RETHINKING INFLATION POLICY:
A TOOLKIT FOR ECONOMIC RECOVERY

ISSUE BRIEF BY **J.W. MASON** AND **LAUREN MELODIA** | OCTOBER 2021

The COVID-19 pandemic disrupted our economy in ways never before seen, but the extraordinary stimulus measures of the American Rescue Plan have set the stage for what could be a rapid recovery—with the right policy choices, and absent further upheaval from COVID variants. With continued public investment and support from the Federal Reserve, the economy could soon not only return to its pre-pandemic conditions but move past them into a historic boom. Already, tight labor markets are providing wage boosts for the lowest paid workers. Alongside this welcome development, however, there has been a moderate uptick in inflation, largely due to some industries that have not been able to raise production in line with renewed demand. Although this inflation is already subsiding, some have used it as an argument for curtailing public spending plans and abandoning measures to support investing in the recovery.

By examining the specific causes and characteristics of the inflation we are seeing during this unusual recovery and in the period of strong growth that may follow it, we can identify more appropriate policy responses than raising interest rates or cutting back federal spending plans—both of which would set back the economic recovery and have a disproportionate impact on low-wage and Black and brown workers. By focusing on supply constraints rather than on aggregate spending and wages, we can alleviate inflationary pressures while keeping the economy on a path toward strong growth and shared prosperity.

In this issue brief, we first explain how inflation is measured, and discuss several challenges with measurement that are particularly important right now. Next, we describe the various causes of inflation, identify the situations in which it is or is not a problem, and explain the current state of inflation. Finally, we offer a set of policy tools that can more directly address the specific sources of price increases.

WHAT IS INFLATION?

Inflation is an average of the price changes over a given amount of time for the array—or basket—of goods and services purchased by the typical consumer. At any given moment, different prices in various industries change in different ways and for different reasons: Prices may be rising steadily as workers' wage increases within an industry get passed on to consumers as higher prices; they may be rising because businesses have more market power and are able to charge more relative to their costs; a rapid price increase may reflect a sudden increase in consumer demand; and finally, prices may rise or fall in response to developments in global markets, with little connection to the dynamics of the US economy. Many of these price changes are due to temporary mismatches between supply and demand, and they can be understood as a temporary cost of adjustment to a new higher level of capacity. As an average of different kinds of price changes, inflation is a useful summary of the general trend of prices. But although looking at an average may be more convenient than looking at a long list of individual price changes for many different types of goods and services, we must remember that inflation represents the many various price changes that make it up, and that the headline inflation number alone cannot tell us the causes of inflation or which policies are best to address them.

MEASURING INFLATION

Inflation is measured by the Bureau of Labor Statistics (BLS) and the Bureau of Economic Analysis (BEA), which collect price data, survey consumers and businesses on their spending habits, and calculate the price of a basket of hundreds of goods and services that the average consumer purchases—from the cost of rental housing to the price of bread, for example. The price of a given basket is called the price index, and the percentage change in the index over some period of time is inflation. The BLS produces the Consumer Price Index (CPI) and the BEA produces the Personal Consumption Expenditures Price Index (PCE). There are some differences in the indexes—the formulas they use, how they weigh each item in the basket, and the scope of what they include. As a result of these minor differences, the CPI is on average 0.5 percentage points higher than the PCE.

The Federal Reserve sets a target rate of inflation that it believes is consistent with its dual mandate of price stability and maximum employment. Currently, the Federal Reserve assumes that the price index should increase by 2 percent on average. This means that periods of inflation below 2 percent should be followed by periods of inflation above 2 percent.

Measuring inflation is not straightforward: The basket of goods consumed changes constantly; goods are not always bought at their listed price; the quality of goods may get better or worse over time; and many of the items included in the price indexes do not have observable market prices at all. Inflation statistics must therefore be interpreted cautiously. At the moment, two measurement problems are particularly important.

1. ***Base effects***. While inflation is typically measured by comparing prices today to prices one year ago, calculating inflation in this way poses a problem during periods of economic volatility or crisis. This problem is called the "base effect." For example, the price of airline tickets fell by half at the height of the COVID-19 pandemic in the spring of 2020, then gradually returned to its pre-pandemic levels over the following year and a half. This means that if we measured the change in airplane ticket prices from a year ago to today, we would see a steep price increase, which would contribute to higher inflation. But that increase in inflation would be entirely the result of low prices a year ago, not high prices today (Konczal, Mason, and Melodia 2021).
2. ***Owners' Equivalent Rent***. Housing is one of the largest regular expenses for most Americans. In the price indexes, housing prices are captured as two distinct items: "Rent of primary residence" and "Owners' Equivalent Rent (OER)." While the cost of rental housing in the CPI and PCE is based on what renters currently pay, OER is based on what homeowners guess their house *would* rent for—it is not a measure of anyone's actual housing costs. This year, OER has risen significantly faster than rents—a reversal of pre-pandemic trends. OER makes up a large part of the price indexes—12 percent of the PCE (US Bureau of Economic Analysis 2021) and a full 25 percent of the CPI (US Bureau of Labor Statistics 2021a). If OER growth continues to accelerate, it will increase measured inflation. But that will not reflect any increase in the actual cost of living; changes in how much homeowners think they might hypothetically rent their homes for do not reflect the genuine problems of housing affordability.

