Fiscal Policy in a Time of High Inflation

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Committee for a Responsible Federal Budget

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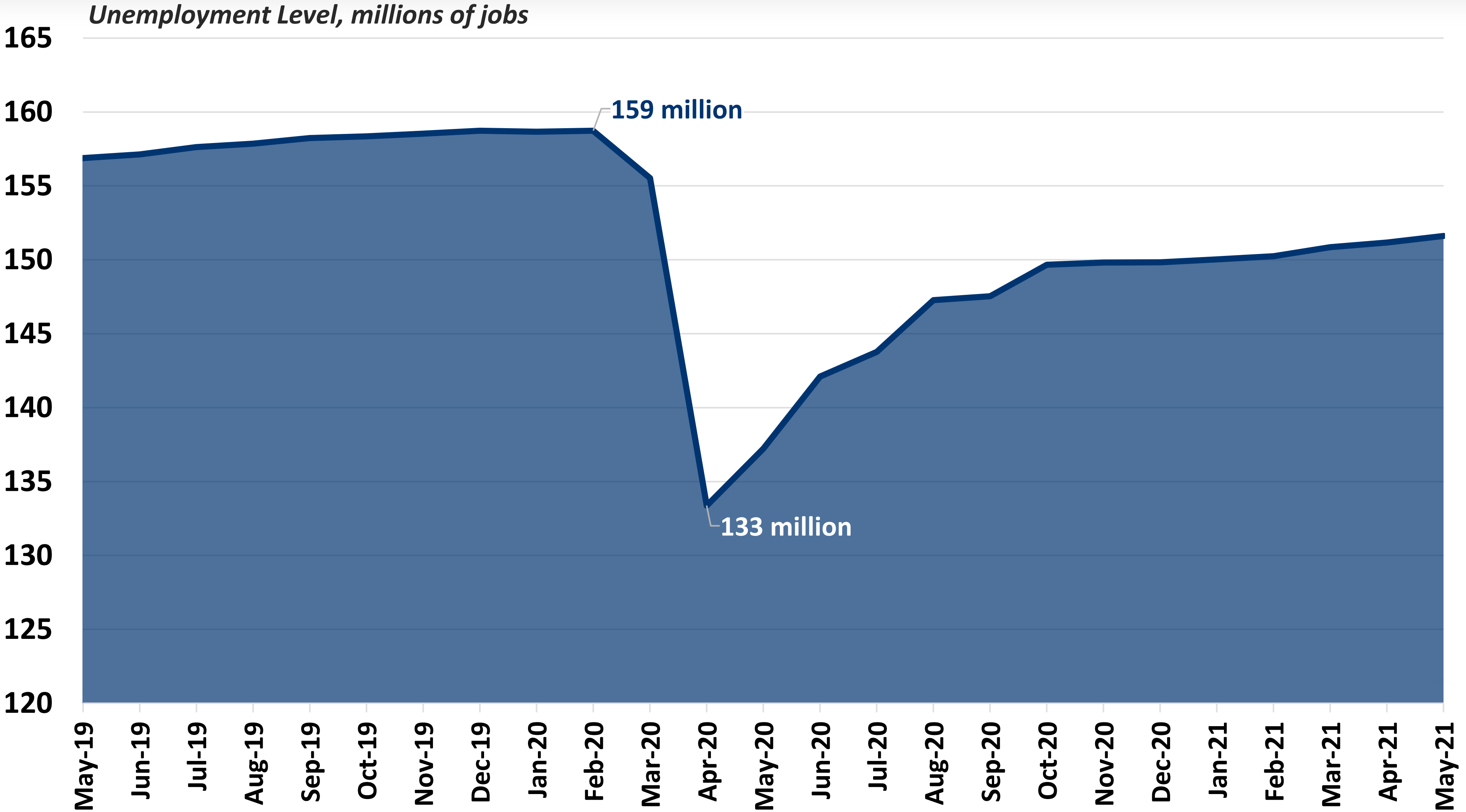
COVID Devastated the American Economy



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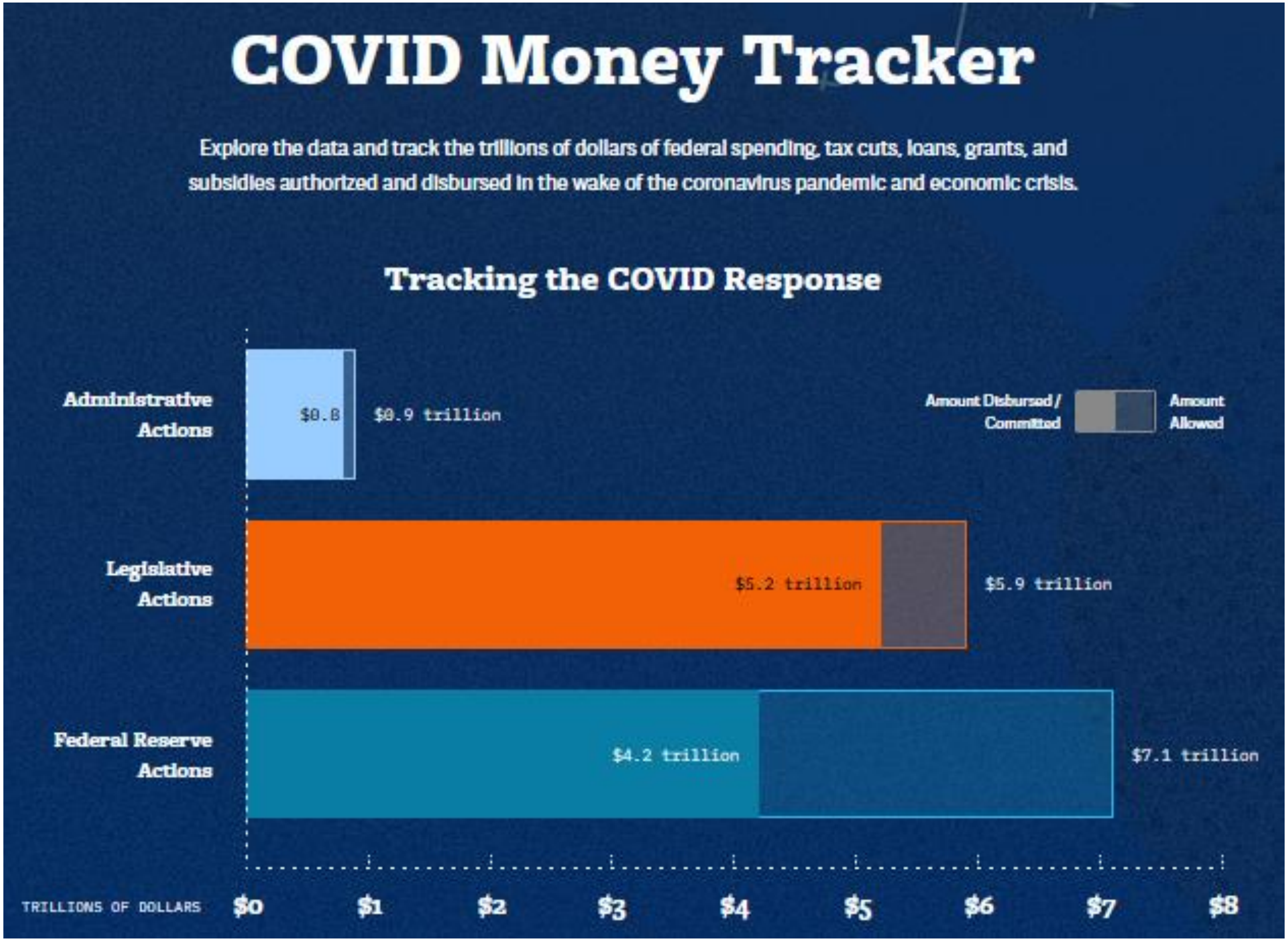
Source: Bureau of Labor Statistics.

