Economist Jason Furman Explains How Inflation Snuck Up on Us and What's Ahead in 2022

A conversation about economies, markets, wage inequality, Congress, crypto, and more.

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Jason Furman (LinkedIn photo)

Consensus inflation estimates going into 2021, which averaged 2.5 percent, didn't quite work out.

Jason Furman, a Harvard economics professor, senior fellow at the Peterson Institute for International Economics, and chair of President Obama's Council of Economic Advisers, wonders how economists missed this.

Sure, it gives credence to the quip about economics being the dismal science. Furman passes some of the blame on the unpredictable surge in Covid-19's Delta and Omicron strains.

But he thinks the main reason why so many forecasters got inflation wrong was an increasing faith in extrapolating from the recent past — instead of relying on sophisticated modeling.

"To think $2.5 trillion in fiscal stimulus — amounting to 11 percent of GDP — would not cause inflation," Furman explains, "required believing either that such a huge adjustment was possible within a matter of months or that fiscal policy is ineffective and does not increase aggregate demand. Both views are implausible."
He adds "multipliers indicated that total spending in 2021 would go up a lot, while production constraints suggested output would not increase by as much. The difference was unexpectedly higher inflation."

What does that mean for 2022?

Furman expects U.S. inflation to slow down a bit, likely coming in between 3 percent and 4 percent by the end of 2022.

But he cautions rising prices remain a core concern. "Instead of making inertial forecasts that the future will resemble the past," says Furman, "taking our models seriously means accounting for high levels of demand, continued supply constraints, and ever tighter labor markets with rapidly rising nominal wages and higher inflation expectations." He projects the pace of inflation of goods may fall this year, but the rate of services-related inflation will likely rise.

This was the start of our extended conversation about economies, markets and what may lie ahead.

What can the government do about inflation?

We haven't had inflation like this for decades and it's never easy to handle inflation of this magnitude and it may be harder to confront after such a long run of inflation being so well contained. There's not a great playbook for the government other than dramatically lowering tariffs, especially on China, and the Federal Reserve raising rates sooner than they had forecast.

Longer term, should companies be thinking about diversifying supply chains to mitigate risks associated with importing from great distances?

I think global supply chains have held up fairly well under the crazy stresses of whipsaw changes in demand due to the pandemic. There may be a small shift toward more domestic production, but not a lot.

What else are you most fearful of at this moment?

Covid mutating is my biggest fear…Omicron or something worse.

Besides inflation, economists' projections about U.S. 2021 growth was also way off.

Yes. Real GDP grew 5.5 percent in 2021. That is much faster than any major forecasters expected.

What is your economic outlook for 2022?

I think the year will start out rough due to Omicron but then get a lot better by the end of the year as our economy and society turn more normal. GDP may grow between 2.5 percent to 3.5 percent. Unemployment rate will likely be around 3.5 percent and inflation may slow to 3 percent to 4 percent. Globally, I think we'll see synchronized growth across Europe and Asia.

Before digging deeper into our present challenges, can you share something of your past that informed your work?

When I was growing up in the 1970s, my father was studying for a PhD in economics. He never finished his doctorate because, ironically, high inflation and interest rates were hurting my grandfather's real estate business. My dad decided to help out, and he never went back to school. So, in a way I'm following through on a dream my father had, which I'm glad he was around to see.

What's it like teaching these days at Harvard?

We were in person in the fall semester, learning the same material in classrooms. Everyone is vaccinated. Everyone is masked. Everyone gets tested several times week. But the scary thing is infections were rising toward the end of the year. I don't think anyone can keep this virus under control unless you lock yourself at home, which for humans is not a tenable long-term strategy.

On the bright side, it's easier to show students how relevant economics can be as we try to understand what's going on across the globe due to Covid — how it's affecting economies and what a remarkable example it provides of an externality.

From a policy point of view, is it important to distinguish inflation directly due to rising costs versus businesses taking advantage of the current environment to boost pushes?

I think 90 percent of inflation is the result of excess demand driven by fiscal and monetary policy. That said, corporations always want to charge higher prices and make extra profits. The question is: Why can they do it now and not before? To understand that, one needs to think less of companies and industries and more about the overall macroeconomic situation — not trying to distinguish between the two forces you mentioned. Policy makers should be focused on why businesses are able to push prices higher now. I think anyone who's trying to understand what's going on in the car market, for example, has missed the big story that it's happening in every market.

Government press releases and the media highlight the latest shifts in data, which often don't tell the full picture. Would you like to see reporting of critical macro data with more historical context (i.e., three- and five-year annualized rates) so we can better understand the longer-term trends in which recent data is only one part of?