WHERE DOES INFLATION COME FROM?

Prices for most goods and services are set by producers of those goods based on production costs and estimates of what the market will bear. The profit margin over costs, or the markup, is a reflection of a producer's market power. In any sector, when the demand for a good exceeds the supply, the price will increase until supply can catch up. In some sectors, supply adjusts quickly, but in others the adjustment requires an extended period of strong demand.

Inflation can have many different causes. It can come from:

1. ***Purchasing power rising faster than potential output.*** When total spending rises or falls, production will rise or fall with it. But there is a limit to how fast businesses can raise output, so if spending rises very rapidly, businesses will be unable to keep up with demand and will raise prices instead.
2. ***Rapid shifts in demand.*** Any rapid shift in demand between different goods (or in different parts of the country, or over time) is likely to result in higher prices, at least in the short run. If demand shifts suddenly for any reason, producers will not be able to keep pace and prices may spike until producers have time to adjust production to meet increased demand.
3. ***Increase in demand for inelastic goods.*** In some sectors, output can adjust rapidly, so an increase in demand leads to more production rather than higher prices. In other sectors, large-scale investment may be needed to raise capacity, or inputs must be ordered far in advance. When these inelastic sectors experience an unexpected increase in demand, they will be unable to raise production and will raise prices instead.
4. ***A high degree of market power.*** In some areas of the economy, goods are highly differentiated, and it is difficult for new producers to enter into the market. In these sectors, producers can set prices independently of their production costs because they lack competitors. Where demand is strong, prices may rise year after year.
5. ***Rising prices in global markets.*** The US economy is not self-contained—many of the goods and services we consume are imported, and even the prices of domestically produced goods, like oil, may be set in international markets. These price changes have no direct relationship with conditions in the US economy, but are sensitive to global conditions, tariffs and trade agreements, and complex distribution logistics.
6. ***Rising wages or other costs that are passed on to prices.*** In sectors where companies have little market power and where wages make up a large part of overall costs, changes in wages and the tightness of the labor market are likely to be passed on to final prices.
7. ***Negative supply shocks.*** A fall in the economy's productive capacity can produce a mismatch between demand and production. Disruptions to supply are normally temporary but may last longer in the face of ongoing or worsening crises, such as those related to climate change.
8. ***An expectation of higher prices.*** When prices rise steadily over a number of years, businesses come to expect that their costs and their competitors' prices will be higher in the future, and so set their own prices accordingly.

When examining inflation, it is always important to identify which prices are rising and why rather than rush to a one-size-fits-all solution. Rising prices are not necessarily a sign that the economy has more demand than it has the potential to meet, which is the assumption that motivates raising interest rates as the default response to above-target inflation. Supply problems in particular areas can push up overall inflation, without meaning that the economy as a whole is operating beyond its potential.

Depending on the source, inflation may or may not be cause for concern. While the media tends to present rising inflation as an urgent crisis, it is important to first decide whether it is a problem that calls for government intervention, before determining the best tools to manage it.

WHEN IS INFLATION A PROBLEM?

In modern economies, prices are always rising slowly. Under the gold standard, periods of deflation were as common as inflation, often accompanied by crises, panics, and periods of economic regress. However, since the US left the gold standard, prices have consistently risen over time—a shift that is closely linked to the development of the modern credit system, which allows purchasing power to grow in line with the productive capacity of the economy. As long as wages are rising alongside prices, rising prices should not pose a problem for the functioning of our economy. Indeed, moderate inflation is closely connected to the avoidance of deep depressions and steady economic growth.

Figure 1.