But Our Response Was Aggressive



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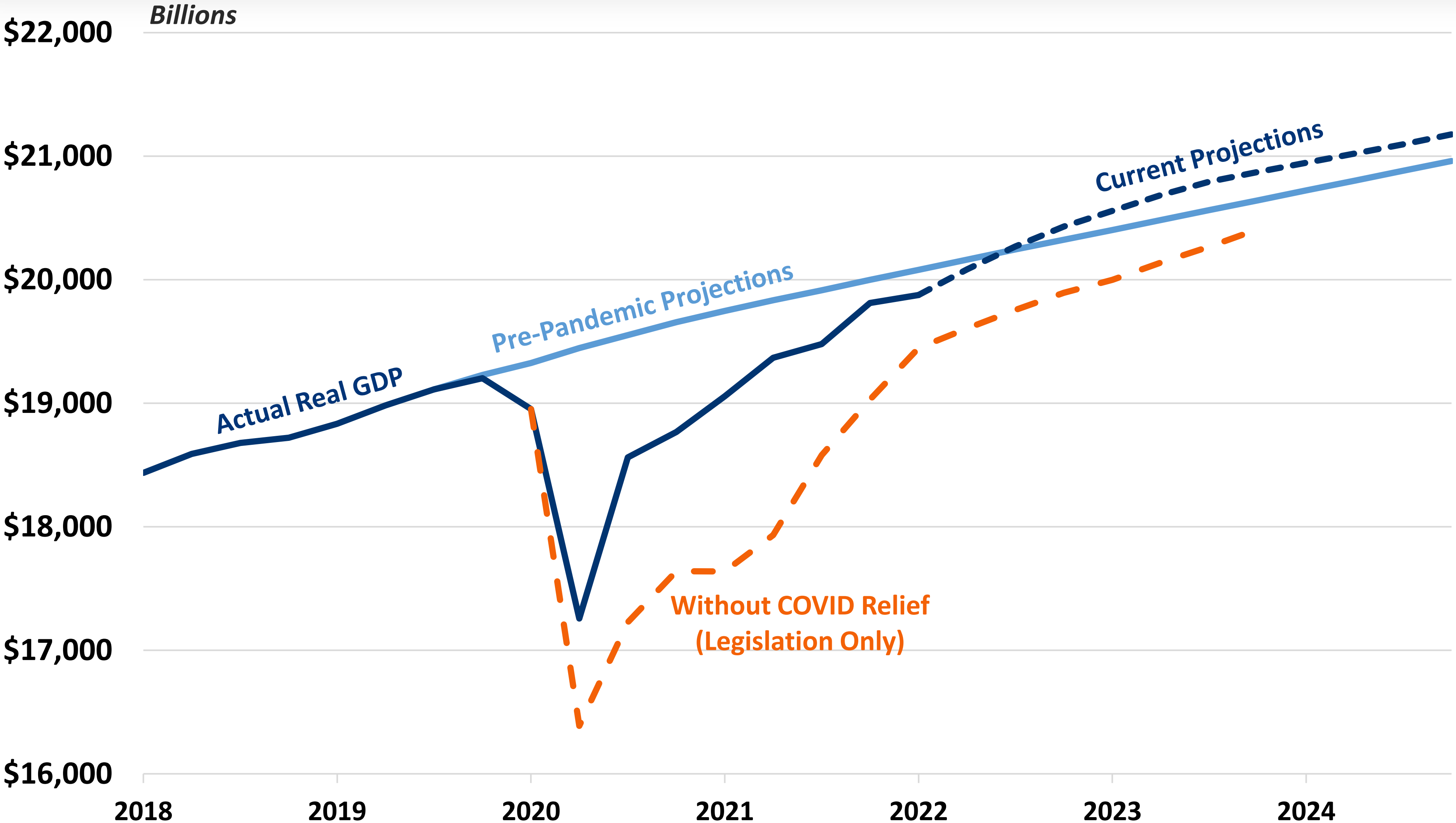
Our Response Supported the Economic Recovery



Sources: Congressional Budget Office, CRFB Calculations

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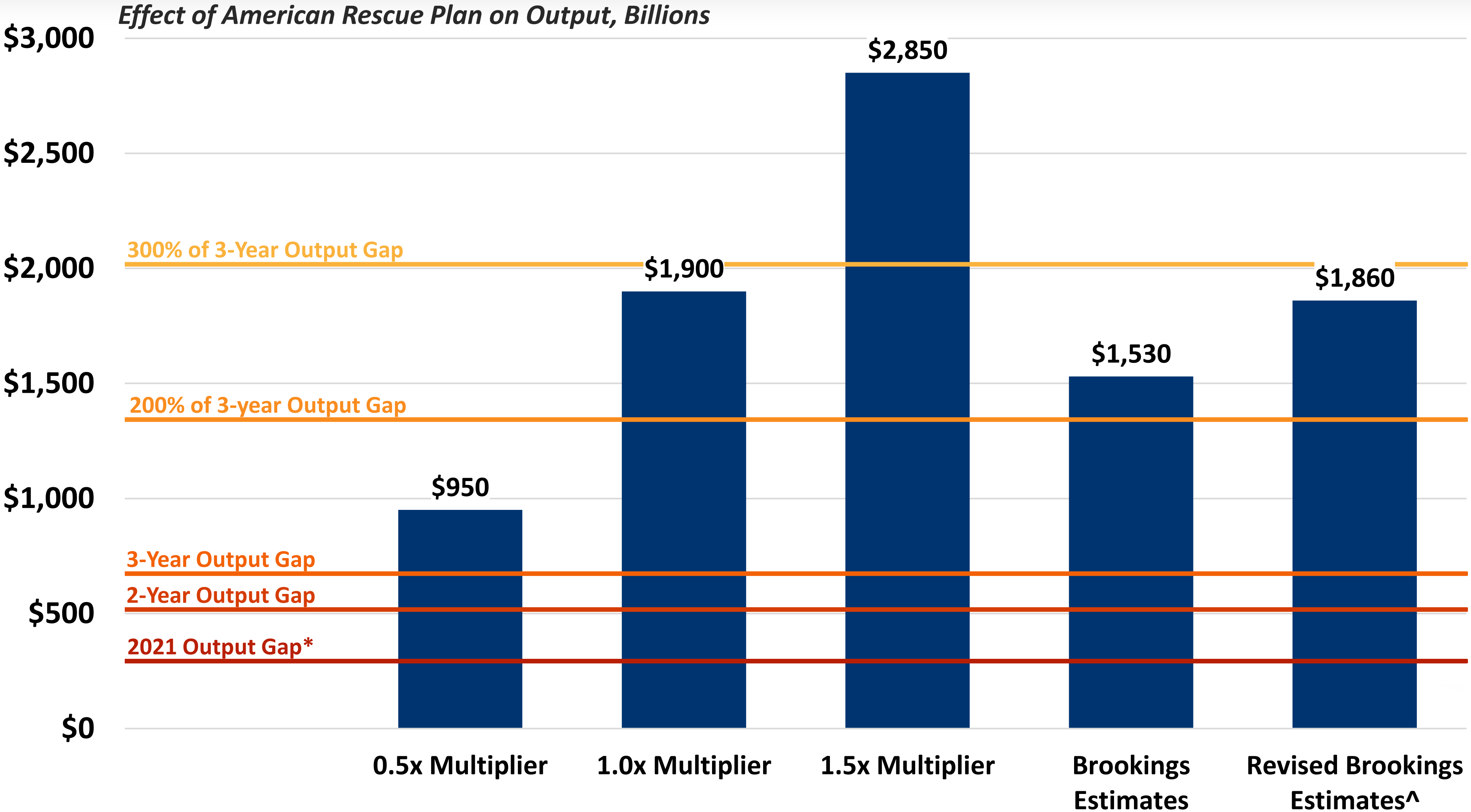
But It Was Clearly Too Large



Assumes policy begins in March and covers the final three quarters of 2021.

^ Based on prior multipliers used by the authors not reduced to account for higher inflation, greater savings, or supply constraints.

Sources: Congressional Budget Office, CRFB Calculations.

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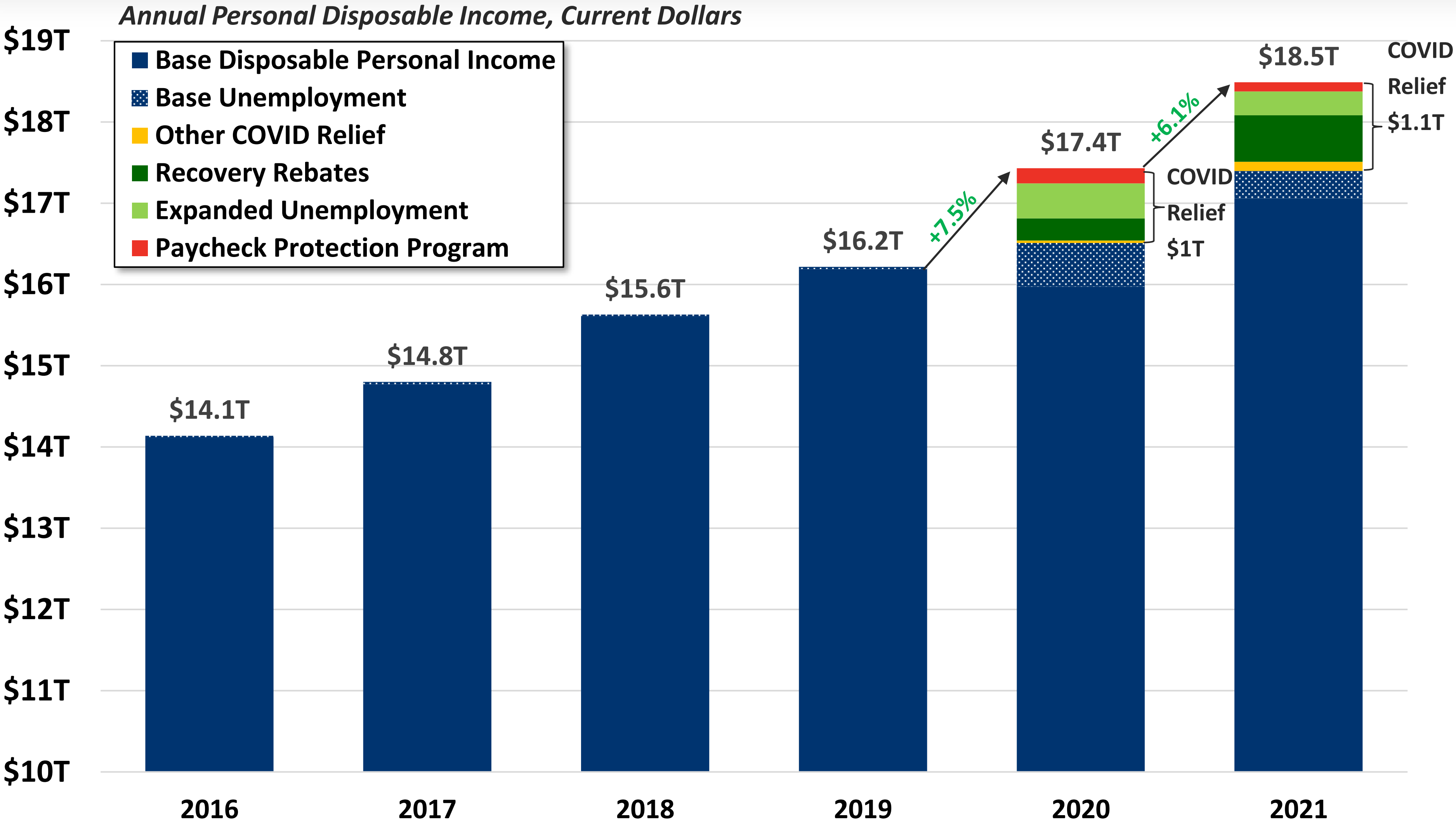
We Boosted Income Way Above Trend



Note: Base Disposable Income includes market income, minus taxes, and regular transfers including Social Security, Medicare, & Medicaid.
Sources: Committee for a Responsible Federal Budget, Bureau of Economic Analysis.

