IlLUminate Blog Transcript: **Ahmed Rahman Explains Inflation**

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ANNOUNCER: 00:01	[music] This podcast is brought to you by ilLUminate, the Lehigh Business blog. To learn more, please visit us at business.lehigh.edu/news.
JACK CROFT: 00:12	Welcome. I'm Jack Croft, host of the ilLUminate podcast for Lehigh University's College of Business. Today is August 24th, 2022, and we're talking with Ahmed Rahman about what's driving inflation in the United States and around the world, and who benefits and who loses when inflation is high. Dr. Rahman is an associate professor of economics in Lehigh's College of Business who holds the Charlotte W. & Robert L. Brown III '78 Summer Research Fellowship. He also is a research fellow at the Institute of Labor Economics. His research areas include economic growth, economic history, immigration, and the economics of education. Thanks for being with us again today, Ahmed.
AHMED RAHMAN: 00:58	Thanks, Jack. A pleasure as always.
CROFT: 01:00	Now we're going to talk about inflation, which is ravaging economies around the world. So let's start from a global perspective, and then we'll zoom in on what's happening in the United States. But in Turkey, I just read this week, the inflation rate is approaching a staggering 80%. Eurozone inflation reached a new record high of 8.9% year on year in July, and the banking giant Citi is forecasting that inflation will top 18% in the United Kingdom in January. So what are the main factors contributing to rampant inflation on a global scale?
RAHMAN: 01:40	Yeah, well, let's start with something cheery. Inflation is often accompanied by things like war and disease. [laughter] So guess what? We are sort of facing similar things today. Let's take war. So you know Ukraine is the world's eighth biggest wheat producer, right? And it's now facing Napoleonic war-styled blockades. So that's not helping matters. Russia is the world's third biggest energy producer, and it's now sort of threatening 1973-styled embargoes and preventing exportation of that energy. So that's not helping matters. Now, those things make it not very shocking to learn that nearly three-quarters of the Eurozone's inflation is attributable to this rocketing energy and food prices, and that's exacerbating energy and food prices around the world. That's not the only thing of course, right? So that's the war part. What about the disease? Well, look, countries around the world generated this huge stimulus to combat the economic shutdowns from COVID. And the problem is because they failed to properly rein these in as the epidemiological dangers have subsided. And so what we have generally is a consequence now where we have this global demand for goods and services that, so far at least, it really overwhelms the global ability to produce and provide those goods and services. And that is the fundamental problem that I think continues to plague much of the world.
CROFT: 03:10	Compared to what we were just talking about in other parts of the world-- compared to what's going on there, how has the U.S. fared in handling inflation?
RAHMAN: 03:22	Yeah, well, I would say it's mixed. [laughter] It's not great. So the first part, I guess, would be on the fiscal side, right? We can look at the fiscal side. And were they responsible? And the fiscal policy is never really directly responsible because they're

not mandated to consider inflation. But I would have to say that the fiscal side made things worse. That seems clear. So, take the Inflation Reduction Act, for example. Now, there's some great things in this bill, but the title seems rather Orwellian to me, right, because it's a bill that's focused on green stimulus. However one might feel about the environmental benefits of the bill—and look, there's a lot of things in there that I think moderates to progressives can really get excited about—but stimulus typically stokes inflation. It doesn't tampen it down. Now, admittedly, there are disinflationary effects that probably will come from this bill, but those are going to take years to manifest themselves, right? So if anything, this bill is going to go in the other direction. On top of that, you've got these governors, many governors around the country. They're sort of trying to outdo one another in providing tax breaks to their constituents. Now, ostensibly, this is to help people afford basic purchases, right, in the wake of these explosive price increases. But in reality, these sorts of measures can only-- often, just help fuel further price increases by raising demand further. And that can make things potentially even worse.

RAHMAN: 05:08

So to me, these governors are sort of kind of killing us with their kindness. So sometimes, tell them, "Don't be so nice to us. This is not your purview." And so this is just some examples of how fiscal policies in this country have potentially made things worse. Of course, things could always get even worse. There was talk from the administration of potentially freezing prices and wages. I'm glad to see that they did not succumb to those kinds of baser instincts. But it also highlights why inflation fighting in the first place really should be left to those who are kind of immunized from the concerns of the political cycle, right? Should be left to those who aren't always running for office. And that's the central bank. That's the Federal Reserve. That's the group that really is responsible.