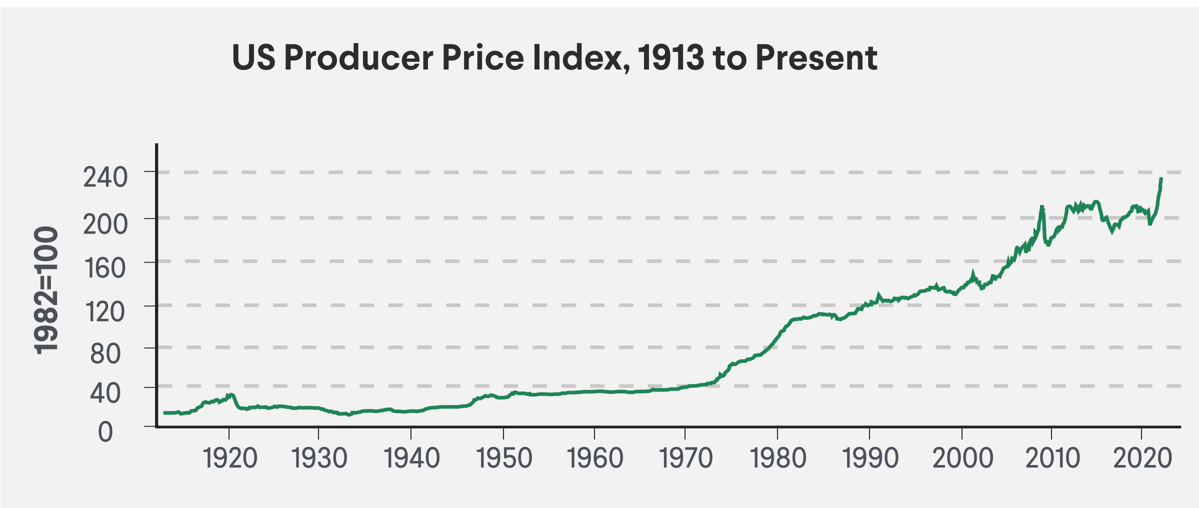

Figure 1 *shows the change in the Producer Price Index (PPI) since 1913. The PPI is the longest-collected price index in the United States. Figure 1 shows that the price index was relatively flat when the US dollar was fixed to the gold standard and has steadily risen since World War II. Source: US Bureau of Labor Statistics 2021b, and authors' analysis.*

Moderate inflation has several benefits. It encourages productive activity by making it more attractive to buy inputs at today's prices and sell something useful at future prices. It also encourages investment in businesses rather than financial assets, and it erodes the burden of debt—both for households and businesses, and for the public sector. Finally, it provides an important buffer to prevent the economy from falling into deflation, as it did during the Great Depression.

In addition, price increases are price signals, and should be understood as a sign that increased supply or reduced demand in a particular sector of the economy is warranted. If rents are rising, for example, we should understand it as a sign that either it is too difficult to build new housing or there is too much demand for housing in a few high-priced areas—or both.

Most textbook discussions of inflation policy assume that rising inflation is always a sign of economic overheating, which calls for reducing demand through higher interest rates or reduced public spending. In many cases, however, an uptick in inflation reflects not an overheated economy, but a temporary mismatch between supply and demand or developments in global commodity markets, neither of which call for any change in macroeconomic policy.

There are two situations where rising prices should be a concern and where policymakers should respond with appropriate policy tools (discussed in a later section) that address the specific causes of that inflation. Neither of the following two situations exist at the moment, though they might develop in the future. However, even when inflation is a concern, it does *not* mean that the right response is to raise interest rates or cut back public spending.

Inflation is a concern when:

1. ***There are persistent, across-the-board price increases.*** When inflation continues at a high level for a number of years, businesses and workers may come to expect that the new higher level of inflation will be permanent. Businesses will set higher prices if they think that their costs will continue rising and their competitors will also be raising prices, and workers may demand higher wages to keep up with the rising cost of living. Once an expectation of regular, across-the-board price increases gets locked in, it may be hard to reverse.

   There are a number of reasons why across-the-board increases are not a concern right now. Inflation expectations change slowly—it takes years of higher (or lower) inflation before they adjust significantly. Right now, survey and market-based measures of inflation expectations do not appear to be changing. The Cleveland Federal Reserve Bank's widely used measure of inflation expectations, for example, shows expected inflation over the next decade to be just 1.6 percent (Federal Reserve Bank of Cleveland 2021). Furthermore, persistent, across-the-board price increases can often be facilitated by employment or other business contracts that include automatic cost-of-living adjustments, which allow a price increase of one item to influence the prices of related items, including people's wages. These types of contracts are much less common today than they once were.

Today's high inflation is concentrated in a handful of sectors. However, if the US economy moves into a sustained boom—a highly desirable development—there may come a time several years from now when it is appropriate to worry about persistent inflation. When, and if, that happens, there are many more effective solutions than raising interest rates to cut off the boom.

2. ***It has a disproportionate impact on low-income and other vulnerable people.***

Higher prices, even if transitory, do raise the cost of living. This is a serious concern for the large number of Americans who already struggle to meet their basic needs. Price increases that impact basic necessities disproportionately harm lower-income households and thus need to be taken seriously, even if they are transitory. On the other hand, for goods and services for which price increases impact mostly higher earners or for items people can delay purchasing or find a substitute for if faced with price increases, it may be sufficient to wait for supply and demand to come back into balance on their own.