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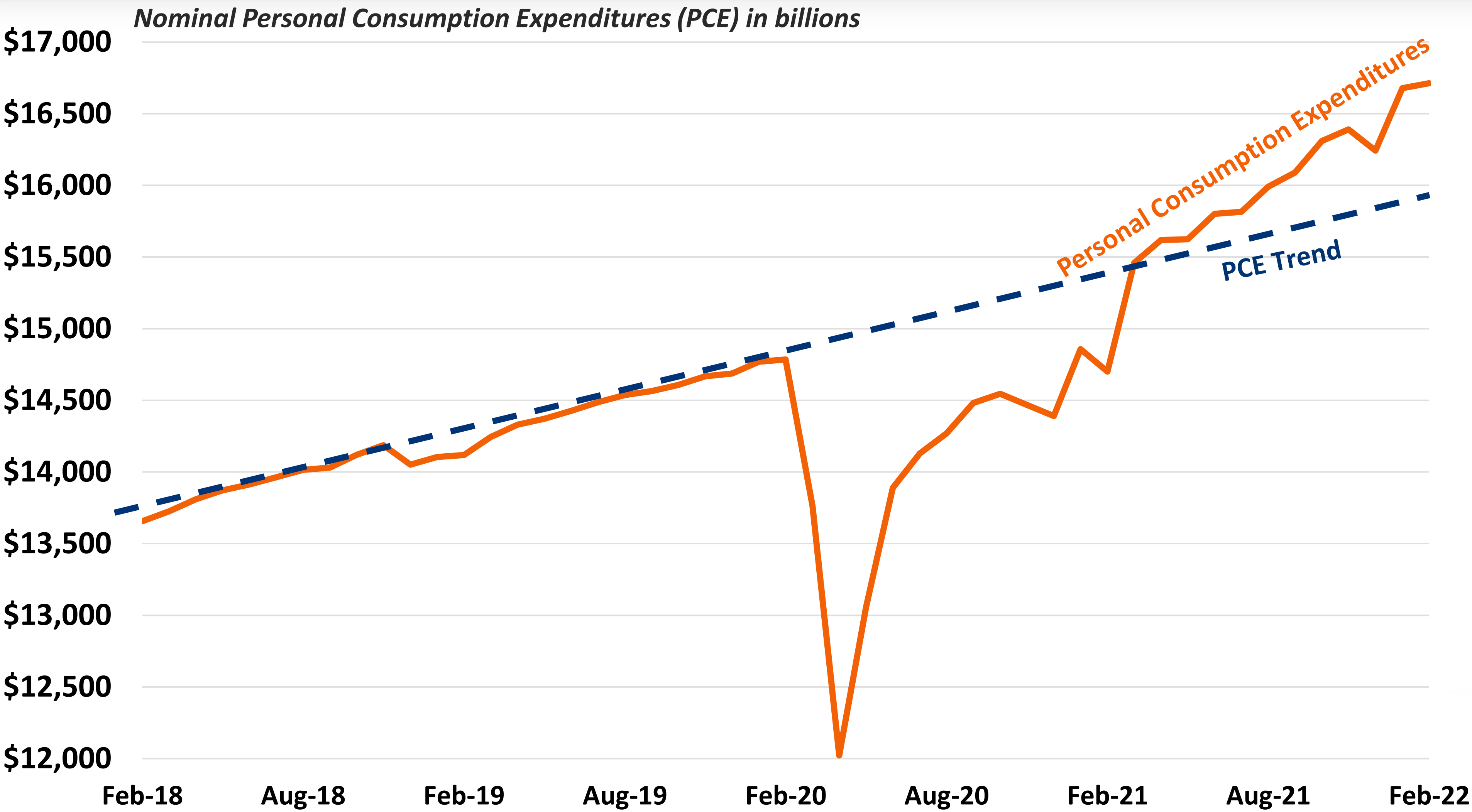
Leading to Economic Overheating



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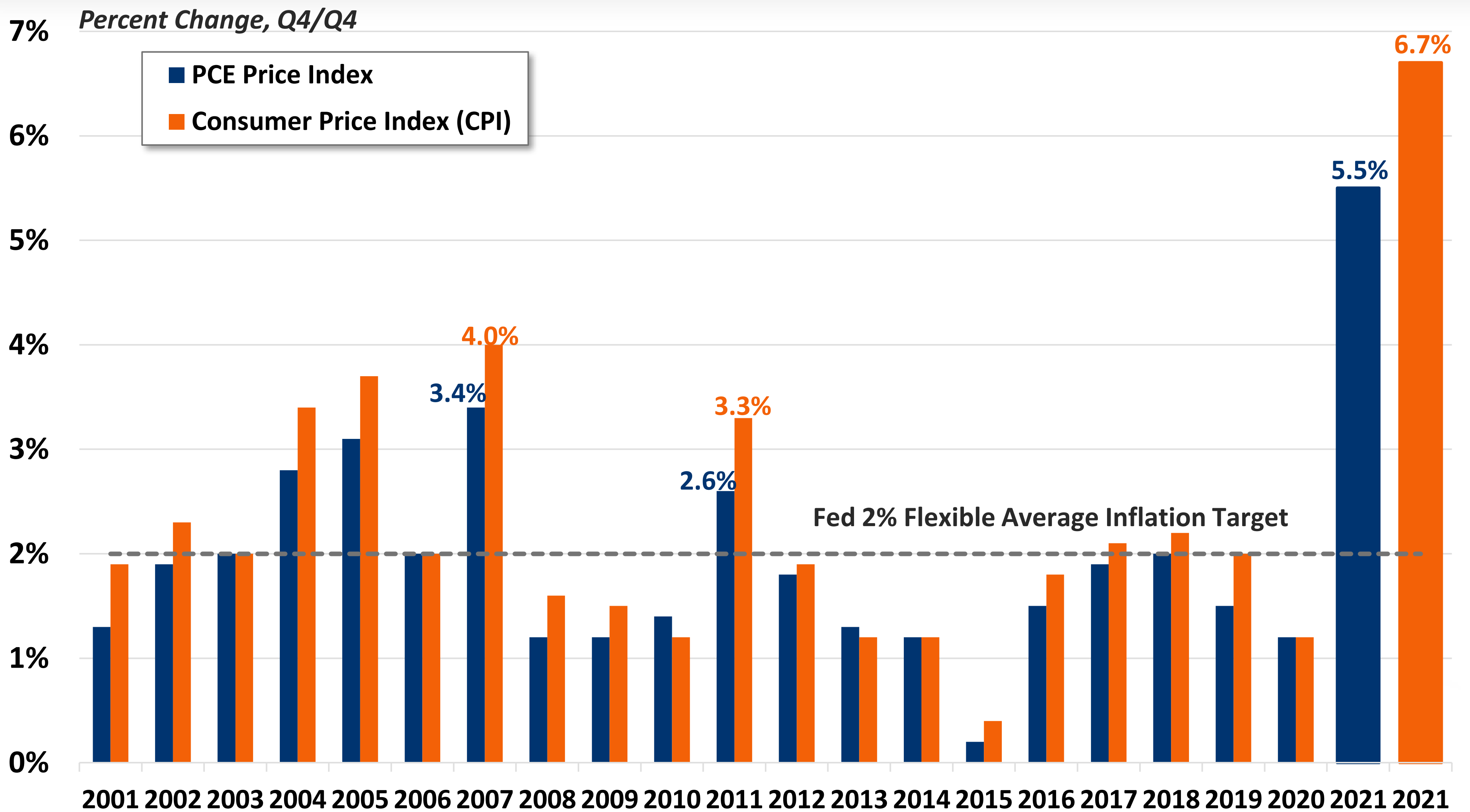
Sources: Congressional Budget Office, CRFB Calculations.

