INFLATION!
What Happens Next – 07.17.2022

Larry Bernstein:
Welcome to What Happens Next. My name is Larry Bernstein.

What Happens Next is a podcast which covers economics, finance, history, politics and current events.

Today's session is on inflation and Fed policies to bring it back under control.

Our first speaker is John Taylor who is the Mary and Robert Raymond Professor of Economics at Stanford. John is famous for developing the Taylor Rule. John will explain his Taylor rule for setting the optimal short-term interest rate and why interest rates need to rise to quell rising inflation.

Our second speaker is Casey Mulligan who is the Ken Griffin Professor of Economics at University of Chicago's Booth School and the Former Chief Economist for the Council of Economic Advisors in the Trump Administration. Casey will explain how government stimulus increased inflation and discouraged employment. He will also discuss his recent work in the pharmaceutical industry that shows how middlemen helped lower prices for consumers.

Our final speaker is Alan Auerbach who was my economics professor when I was a student at Penn. Alan is currently the Robert D. Burch Professor of Economics and Law at UC Berkeley. Alan will discuss the dynamics between current inflation and employment.

I chose the topic of inflation for this week's podcast because the CPI statistic released this week was up 9.1% which was the highest annual rate of inflation since 1981. The price of energy is up 41% on the year, food is up 10.4% and all other items are up 5.9%. It is the ex-food and energy inflation that is most disturbing because it indicates the breadth of the inflationary problem.

The detail of the CPI report is also informative. Rent was up 0.8% last month alone which was the largest monthly increase in 36 years. Dental services increased 1.9% last month and was the largest monthly increase in dental expenses ever recorded. Motor vehicle maintenance rose by 2.0% last month, the largest increase for any month in 48 years.

Rent, Dentistry, and Auto Maintenance price increases cannot be blamed on fighting in Ukraine, or supply chain problems at the ports. This is good old-fashioned inflation caused by too much money chasing too few goods and services.

The Fed is raising interest rates but they are late to the party. We are going to hear today from a monetary specialist, a labor market economist, and a macroeconomist on how to bring inflation back under control.

Let’s start with John Taylor.

Larry Bernstein:
John, thanks so much for joining us today. In your opening remarks can you discuss if you agree that the Federal Reserve should have started raising interest rates months ago to subdue inflation?

John Taylor:
The FED got behind the curve.

There was another period where the FED was behind almost as much, and it was back in the 70s, when Arthur Burns was the chair of the FED, President Nixon was the President of the United States. And Arthur Burns said, "Hey, it's not us. It's you." And so, he convinced Nixon to have wage and price controls on the whole economy. And, it was a disaster. And eventually, people wised up and realized it was monetary policy and, we learned from that experience. But, what's surprising now is the FED has never been so far behind, when inflation rate's 5%, 6%, 7% even higher by some measure.

The 70s, the FED got so far behind, they had to catch-up. And catching up was damaging. So, this particular episode is different and inflation is not seven or eight years old, it's a year and a half old or two years at the most. That's what the advantages of a rule or a strategy is, the FED could indicate that, "look, we can't have inflation this high and have interest rates this low. So, we're gonna have to raise it."

Some of the members of the FOMC have already begun to talk about that it has to be over 3% or so. What's most important now is the FED indicates inflation is high, expectations of inflation are high, people are worried, we're gonna have to raise rates. And that's not bad, that's good for the economy.

And quite frankly, the economy's already slowing because people anticipate some kind of reaction. I'll finish here, very important for the FED publish rules, that's the hope why we could get out of this with much less damage than in the past.

Larry Bernstein:
John Taylor, you’re an economist who created the Taylor Rule. Your rule is meant as a target for the Federal Reserve to set the FED Funds rate. The formula is based on the sum of the rate of inflation, plus the real interest rate plus an additional amount based on the output gap. Can you explain the Taylor Rule’s application to today’s economy?

John Taylor:
Well, it's a very simple rule so it's easy to explain. The interest rate should be higher if the inflation rate is higher. And there's a coefficient at 1.5, so inflation rises by 1%, the interest rate

should rise by 1.5%. So that's part of it. And if the inflation rate is 2%, and the real rate should be 1%. You should be aiming for 3% in normal times.

Larry Bernstein:
To clarify, the interest rate should be the sum of inflation and the real rate of interest or around 3% in normal times.

Inflation is running over 8% and that is 6% more than the inflation target, but no one is recommending raising rates by 6%. What am I missing?

John Taylor:
Yeah.

I think the most important thing with these rules is you don't surprise people. If the FED moves to 5% overnight, that'll be a surprise. I always argue is that you use these rules in a prospective way. If inflation is going to continue to be this high, we will have to raise rates. That's what good monetary policy is about.

