June 17, 2022
Labor Market Reports
research@employamerica.org

Employ America Research Report

A Holistic Anti-Inflationary Strategy

Arnab Datta
Senior Counsel,
Employ America

Skanda Amarnath
Executive Director,
Employ America

Executive Summary

Policymakers are almost singularly-focused on finding ways to curb inflation. President Biden recently announced an anti-inflationary strategy and some in Congress are proposing useful solutions.

Most lawmakers and policymakers look to the Federal Reserve as the institution best suited to address inflation, but as we've previously written, the Fed's causal mechanism primarily runs through a weakening labor market and outsized recession risk. Especially given that the supply constraints in question are not primarily about "labor supply" itself, the White House and Congress should take a more direct approach that at least serves as a powerful complement to the Fed's current efforts. To avoid exclusive reliance on the Fed's more perverse mechanism, the White House and Congress should be thinking along three potential dimensions:

1. *Investments where productive capacity has proven most deficient or fragile during this episode, so as to catalyze accelerated production and defray the capital costs that may otherwise be passed onto consumers.*
2. *Targeted policies for reducing demand at their funding source, particularly where the government is a substantial purchaser or subsidizer of consumer spending.*
3. *Policies that facilitate greater competition and technological diffusion.*

First, it would be prudent to invest in key areas where physical production capacity is necessary to stabilize prices, and in ways that support industry efforts to build resilient supply chains. These actions include using the ***Exchange Stabilization Fund*** *to support investment in the production of key commodities, preserving existing capacity tied to the production of energy services and refined petroleum products, and passing key sections of the Bipartisan Innovation Act.*

Second, the Administration and Congress should reform costs in two areas that are closely targeted to the sources of demand for consumption: healthcare and higher education. As a significant purchaser and subsidizer of both, the Federal Government can use its authority to push for important cost-controlling reforms. Some of these

would have more instantaneous impact, while others would take multiple years to take full effect, but all of them are worthwhile.

Third, the Federal Government can do more to encourage competition in two key sectors: telecommunications and air travel. Taking necessary steps to make 5G access universal, including through regulatory action and targeted compensation for equipment upgrades, would encourage price competition that could have dramatic effects on telecommunication services inflation. Likewise, funding airport gate expansions would encourage competition among air carriers by lowering the barriers to entry for lower-cost carriers.

A Holistic Anti-Inflationary Strategy

Nearly everyone agrees: taming inflation is our biggest economic challenge. Though some signs of potential progress are emerging, consumer price inflation is likely to stay elevated over the near-term, especially given recent geopolitical developments. The effect of the war in Ukraine on commodity prices is adding another source of price pressure beyond bottlenecked supply chains for key goods, further ratcheting up costs for everyday Americans. This reality has been used to undercut the case for more federal investment, and threatens the legacy of the American Rescue Plan, despite the fact that developed nations who undertook comparatively timid fiscal responses to the pandemic are experiencing comparably historic rates of inflation (albeit for a different set of supply-related reasons).

In a recent op-ed, President Biden reiterated his belief that “the Federal Reserve has a primary responsibility to control inflation.” Though policymakers’ default discretionary weapon against inflation – interest rate hikes – can theoretically work, it is worth remembering that the causal mechanism through which the Fed primarily slows inflation comes with perverse consequences for workers and businesses alike. Exclusive reliance on monetary policy to resolve high inflation could push us into a recession and potentially undo the very real economic progress we’ve made: the strongest employment recovery in over four decades.

The President is taking some important steps to combat inflation where he has authority. Tying infrastructure investments to sound housing policy is long overdue. Similarly, the regulatory action announced to stabilize longer term oil production through forward contracts deserves recognition. But the moment calls for a more urgent, direct, and all-of-the-above approach, and there is still much more that the White House and Congress can do.

In our view, actions should be oriented around three objectives: (1) investments where productive capacity has proven most deficient or fragile during this episode; (2) targeted policies for reducing sectoral demand at their funding source; and (3) policies that facilitate greater competition and technological diffusion. The outcome of these actions together would prove far more equitable than achieving disinflation by leaning on rate hikes or a weaker labor market. These three sets of policies instead attack challenges at their root cause and—unlike the Federal Reserve's Actions—have more direct, identifiable, and predictable effects on the consumer prices that contribute to inflation.

The solutions suggested here are not intended to be comprehensive, and they are proposed here as a complement to the Federal Reserve's actions. We welcome additional ideas for hastening disinflationary outcomes through more direct and equitable means. However, we do feel these three approaches represent an economically and politically feasible start.

Investments to Enhance and Preserve Productive Capacity

Much of today's inflation can be attributed to an acute shortage of physical capacity. A subset of relatively capital-intensive sectors account for much of the inflationary surprise in 2021-22. From oil to electricity to semiconductors to housing inputs, investments to increase physical production capacity would be valuable to the stabilization of both prices and the broader macroeconomic trajectory. This is also an area where an overreaction from the Fed may ironically prove counterproductive—hiking interest rates will raise the cost and availability of financing, while also signaling to the private sector that investments made today may not be sufficiently validated by future demand. It would be prudent for fiscal policy to help fund investments in expanded production and defray some of the costs involved in industry's current efforts to build resilient supply chains. Especially for hyper-volatile (and often environmentally costly) goods, public support for investment in production deficiencies and comparable alternatives would cut through the uncertainty that holds investment back.