Over the long run, prices of goods consumed disproportionately by lower-income families have increased faster than overall inflation. A recent study by the Council of Economic Advisors found that lower-income families have experienced a higher effective inflation rate over the past 30 years due to the higher proportion of their spending that goes to childcare, rent, and health care costs (Council of Economic Advisors and Office of Management and Budget 2021). The study demonstrates the need for public policy that prioritizes price stability in these sectors. For example, since rent makes up a larger share of low-income households' budgets, increasing rent prices will have a disproportionate impact on low-income families. This situation would call for increased investment in affordable housing and measures to limit rent increases in areas where housing supply is inelastic.
The high inflation we are experiencing today, however, is coming from a different set of goods. Apart from gas, the biggest price increases are for things that are not

basic necessities and that higher-income families typically spend more on—new cars, travel, and restaurant meals (Mason 2021). While everyone should be able to travel and eat out, price increases in these areas cause less immediate hardship than price increases for basic necessities. Even when higher prices are hurting living standards for low-income families, however, raising interest rates is still not the best solution as it would directly slow growth and increase unemployment, which would disproportionately reduce incomes for Black, brown, and lower-wage workers (Thorbecke 2001; Bivens 2021a) while only indirectly influencing prices.

WHAT IS HAPPENING WITH INFLATION RIGHT NOW?

As of August 2021, annual inflation measured by the CPI stood at 5.2 percent (US Bureau of Labor Statistics 2021a), meaning that the average price of goods in the CPI basket was 5.2 percent higher than it was one year before. Inflation measured by the PCE has been running about one point below this (US Bureau of Economic Analysis 2021). The last time measured inflation was this high was in July 2008.

These numbers are partly due to the base effect. Prices for many goods and services fell between February and May of 2020, some very steeply, and so inflation has appeared high since February in part because prices have been climbing out of a deep hole. Measured as the change from a year ago, CPI inflation as of August 2021 was 5.2 percent—well above the Fed's 2 percent target. But measured as the annualized change since before the pandemic in December 2019, the inflation rate is 3.4 percent (US Bureau of Labor Statistics 2021a). Over half of today's excess inflation simply reflects the fact that prices a year ago were still depressed by the pandemic.

In fact, almost all of the variety of causes for the current high inflation numbers are directly linked to the pandemic. As non-essential businesses shuttered their doors in the spring of 2020 to prevent the spread of COVID-19, 9.6 million people lost their jobs. Many other people began working remotely (Parker, Minkin, and Bennett 2020) and prices of some goods and services fell. Many businesses, anticipating a slow recovery similar to the one that followed the 2007—2009 Great Recession, cut back on orders for essential inputs. However, unlike during the Great Recession, robust fiscal policy effectively maintained household incomes. As a result, when restrictions were lifted and employment began to recover, there was a surge of demand that many businesses were unprepared to meet.

SOURCES OF INFLATION DURING THE PANDEMIC

As shown in Figure 2 below, energy, automobiles, and a handful of industries directly affected by the pandemic account for *all* of the excess inflation this year.