Larry Bernstein:
If the FED is behind the curve, why not raise interest rates immediately to the correct interest rate, why does the FED want to raise interest rates to the correct rate over several months?
John Taylor:

The reason is you don't wanna shock everybody. Members of the FOMC is saying it has to be over 3%. Maybe a couple 75 basis points are what's required. I think the trick here is you have to make the adjustments in a way that is consistent with the markets. It can do damage to have interest rate that's increasing too rapidly. So you have this compromise. I think one year works pretty well and you move to it gradually.

Larry Bernstein:
Beginning last fall when inflation started to increase quickly, both the FED and the Biden Administration said that inflation was transitory and that price increases were caused by supply chain problems. After the war in Ukraine started, the Administration blamed Putin for rising gas prices. Do you believe that inflation is transitory?

John Taylor:
If you look at the data, that's not this transitory thing. There's always supply effects. There's always events happening in the world. It's a monetary phenomenon.

And that's something that has to be emphasized and stressed. I focus a lot on the interest rate being low, there's money growth, there's purchases of assets, all those things which come into play in thinking about it. But the main thing is that as you point out, the transitory aspect seems to have disappeared from the vocabulary and people realize that action needs to be taken. And they're just starting to do that.

Larry Bernstein:
Existing home prices have risen 20% in the past 12 months. What does this tell you about inflation?

John Taylor:
Some prices move more rapidly than others, housing prices go up very rapidly. But they also can come down. And the trick here is monetary policy won't always be accommodating these high prices. And that it can't last. And the hope is that inflation starting with housing or other durable goods will moderate and come down off these very high levels without having the contraction.

That's why I like rules or strategies. You indicate not only where the interest rate is now, but where it will be a year from now or even two years that are necessary to make this a smooth adjustment.

And internationally becomes very important because you cannot have a global inflation and have little inflation in one country. It just doesn't work that way. So, as the FED begins to tighten, you're also seeing other countries raising interest rates.

Larry Bernstein:
The CPI statistics for the US economy show incredible breadth in inflation across goods and services. Sure, oil is up, but everything else is up nearly double digits as well, like food, car prices, housing etc. What do you make of the breadth in inflation?

John Taylor:
Well, first of all, the breadth that's beyond Ukraine, it's beyond the backup in ports. Monetary policy should focus on keeping the overall inflation rate low and keeping the economy steady. I don't mean that it does everything with respect to income distribution, with respect to regulation. The Central Bank focuses on inflation that's a big enough job rather than try to do everything else.

So monetary policy is one aspect. There's fiscal policy, there's regulatory policy, there's international policy.

So, let's focus on the things that monetary policy is good at based on history and based on theory. And do those.

Larry Bernstein:
The US had a $1.9 trillion dollar stimulus in 2021 plus an infrastructure bill. Was fiscal policy procyclical that increased the inflation problem?

John Taylor:
Well, maybe we overdid it. I think the stimulus that we had recently is questionable.

Larry Bernstein:
During the inflation of the 70s, wages got indexed to inflation and it was very challenging reducing inflation afterwards.

John Taylor:
If prices continue to go up, wages will rise. And that'll cause inflation to rise even further. That's the so-called wage price spiral.

We haven't seen it yet. That’s why I think there's some hope that we'll be able to deal with this. Remember a policy which addresses inflation. It doesn't necessarily make unemployment higher. It's just expectations of inflation are lower.

The economy is different, there's more flexibility to deal with these issues than there used to be.

I'd say going back to previous periods, inflation took a long time to build up. Wage inflation took a long time to rise. We're not quite there yet.

Larry Bernstein:
There are lags to monetary policy that means that it takes time for changes in monetary policy to change the economy. Some say that the lag is around 18 months, what does that mean for changing interest rates?

John Taylor:
So, lags are so important. That's, all these rules and strategies were built off of models and ideas that included the lags. It's a big, big thing. You want to have a policy that takes into account the lags.

But I think what we found long ago was that these lags are not fixed. To some extent the lags are based on expectations of what you think is gonna come. And so, expectations can adjust very quickly, and so what many people found working with ideas and equations and theories and models, whatever you wanna call it, is that the economy could adjust more quickly if the central banks were clear about what they're doing.

Some people argue, "Hey, there's no lags. We can fix expectations." We had this theory called rational expectations. Meant that people would just look at what the central bank was doing, and they would adjust their prices and wages accordingly.

Larry Bernstein:
What is your forecast for both nominal and real interest rates in the next year or 2?

John Taylor:
The FED, they're behind now. They hope that by getting the three, three and a half, maybe inflation will come down. But I don't think there's too much question that the real rate has to rise in order to deal with the inflation issue.