CROFT: 05:57

Yes. And along those lines, it occurred to me as you were talking about the governors who were all giving further tax breaks, my understanding is that a large portion of that has to do with all of the federal aid that they received, and so they all have these nice budget surpluses in a year that is a reelection year for many of them. So of course, they're going to be the heroes to the voters.

RAHMAN: 06:24

No, exactly, right? And in fact, we haven't given them the greatest incentives because this is money that will be taken away from the state if they don't spend it. [laughter] So now we have a situation where the federal government is actually incentivizing states to spend this money precisely at a time when, actually, we want to rein back the economy. Now, again, as I said, these were policies that were done past a couple of years ago in the heart of a crisis that we knew very little about. But we knew that it was devastating the economy in terms of jobs, in terms of employment, in terms of consumption, and in terms of investment. And so those things totally made sense in the year 2020. Now that we're in August 2022, they make exactly the wrong kind of sense. [laughter] So in one hand, we really can't blame state administrators for doing this individually, but this is a serious coordination problem, right? The federal government really should do whatever it can to try to rein in that spending without penalizing those particular states and leave the job of inflation-fighting really to those who are outside of, as I say, the political cycle, which is the Federal Reserve.

CROFT: 07:32

Right. And now, in terms of what you were just talking about, thinking back just a mere two years ago at how quickly things became just horrible in terms of almost all of us who are living today's lifetime, in terms of what we had seen and dealt with before and the massive hemorrhaging of jobs-- but here we are two years later, and we're basically where we were before the pandemic in terms of the unemployment rate. I'm wondering is that somehow [laughter] even making inflation worse? Or how do those two things work together or not work together?

RAHMAN: 08:23

Right. So they very much work, they affect one another in very intricate and sometimes super complicated ways. But we have to say that President Biden's-- the $1.9 trillion fiscal stimulus, right, was just passed in March, I think, of last year. And it added all this extra oomph to an economy that was already recovering pretty quickly after past multiple rounds of spending. And it actually brought the pandemic stimulus, right, the spending, to try to get those jobs back online. So 25% of GDP, which was absolutely the highest in any of the developing or developed world. So the White House hitting the accelerator, right, actually, I think brought those jobs back, had unemployment reach back down to areas that we thought were going to be sustainable. But as it turns out, that was, in some sense, an excessive stimulus that the Federal Reserve could have sort of counteracted by hitting the brakes. Precisely when that White House is hitting the accelerator, the Fed should actually go in the other direction. And in that way, the hope is you end up with a healthy economy with jobs that are sort of sustainable, but at the same time, prices are not exploding out of control because people are demanding all these goods that our supply constraints are limited in terms of what people want. So basically what happens, yeah, we have this job creation. It looks like we're back to normal. I don't think we're back to normal. I think we've exceeded in many ways what the longer-run output potential is for this country. And so that's where, on the one hand, you see really good signs, right? Job growth, being very robust. Yet, at the same time, it's actually contributing to price increases more and more.

CROFT: 10:15

Now, are there any other major factors, again, specifically for the U.S., that are either helping to drive up or hold back inflation?

RAHMAN: 10:26

Yeah, I mean, so maybe let's think about inflation hitting specific areas. The three where inflation continues to sort of accelerate these days are food, housing, and sort of used vehicles, right? And there's some relatively unique features about our current inflationary climate that actually drives each of those things. Food, we discussed a little bit earlier. War and supply chain nightmares are definitely contributing to that. Housing is interesting. Housing costs continue to rise. And much of this, I think, is this rising demand for sort of home life, home amenities. I've heard some call it the quote-unquote, "Virginia Woolf effect". Virginia Woolf said, "Every author needs a room and some space in order to write." Most of us aren't authors, but we are increasingly looking for that space to work in our homes. And so our demand for home life is sort of, is shifting accordingly as the working from home revolution sort of plays out, right? So we're spending more and more time in our homes. We want those homes to be more comfortable, more spacious, more full of stuff. And so we're seeing soaring real estate costs both in terms of more rents and prices, values of homes, even as office spaces remain empty. And that adjustment continues on, and that's exacerbating inflation as well.