2021 Inflation Was the Highest in 40 Years



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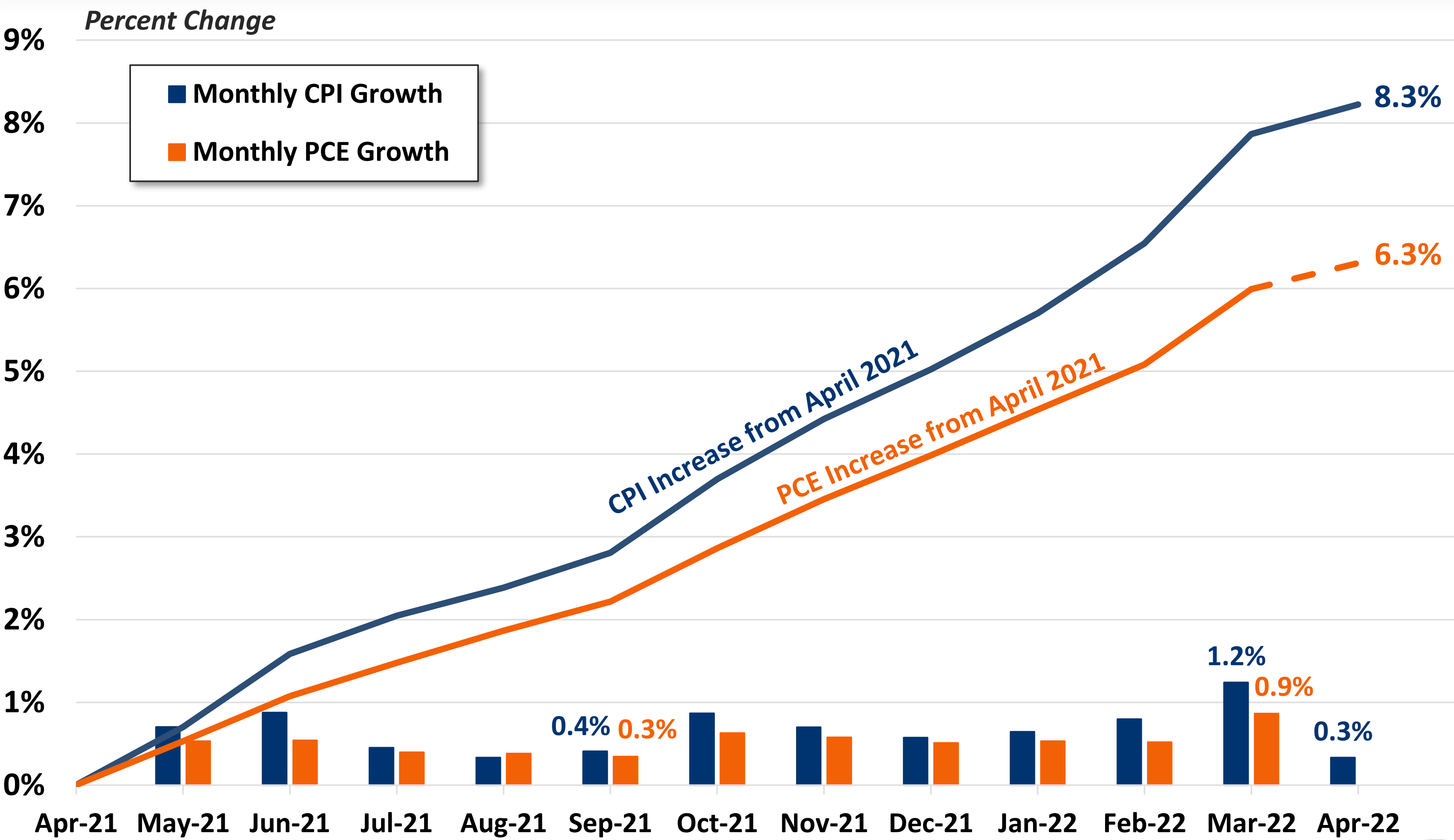
Sources: Committee for a Responsible Federal Budget, Bureau of Economic Analysis, Bureau of Labor Statistics.

And Inflation Has Risen Further Still



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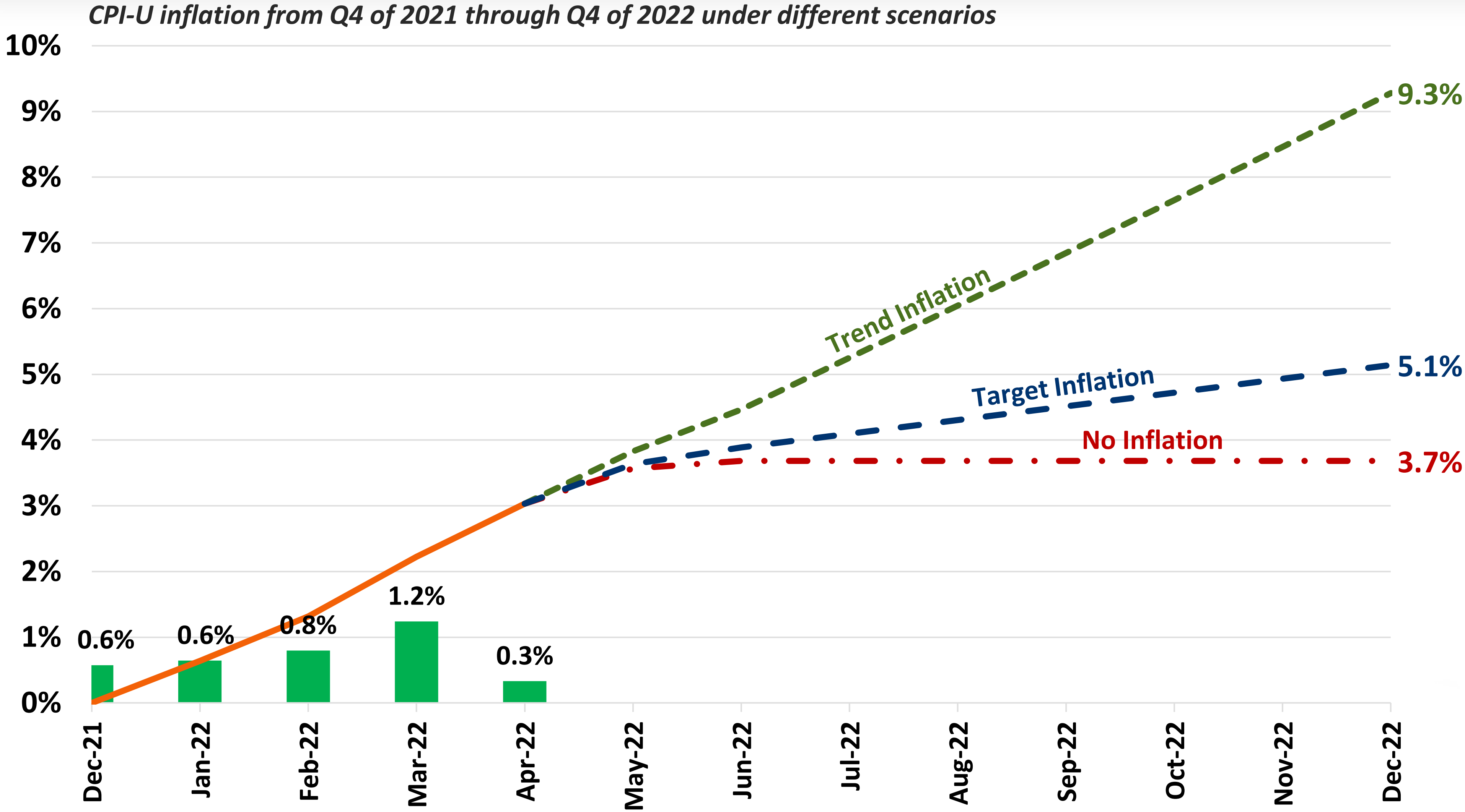
Sources: Committee for a Responsible Federal Budget, Bureau of Labor Statistics.

Inflation Will Remain High in 2022



Note: No Inflation assumes CPI remains at April levels, Target Inflation assumes 0.2 percent monthly inflation growth, and Trend Inflation assumes growth continues at the average rate of all months this year.
Sources: Committee for a Responsible Federal Budget, Bureau of Labor Statistics.

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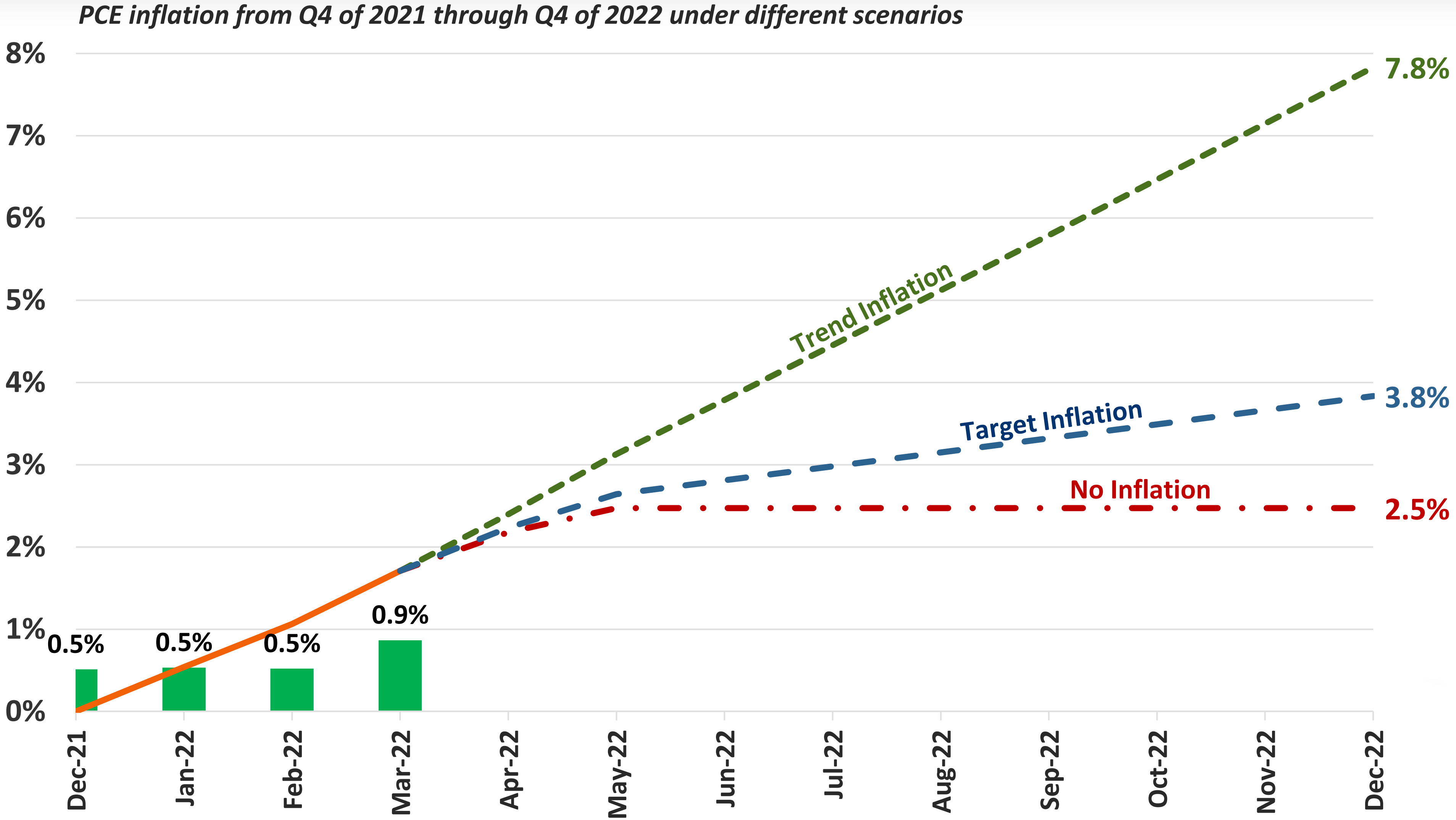
Inflation Will Remain High in 2022