Larry Bernstein:
Larry Summers has recently said that we need to get interest rates close to 6% in order to quell the current inflation. Do you agree with him?

John Taylor:
I don't think that Larry has a specific model or rule. He says that it should be higher. He was just at the conference we had here and expressed those views. I think they all tie back to the same thing that rates need to be higher to deal with the inflation rate. I think the most important thing is to experiment in a real time sense with these alternatives. Is it 3%, is it 6%, is it 5%, and what's the speed? The commentary that Larry Summers is putting out is very important. He's been there. He's seen it and is influential.

The fact that the FED chair testifies, there's people who are asking questions, the programs like this, the newspaper, create an important dialogue, so that it's not done in a vacuum.

I think there's a promising aspect of this episode and the people learn from history. I hope we can make this adjustment, and that it's better to be close to some rule or strategy than farther away. Inflation started to increase for that reason.

Whatever strategy or rule you use, and a rule can be a guideline. The FED has to say why they're off if they are off. And it provides a great deal of transparency. It provides a great deal of knowledge of what the FED is doing. There's debates within the FED and that becomes more public, I feel like that this is all part of good policy.

Another reason to be transparent, so the European Central Bank knows as best as possible, what the FED is doing, and the Bank of England, et cetera. So, that provides additional transparency and indication of what you're doing. I tend to use the world strategy rather than rule when I can, who could disagree with having a strategy? Well, you might disagree about a rule. It sounds more tactical, but strategy or overall sense of how policy works is an attractive feature of policy.

We have a global inflation problem right now. You look at Latin America, it's increasing, and in England, it's increasing. It's all over the place, and that's another reason why the FED's actions are important, because it will encourage other countries to raise the rates as well.

Larry Bernstein:
Next topic is asset prices. Stocks are down 20% this year. How do asset prices affect inflation and FED behavior?

John Taylor:
So, asset prices are a very, very important part of the transmission mechanism of monetary policy. So, you don't wanna ignore them. They go in the same direction. A higher interest rate tends to slow the appreciation of the stock market.

Larry Bernstein:
John, I end each session on a note of optimism. What are you optimistic about as it relates to monetary policy?

John Taylor:
I'm optimistic that we'll be able to get the inflation down without much of a harmful effect on the economy. If we have a perfect thing, people adjust their expectations of inflation, adjust their wage demands. Ultimately, we will need a lower inflation rate for a successful economy. My optimistic note is by thinking about the mechanism, thinking about how expectations are formed, thinking about history, thinking about other countries, that we'll be able to get this right.

The inflation rate, while it's been there for a year and a half or more, it's not like it was in previous periods. And so, there's something that can be done about it, and I think the FED, if it can make this adjustment in a smooth way, and that's why I'm optimistic.

Larry Bernstein:
Casey, thank you for joining us. In your opening remarks, can you describe what is causing the rise in inflation and whether that will result in a recession?

Casey Mulligan:
There's talk about a recession right now, and this is an interesting time where we could have a recession by one definition but not by the other. GDP definition: looks like we could have a recession. But nonetheless, employment be growing during that GDP recession. By definition, that's a pretty bad productivity recession, because productivity is GDP per worker.

But it was predicted. When we saw Biden's agenda in 2020, we tried to work out the consequences. And there's a lot of productivity-reducing elements of that agenda.

Maybe a bit of a surprise is how the Build Back Better hasn't passed, which has tax increases on business built in. But inflation has done that work for Biden. Inflation amounts to a pretty hefty tax on businesses, because the business tax code is an index to inflation. To oversimplify a bit, businesses are experiencing a lot of bracket creep, to use the Ronald Reagan term, and that's a big disincentive to invest. And investment's one of the ways we get productivity.

Ultimately, the capital comes to businesses from people, so that is raising their cost of capital because their owners and their creditors are paying more in tax and getting less in return. It also happens on the business side. They're allowed to deduct for their expenses for capital equipment and other investments.

But it's based on historical, not based on what it costs to replace the car, truck, whatever. Inflation is driving up those replacement costs. The end result is big hit on the return to capital. And that's a pretty effective way -- we saw it in the '70s -- of really killing off business investment.

Larry Bernstein:
With high inflation, there's an enormous cost to the suckers who are holding US dollar cash instead of real assets. That non-interest-bearing cash is funding our deficit now. Is inflation an effective way of paying for government expenditures instead of taxes?

Casey Mulligan:
Let me just point out the history around that. What you see time and time again is after a war that you get inflation. A war gets paid for in part with inflation. There've been arguments that it makes sense for wars because wars are unpredictable, and you can catch people by surprise. It's been a historical pattern.