RAHMAN: 11:43

And then, of course, the global chip shortage, right? That's the primary reason used cars are so expensive right now because limited productivity and availability of new vehicles. Chips are in demand for old vehicles, and there's only finite supply of those. And prices of used cars are really, really rapidly rising. These are demand-supply imbalances for goods. And there's some hope that those should resolve themselves relatively soon. We've actually seen some good news in terms of falling food prices. Food and Agriculture Organization index, they have an index of global food prices. And that's plunged actually in July and August. And so those effects hopefully will show up in grocery markets, supermarket isles in a few months. But there remain these imbalances when it comes to services in particular, right? Again, I don't know if you heard. There's a variety of jobs and services that continue to be unfilled. But the demand for those services have continued to rise. And even if those positions are being filled, actually, it turns out workers may not be that particularly productive in them. Now, Jack, you and I, I'm sure, would never be accused of something like this, but I've heard this trend called 'quiet quitting.'

CROFT: 12:58 I just heard about that this week as well. Yeah.

RAHMAN: 13:00 Yeah [laughter]. So quiet quitting, just kind of like showing up and I guess doing just the bare minimum, right? You got a job, but not really. You're not really doing anything. So if more and more people are doing the so-called quiet quitting-- and again, you can't blame a lot. I mean, they're burnt out. They are sick and tired of the sort of hustle culture that's been sort of permeating that they've been going through over the last few years. But this is going to be tough to fight inflation when inflation is too much money, chasing too few things. And we're not going to be able to have those things if we're not making those things, right? And a lot of those things include services. So this is just yet another headwind that we're facing. It's still unclear how this is going to play itself out.

CROFT: 13:42 I want to move now into that area of who's benefiting, who's losing as a result of inflation. And I think exhibit A for most people are the oil and gas producers who have made record profits this year, and their stock prices have far outperformed the rest of the S&P 500 this year. So some are calling it price-gouging. Is that what it is? Or is there something more complex than that going on here?

RAHMAN: 14:13 Yeah, well, Jack, maybe you won't be that surprised if I say, "Yeah, it's a little more complex." [laughter] But it's not to say that the argument of price-gouging is entirely without merit. I mean, inevitably, you're going to have some firms that are going to benefit a lot. We've actually quite literally heard about the evidence in these earning calls, right, where CEOs are saying, "Hey, this inflation is actually helping us big time in terms of our bottom line." And in some ways, it's inevitable when you sell a product whose price is rising and whose price demand is fairly inelastic, meaning that consumers, they don't tend to substitute away from the product when the price goes up. And hello, that's energy in a major way as well as some other products that simply people won't be able to move away from even if prices rise, right? But at the same time, there are some structural things that creates a situation where it looks like these firms are benefiting when in fact it's not much they can do in terms of living with those price increases. Supply response is one thing. Energy supply responses tend to be inherently sluggish, right? Just drilling-- I mean, it just takes a long time to set up the infrastructure to do it.

RAHMAN: 15:26 On top of that, demand for oil and gas is a lot bigger in Europe than America, and that's fostering a lot of exports to Europe, OK? So that's simply the product goes where the demand is, but it's exacerbating our price increases here at home, right? So on the one hand, while some companies are certainly probably taking advantage of this inflationary background to kind of exploit their monopoly power, there's always this debate, "Should the administration or Congress-- should we name and shame some of these companies?" So far, I don't think they've really done that, and I hope they don't. Because maybe that's politically expedient, but it typically doesn't do much to create disinflation in the economy, right? I'd rather see policies that curb that market power in the first place, so those companies wouldn't be able to exploit those price increases rather than actually sort of name and shame the companies now, after the fact. After the government, in some ways, has given them, those companies those monopoly powers. So is it any wonder that they're going to be benefiting so much from price increases since in many respects, there's only a few companies. There's not a lot of competition.

CROFT: 16:29 Now, besides the energy industry, who else or what other sectors benefit when inflation rates soar the way they have in the past year?

RAHMAN: 16:39 Yeah, so I think one thing is sort of textbook, something I hope to teach later in the semester, is one group that surprisingly can benefit are debtors. The size and extent of this inflation has caught nearly everyone off guard, right, last couple of years. So people who borrowed money before 2022 are now finding their debt burdens a bit lighter, right? Their interest rates that they had locked in are going to often be much smaller than at the rate at which current inflation is lowering the value of these interest payments. So because to most of us, inflation was a surprise, it turns out lenders set their rates too low, right, as it turns out. So as a consequence, many lenders now look like they're paying their borrowers to take their money, right, which, whoopsie, that's not something they intended, but that's simply one of the consequences of unanticipated inflation. So those with fixed mortgages or student loans, yeah, they are somewhat shielded from the more problematic aspects of inflation due to their lower debt burdens. There's a silver lining. If you owe money, you don't owe quite as much money.

CROFT: 17:51 And then there are others, other than debtors, who are in some way benefiting or at least are not being harmed as much by inflation,?