Note: No Inflation assumes PCE remains at March levels, Target Inflation assumes 0.2 percent monthly inflation growth, and Trend Inflation assumes growth continues at the average rate of the last three months.
Sources: Committee for a Responsible Federal Budget, Bureau of Labor Statistics

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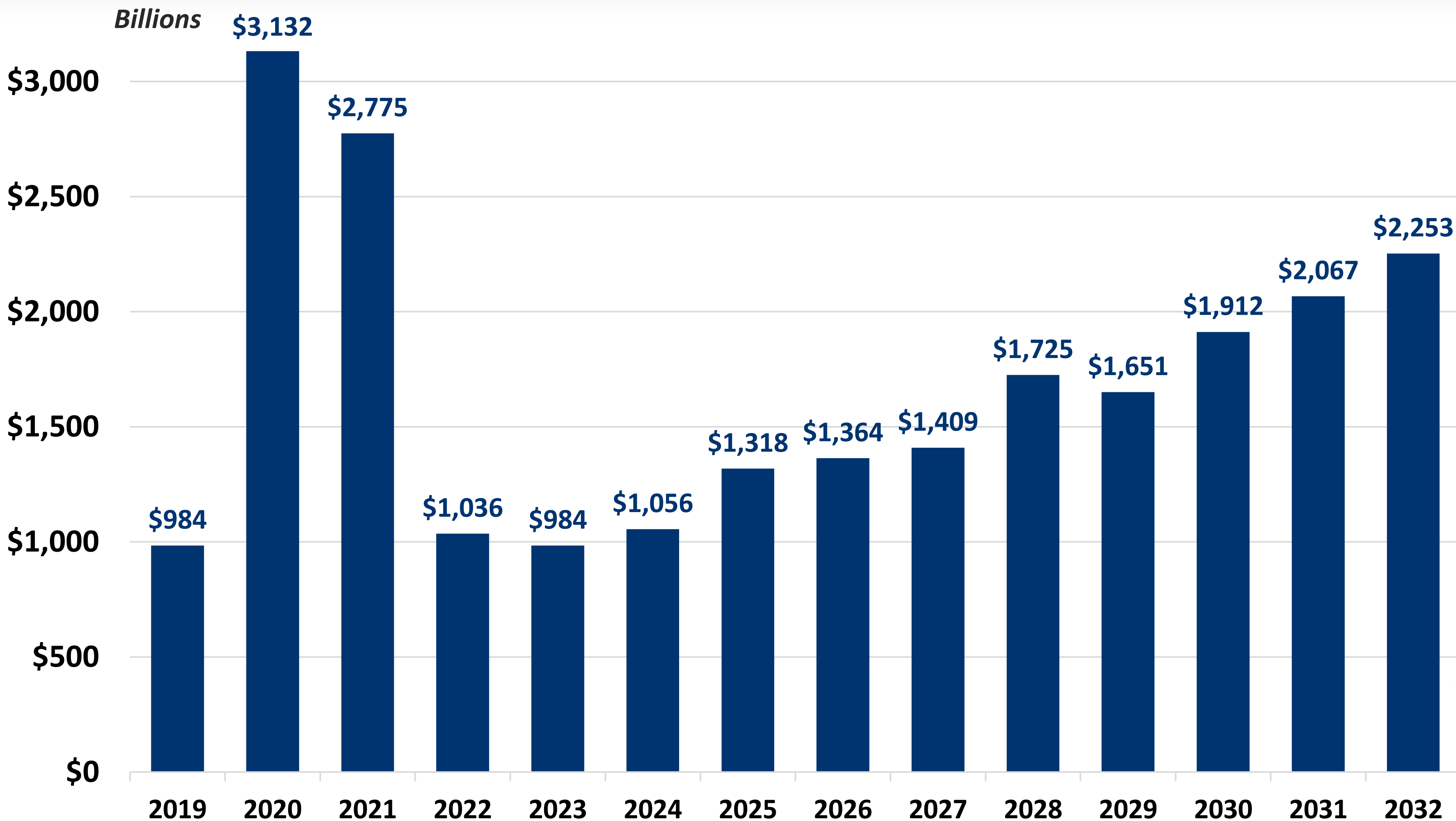
Will High Inflation Persist?

Yes	No
Low real interest rates	Aggressive rate hikes & QT
Delayed inflation (rent, M'care)	Transitory deflation (cars, oil)
$2.3T of excess savings	Shrinking balance sheets
$8T more housing wealth	Disappearing stock gains
Tight labor markets	Growing labor supply
Strong state & local finances	~$2T drop in federal deficits
New supply shocks (Ukraine)	Supply chain fixes
Wage-price spirals	Shift from goods to services
De-anchoring expectations	Anchored LT expectations
Interest Rate-price spirals	Strong reaction to Fed forward guidance

Deficits Are Falling as COVID Relief Expires



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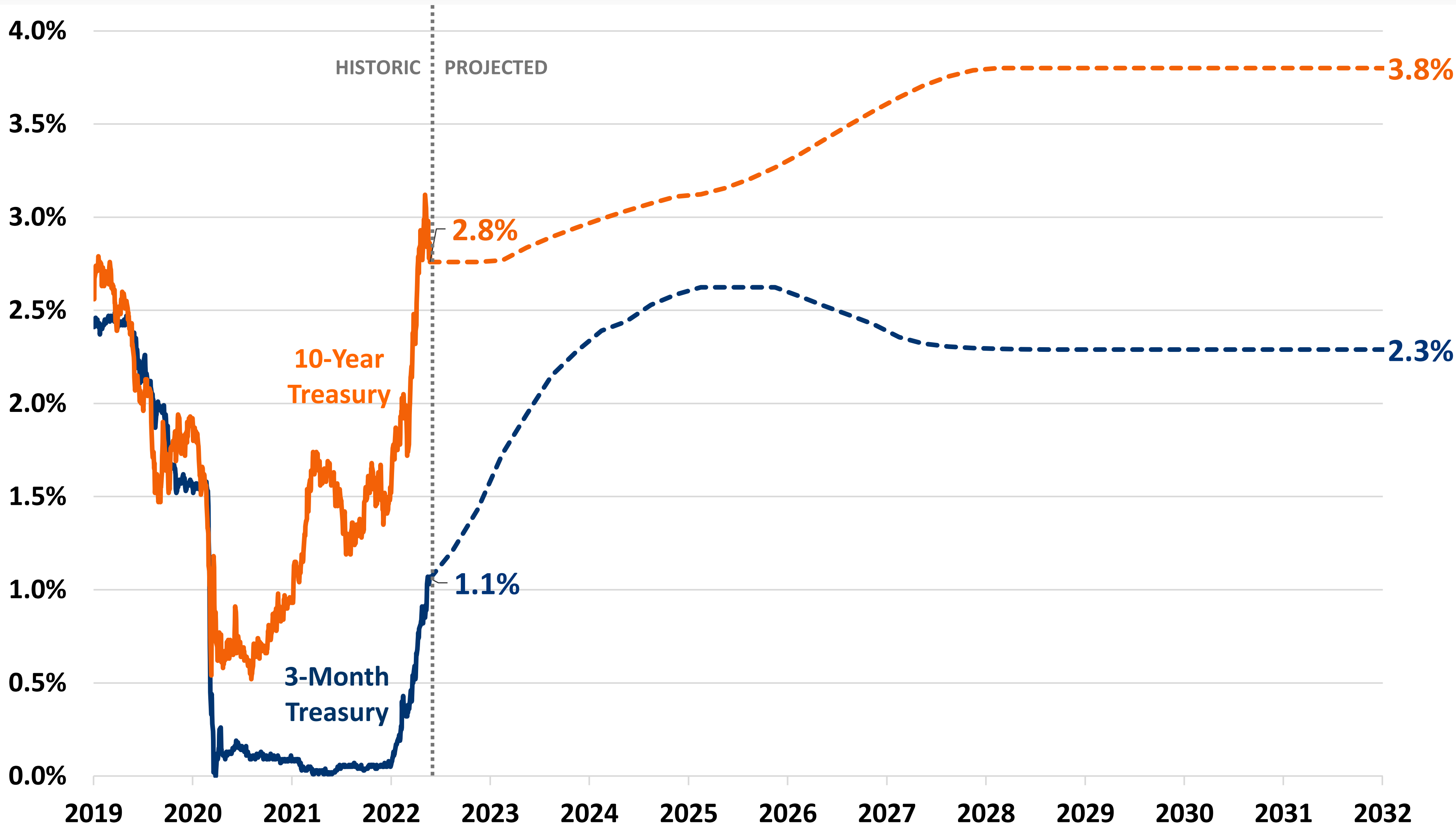
Source: Congressional Budget Office