And maybe COVID is like that. It was a one-time war with a virus. Maybe in that instance, surprising people with some inflation is better than the alternative ways of raising the funds. It fits in a historical pattern pretty well.

Larry Bernstein:
How did Biden's COVID stimulus bill impact the economy?

Casey Mulligan:
The COVID bill had a lot of funds for people who were poor and unemployed. You and I talked years ago during the Obama stimulus about some of those incentives. This was almost an order of magnitude bigger incentive. $300 a week bonus. Obama's bonus was $25 a week. That's so quaint now.

We saw that with businesses having incredible time getting people to work and of course being told, "Well, my pay for staying home is very good." The red states, even though it was money coming from Washington, put an early end to it. And we saw the red states get into early recovery.

Larry Bernstein:
You mentioned on a previous episode of What Happens Next that you expected the stimulus bill discouraged employment by those workers and that when the money ran out, then they would get a job. There is enormous demand for labor now, the JOLTS survey of businesses seeking workers is over 11mm jobs. Last month was the second highest on record. Historically when the Fed was trying to reduce inflation, they would trigger a recession when higher interest rates would trigger layoffs, so there was a transmission between interest rates and the

labor markets. What do you make of the relationship between higher interest rates and the labor market?

Casey Mulligan:
I've never believed in much of a connection there. I think the Fed's jobs to keep inflation to a low, predictable level of inflation for people. I don't think they can affect the real economy that much. There are parts of the economy that would be affected. So, mortgages, maybe car loans. And those can translate into some of your headline employment numbers because already home construction is a pretty volatile industry in terms of employment. To the extent we see tepid employment growth, I would expect to see it the least in some of those interest-sensitive industries.

I worked for a president who was from that industry. President Trump was a commercial real estate builder. He wouldn't accept from me the idea that Fed policy doesn't affect anything.

Larry Bernstein:
During the 2008 housing downturn, workers who lost their jobs had trouble finding new employment. Today, there's enormous demand for skilled and unskilled workers in the economy. So would you expect workers to find new jobs quickly?

Casey Mulligan:
When I left the White House, I warned the president, "If we have a downturn, I'm worried that Congress will make it deeper." They'll come forth with packages, a safety net, on top of the safety net we already have, that allow people to make that transition more slowly. So, we haven't seen Congress do that yet, but it would fit the historical pattern, that they would come in and say, "Oh, it's time for the $300 a week bonus." Or maybe they would scale it back to a mere 100 a week. But that would make the transition a lot more difficult.

Larry Bernstein:
You mentioned two different types of recession. One was where you see two consecutive quarters of declining GDP. Another might be an uptick in unemployment. How do you see this one playing out? Do you expect to see significant upticks in unemployment or just a decline in GDP?

Casey Mulligan:
I think it's been primarily a decline in GDP. Unemployment can go up for two reasons: people working less or people not considering themselves retired. Some of the policies will be targeted toward the unemployed but not targeted toward the retired and the others. But certainly, we have a productivity problem. That means that GDP's going to fall more than employment. And maybe employment doesn't fall at all.

Larry Bernstein:
What are your thoughts on the current state of the labor market?

Casey Mulligan:
One of my kind of mottoes is price and quantity – the headline numbers on the labor market at the quantity, how many people working. But there's also the price side. What's going on with the wages? What's going on with productivity? That side of the labor market is not doing well, and the productivity of the recession's going to mean low real wages for people. There are also these semi-retired people you're talking about. They're knowledgeable people, and that knowledge has to get passed on somehow. In the old days, it happened because the younger folks were guided by the older folks, right there at the workplace together. You have this generation of young workers who aren't getting the training and having to learn things the hard way. That's not going to be good for their personal wages and the economy as a whole, not good for productivity.

Larry Bernstein:
Young people used to learn in an apprentice-like fashion from older workers. How do you think Zoom culture will affect productivity and the knowledge transfer between the old and the young?

Casey Mulligan:
It's something I tried to quantify in March 2020. I wrote a paper both about the closed schools where people are formally learning from older people called teachers, but also for the informal learning that happens at work, which is also very important. It doesn't go in the schooling statistics. And that was a big loss. I estimated that half of the productivity growth for that cohort of people who were age 20s when the COVID came, they wouldn't get.

They'll always be a little bit behind. It's like missing a grade in school. I deal with a lot of young people in my job and I always urge them, "Take that job that's in person and put it on your resume that it was in person so that your next boss knows that you actually learned something rather than being a square on one of these screens."

Larry Bernstein:
Casey, what are you optimistic about?