Sometimes you want to see what's been happening over the most recent quarter. But I would also recommend seeing trends over five years and longer to see price changes in context — such as gasoline prices in real dollar terms, which are not that high in an historical and global perspective. But one would misunderstand the American people if one is not sensitive to current price movements.

There's concern about current real wage growth, which we haven't seen for a long time. How should people interpret the recent numbers beyond the headlines?

I look at so many pieces of data from so many different angles that I don't think there's one right way to view information. It always depends on what question you're trying to answer. Right now, my favorite approach is to look at everything compared to the trend prior to Covid — comparing the economy now to where I think it would've been without the pandemic and the policy response.

While there's the risk of stoking and playing into people's fears by focusing on the latest data, there's also the risk of appearing out of touch and unsympathetic to the problems that people feel if one is too focused on longer-term trends. And what we're hearing now is how fearful many Americans are about rising prices.

Are you concerned about rising wages?

I think it's great that wages are rising for the lowest paid workers. We're actually seeing some reduction in wage inequality, which is a wonderful thing to see. But I'm also worried about a wage-price spiral, which ultimately doesn't propel anyone ahead and ultimately with higher prices leaves many people behind.

Given the tremendous growth in corporate white-collar compensation that's been going on for years, shouldn't we be concerned how that might be contributing to inflation?

Inequality and inflation are two very different matters. The top corporate earners have been enjoying much faster increases in compensation over productivity for years. But it hadn't been contributing to rising inflation, which only started in the aftermath of extraordinary fiscal and monetary stimulus.

Can we have meaningful wage growth for the non-one percenters without it being inflationary?

I think we can. We had two periods of serious wage growth over the last 40 years — the late 1990s and between 2015 and 2020 right before the pandemic — and in both instances they didn't contribute to a sharp rise in inflation.

The Economist recently reported an annualized decline of -5.25 percent in productivity in the third quarter. Does that concern you?

Productivity is very poorly measured on a quarterly frequency. There's a lot of noise in the numbers. So, I would never look at quarterly productivity data and try to draw conclusions. More broadly, however, chances are productivity is up since the pandemic. What's not clear yet is whether the increase is something durable or just temporary with people working longer hours in ways that may not prove sustainable.

What duration would render the measure of productivity meaningful?

I like to look at trailing 5-year numbers. This means you can't know when there's a sudden change. Productivity growth picked up after 1995 but it took a couple of years to really know if it happened. And productivity slowed in 2005 and again it took a couple of years to know whether it was real.

There was an unsettling article in The New York Times written several months back by its lead economic correspondent that said the economy was doing better now that

has been for a while, but people are more fearful than ever. That was evident in data reported by the University of Michigan. Can you unwrap that paradox?

I'm not sure. Unemployment is pretty low, wages are going up, but inflation is affecting everyone. There are a lot of reasons to be pessimistic and nervous at the moment. And consumer sentiment is decidedly negative. Part of that is also politics, especially if your party is not in power. Part of it is persistence of Covid. The bigger test is not what people tell pollsters but how they behave. Right now, consumers are spending a lot of money. So, they are not behaving in a manner that worries me. Still, I'm concerned. But not that concerned about this recent shift in polled consumer sentiment.

Could this polled sentiment eventually have an impact on consumer behavior and political decisions by leaders and voters?

Yes.

You recently said inflation and real wages are terrible. Please explain.

Right now, while job numbers are terrific and the unemployment rate is low, prices are rising faster than wages. Over the past year, prices are up by more than 7 percent while wages are up 4 percent to 5 percent. Ideally, this should be the opposite with real wage growth being a percentage point faster than inflation. Many workers are finding themselves falling behind as prices continue to rise.

Can you posit how these macroeconomic trends may impact investors over the near term?

Interest rates have been falling for a long time and I expect them to stay relatively low after the Federal Reserve tightens rates, which I expect will top out at no more than 2 percent. The 10-year rate may peak around 2.5 percent to 3 percent. That will mean continued low rates of return on debt and more people investing in stocks and that should continue to drive equity valuations — even with the inflation we've been seeing. This shows how deep-seated and profound the shift has been in favor of stocks.

Seeing how dysfunctional Congress has been, are you concerned how a broken legislative branch could impact economic and market risk?

I think the current state of our Congress is an additional and unnecessary source of uncertainty for our economy. That said, Congress still seems to avoid the most catastrophic mess-ups. But the most crucial actions always take too long, and one

day there could be an accident. I think it's important to distinguish between the failure to do good things and actively doing bad things. I'm unfortunately sort of immured not to struggle with good policies that have died in committee or the Senate floor. That's inevitable. But we should be able do less harm with things like the near perennial fight over the debt limit.