Interest Rates Are Rising as Fed Tightens



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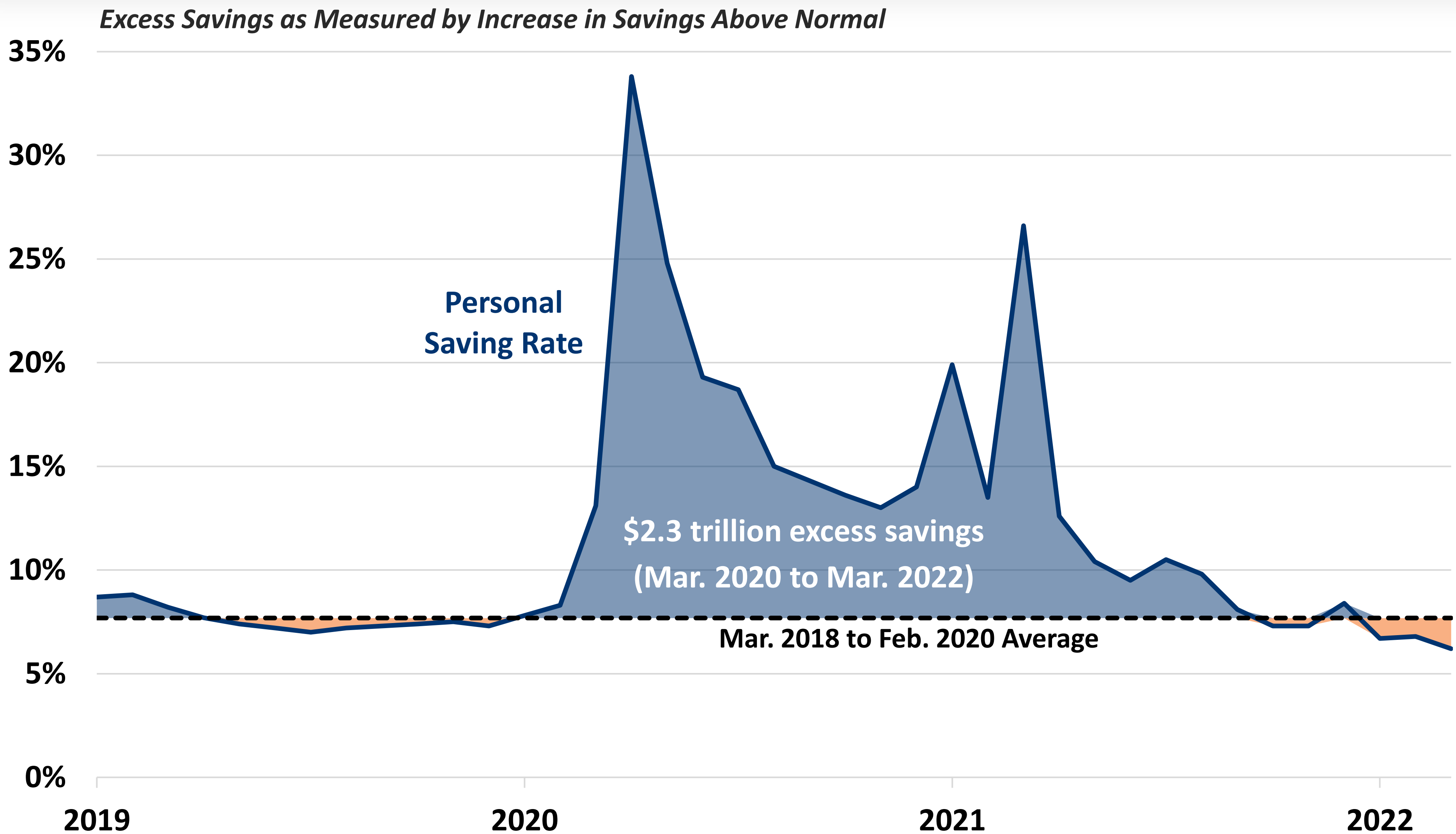
Sources: Federal Reserve, Congressional Budget Office

But People Still Have Plenty to Spend



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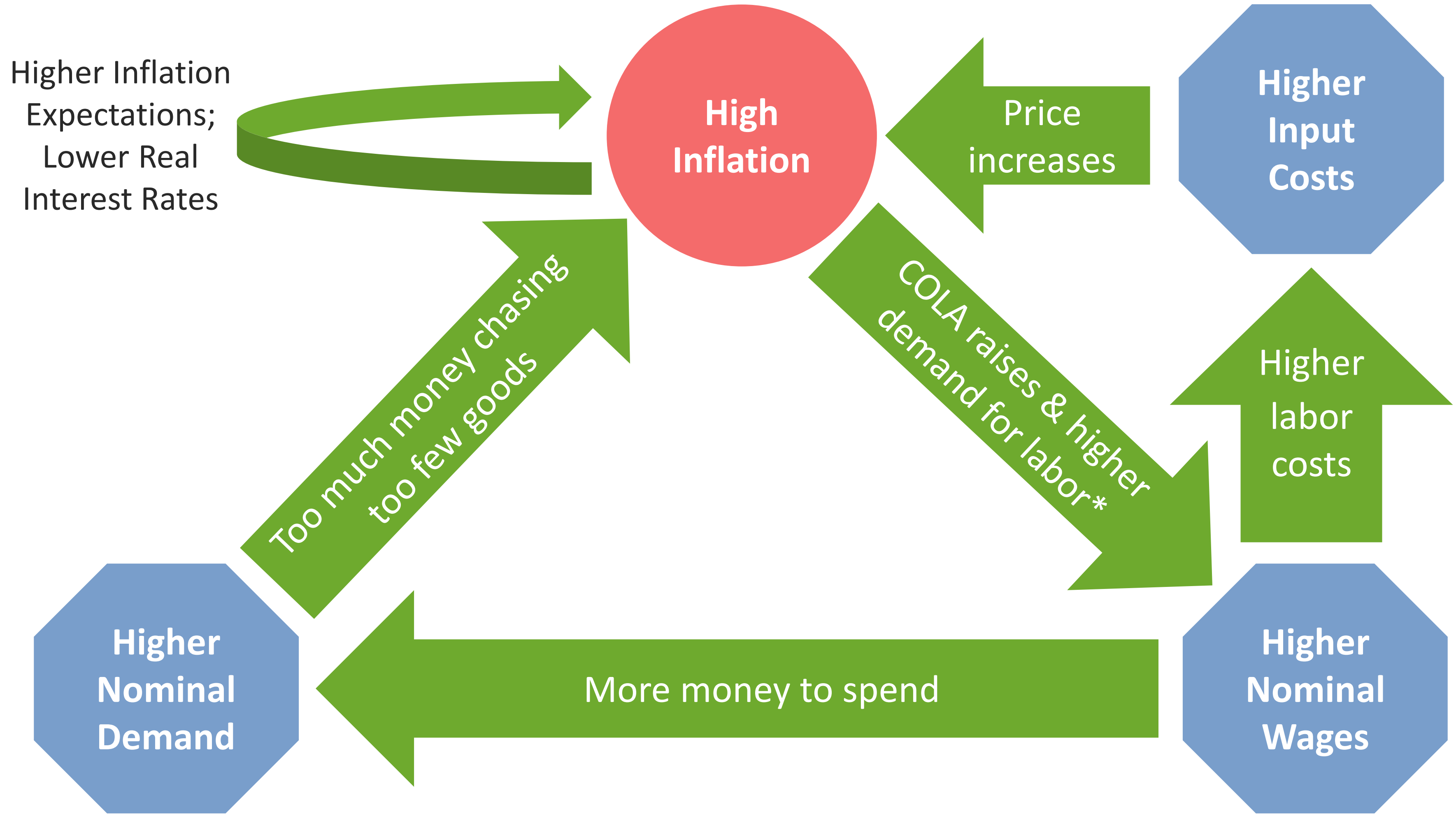
Sources: Jason Furman based on Bureau of Economic Analysis, Macrobond.

And Wage-Price Spirals Can Prolong Inflation



*Inflation lowers real wages, Increasing quantity of labor demanded. This boosts hiring, wages, job switching, etc.

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The Federal Reserve Is Supposed to Fight Inflation

Economists prefer monetary policy over fiscal policy for managing inflation *and* fighting recessions

Furman & Elmendorf (2008) explain why for recessions:

- Monetary policy can adjust much more quickly
- Monetary policy can best judge timing and magnitude of needed intervention (economists > politicians)
- Fiscal policy is more likely to do long-term harm

Similar arguments apply for inflation – we want interest rate hikes, not tax hikes and spending cuts, to be the main tool for fighting inflation

So What Is the Federal Reserve's Plan?