Figure 2

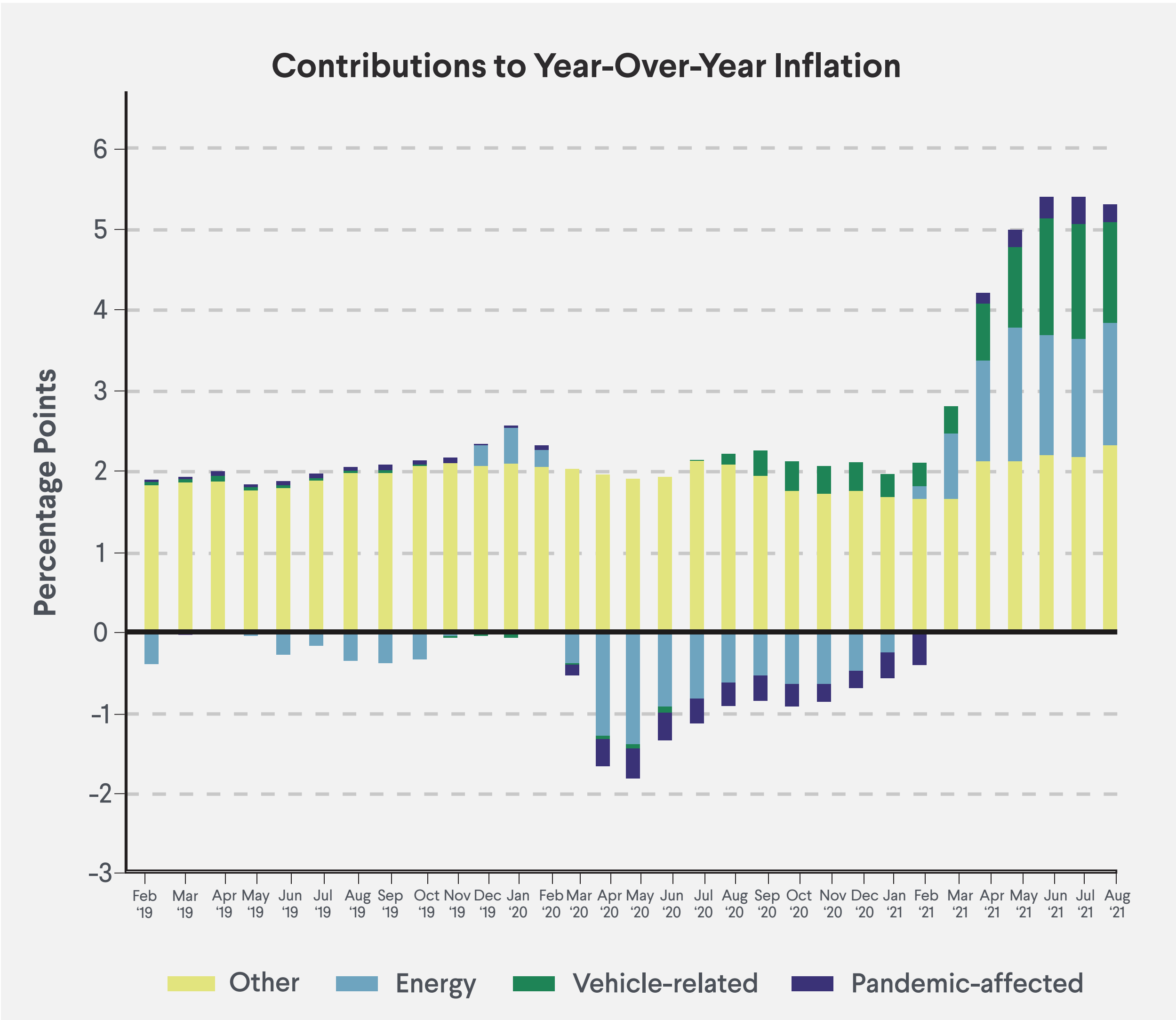

***Figure 2** shows groups of goods and services and their contribution to overall year-over-year inflation throughout the COVID-19 pandemic. Pandemic-affected goods and services consist of airfare, hotel accommodations, and admission to events. Vehicle-related goods and services include new and used cars, car parts, and car rentals. Energy includes gasoline, electricity and other utility services, and fuel oil and other fuels. The Other category is comprised of all of the other goods and services in the Consumer Price Index. While the Other category has remained fairly stable, experiencing the target 2 percent inflation throughout the pandemic, pandemic-affected, vehicle-related, and energy goods and services have been major contributors to the overall decrease and/or increase in the CPI during the pandemic. Source: US Bureau of Labor Statistics 2021a, authors' analysis.*

In some sectors, especially those related to travel such as airline tickets and travel accommodations, much of the inflation over the past year is the result of the base effect. As of August, for example, airfare prices were about 7 percent higher than they were a year ago—but almost 20 percent lower than before the pandemic (US Bureau of Labor Statistics 2021a).

In other areas, such as lumber and new cars, price increases are the result of supply chain bottlenecks and prior underinvestment. As has been widely reported, automakers sharply cut back orders for semiconductors and other essential components early in the pandemic, in anticipation of a much longer recession. When demand came roaring back this year, production was unable to keep up. Similarly, the sharp rise in lumber prices earlier this year resulted from the strong recovery in housing construction with limited capacity at sawmills—which occurred because the lumber industry had reduced its capacity following the 2007—2009 recession (Klein 2021).

Restaurant prices are similarly the result of pent-up demand. Spending at restaurants is one area in which spending fell most during the early days of the pandemic, and it is now rebounding rapidly. While rising restaurant prices might appear to be linked to the rapid wage increases in this sector, it is not clear that restaurants' labor costs have actually increased (Bivens 2021b). In any case, higher wages in this sector are a positive economic outcome. Food service is one of the largest low-wage industries in the country—as of 2020, food preparation and serving accounted for the majority of all minimum wage workers in the US (US Bureau of Labor Statistics 2021c)—and so higher wages in the restaurant industry are desirable as they would reduce inequality and boost economic growth.

Finally, energy prices are rising in part due to domestic supply-chain issues, but mainly because oil prices have risen. Oil prices are set in global markets that have little to do with domestic economic conditions. History suggests that spikes in energy prices are short-lived, with large rises followed by falls.

IMPACT OF CURRENT INFLATION ON LOW-INCOME HOUSEHOLDS

Today's price increases, concentrated in a few sectors, are affecting low-income families less than inflation usually does. Table 1 examines the consumption basket reported by households with pre-tax income below $30,000—about a quarter of the US population. The middle column indicates whether a given category of goods and services makes up more or less of low-income households' spending as compared to the overall population (according to the most recent Consumer Expenditure Survey, which surveys households about their spending and is used to weight the relative importance of each item in the CPI basket). A positive value indicates a category that accounts for a larger share of low-income households' spending, while a negative value indicates a category that accounts for a smaller relative share of low-income household spending. For example, rent of primary residence currently accounts for 8 percentage points more of low-income households' spending as compared to spending by all households, whereas new vehicles make up a lower share of low-income households' spending. The last column shows the year-over-year price change in each category. With the exception of energy, all of the items with the highest inflation—those listed in yellow—are ones disproportionately consumed by higher-income families. While inflation over the past 30 years has disproportionately impacted lower-income households, the inflation experienced over the course of the pandemic thus far is largely for items that lower-income households do not report spending as much on.