Would you like to see congressional approval over the expansion of the debt limit eliminated?

Yes.

So, you don't think having the debt limit brings any discipline to the budgeting process?

No. I think it just adds uncertainty and risk. And politicians who use it for an advantage know it's a threat we can't carry out. We shouldn't talk about threats that aren't credible.

Does the concept of a debt limit exist in any other major economy?

Denmark has something vaguely like it, but no other developed country has anything closely related to it.

Sounds like you don't see any serious economic impact of Congress' inability to function productively.

You saw some republicans vote with democrats on the infrastructure bill and then receive death threats. I'm all for bipartisanship and working together. But presently it's hard to see how republicans can do that and it's hard to see how democrats can go it on their own. We currently are in a depressing political climate.

I've recently posed the question of a dysfunctional legislature to a Spanish fund manager and he said don't sweat it too much, Italian and Spanish economies have been thriving with dysfunctional parliaments for a long time. Do you take away much solace from that perspective?

I think if you were to tally the impact of congressional dysfunction, it probably comes down to plus or minus 0.2 percent on growth rates. They are not the differences between the U.S. and say a place like Argentina. All of our debates are over things that are relatively small. But that said, over time that impact on expansion can be meaningful. When I was in government, if there was an opportunity to expand growth by $20 billion, I was for it. It's not a large amount. But such improvements can add up.

I interviewed Niall Ferguson a while back and we discussed the cost of our military ventures in the Middle East and Afghanistan and he seemed to discount the impact of the costs on our economy, which at the time exceeded $1 trillion. Given how much more expensive that tab grew, not to mention how destructive and unproductive those ventures were, many may think the price of such spending has been a huge opportunity cost.

I think the cost-benefit analysis of Afghanistan is more likely to be measured in lives lost and what it means for the safety of Afghans going forward. These are larger in magnitude than the dollars that were spent. But, yes, we should think about all costs.

Over the next several years, what are the geopolitical and financial risks posed by China?

I think it is very likely that China's growth will slow. China's economic policy making has become more erratic. And the country's slowing growth combined with authoritarian government can lead to unpredictable consequences. For example, when things are going bad in Russia, Putin invades a neighboring country to shore up his popular support. I worry about risks like this coming from China are going up. I don't fear China growing rich and dominating the world, but that its economy will stagnate and stall out and the country turns angrier as a result. I would much rather have them be a much bigger part of the global economy.

If you're concerned that China's economy is slowing, what impact could that have on China's ability to buy our bonds and fund our deficits?

The portion of our debt that China purchases is relatively a small and shrinking share of the U.S. Treasury market. So, I think other countries, along with the Fed, could fill the gap created by any slowdown in Chinese Treasury purchases so as not to impact our interest rates. Of all the risks I see with China, a large-scale selloff of Treasurys is among the lowest on my worry list, especially since any material reduction in Chinese purchases of dollars would hurt their exchange rate and its own economy.

While a thriving China may be more desirable than not, many folks remain frustrated about the impact on our own jobs and economy when China failed to deliver on large structural changes as promised in return for entry into the World Trade Organization, which gave China an open door to the world's most important economies. Outstanding imbalances between the West and China remain. Did President Clinton give away too much when he signed off on China's elevated trade status? Have we learned anything from this?

At the time WTO membership was granted in the 1990s, China was reforming very quickly and was continuing those rapid reforms for a period of time. I don't think the WTO bet has fully panned out, but I'm not convinced the alternative would've been better. The WTO bargain was only going to be as good as China's interest to reform. It then became less in their political interest to reform. That said, there's widespread inequality in wages between emerging and developed markets and I think protectionism is among the worst ways to correct inequality.

Before the pandemic and the sharp decline in interest rates, Henry Kaufman bemoaned the failure of the Fed not to have better normalized interest rates, wishing overnight rates had moved closer to 3 percent to achieve a healthier balance between savings and investing, to help capitalize banks, and to more accurately price equity risk. Should we still hope for this after the pandemic's shock has passed to achieve a more balanced economic and investment environment?

As I mentioned earlier, my guess is we're not going to see overnight rates topping 2 percent any time within the current cycle. The underlying equilibrium interest rate is simply much lower than it used to be. This does cause all sorts of problems in terms of properly assessing equity valuations and risk that institutional and retail investors face. But I don't think these problems were caused by central banks, which have been forced to accept the financial world as it is.

So, you don't believe there will be either the will or justification for materially higher base rates, even if it meant bringing more balance and health to markets and the economy?