Casey Mulligan:
I always had a lot of confidence in the American people, generally. When we had that Obama stimulus, I was frustrated that the academics didn't realize the problems with it, but the regular people did. And you saw a wave in the 2010 elections. So, I think people understand that some of these policies have gone too far off of the middle way. We saw that in Virginia, and I think we'll see that nationwide. And that's ultimately the strength. If I've got to choose between the people being wise, versus a few of the experts being wise, I'll choose the people, because the people are in charge in our country, as they ought to be. And so I continue to be optimistic as I have been my entire career. And the American people maybe don't have the technical expertise, but they have a lot of sense. And they can understand the big picture. And when they're given an opportunity, they generally push our policies in a better direction.

Larry Bernstein:
As chief economic advisor during the Trump administration, you were responsible for writing the annual economic report of the president. How do Biden's economic reports differ from yours?

Casey Mulligan:
Well, it's a big difference. Now I think a lot of the difference between our reports and Biden's is more that the Trump's reports were so unusual, historically. We applied economics over, and over, and over again. We have more supply and demand analyses in our economic reports than the entire history of economic reports. We use supply and demand for drug addiction, homelessness, energy. We had used it for vaccine innovation before there was any pandemic to vaccinate against.

Larry Bernstein:
Why do you think the Biden's Administration's Economic Report of the President reverted back to its previous incarnation?

Casey Mulligan:
They didn't serve special interests. A lot of special interest got angered, especially special interests within the government. To say that the FDA is a problem when you're running the government, of which the FDA is a part; to say that human, health and human services made big mistakes around opioids. Only a Trump-type of character would allow that stuff to be said. And we, the staff, realized that this is an opportunity to say things that haven't been said before.

I mean the other part would be that this is a different party in charge. They have a big emphasis on monopsony in that report, that the reason wages are low is because people, in effect, live in a one company town and they have nowhere to choose from. Totally opposite of what you and I have talked about.

It's a very Marxist emphasis. Marx really liked to describe the economy as a one company town. Your choice is to work for the man or starve. And he liked to boil it down to that choice as if it were slavery. That's their conceptual framework in a lot of that report. And I think it's terribly misdirected. Human capital, the knowledge, health, the kind of things that you and I talked about today -- those are the things that raise wages. And when you don't have them, you have low wages.

Talking about the one company town is an entire distraction. I guess it justifies some additional level of regulation and maybe that's what they want.

Larry Bernstein:
In this week's Wall Street Journal, you have an op-ed about the role of firms that work for your health insurance companies that are responsible for drug distribution to patients. What were your key insights?

Casey Mulligan:
They're called the pharmacy benefit managers. Trump called them the middlemen. A lot of people, Democrats and Republicans, call them middlemen because they don't make the drugs, they don't have a retail outlet to hand out the prescriptions to the patient. They are in the middle. They've created competition where there really would be very little competition. They get the few drug companies we have, they get them at each other's throats while offering very big discounts. Especially on the older drugs that are far from the innovation stage of things.

It really helps save patients money but most important, encourages utilization. That's how they get the rebates. They go to the drug company, and they say, “hey, if you give us a good discount, we will make sure people will take your drug when they need it.” And they say that to the other drug company that's competing against, and as a result they get some great discounts and big utilization.

So many of these new drugs are lifesaving drugs. And you get people utilizing them. That saves on hospital costs, makes people healthier. It's almost like the market bootstrapped itself into competition. We have these patents there that are stopping competition, and the market figured out a way to create it anyway.

Larry Bernstein:
Drug prices differ around the world. I was in South Africa and my daughter needed a specific drug and it cost a small fraction of the price as in the US. This has been a hot political issue that American pharmaceutical firms price discriminates based on the country you live in. And it seems that most frequently the American government and American consumer subsidizes people offshore. Is that true?

Casey Mulligan:
Europe doesn't have these middlemen; the patients and plans don't need to hire somebody to get them a deal because the government has already put a price control on it. Their generic market is now very healthy, later in the drug lifecycle. I mentioned the stage of the drug lifecycle because the innovation happens upfront. It's an investment decision, like any other industry. Should we spend the multi billion dollars to try to discover a better treatment for this condition? The rate of return on the new drugs are really important for that innovative process. And the Europeans really legislated away any return on that. It's a theft of intellectual property. The Chinese will come and just take our formula if they can, whereas you're not going to be able to get much money for your formula in a European country. One of the things Europeans have had to deal with is they get the new drugs later. The companies aren't in a big hurry to roll out their new drug in Europe when there's not going to be much revenue for them. So, I think they get drugs about three years later. They got the vaccine about six months later. And it's not an accident.

