OPINION | COMMENTARY

Bad News About the Good Inflation News

In the 'general equilibrium'—the big picture—encouraging signs often have discouraging implications.

By Jason Furman
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A 'Now Hiring' sign outside a Home Depot store in New York, Feb. 17.
PHOTO: JEENAH MOON/BLOOMBERG NEWS

Wishful thinking has led economic forecasters to underestimate inflation over the past year. Observers correctly identify one factor that would bring inflation down while missing other, inextricably linked factors that would raise it. The latest examples: expectations of a dramatic reduction in inflation as people return to the workforce, consumers switch from buying goods to services, and the pandemic recedes.

In February 2022, there were 2.3 million fewer people in the labor force than before the pandemic, after adjusting for changes in the age distribution. It is plausible that most of these people will return to the labor force, adding 200,000 jobs a month over the coming year and raising the labor-force participation rate by about a percentage point. Many have argued that these returning workers will expand supply and bring down nominal wage and price pressures.

Yet the last time we had a similarly big increase in labor-force participation, in the late 1970s, it did nothing to dent inflation. Structural changes in labor supply generally don't affect inflation much. Underlying the optimism about the return of workers lowering inflation is an error economists call "partial equilibrium thinking"—failing to see the big picture, or the "general equilibrium." Returning workers increase supply, but they increase demand as well through the spending power of their income.

Perhaps the increased supply will exceed the extra demand. But the difference—and thus the effect on inflation—is unlikely to be large. Moreover, whatever brings the workers back may be associated with other changes in the labor market that further expand demand and tighten labor markets.

The analysis of the goods-services shift has been plagued by similar reasoning. Consumers have been spending much more than normal on goods and less than normal on services. The pandemic was a factor, as people shifted from, say, buying gym memberships to stationary bikes. But much more of the shift to durable goods was the result of the fiscal stimulus. When a family gets a one-time check, it often goes toward a one-time purchase. Despite higher prices, consumers still bought many more durables in June 2021, when nationwide deaths with Covid averaged 300 a day and falling, than in December 2020, when the death count was 3,000 a day and rising.

Regardless of the cause, the shift from services to durable consumer goods resulted in extremely rapid goods inflation in 2021, while services inflation was muted. This has led analysts to make statements to the effect that core inflation would have been 2 points lower if consumer durables hadn't gone up in price. It's the partial equilibrium fallacy again: If goods prices hadn't risen as much, consumers would have spent more on services, driving up their prices.

It's likely that the goods-services rotation boosted inflation somewhat in 2021, because goods production is less responsive than services production to increased demand. If so, then the rotation back from goods to services will lower inflation—but only modestly after offsetting forces. Over the past three months core services inflation has run at a 4.7% annual rate, well above its pre-pandemic pace, and it is hard to see service inflation coming down much in 2022. Rents are rising, prices of pandemic-depressed services like air travel and live entertainment are likely to rise with demand, and the main cost of producing services—wages—continues to exert upward pressure.

More generally, the Fed and other forecasters appear to be counting on the shift from pandemic to a manageable endemic lowering inflation. But like the pandemic's onset, this will unleash forces that push prices in different directions. It will raise services and energy prices and lower durable-goods prices. It will expand both demand and supply by an unpredictable relative magnitude.

In 2020 the net effect of the initial pandemic wave was to lower inflation globally. Then, in the first half of 2021, inflation popped up as economic activity resumed. A full return to normal in 2022 would mean more lives saved and better lived—but not necessarily a dramatic reduction in inflation. If anything, it is likely to be an additional source of upward inflationary pressure.

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