Inflation Myths and the US Economic Rebound 2021

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Today, May 12, 2021 the US Labor Department released its report on businesses now raising prices, as the US economy reopens in the wake of Covid vaccinations and moderating Covid infections. The CPI, or Consumer Price Index, rose 0.8% in April, after a 0.6% in March, and 4.2% for the twelve months ending last month, April 2021, which was the largest increase since 2008.

Republicans, conservatives, and business interests are using the fact of recent rising prices to attack legislative proposals to increase government spending. They argue the recently passed $1.8 trillion 'American Rescue Plan' (Covid Relief Plan) by the Biden administration was too generous. And proposals to spend on Infrastructure ($2.2T) and American Families ($1.5T) will only stoke consumer spending and boost inflation further.

They and their mainstream media friends are arguing that fiscal stimulus putting money in the hands of households is driving up prices. In other words, consumer DEMAND is now causing prices to rise sharply, they argue.

But is it? Or is the problem of rising inflation a business SUPPLY problem?

Inflation Not Due to Fiscal Spending & Household Demand

There is little evidence that fiscal stimulus spending is responsible for recent price hikes. The fiscal stimulus spending for 2021 is far less than reported, so its effect on household Demand spending—and therefore Inflation—is thus far minimal. The recently passed American Rescue Plan is not actually $1.9T, as media reports. The Congressional Budget Office, the research arm of Congress, reports that only $1 trillion in spending is even authorized for 2021. And of that, at least $200 billion or more won't be spent in fact: it will be hoarded and unspent by households and local governments or used to pay down debt and won't get into the US economy in 2021. The majority of the remaining $800 billion hasn't even hit the US economy yet and won't until late 2021. And what about the Infrastructure and Family Assistance subsequent proposals?

They're just on paper. And won't get passed until sometime in 2022, if then, and certainly reduced in authorized spending by large amounts. In short, the Republican-Business hype about $6 trillion going to households and consumers is just another 'big lie'. It's no more than $800 billion—that is, just about the amount of similar fiscal spending in 2020 that dissipated in just two to three months. Put another way, the fiscal 'stimulus' is not really a stimulus—just a 'mitigation' spending measure designed to put a floor under the economy while waiting (and hoping) for the reopening of the economy to generate a sustained recovery.

A fiscal spending of at most $800 billion this year—which has hardly even hit the US economy yet—is not sufficient to generate excess demand by households to cause inflation. So much, therefore, for the argument that government fiscal spending is causing excess household DEMAND spending that is resulting in current inflation!

Inflation Due to Business Supply Problems

A closer look at the CPI shows that the problem of recent rising prices is a SUPPLY problem in business, not a DEMAND problem due to households' excess income.

Much of the recent CPI increase, when broken down, is due to sharp increases in auto prices, especially used cars. That is a supply problem: auto companies are experiencing a crisis in obtaining semiconductor chips for production. New car production has fallen. That's created a shortage that allows the companies to jack up prices on their new cars. In turn, it has resulted in used car prices rising even further and faster than new cars. New car prices have surged 9.6% and used cars even more, by 16.7%, according to the Wall St. Journal. Auto prices have surged 21% of the past year. April's car and truck double digit price hikes—the highest since 1953—thus account for more than a third of the overall 4.2% April CPI increase!

The 2020 economic contraction resulted in businesses reducing their inventories of unsold goods deeply. They now have shortages. Recent US GDP numbers show inventories collapsed last year and continued to contract in the first quarter of 2021 as well. This has created a condition that now allows businesses to sharply raise prices due to the shortages of supply. This is a condition and problem across many industries and companies today.

Businesses in 2020 were not able to raise prices due to the massive unemployment and inability of consumers to spend as the economy was largely shut down. Service industries like airlines, travel, lodging, entertainment, restaurants & bars, and retail were especially hard hit. In response, many of the companies in these industries cut prices in order to try to capture what little household demand there was. Now, as the US economy reopens, they are trying to recoup those losses by sharply raising prices, trying to test what the market will bear in terms of inflation.