Larry Bernstein:
Pre-COVID, the pharmaceutical industry was viewed in the political arena as charging egregious prices. And then with the vaccine, the public persona of the pharmaceutical companies improved dramatically when they successfully offered a working vaccine. What do you expect the pharma reputation to be post-Covid?

Casey Mulligan:
The pharma companies were headed for a very sweet spot as they really made this big problem a lot more manageable. And they did it in a hurry. From an image perspective, I think I'm worried that they overshot it, that now they're getting the vaccines for the kids and encouraging that they be mandated. It gives the perception that the companies are trying to use our public policy to pad their bottom line by expanding their market beyond where it merits expanding. We can debate whether it merits expanding, but from an image perspective, the pendulum's swinging a little bit back.

The marketing of the vaccine became a political thing. In fact, I'll take some personal blame for that. One of my career regrets is that when we did our analysis of pandemic vaccines before the pandemic, we talked about, the private sector needs to be manufacturing this stuff. They can do it quick. They can do it on scale if anybody can. Keep the government entirely out of manufacturing. I wish I had gone one more paragraph and said, "Keep the government out of the marketing," because the government is terrible at marketing.

Larry Bernstein:
What do the middlemen do in the pharmaceutical distribution? How do they help consumers and insurance companies provide you the maximum value of pharmaceuticals per dollar of insurance?

Casey Mulligan:
Coke and Pepsi's a good example. There's a little restaurant across the street from my house called The Maple Tree, and they've just got one restaurant. But they tell Coke, "Hey, Coke, if you give us a deal, everyone in this restaurant's going to have Coke." And they tell Pepsi, "Hey, Pepsi, if you give us a deal, everyone in this restaurant's going to have Pepsi." That really inspires a lot of competition. And they get quite a good deal. And more soda gets drunk.

The PBMs are doing the same thing around these drugs. They'll say, "We've got a couple treatments for this condition. Hey, manufacturer A, if you give us a great deal, you are the treatment that will be used on our members." And they say that to manufacturer B as well, and they really get them fighting it out to be the exclusive one. And that increases treatments for that condition, and it's much cheaper.

They also have a massive computer system. So, you can go to a lot of different pharmacies, and in their computer will be how much Larry owes based on his health insurance. And that's saved the patient a lot of time. They don't have to take the receipt home and mail it in to the insurance and get the check and cash it. That's been all cut out by the middlemen.

Alan Auerbach:
I'd like to start with a quote attributed to Will Rogers. “If you find yourself in a hole, stop digging.” The US economy recovered much more rapidly than was predicted in the Spring of 2020. And fiscal policies adopted early in the pandemic played a role, but expansionary fiscal policy was pursued too much and for too long. In particular, the American Rescue Plan Act enacted in March, 2021, when the employment rate had already fallen to 6% and real GDP had already recovered beyond its pre-pandemic peak, provided $1.9 trillion in additional funding and tax reductions including large direct payments to household and substantial aid to state local governments.

Why did we do this? I think there are three potential explanations. First, we were still uncertain about the direction of the pandemic. And just as we underpredicted the strength and speed of the recovery at the beginning, we were also pretty uncertain even in the Spring of 2021, whether we'd have a relapse.

Second, some of our leaders were plagued by recriminations about not having done enough in 2009, and third a purely political explanation. They were in control of both houses of Congress and the presidency for the first time in a decade. And they felt that this was the time to stuff as much as they could before they lost the opportunity to do so.

Whatever the reason that's where we are, what path should we pursue now for fiscal policy? Well, first do no harm that is stop digging. The debt to GDP ratio has risen from 80% of GDP before the pandemic to 100% percent now.

In the short term, we should try to reduce deficits through judicious spending reductions and tax increases. And the key here is to target demand and not supply that is seek policies that soften demand to help fight inflation but not restrict supply. This would also be a good time to address the long-term problems that have debt on an unsustainable trajectory. Entitlements: Medicare, Medicaid, and social security already account for more than half of the noninterest spending of the federal government. Do I think that this will happen in election year? Of course not, but the problem needs to be addressed at some point and the sooner the better, and we don't have a recession to blame for not taking action right now.

Fiscal policy bears some of the responsibility for the inflation that we are currently experiencing and good fiscal policy can contribute to its reversal. Thank you.

Larry Bernstein:
As your student in 1985, you taught us macroeconomics from a neo-Keynesian perspective. To minimize volatility, governments would implement counter-cyclical fiscal policies. More spending during recessions and less during growth periods. In retrospect counter cyclical policies seem politically impossible. In your opening remarks you tried to explain why the Democrats increased government spending by $1.9 trillion even when it was likely that were

already on a growth path. Do you think that countercyclical fiscal policy is impossible to implement in the current political environment?