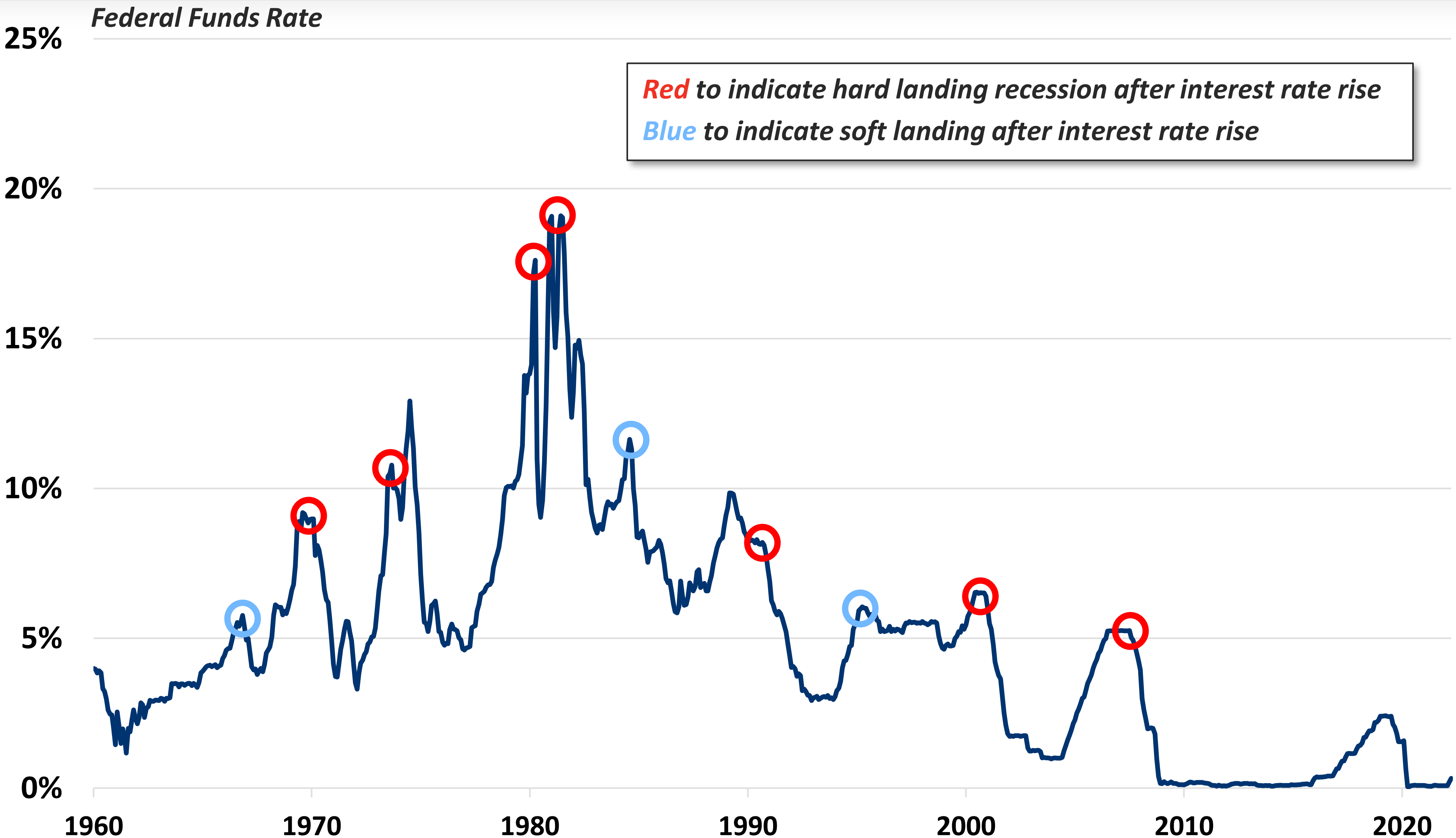
The Plan:

1. Steadily raise interest rates to ~neutral rate (2.5-3.0)
2. Allow balance sheet to shrink by attrition
3. If #1 and #2 don't work, raise rates further

The Problem:

- Raise rates too little, inflation persists
- Raise rates too much, recession emerges
- Raise rates just right, you might get both (stagflation)

Soft Landings Are Hard to Navigate



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Sources: Committee for a Responsible Federal Budget, Federal Reserve.

Should Fiscal Policy Get Involved?

Economists recognize role for fiscal policy in recessions

Furman & Elmendorf (2008) explain why for recessions:

- Fiscal policy can reduce uncertainty of total thrust provided to the economy
- Fiscal policy is helpful when interest rates are constrained by the zero lower bound or policymakers want to support employment at a higher rate
- Fiscal policy has shorter outside lag – can work faster
- Fiscal policy may be needed when monetary policy is proving ineffective

Should Fiscal Policy Get Involved?

We *should* recognize role for fiscal policy in inflation

When it comes to fighting inflation, we argue:

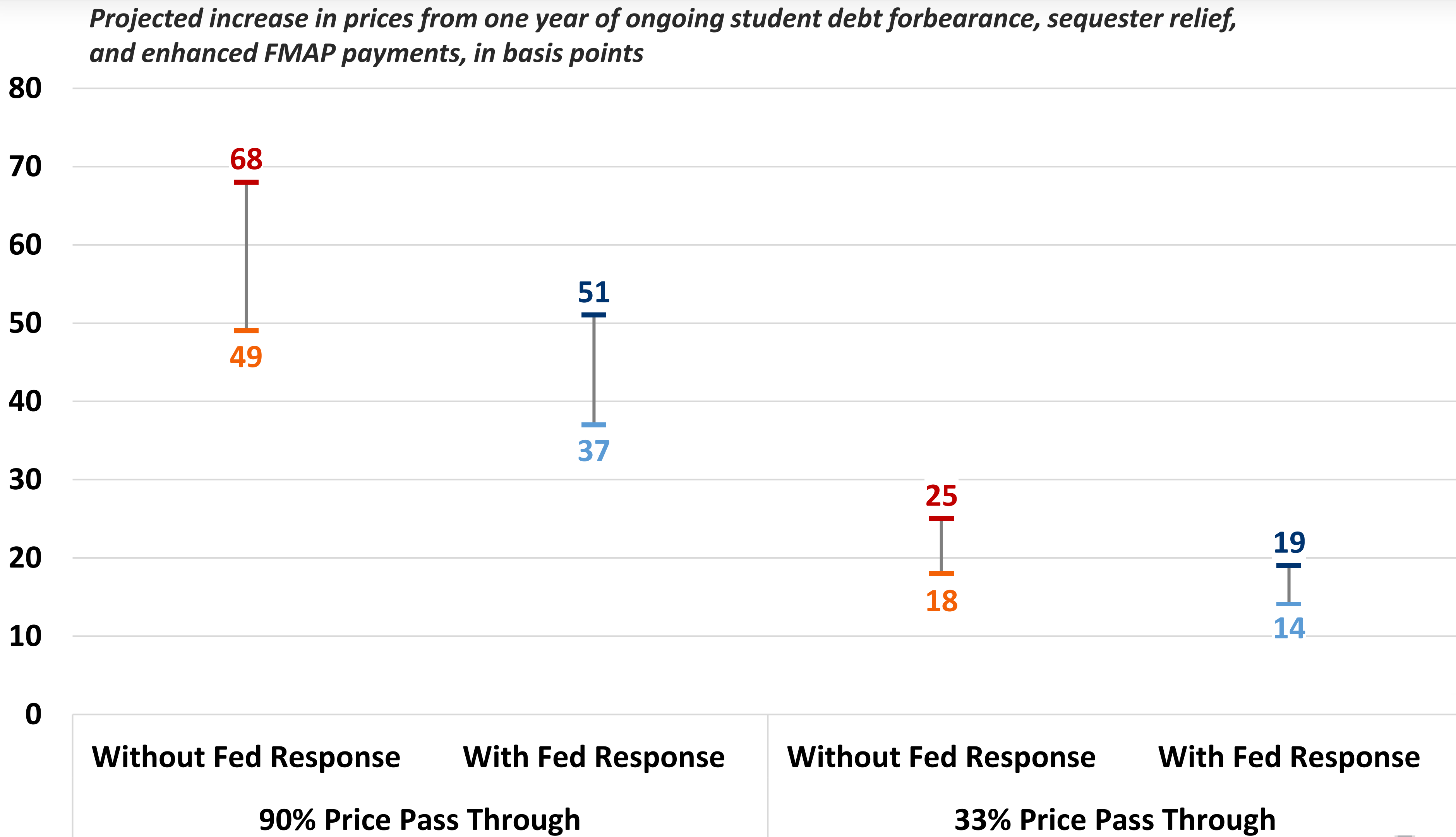
- Fiscal policy can reduce uncertainty of total thrust provided to the economy, anchoring expectations
- Fiscal policy is helpful when trying to avoid raising interest rates well above the neutral rate
- Fiscal policy and monetary policy together can spread and thus limit the “pain” from inflation fighting
- Fiscal policy can cut the cost of higher interest rates

Fiscal policy should *assist,* not replace, Fed policy

How Fiscal Policy Can Help Fight Inflation

- **Do No Harm** – End COVID relief, offset new legislation
- **Lower Health Care Costs to Reduce Prices** – Reduce excessive Medicare payments, lower drug costs
- **Cut Deficits to Reduce Demand** – raise taxes, cut and cap spending, impose user fees, increase premiums
- **Promote Work to Boost Supply** – repeal earnings test, improve work requirements, EITC for older workers, vocational rehab, etc.
- **Support Savings** – Savers' match, "inflation bonds"
- **Enact Other Anti-Inflation Reforms** – energy, trade, government procurement, regulations, etc.