Looking at the recent CPI numbers once again, apart from auto prices new and used, the sharpest increases in the CPI index are occurring in airline prices, other travel related prices, hotels and lodging, and similar services—all rising recently at more than 10%! At the same time, auto insurance companies and utility companies are raising prices by double digits as they price gouge consumer in the recovery. Consumers aren't buying more utilities. That demand remains stable. Nevertheless, the big utility companies are using the opportunity to boost prices. The auto insurance companies experienced a big windfall in profits in 2020, as households drove less and their insurance premiums remained at pre-pandemic levels. But now they too are raising prices by double digits to 'game' the system. Then there's the oil companies sharply boosting prices at the pump to recoup their losses in 2020.

Not to be left out, in addition to these supply driven causes, new housing prices are surging as well as shortages in lumber and other materials, and due to the low availability of housing stock. In other words, a SUPPLY problem, causing inflation!

Global Markets As Cause of Inflation

Wholesale prices for commodities like aluminum, copper, and crude oil are all rising sharply as well, as investor speculators buy up futures contracts to resell later at a big profit. These now rising wholesale prices will soon penetrate consumer prices, causing retail price inflation. But that means the problem once again is not the household consumer and demand; it is the professional financial speculator causing most of the current rising world commodity price inflation.

And then there's the problem of the falling US dollar, which drives up imported goods prices (in the CPI), which has nothing to do with household demand either. The Federal Reserve US central bank has a policy of keeping interest rates at near zero. It has pumped more than $4 trillion into banks the past 18 months; and continues to provide $120 billion every month to ensure rates stay low. This policy and subsidization of low interest rates has resulted in less foreign investor demand for US dollars to buy US Treasury bonds that pay little interest. That reduced demand for dollars drives down the value of the US dollar. And that lower valued dollar in turn, raises the cost and price of imported goods coming to the US. Import prices of goods in the CPI therefore rise in turn and contribute to the general increase in the CPI. In short, the falling dollar is a cause of inflation that has nothing at all to do with excess household demand for goods due to fiscal spending.

Problems with the CPI as Indicator of Inflation

How reliable is the CPI, in general, and especially as a measure of economy-wide inflation?

The answer is not very. There are major problems with the CPI as an accurate indicator of the price level—i.e. of inflation. Here's just some of them:

First, the CPI is not even an indicator of the general price level and inflation, as economists well know. It is an indicator of the cost of living for urban households only. Cost of living and inflation/price level are not the same thing, contrary to the general public's understanding of the two concepts.

The CPI measures only around 450 different 'goods and services' in the economy—i.e. the most purchased by urban households. There are millions of different goods and services in the US economy with prices, none of which are included in the CPI but are part of the general price level.

Second, unknown by the general public, the US government keeps secret how it calculates most of the CPI. Why so? It says it does that in order not to reveal how businesses raise prices because it would reduce competition among businesses. But that's nonsense. Most businesses, especially the larger corporations, know full well how their competitors raise prices.

The US government reveals more detail about how it calculates employment and unemployment, but keeps secret most of its methods secret how it manipulates CPI raw data. It does that, in my opinion, in order to 'low-ball' inflation. It has an incentive to under-estimate the CPI. The higher the inflation, the more the government must spend in cost of living for social security, food stamps, school lunches, government pensions, and so forth.

So it prefers to low ball inflation and does so in a number of way. Unlike employment stats, it also avoids segmenting inflation by race, age, gender, and income levels. That would show how CPI inflation more seriously impacts minority and low income households.

Third, the CPI measures the increase in inflation compared to a similar month or quarter in the previous year. So if prices were falling last spring 2020 due to the severe economic contraction, prices this spring 2021 appear especially high. Businesses are recouping price cuts (deflation) last year, so price increases appear even higher this year. In other words, it matters what 'base year' is used to estimate the CPI (or any inflation index for that matter). The CPI can be either higher or lower depending on what base year is used. And if the base year was deflationary, with falling prices as was 2020, then the subsequent year, 2021, inflation and CPI appear exceptionally higher than otherwise.