Alan Auerbach:
When we're in a recession, they can increase spending and cut taxes. Governments don't have trouble doing that. It's much harder to have tax increases and spending cuts to relieve the inflationary pressure in the economy. It was true during the Johnson Administration when the economy was running red hot because of the Vietnam war, and it's been true in many administrations since then. And it's clearly gotten worse because I think the parties now are both seeking political advantage by giving things for their constituents. That doesn't leave a lot of room for responsible behavior.

We're relying a lot more heavily on the Federal Reserve to do all the work. And as we've experienced over the last year, the Federal Reserve's not perfect either. To give them the benefit of the doubt they were in a new situation a year ago, how much of it was due to supply shocks and temporary factors and how much it was due to a permanent underlying strength in the economy. It would be better to have fiscal policy playing a role as well. But I think unless it's automatic stabilizers, tax increases that happen because profits and incomes are higher or unemployment benefits going down because fewer people are unemployed. Those things continue to function perfectly well as countercyclical policies, but they're automatic. Discretionary fiscal policy when tightening is needed is not really alive.

Larry Bernstein:
Well anchored inflationary expectations is a valuable public good and that now seems to be at risk. Have inflationary expectations already become unanchored?

Alan Auerbach:
We had very good monetary policy for a long time of keeping inflation expectations well anchored. Everybody's talking about losing that anchoring of expectations. If you look at the implied break-even inflation forward inflation rate in the TIPs market at five and 10 years, it's going down in the last several weeks and it never got that high, it's about two and a half percent, five years out about 2.3%, 10 years out. That's higher than it was. It was about one and a half percent before the pandemic, but it's not like we've had in 1979 or the early eighties. If we didn't do anything about it and adopted unhelpful policies like wage and price controls and things like that. I think we could get ourselves back into that dark period, but I think we've got a while to go before we get there.

Five and 10 implied inflation expectations have gone down in recent weeks precisely because the FED not only took a substantial action in its last meeting, but it implied very strongly that it was going to continue doing that.

Larry Bernstein:
The labor market is incredibly strong. There are 11 million unfilled job openings. How will higher interest rates impact the job market, and does the strong labor market make the FED's job harder to slow down aggregate demand?

Alan Auerbach:
I find the current labor market numbers puzzling. To think about how much the labor market tightness is feeding into inflation, you need to have a good measure of where we are relative to a normal non-accelerating rate of unemployment or the NAIRU or what we used to call the level of full employment. And by some measures we're there, 3.6% unemployment rate. That's pretty much where we were just before the pandemic, when the economy was humming along by long by other measures. The labor force petition participation rate's still a bit low, although it's recovered a lot, but you look at job vacancies and it's absolutely crazy.

And by that measure, you're way beyond any conceivable level of full employment. Perhaps that's the most informative in terms of labor market driving inflation.

Larry Bernstein:
The FED wants to reduce inflation and they are increasing short-term interest rates. The Eurodollar market sees the Fed's raising rates to 3.5% by next June and then the FED is expected to cut them back down. Do you expect a recession?

Alan Auerbach:
The FED is hopeful. Other people think it's pretty unlikely we'll avoid recession. The housing market is traditionally where you'd expect to see the action. There's unbelievable housing demand, which is driven prices up during the pandemic. I won't be at all surprised if the interest rate increases go beyond three and a half percent. We would have to be very lucky to be able to stop there.

Larry Bernstein:
You mentioned in your opening remarks that you wanted to increase aggregate supply. What policies can the Biden Administration adopt that would increase supply?

Alan Auerbach:
To the extent that we have tax increases, we stay away from discouraging economic activity. I am not a big fan of increases in business taxes right now. If there is going to be any legislation this year, which now looks pretty unlikely that's where the tax increases would likely be. And that's unfortunate given that there are already built-in tax increases coming in this year and in the years to come from the jobs act, which had all these temporary provisions and 2022 was a key year in terms of reducing incentives for investment requiring amortization of R&D and tightening interest deductibility and so forth.

I certainly wouldn't go beyond those measures and add additional business taxes. And that's what I'm thinking about when I'm saying don't try not to restrict supply.

A carbon tax just because as an economist to main maintain good standing in the profession as the way we should be doing environmental policy. And give us some revenue at the same time.

Larry Bernstein:
President Biden has proposed the opposite of your suggestion, a pro-carbon tax policy. He mentioned that he wants to reduce the Federal tax on gasoline.

Alan Auerbach:
I could live with phasing the carbon tax increase in rather than doing it immediately. A temporary reduction in the gasoline tax. The last time I remember that being proposed was during the summer of the 2008 campaign when Hillary Clinton and John McCain both proposed doing it. And Barack Obama rose in my estimation by refusing to go along. Gasoline prices are temporarily high because of the Ukraine war. Introducing a carbon tax, even at a very small rate, just as a signal that we're going to be moving in that direction, I think would be a very beneficial thing to do.