Do No Harm



Source: Committee for a Responsible Federal Budget.

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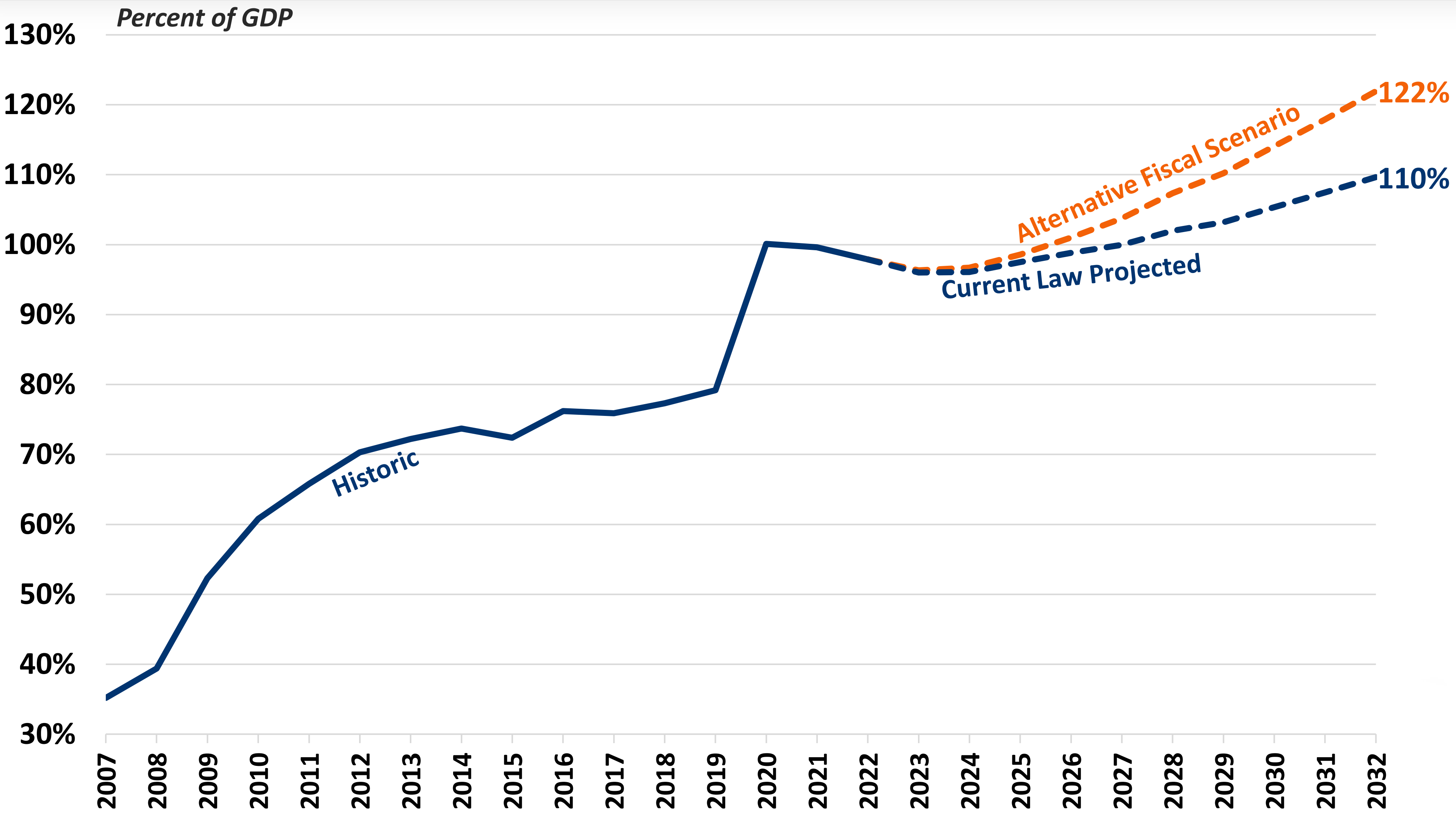
Lower Health Care Costs

- ❑Enact Drug Pricing Reforms
- ❑Reduce Provider Payments (Site-Neutral, Post-Acute)
- ❑End Excess Medicare Advantage Payments
- ❑Reform Cost-Sharing Rules
- ❑Raise Premiums (Means-Tested?)
- ❑Restore "Cost-Sharing Reduction" Payments
- ❑Restrict Medicaid Provider Tax Loopholes
- ❑Limit Health Care Tax Preferences

Do Whatever Else You Can

- Cap discretionary spending, cut mandatory spending
- Raise revenue, especially from upper middle class
- Pursue mechanical price reductions – lower procurement/infrastructure costs, cut tariffs
- Boost supply where you can, don’t expect much
- Support savings where you can, don’t expect much
- Don’t worry (too much) about multipliers, we need the deficit reduction regardless

The National Debt is Headed to Record Levels



Note: "Alternative Fiscal Scenario" assumes extension of individual tax cuts in the TCJA, extension of expiring tax credits in the ARP, extension of various tax extenders, and discretionary spending growing at the rate of GDP.
Sources: Congressional Budget Office and Committee for a Responsible Federal Budget.

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Extra Slides

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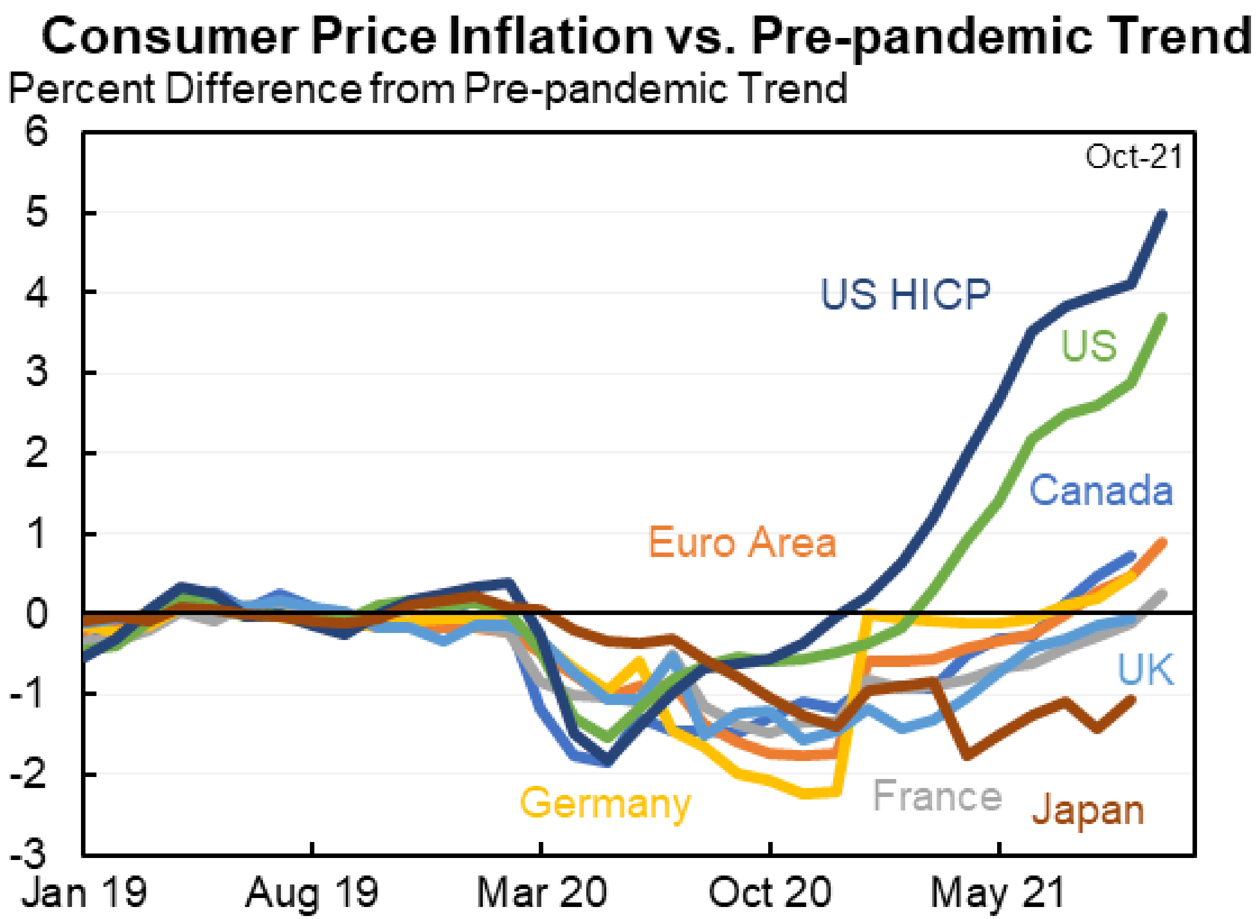
And Inflation is Higher Here than in Europe



Note: Pre-pandemic trend based on log-linear regression of Jan-2018 to Dec-2019. HICP (EA, France, Germany, US) and UK CPI seasonally adjusted using Macrobond.

Graph from Jason Furman

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Illustrating a Wage-Price Spiral