Apart from the CPI not being an actual measure of the general price level and its methods for estimating inflation kept a secret, there are further problems with the CPI itself. Here's just a few:

1. The CPI's basket of 450 or so goods and services have weights assigned for the various goods and services. In other words, the cost of lodging weighs more in the final CPI calculation than does, for example, the cost of smart phones. But the weights are changed only every 4 or 5 years. The cost of food, autos or housing may surge significantly in any given year (now occurring) but their weights are not changed to reflect the increase. The CPI is thus under-estimated for that year. Moreover, the weights are not segmented by household income levels. So for the median or even more for the working poor households, the cost of rents result in an even greater inflation effect than for, say, wealthier households. The poor are impacted by inflation more as a result. Their CPI cost of living is thus much higher than the general CPI number

2. The CPI makes adjustments for rising quality of goods. For example, even though the cost of a new iphone may be higher this year for the buyer, because the new iphone has more features and functions, the government calculates a zero rise in price or even a price deduction for smartphones in its overall CPI calculation. The buyer-consumer may experience an actual price hike, but it doesn't show up in the CPI as such.

3. There's also what's called the 'substitution bias' problem in the CPI. This happens when prices rise for a product in the CPI basket and the consumer responds by not buying that higher priced good and buys instead a lower cost substitute. There's an actual increase in the price level for that original good that isn't captured in the CPI because it isn't purchased.

4. New goods and services that are created in the economy and their inflation are not captured because they may be not yet included in the 450 basket of goods and services of the CPI. Their prices and inflation are for certain part of the general price level rise, but aren't reflected in the CPI. And remember, there are millions of goods and services not included in the CPI.

Add to these issues and problems, there is no adjustment for the value of the dollar falling, or for the fact the CPI measures only urban cost of living, or there is no segmentation that would show lower income households' CPI are higher, the CPI excludes altogether certain important items that account for inflation: there's no mortgage rates estimated in the CPI or rising income taxes. And many economists argue the CPI still significantly underestimates price increases for online shopping.

Summary

All the hype from Republicans and mainstream media that the recent, and pending, fiscal stimulus spending is driving up inflation has no basis in fact. It is an argument designed to be used to block and roll back the spending that would benefit households and consumption. That argument assumes the emerging inflation is a household DEMAND driven problem. On the contrary, rising prices are far more a business SUPPLY problem. Businesses are using the supply shortages as an excuse to boost prices, and to test how much the markets will allow, to generate and recoup 2020 losses and price cuts during the pandemic. A detailed look at recent CPI numbers shows the biggest increases in prices are due to shortages in supply and those business sectors trying to recoup losses. Other businesses without losses in 2020 are going along and doing the same, using the rising prices as a cover to raise their prices as well.

The Biden fiscal spending is a small fraction of what the opponents claim. Only $800 billion will be spent in 2021 (and likely less as more workers leave unemployment benefits for jobs). It's not $6 trillion as the business media in particular likes to tout. $5 trillion of that claim is just talk of legislation that won't hit the economy until 2022 or after, or not at all, and the remainder of the Biden American Rescue Plan of $1.8T is spread out over 10 years!

Finally, the CPI is not an indicator of inflation and has a number of serious limits when it comes even to estimating the cost of living for US households. In general, moreover, it grossly under-estimates even the cost of living and is not a reflection of rising general prices and inflation.

Inflation will rise in 2021, for certain. But it will be more due to business practices and SUPPLY problems as well as other global conditions—and all that has little to do with consumer demand and government fiscal spending programs or legislation.

Nonetheless the US economic ideology machine, and its mainstream media conduit, will continue to pump out the fiction and myth that it's government spending and excess US middle class and working class household demand that is the problem behind inflation.

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