Monetary policy is going to be by far the most important thing we can do. And labor market measures to encourage people to work.

Larry Bernstein:
Can you believe there are 11 million job vacancies?

Alan Auerbach:
I don't know what to think about it. The pandemic has made economists humble in many ways; the different indicators of the labor market don't mesh the way we usually see. As the economy softens, we're going to go through a period where the labor market begins to look not weak, but normal. My guess is the unemployment rate's not going to rise that much. Demand for workers is going to soften somewhat. So those huge number of vacancies is going to go down and we'll see something closer to balance in the labor market. It would take a really big drop in demand and interest rate increases more than three and a half percent for us to go to a situation where firms start shedding a lot of workers.

Larry Bernstein:
The current political forecast is that Congress will be majority Republican after the midterms. Do you think there could be a political compromise that would reduce government deficits?

Alan Auerbach:
If I were to put my optimistic hat on, Biden has the ability to talk to Republicans, he's shown that. The parties have painted themselves into corners and it will be hard to come out and meet Republicans, say no tax increases. Democrats say no spending cuts and it's pretty hard to have a policy that soften demand if you take those two things as given.

In a really terrible recession or runaway inflation, but short of that it's hard to see much happening.

Larry Bernstein:
In your academic research, you focus on entitlement reform. Do you think we have any chance of any changes to Medicare or social security to get these programs on a sustainable path?

Alan Auerbach:
What a good entitlement reform measure would look like, it would have a lot of advanced notice the way the 1983 social security changes had those increases in the retirement age done phasing in. We could be doing that now.

Larry Bernstein:
I've always thought that we would pay the entitlement programs if society could afford it and we would not if we couldn't. Why not change entitlements to be linked to nominal GDP instead of CPI so that it was honest about payment.

Alan Auerbach:
Who should be bearing the risks? The demographic risk of these programs, what the productivity growth rate is going to be, what mortality rate is going to be. And there's certainly argument for sharing that risk. That is not all of it should be borne by the retiring generations. One of the arguments for putting some of that risk on younger generations is that they have more years to make it up. You don't go to an 80-year-old and say bad year too bad for you.

There's a benefit to not to waiting because people don't save enough for retirement, but we certainly want to give them every encouragement to do so. And if their benefits are going to be lower, we want to give them every opportunity to stay in the labor force longer.

I was on a National Academy's panel some years ago. We issued a report six years ago that considered having an increase in the normal retirement age. One of the disturbing things that's happened in recent decades is the life expectancies have diverged. Life expectancy depends a lot on income distribution. It was always related. That is more affluent people always lived longer but it's become much more significant than it was.

Telling a person who's going to die in his early seventies, that the retirement age just went up from 66 to 69. You're cutting out a lot of his benefits and others not so much. And one of the policy ideas we talked about was having an income linked retirement age, if I were working in manual labor, I probably have a lower life expectancy too. One modification of our formulas could be to have a reduction in benefits that would be bigger for people who are living longer.

Larry Bernstein:
Alan, what are you optimistic about?

Alan Auerbach:
I have some hope that the economy is going to come out of the current situation without a serious recession. I'm somewhat hopeful that mixed government starting in 2023 that the two sides see their way forward to making some compromises in the fiscal area as well as other areas.

Larry Bernstein:
Thanks to John, Casey and Alan for joining us today. That ends this session.

If you missed last week's show, check it out. The topic was eyewitness accounts of the Highland Park Massacre. The speakers were my brother-in-law David Baum and his daughter Brittany Wroblewski.

David and Brittany were present when the shooting started. David is an OBGYN and when the shooting stopped, he ran to assist the victims. You will want to hear his descriptions of what happened and what can be done about it. Brittany will highlight what it was like for a young mother to have participated in the parade and then to have run for her life.

I would like to now make a plug for next week's show.

Our first speaker will be Michele Margolis who is an Associate Professor of Political Science at the University of Pennsylvania. Michele has a new book entitled From Politics to the Pews: How Partisanship and the Political Environment Shape Religious Identity.

Our second speaker will be Julian Zelizer who is the Malcolm Stevenson Forbes, Class of 1941, Professor of History and Public Affairs at Princeton University. He has a book entitled Burning Down the House: Newt Gingrich and the Rise of the New Republican Party.

You can find all of our previous episodes and transcripts on our website Whathappensnextin6minutes.com. Replays are also available on Apple Podcast, Podbean and Spotify.

Thanks to our audience for your continued engagement with these important issues, good-bye.