Table 1

Impact of Pandemic-Related Inflation on Low-Income Households		
Expenditure Category	Difference Between Share of Spending by Low-Income Households and All Households	Inflation, July 2020-July 2021
Rent of primary residence	8.3	**1.9**
Food at home	2.4	2.6
Electricity	1.5	4
Medical care services	1	**0.8**
Medical care commodities	0.35	**-2.1**
Recreation commodities	0.35	3.2
Water and sewer and trash collection	0.3	3.7
Education and communication services	0.2	**1.2**
Motor fuel	0.2	**41.6**
Utility (piped) gas service	0.2	**19**
Apparel	0.2	4.2
Motor vehicle parts and equipment	0.05	4.3
Fuel oil and other fuels	0.05	**30.9**
New vehicles	-0.15	**6.4**
Transportation services	-0.15	**6.4**
Lodging away from home	-0.3	**21.5**
Used cars and trucks	-0.3	**41.7**
Alcoholic beverages	-0.3	2.4
Food away from home	-0.35	**4.6**
Recreation services	-0.6	3.7
Household furnishings and supplies	-0.7	3

Table 1 *compares inflation as of July 2021 in specific expenditure categories with the relative share of spending in that category by households with incomes under $30,000. The items highlighted in yellow experienced the largest price increases over the past year, while prices of the items highlighted in blue increased the least. The middle column was calculated by finding the difference between the weight of each item in the CPI basket for all consumers and the weight of each item for households earning less than $30,000 per year as reported in the Consumer Expenditure Survey, covering July 2019 to June 2020. A positive value indicates a category which accounts for a larger share of low-income households' spending than all households' spending, while a negative value indicates a category that accounts for a smaller relative share of low-income household spending. The last column shows which expenditure categories saw price increases in July 2021 (compared to July 2020). Table 1 relies on two different data sources: the Consumer Price Index (for the inflation) and the Consumers Expenditure Survey (for expenditure shares). The categories listed are from the CPI; the expenditure shares are from the CEX categories that are the closest matches. Source: US Bureau of Labor Statistics 2021a and 2021d, authors' analysis.*

WHAT SHOULD WE DO ABOUT INFLATION?

When inflation is persistent and across the board or it disproportionately impacts low-income or other vulnerable households, it is necessary to take steps to control it. But rather than reduce spending across the board, as inflation policy has sought to do since the 1980s, it is better to identify the sectors of the economy that are responsible for rising inflation and address price increases in these sectors directly. In this section, we briefly discuss the problems with using interest rates as the primary tool for managing inflation, and then suggest a set of alternative tools that would address inflation directly at the source.

WE SHOULD NOT RAISE INTEREST RATES

Currently, the primary method by which the US government addresses inflation is the Federal Reserve raising interest rates. The goal of raising rates is to slow economic activity and raise unemployment, which often results in a recession. Raising the costs of new borrowing discourages investment, especially in housing, and the resulting rise in unemployment forces workers to accept lower wages. These lower wages are then passed on as lower prices. Lower incomes lead to less demand for goods and services, which may result in lower prices as well.

This strategy has had some success in limiting inflation. Most economists agree that the very high rates and deep recession of the early 1980s helped bring the high inflation of the 1970s under control. But over time, it has become clear that conventional monetary policy is much less effective at stabilizing demand than was once believed, while the costs of recessions and unemployment are much greater. This approach to inflation, which relies on hiking interest rates and raising unemployment, comes with very large costs, both for the economy as a whole and for the workers—disproportionately Black and brown, younger, and less educated workers—who lose their jobs when the overall unemployment rate rises (Mason, Konczal, and Melodia 2021). It is increasingly clear that responding to inflation by cutting back spending across the board is needlessly destructive and often fails to address the true sources of rising prices.

For the inflation we are facing today, raising interest rates would not only be premature but actively counterproductive. One key source of inflation today is the automobile industry's failure to plan for higher output. If strong demand is sustained, automakers will bring capacity back up and auto price inflation will subside. But if the Fed raises interest rates, it will discourage automakers from investing in the capacity to increase supply. Rather than restore production to its pre-pandemic levels, it would be a decision to keep society poor enough that we can only afford what businesses are currently able to produce. With time, supply will recover to meet demand; raising interest rates now would instead reduce demand to the temporarily lower level of supply, in effect locking in the disruptions of the pandemic.

Raising interest rates or cutting back on public spending now would also undermine the goal of achieving full employment. Sustained full employment plays a critical role in reversing the growth of inequality; narrowing the race, gender, and education gaps in employment; and drawing new people into the labor force. A major goal of full employment is to raise wages for low-wage workers, something it is impossible to achieve if we respond to rising wages in low-wage sectors, like restaurants, as a sign of overheating. We should instead see rising wages as a sign that labor market policy is working as intended.

