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On the Issues

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Inflation Menace Has Echoes of Volcker's Days

By Kevin A. Hassett

In this article, Kevin A. Hassett examines current predictions of inflation and explains that if some estimates are right, the Fed will have to address inflation sooner than it would like in order to avoid reliving the early eighties. Out-of-control inflation would also counteract recent efforts in Congress to stimulate investment activity because corporate tax policy penalizes firms when inflation is high.

If you are like me, the notion that inflation could climb to double digits seems almost absurd. But have years of U.S. Federal Reserve success lulled us all into a false sense of security?

Economists tend to be cautious about the things they say in public. If, heaven forbid, you find yourself in a room filled with dismal scientists this month, you are likely to hear whispered private conversations that become almost apocalyptic about inflation.

It is by no means certain that the worst will happen, but if it does, the economic consequences could be—as they were in the early 1980s—crushing for an already weak economy. The inflation outlook right now is as scary as it has been since then-chairman of the Federal Reserve Paul Volcker grabbed his lance and impaled the dragon in 1979. Back then, Volcker inherited a year-over-year consumer price inflation rate that soared to above 14 percent. His aggressive actions hurled the economy into a deep recession, but inflation ever since has remained in the single digits.

Is that streak about to end? Adding to the risks are soaring food and energy prices and a Federal Reserve that might well be asleep at the wheel. In its June 25 statement, the Fed's Open Market Committee stated: "The Committee expects inflation to moderate later this year and next year."[1]

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The central bank certainly is not alone. This month's Bloomberg survey of sixty-one economic forecasters shows them expecting inflation—as measured by the rate of change of the Consumer Price Index (CPI)—to rise to an annual rate of 4.1 percent in the third quarter.

Like the Fed, forecasters are optimistic about the future, expecting on average that the rate will fall to 3.4 percent in the fourth quarter. Others are hardly so sanguine. Consumers see a much worse scenario ahead. According to the latest Reuters/University of Michigan survey, respondents expect inflation one year out to climb to a twenty-seven-year high of 5.2 percent in May.

There are even some economists who see the wisdom of the masses. Mark Zandi, chief economist for Moody's Economy.com and one of the savviest students of the economy, told me in an interview last week:

> Energy and food prices, which together account for one-fourth of the CPI, will rise nearly 20 percent annualized in the third quarter. Top-line CPI inflation looks destined to top 7 percent annualized in the third quarter. It is very possible that third-quarter inflation will be the strongest since the third quarter of 1981.

The fact is, if inflation can climb to 7 percent, it can go to double digits. All that needs to happen

is for energy prices to jump to an even higher level. Any number of things could cause that: a supply disruption, a flare-up in tensions between Israel and Iran, or a heavy storm in the Gulf of Mexico immediately come to mind.

The impact of such events on the overall economy would be catastrophic. The Federal Reserve would be forced to crack down just as Volcker did three decades ago. How bad could it be? The central bank would probably have to increase the federal funds rate to the point where interest rates adjusted for inflation are positive. The federal funds rate might have to climb well above 6 percent.

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There is another problem that might be as bad: the tax code has never been very forgiving of inflation. Higher prices lift tax rates on capital. First, capital gains taxes are not indexed for inflation, so phantom gains lead to big tax bills. Second, when wages go up to compensate for higher inflation, that kicks many people into higher tax brackets. Third, corporate tax policy penalizes firms in a number of ways when inflation is high.

The scale of these effects can be enormous. For corporate taxes, a study that I coauthored for the National Bureau of Economic Research with former Federal Reserve economist Darrel Cohen and Columbia University economist and AEI visiting scholar R. Glenn Hubbard found that an increase in expected inflation to 8 percent from 2 percent would raise the cost of capital for companies by about 10 percent.[2]

Such a massive increase might depress investment this year even with the efforts of Congress to stimulate investment with temporary expensing, a measure that was passed as part of this year's stimulus bill. If companies look ahead to a world with higher inflation, they will not want to have as many machines and might begin making fewer purchases this year.

The odds continue to favor a weak but not terrible economy this year, with high but not raging inflation. Still, inflation has been tame for so long that many economists, including those in the Fed, may have forgotten how high it can go.

My guess is that the central bank will reacquaint itself with these risks in the coming months. If it does, it will begin to move against inflation sooner than it would otherwise prefer. If it does not, we may have to relive the early 1980s all over again.

Notes

1. Federal Open Market Committee, news release, June 25, 2008, available at www.federalreserve.gov/newsevents/press/monetary/20080625a.htm (accessed July 3, 2008).

2. Darrel Cohen, Kevin A. Hassett, and R. Glenn Hubbard, "Inflation and the User Cost of Capital: Does Inflation Still Matter?" (Working Paper 6046, National Bureau of Economic Research, May 1997), available at http://papers.nber.org/papers/w6046.pdf (accessed July 3, 2008).

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