The Fed should be focused on employment and inflation and not market prices. Even with the low interest rates we had over the past decade, inflation was low and stable. That tells me we need low rates for our economy to function. If one is bothered by that, the right answer is more public debt to drive up the equilibrium interest rate — not more contradictory monetary policy.

The Senate killed the latest version of Build Back Better, in part due to the conflicting assessments that were made against Biden's bill — which likely contributed to the bill's defeat. Former New Jersey Governor and political pundit Chris Christie asserted

the bill's actual costs were to 2 to 3 times greater than the President had stated. What's true?

CBO scoring determined that over 10 years, the projected cost would be around $100 billion. The estimated actual net cost of BBB over that time would be roughly zero, which assumes programs expiring. But I fear the real cost of not having passed such legislation will now be borne by families promised certain crucial benefits (like child tax credits), who structured their lives and work around this aid, but which now has been pulled. I hope Congress will extend such commitments.

The President and the democrats will still try to revive parts of the bill. Broadly speaking, you believed BBB would not have been inflationary. Please explain.

BBB over time would've been paid for, it would've increased productivity of the economy, and the Fed would've had more than enough time to offset any potential increases in inflation.

How would it have improved productivity?

Preschool and childcare assistance would've allowed more parents to work and over time such investments in children pay off in terms of their higher productivity as adults. It would've also given a boost in the fight against climate change and poverty.

Even with the recent rise in market interest rates, real interest rates remain negative. How long do you think investors will be willing to purchase medium- and longer-term debt that provide real negative returns?

What's their other choice? If negative real yields are the best they can get, that's what they will take. This is not the Central Bank's fault. This is the structure of the economy.

Europe has suffered protracted nominal and real negative yields for quite some time. Does that concern you?

I think negative real yields are a symptom of other problems, not a cause of those problems.

There's been some post-mortem on the immediate fiscal and monetary response to Covid. Any lessons learned about how the government might've responded more effectively?

The initial economic response was very good. But it got too large. The Fed stuck with ultra-low interest rates for too long. But I would rather see the government having done too much than too little. I hope responses to future crises bring more rigorous consideration to how much assistance is really needed and not to simply spray large sums. There certainly could've been more targeting to provide aid to households who truly needed the assistance. And as it was constituted, most of BBB relied on means-testing.

Do you think the Fed is on the right course?

Going into 2022, the Fed so far has done a good job in articulating its thinking and in not scaring markets. Latest indications suggest it will boost rates in March with several more hikes throughout the year. But if 2022 inflation is a on pace to hit 4 percent or more, the Fed might have to do even more and that might prove challenging for the economy.

Might quantitative tightening — the Fed selling off assets — be a more benign way to raise longer rates rather than by pushing up overnight rates?

I wonder that myself. I don't have a strong opinion about reducing the balance sheet versus raising rates. The Fed spent a lot of time considering these two options when we came out of the last cycle. It came out on the side of raising rates because that's more transparent, sending clearer signals to markets and the economy with magnitudes that are easier to communicate. But these are two tools that can roughly get you to the same place. Further, I don't expect the Fed to sell off its balance sheet after it finishes tapering. It will just let debt assets mature off.

Can you connect the main three drivers pushing up inflation with how raising rates will effectively combat these forces?

Prices are being driven up by demand, supply is more constrained because not all workers have returned, and wage-price spirals and expectations are building on themselves. Higher interest rates ripple through the economy, affecting all sorts of borrowing by consumers and businesses helping to reduce demand. Higher rates also buy more time to help suppliers meet demand. By reducing demand, higher rates should eventually ease pressures on our ports, improving supply chain movement. And higher rates better moderate expectations.

How long do you think it will take for rising rates to start containing and reducing inflation?

A year to a year and half.

Going back to the subject of risk assets for a moment, are you concerned about the immense amounts of assets that have been pouring into junk bonds, SPACs, unregulated crypto currencies, and distressed real estate whose high prices are being driven not by fundamentals but by pure demand?

I'm nervous about the frothiness of asset markets. That's why I think it's good to have more fiscal policy, which hopefully will reduce the need for aggressive monetary policy. The real question you're asking is what can the government do about any of this? We can move to more normal monetary policy. And increased regulatory solutions would help. Crypto exists in part because many investors see regulatory arbitrage as a way of getting around a lot of rules. And that's problematic.

What are a couple regulatory changes you would like to see adopted?

One being pursued now is taxing crypto and making sure it's not a tax haven. I would also recommend stronger know-your-customer rules. And I think increased consumer protections would help — especially as it pertains to, but not limited to, crypto.

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