WE SHOULD USE POLICY TOOLS THAT ADDRESS THE CAUSES OF SPECIFIC PRICE INCREASES

Taking a sector-specific approach to inflation can directly address price increases without the negative side effects of interest rate increases or cuts to public spending. Addressing price increases from the supply side also creates opportunities to boost productivity and to address other economic and social problems such as the climate crisis. The following strategies are responses to inflation that will address the true causes of inflation. Many of these interventions have been used successfully in the past.

1. ***Let markets work.*** If a price increase is due to a temporary mismatch between supply and demand *and* does not make a large contribution to the cost of living for low-income workers and households, the best response is to allow the market to work. When prices rise, businesses are incentivized to invest in their capacity, which will eventually result in increased supply that will stabilize prices.

   Example: Such an approach was successful in addressing used car price increases in spring of 2021. From March to April 2021, used car prices rose 10 percent, the largest monthly increase since the US began collecting used car price data. However, after three months of record price increases, used car prices stopped rising in July, and by August were actually falling. Consumers and businesses responded to the price increase signal by more quickly selling their own cars into the used car market, increasing supply. This, combined with pent up demand dissipating and price increases providing a signal to some consumers to wait before buying, was all that was needed to stabilize used car prices.

2. ***Identify and address sources of supply bottlenecks.*** Global supply chains, global trade rules, and climate-related disasters all contribute to bottlenecks in manufacturing today. They lead multiple sectors to face significant supply constraints, because existing suppliers further down the supply chain are unwilling or unable to raise output, and entry into the market by new companies is difficult. If a price increase is the result of supply constraint, the best policy tool is for the government to use its political leadership to facilitate the removal of the barrier directly or to use public resources to incentivize the growth of new public or private producers who can raise output in line with demand. When the government uses industrial policy to remove bottlenecks in production, it helps control inflation, boosts the capacity of our economy, and creates new jobs.

   Example: The supply of housing is uniquely limited by the fixed supply of land. This is exacerbated by land-use rules and other barriers to building denser housing. The construction of new housing and the maintenance of existing rental units and public housing has been on a downward trend since the 1970s (Bernstein et al. 2021). While labor and material costs may drive some of the increasing prices for housing, local zoning restrictions and municipal public policy have also limited the supply of new housing. To the extent that inflation is driven by rising rents, the focus should be on raising the supply of housing through incentives to build denser housing or investments in public housing construction and maintenance.

3. ***Identify and address sources of price markups.*** In industries where one or more companies have monopoly power, companies can raise prices regardless of increases to their cost of production because they have no or few competitors. In these instances, the best response to price increases is for the government to enforce antitrust laws, to crack down on illegal price fixing, and to use industrial policy to incubate new private businesses in the sector or introduce a public option. These policies can limit price increases while also fostering fair and competitive markets.

   Example: The Council of Economic Advisors (CEA) has monitored food prices during the COVID-19 pandemic and found that half of the increases in food prices since December 2020 were driven by the rising prices of beef, pork, and poultry products, which rose by 14 percent, 12.1 percent, and 6.6 percent respectively (Deese, Fazili, and Ramamurti 2021). According to the US Department of Agriculture (USDA), four conglomerates control approximately 55—85 percent of meat processing for all of these products due to increasing consolidation in the industry over the past five decades. Meanwhile, these companies have had some of their highest net income and profits in history since December 2020—while they have raised prices. Rising profits suggest that price increases have been driven by market power rather than higher costs. A key solution to rising food prices would therefore be to reduce the monopoly power of the food processors who are squeezing consumers and farmers.

4. ***Change the direction of credit creation.*** Historically, the Fed and other public agencies have used credit policy (rather than raising interest rates) to selectively channel credit to some parts of the economy in order to spur investment and increase supply, while limiting it to others. This can include directing lending to strategic export and capital goods industries, providing public investment in infrastructure development, and offering mortgages and financial assistance to first-time homebuyers, among other strategies (Konczal and Mason 2017).

   Example: Following the financial crisis a decade ago, and again during the pandemic, the Fed purchased a large share of mortgage-backed securities, helping to sustain mortgage lending (Frame et al. 2021). A Fed program to purchase bonds financing renewable energy projects and other green investments could increase the flow of credit into those sectors, speeding the transition away from fossil fuels. In the long run, a shift toward sustainable energy sources is not only essential to maintaining a habitable planet; it will also replace fossil fuels, which are a major source of inflation in today's economy.