RAHMAN: 18:03 Right, so again with the debtors-- and again, people sort of always make these sorts of bets on the economy. Again, we just said certain companies, they're going to benefit. And let's face it. There's going to be more wealthy individuals in the economy who will be able to shield themselves from inflation far better. So while they're not winners, they're sort of, at least relatively speaking, right, better off as opposed to those who cannot shift their burdens. So those who, for example, spend most of their money on food or housing, right? Those two things that we talked about earlier, where inflation is going like gangbusters. And at the same time food and housing, yeah, that's something that we all need. But as a relative share of our income, those who're poor tend to spend the vast majority of their income on those things. And so they're really seeing their real incomes plummet a lot because of what they spend on. Wealthier people can shield themselves simply because as a fraction of what they make, they don't spend that much on those things where inflation is going up a lot. So that's, again, one of the more deleterious aspects of inflation is that it creates this sort of winner and loser scenario in the economy. It's bad from an efficiency perspective, but it's also bad from an equity perspective as well.

CROFT: 19:26 And are there any other sectors of the economy or population groups that are predominantly harmed by these high inflation rates?

RAHMAN: 19:38

Yeah, as someone who just moved away from the public sector to the private sector, [laughter] I'd have to say, "Uh-oh." Right? Because un-unionized and private sector employees, they're going to feel the pain of inflation more than their unionized or public sector counterparts since unions tend to have stronger wage bargaining power than individuals, and so they can kind of renegotiate the wage to combat the inflation. Public sector wages are inflation-indexed already, so you don't necessarily have to worry too much about those renegotiations because it's sort of built into the system. Those who don't have those kinds of institutions are going to be faced-- They're not shielded, right? And so that's another group of people that are going to be a little bit worse off. Older people, they tend to always lose out more than others because they tend to rely on these fixed incomes. Those incomes are typically not indexed to inflation. They have high medical expenses. Those tend to rise during inflationary times. So yeah, it is definitely, again, shifting the burdens to people who are already potentially weren't in a good place to begin with in 2020. And now we have this added dilemma for them.

CROFT: 20:50

Now, you'd mentioned a couple of times early on, as we were talking about the government response, the Federal Reserve, the nonpolitical part of the equation.

RAHMAN: 21:02

Or so they say. Yes.

CROFT: 21:03

Or so they say, yes, [laughter] always that caveat. What kind of grade would you give the Federal Reserve for how it has handled either restraining or managing inflation? And are there things that you think, steps they could have taken that they did not?

RAHMAN: 21:23

Yeah, it was interesting. My students just asked me about my grading policy just yesterday. [laughter] Well, I would say-- let's say - I don't know - C minus, maybe, which is not terrible, terrible, but man, they could have done a lot better, right? So for 30 years, central banks, they focused on so-called inflation targeting, right? That is, they're shooting for a specific rate of inflation, the rate of price increases, and almost implicitly makes a promise that that's the rate that's going to be, or at least they're going to do everything in their power to get that rate to that specific point. And I would have to say the Fed generally having the tools to stop inflation kind of failed to use them, at least in time, right? So now we have the worst overheated economy, which is our economy as a big rich economy, in those past 30 years. Now, what accounts for that? Well, again, as I said, the fiscal side definitely was making things a lot more heated, and the Fed failed to kind of offset that.

RAHMAN: 22:22

I think the other thing is, interestingly enough, the central banks around the globe have sort of been focused on other things. It's interesting. They sort of seem dissatisfied with just the work of managing the business cycle. It seemed maybe they want to take on more glamorous tasks, fighting climate change, minting digital currencies, things that central bankers typically don't focus on. And for the Federal Reserve, our central bank, the shift seemed apparent, for example, promises that it was going to pursue a sort of broad-based inclusive recovery, right, focusing on different segments of the population, those that were historically disadvantaged. Now, that rhetorical shift kind of ignored this idea that-- and we teach this in every macro class, including my own. The rate of unemployment where inflation will take off is not something that the central bank can directly control. It needs to monitor what the rate of employment is. And if the rate of employment gets too low, then it needs to tap the brakes. But that rate of employment really depends on the nature of the economy and the structure of society, neither of which is really a function of central bank policy, despite the rhetoric. And so I think, in some ways, the Fed lost its eye on the key goal by being a lot more-- let's just say thinking about these progressive policies, which again, you could be very much for. But maybe thinking about the central bank implementing those policies is not the best idea. So I think it's created a situation. The Fed got out of its lane. It probably should stick to its lane. And this is something of a mess that the Fed is only now trying to clean up.

