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US inflation is running high. What should we worry about now?

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Image credit: REUTERS/Mike Blake

A consumer price index (CPI) inflation rate in October at 6.2 percent from a year earlier; a very hot labor market. Maybe some of us were not completely wrong when we expressed worries about the size of the Biden stimulus last February. (See my blog here.) So far, if anything, it looks like we were too optimistic about the degree of overheating, the supply side constraints, and inflation.

But this is not the time for boasting (although it is very tempting, given the torrent of aggressive comments we got at the time). I feel it is only half time. The worriers are ahead, but there is a second half, and nobody has won yet.

Growth and demand pressure may slow down on their own. Workers may return to the labor market in droves, decreasing labor market pressure. Inflation will likely slow down sometime early next year, perhaps decreasing as sharply for a few months as it increased this year. Inflation expectations may remain anchored. A small increase in interest rates will do the trick. And everything will be fine.

But this is no longer the most likely scenario. There is still a lot of pent-up demand, be it for consumption or for investment. Even with new entrants, the labor market is likely to remain tight for some time; workers who have lost purchasing power will try to get it back. Even as price inflation initially slows down, wage inflation may well pick up. It may build slowly but lead to wage-price dynamics with more momentum than the price inflation due to supply chain issues. And inflation may be hard to stop without a large increase in interest rates by the Federal Reserve.

I have no doubt that the Fed will increase rates, probably a bit late, and then by more than it hoped to. But it will, so I do not expect high inflation to last forever. The questions we now must face are: How much will the Fed have to increase interest rates, and for how long? Markets seem completely relaxed, 5-year real rates are close to minus 2 percent. I do not think they should be. The history lessons we should look at now are episodes of disinflation.

Is there any relevance at all to the (admittedly much bigger) Volcker disinflation of the early 1980s and its large output costs? How much is different today? How would a sharp and largely unanticipated increase in rates affect not only the economy but also the financial system, and the prospects for emerging markets? This is what we must think about.

This is not the time to fight about inflation between "team temporary" and "team permanent" (what stupid expressions!). It is neither the time to pretend that everything is right nor the time to argue that we are on the verge of hyperinflation. It is the time to think about what happens if inflation turns out to be higher and harder to fight than the Biden administration and the Fed expected. There is definitely plenty to think about.

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