5. ***Reform wage bargaining to deliver steady raises.*** Wage growth is not a major source of inflation today, but in a sustained boom it could be. Since the 1980s, the orthodox view has been that rapid wage gains call for action to raise the unemployment rate, so as to reduce the bargaining power of workers. This is a crude and destructive tool, which requires workers to be "traumatized" (in Fed Chair Alan Greenspan's words) to prevent labor costs from rising too rapidly (Mitchell and Erickson 2005). In a future with full employment, where everyone who wants a job can find one, we will need new tools to manage the pace of wage increases. This will require a larger role for workers and the public in pay-setting: When workers can bargain with employers as equals, they can demand other improvements in working conditions and benefits in place of inflationary wage increases. During World War II, for example, strong unions helped workers win major improvements in health and retirement benefits, allowing them to benefit from tight wartime labor markets without fueling inflation.

   Sectoral bargaining and wage boards can help deliver a steadily improving standard of living, rather than a chaotic race between wages and prices. Sectoral bargaining means that workers across an occupation, industry, or region—rather than at a single enterprise—collectively bargain over compensation floors and other benefits.

A wage board brings employers, workers, and the public together to negotiate wages and benefits for an entire industry. The same thing can be achieved more informally when the federal government uses its power as an employer and contractor to set wage standards for the broader economy. These tools are not just ways to increase wages for lower-wage workers and reduce income inequality; they also create the possibility of industry-wide planning and negotiation to guarantee that workers benefit from strong labor markets without setting off a wage price spiral.

Examples: The Davis-Bacon Act regulates wages and working conditions for contractors on federal construction projects, setting a standard for much of the construction industry. Similar standards could be applied in other areas where the federal government is a major contractor or funder, including health care, childcare, building services, education, job training, and the green economy. Such standards not only help pull up wages at the bottom; they also set a benchmark for raises in general, helping maintain a stable pace of wage growth. In countries like France, Germany, and Australia, unions are empowered to bargain for wages across a whole industry and not just with particular employers (Dube 2019). In Australia, a major argument for this system of centralized wage bargaining was that by maintaining steady growth in real wages, it allowed the country to combine low unemployment and low inflation (Baird and Lansbury 2004).

6. ***Regulate and negotiate prices.*** When prices are rising rapidly for basic necessities that people cannot delay consuming—like housing, food, and medical care—it may be necessary to adopt rules that limit how fast prices can rise or set a cap on prices. Alternatively, the government can use its power as a large buyer to negotiate better terms with suppliers, putting downward pressure on specific prices throughout the economy. In periods of crisis and national emergencies, the government has used its power to implement economy-wide price regulations, setting a ceiling on price increases for a wide range of goods and services. Economy-wide price regulations are unlikely to be called for in the contemporary United States, but there are many cases where the government can take action to limit price increases for particular goods and services. For example, a number of local governments in the US impose some form of rent regulation—not an absolute ceiling on rents, but a limit on how fast rents can rise.

   Example: Over the past 20 years, prescription drug prices have outpaced overall inflation, rising an average of 3.3 percent each year (US Bureau of Labor Statistics 2021a). In response, President Biden has called on Congress to give Medicare and the Department of Health and Human Services (HHS) the authority to negotiate the prices of 50 prescription drugs on behalf of Medicare providers and beneficiaries (Biden 2021). Giving the HHS Secretary the authority to negotiate these prices would help guarantee older Americans access to life-saving medication and produce significant savings for the federal government. Controlling drug prices in this way would also bring down inflation, especially if, as is likely, lower Medicare prices brought down prices for the industry as a whole.

CONCLUSION

Many price changes caused by different factors and in different sectors of the economy are behind the CPI and PCE headline inflation numbers reported each month. Rapid price increases may have many causes—there is no reason to assume they are a sign of economy-wide overheating. Traditionally, economists have seen rising inflation as a sign that steps need to be taken to cut back demand, either by raising interest rates or reducing public spending. But when inflation is mainly due to supply-side problems, as is the case today, these kinds of measures are counterproductive. They will slow, or even prevent, the recovery of the economy's productive capacity. Instead of raising rates or cutting back spending on vital public needs, we have tools to respond to rising prices directly that have been successfully used throughout US history.

At this stage in the recovery from the COVID-19 pandemic, inflation is clearly the result of temporary mismatches between supply and demand. It is imperative that we deal with it by speeding the recovery on the supply side, rather than trying to push spending down to match the lower level of production businesses are currently capable of. Much of the inflation we are seeing today will abate on its own as supply bottlenecks are resolved and businesses respond to higher prices by raising production. In other areas, such as housing and health care, rising prices are the result of long-standing problems of restricted supply and excessive market power. Here, the solution is public investment and policy changes to expand supply. Higher interest rates and fiscal austerity will not address any of these problems.

If inflation fears lead the Fed to raise rates aggressively or Congress to scale back or abandon the Build Back Better agenda, those policy decisions will turn today's temporary disruptions into a permanently weaker economy with higher unemployment and greater racial and income inequality. On the other hand, if policymakers recognize today's inflation for what it is—the short-term friction of a rapid recovery—then today's inflation may become a footnote to the story of a historic economic boom.

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