CROFT: 24:07

Now there are signs that inflation hopefully [laughter] is peaking in the U.S. and elsewhere. What's your assessment of what lies ahead? Is there relief in sight for those who have struggled the most with inflation and, for that matter, for all of us?

RAHMAN: 24:25

Yeah, no, it's a great-- I mean, this is the big question. The real question, I think, is if inflation now at this point is sort of embedded in markets, meaning, "Is inflation going to be with us for some time?" Because our expectations are now that inflation will be with us for some time. [laughter] It's a self-fulfilling prophecy, and that's the danger of inflation being embedded is that it's very, very difficult to kind of ring that inflation out. Now, there's many hopeful signs that's not the case. As I mentioned, the food prices index seems to be going down. We know that energy and gas prices have fallen. And so those are the kinds of things that look good. However [laughter]—as an economist, it's going to be a however for me [laughter]—there are some not-so-great signs. So strip out energy and food, right, of inflation. In the Eurozone, that inflation then comes down to 3%, right, without the energy and the food. But in America, it's still 6.5%. So it seems that our inflation in this country is a lot more broad-based, which again, seems to suggest, "OK, there's a little bit more of the embedded type." It's also unclear how sensitive investors are to whatever it is that the Federal Reserve is doing. Again, in this case, they're raising rates. Well, how sensitive are firms and industries to those rate increases? There's some suggestion that they're not really changing their behavior all that much, and all that means is that the Fed will have to do a lot more rate increases in order to truly stamp out this inflation, which means potentially a lot more pain for us going forward.

RAHMAN: 26:01

And then, finally, maybe just looking at America's labor market, something I'm particularly interested in. Our labor market compared to, let's say Europe, is definitely overheated. Wages are growing kind of like 6%. Again, it sounds good, but when wages grow, prices grow along with it as companies need to adjust their prices, and then you end up with that terrible price wage spiral, potentially. So bottom line, there are some really good things on the horizon that would seem to suggest prices are coming down. But I think it will be elevated for the foreseeable future, at least for 2022, even as disinflation happens, meaning our rate of increases hopefully have tampered down and will go down. But I don't think we'll be down to the 2% for quite a long time.

CROFT: 26:47

And the way I usually wrap up is to ask if there's anything-- and we have talked about a lot here, obviously, but is there anything I haven't asked you about or about inflation that you think our listeners should be aware of?

RAHMAN: 27:01

Yeah, I mean, inflation is often-- basically hits us all. So we think about this in a very micro sense. I'm a macroeconomist. And so sometimes, I think about some of these bigger things. And one key thing to remember is, like our parents had taught us, breaking promises always has consequences, right? Maybe not immediately, but over time. So the Federal Reserve, which is our central bank, the most important central bank on the planet, as I mentioned promised us a stable and modest inflation of about 2%. And for a long time, they have been under-delivering. And now they are wildly over-delivering. This hurts lots of Americans, as we mentioned. It also hurts other long-term bond holders, foreign central banks, and governments who owe $4 trillion, for example, worth of treasury bonds, right? So what that might happen is they might put an inflation risk premium on America's cost of borrowing, and that would be bad for all of us. And then the other thing is, even America, the paragon of financial probity, breaks its inflation promise during tough times, I think there's worries around the world that lots of governments will do the same, right? So I think we have to acknowledge the fact that the U.S. continues to lead the world economy. So when the United States breaks its pledges, there are ripple effects around the world that come back to us in a negative way. And so I think the world just kind of waits to hear what policymakers in Jackson Hole, which is their next meeting, will say, and they wait with bated breath, and I wait as well.

CROFT: 28:37 Okay, I guess we'll all be waiting for that, so. [laughter] Ahmed, thanks again for being with us on ilLUminate today.

RAHMAN: 28:45 Yeah, thanks a lot. It's always fun.

CROFT: 28:48 All right. Some of Ahmed Rahman's recent work focuses on factors leading to economic divergence and convergence among nations, the effects of peers and teachers on college student performance, the impacts of different experiences and military service on private sector employment, and the wage and employment effects of immigration on native workers. This podcast is brought to you by ilLUminate, the Lehigh Business blog. To hear more podcasts featuring Lehigh Business thought leaders, please visit us at business.lehigh.edu/news. And don't forget to follow us on Twitter @LehighBusiness. This is Jack Croft, host of the ilLUminate Podcast. Thanks for listening.