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Economic Strategy

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Why high inflation is misery

High inflation drives down real wages.

The year 2021 saw the Biden Administration provide strong stimulus to the US economy. This stimulus was provided in terms of the large budget deficit of the "American Rescue Plan" plus the additional stimulus of the "Bipartisan Infrastructure Law".

The result of all this stimulus is that US unemployment in December fell to 3.9%. This is full employment on any measure. At this level of a low unemployment, the US economy is running out of people to give extra jobs to. Despite this, Biden's popularity has fallen to levels not seen for any US President since the early 1970's. How could this be?

The problem is that as unemployment has gone down, driven by large budget stimulus, that same budget stimulus appears to have driven inflation up. Inflation for the year to December showed a CPI increase of 7.0%. This is the number that appears to be driving Biden's popularity down.

Figure 1: US Misery Index

Source: Morgans

In Figure 1 we see the combination of inflation and unemployment shown together in what is called "The Misery Index". Back in the 1970s, when there was both high inflation and high unemployment, it was common for the media to refer to the total of both as The Misery Index. It appeared that both had major effects on electoral popularity, so the combination of both in a single index gave the observer a feel for the political sentiment at the time.

The level of the US Misery Index for December is 10.9%. This is a combination of the CPI inflation rate of 7.0% and the unemployment level of 3.9%. Looking at the chart shows us that the Misery Index is currently little better than the worst period of the pandemic in 2020. The Misery Index is also no better than the worst period in the US economy following the financial crisis in 2008. These high numbers give the feel for why political sentiment is so poor.

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It is easy to understand why unemployment has such a negative effect of sentiment. Still, why does high inflation also have that effect? Let us go back and look at a little bit of economics by perhaps the greatest economist of the 20th century, John Maynard Keynes. In 1936 Keynes published his classic work “General Theory”. In this work he discusses the problem of his time during the Great Depression. The problem is not inflation, but deflation. This means prices are not rising but are falling. The problem is that prices are falling, but wages are not. This means that the level of wages divided by prices is rising. Real wages are rising. As they rise, they are pricing labour out of employment. As real wages go up, more people get thrown out of jobs.

Keynes’ solution has appealed to politicians ever since. Keynes suggested that the government should spend money that it did not have. The Government should run a fiscal deficit. Keynes believed that this fiscal deficit would lift the price level. As the price level rose, then real wages would fall pricing labour into employment. As real wages fell, more people would get thrown into jobs. Keynes solution worked in theory, and it worked in practice. History has shown that Keynes solution was also extremely politically popular. Keynes’ solution was then frequently employed to boost employment during the recessions that followed over the next many decades. Of course, Keynes also believed that in economic booms, governments should run fiscal surpluses. This solution is less politically popular.

One problem about Keynes’ solution is rarely discussed. As a central part of how it works, it means that the increase in fiscal stimulus will drive up prices which drives real wages down. This problem becomes more apparent the bigger the fiscal stimulus is. This time around, the US fiscal stimulus of some 16% of GDP in 2020 and 11.25% of GDP in 2021 is the largest fiscal stimulus since World War II. The inevitable result of this fiscal stimulus was for it to work, it would have to drive real US wages down. Quite logically, if the budget stimulus was the largest since World War II, the fall in real wages would be one of the most dramatic since World War II. This is the problem we see displayed in the Misery Index. US CPI inflation caused by the fiscal stimulus, is generating declines in real wages. Those declines in real wages are causing misery. Misery is not politically popular.

It is apparent that the Biden Administration does not understand the problem. Up until and including January 2022, Biden has been promoting his Build Back Better program. Back in 1974 when this problem was previously experienced, the US Congress created an independent bipartisan organisation to look at spending proposals. This is called the Congressional Budget Office. In December the Congressional Budget Office looked at the Build Back Better proposal. An analysis of their work was published by the Non-partisan Committee for A Responsible Budget on 10 December 2021. The Congressional Office found that the full cost of the proposal over a 10-year period was $US4.73 trillion. They also found that the deficit impact including interest payments at the then very low level of bond yields was $US3.01 trillion. Clearly, this would have been a sensible proposal if the US was still in a position of major unemployment. This is no longer the case. US unemployment is now 3.9%.

Adding further fiscal stimulus at this time, can add no jobs. Adding fiscal stimulus can add significantly higher inflation. Adding more inflation just adds to misery. We are already learning that misery is not politically popular.

Reference:

Committee for a Responsible Federal Budget: CBO Estimates a Permanent Build Back Better, December 10, 2021.

The General Theory of Employment, Interest and Money, John Maynard Keynes, 1936.

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