

And…Inflation Expectations are Sticky



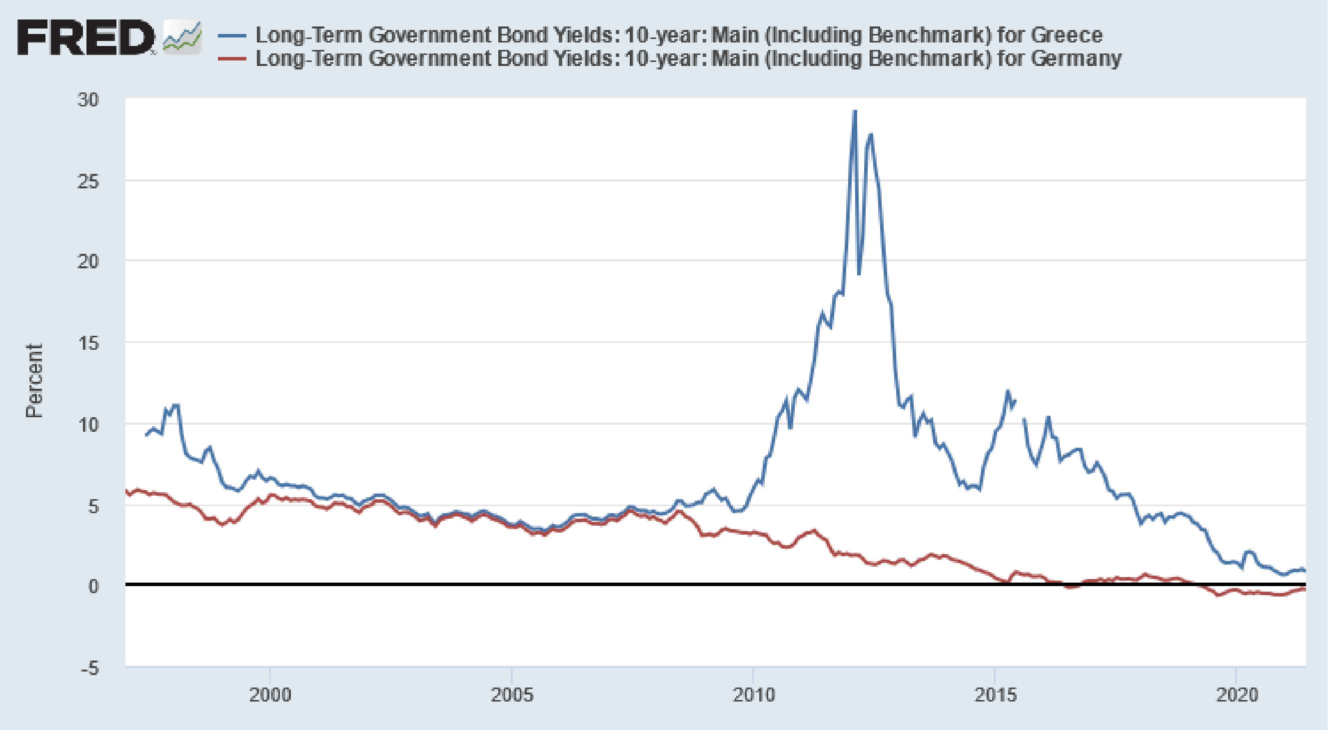
Inflation expectations (for year ahead) respond to current inflation spikes, slow to adjust to undershooting

Market not Pricing in Much Inflation…(yet?)



5-year break even: 2.5%, 10-year: 2.4%

But…markets can be calm… until they're not



"How did you go bankrupt?" Bill asked.

"Two ways," Mike said. "Gradually and then suddenly."