Perhaps most important in the short-run, the President and Congress should make every effort to expand investment in the production of major commodities, particularly where supply losses are tied to Russia's invasion of Ukraine or where Asian supply chain bottlenecks remain most substantially acute. Energy sources like oil and gas, metals like aluminum, nickel, palladium, and copper, and agricultural inputs like potash and wheat could all benefit from additional investment support. These commodities are often subject to hyper-cyclical price pressures that understandably raise the hurdle rate producers in the private sector require in order to engage in accelerated investment in response to what may prove a one-time shock. Given the havoc that this commodity price volatility has already wrought on underdeveloped and even developing countries' balance of payments and exchange rates, the Treasury Department should use the Exchange Stabilization Fund to support financing of commodity production. **With**

financial markets already bracing for the risk that the Fed inflicts a full Volcker shock, the White House and the Treasury Department can announce programs today that would help to insure and accelerate supply responses in key industries.

In the case of crude oil, we have already laid out a systematic plan for accelerating investment within the domestic sector. This plan is structured by the SPR's authority to sell physical put options, while using the ESF to make financing more affordable and available, and invoking the Defense Production Act to coordinate production around more granular input bottlenecks (e.g. steel pipe, fracking sand). This plan is not just a specific fix for today's most pivotal foreign policy, economic policy, and public opinion challenges. Components of our plan are equally relevant to a number of additional commodities that are in short supply, and may provide a more resilient method for coordinating the energy transition.

However, production increases alone will be meaningless if critical existing capacity is not preserved. It's a promising sign that the Biden Administration has started inquiring about preserving domestic refining capacity and the prospect for restarting recently closed refineries—particularly with more than 1 million barrels a day of the nation's refining capacity shuttered since the start of the pandemic. The administration should extend that approach to prevent the closure of nuclear power plants across the country in Michigan and California. Congress can support their efforts with more investment to enhance and increase capacity for current refineries and energy infrastructure. In the absence of such investments to maintain and restart existing energy assets, we could be looking at power outages across multiple states and persistently elevated refining margins, which directly adds to the price Americans pay at the pump.

Rent inflation is typically the most persistently cyclical component of inflation and very sensitive to labor market conditions; with labor market conditions rapidly recovering back to their pre-pandemic state, rental inflation is also on track for a rapid recovery. Yet despite the elevated level of activity in the housing market, we still have yet to see the completion of newly constructed housing units improve substantially. Over 1.6 million housing units are currently under construction, over half of them multifamily housing units that–if delivered to market–could help alleviate pressures stemming from rapidly recovering rental demand. Congress and the Administration should explore mechanisms for directly funding and addressing the additional costs associated with the current backlogs in residential construction, particularly where single material inputs (often imported) remain in short supply.

The Administration's actions to support more affordable housing construction are admirable, but Congress can and must do much more to address the longer run housing shortages. We still face a shortage of nearly four million homes (or higher by some estimates). Congress should consider direct measures that fund new housing like the Low Income Housing Tax Credit and the Housing Trust Fund.

The Bipartisan Innovation Act also helpfully defrays costs for firms already investing aggressively to ease arguably the most impactful "core inflation" bottleneck: semiconductors. Insufficient semiconductor production capacity is affecting prices across a number of durable goods, most notably automobiles. Congress should also consider further appropriations for the Defense Production Act fund, which could be flexibly deployed to address bottlenecks in critical industries. By offering fiscal support for firms that have committed to make major investments, Congress can help limit the extent to which the financing cost of those investments gets passed on to consumers, all while ensuring that the likelihood of future bottlenecks diminishes. Furthermore, the Office of Supply Chain Resilience at Commerce must be given the authority to make investments in our nation's businesses in order to support efforts to build supply chain resilience, as the House-passed bill includes. Taken together, these investment decisions could dramatically improve inflation outcomes over the coming years.

Targeted Demand Reduction

A principal effect of interest rate increases is to slow job growth with the goal of reducing aggregate demand, thereby reducing inflation. Understandably, this policy response hits low-wage Americans – who benefit the most from a tight labor market – the hardest. Policymakers' reliance on blunt interest rate increases perversely reduces businesses' willingness to spend on both capital and labor, while doing much less to directly influence the final demand for goods and services captured within consumer price inflation. The Fed's primary mechanism for affecting consumer prices on the demand-side operates by worsening labor market outcomes, despite the fact that current inflation is primarily not an employment- or wage-driven phenomenon. Congress and the Administration could reform costs in two areas that would be more equitable and closely targeted to the sources of demand for consumption, while having a significant impact on inflation: healthcare and higher education.

We face the highest health care costs of any advanced economy. They affect all parts of the economy, and are determined by a devilishly complex series of pricing mechanisms, both public and private. But importantly, the Federal Government has the authority to directly reduce the costs of healthcare. Over the coming months, the Administration should consider reductions across fee schedules (particularly the Physician Fee Schedule). Furthermore, it should follow through on previous reforms to encourage site-neutral payments, which would also reduce waste and fraud. These steps would not only reduce health care spending funded through the public sector, they also increase the bargaining power of insurance companies relative to providers—thereby reducing cost within the private sector and potentially lowering deductibles and premiums. We have strong evidence from the 2010s that these targeted reductions actually reduce healthcare inflation—a Chicago Fed study found that similar reductions that helped pay for the Affordable Care Act contributed to the persistently weaker inflation between 2014 and 2016. And as President Biden mentioned, it is high time for Congress to allow Medicare to negotiate for the price of prescription drugs. These measures in concert would reduce pressure considerably on the largest single sector of consumer spending.

Next up: higher education. The Federal government exerts significant authority over universities and colleges, as a funder through research grants and other aid, and as a purchaser through individual grants and scholarships. Federal funding, in one form or another, accounts for 14% of college revenue. The Federal Government should tie Federal support to commitments to tuition increases and exert internal cost discipline. As President Obama once said, “you can’t assume you’ll just jack up tuition every single year… We should push colleges to do better; we should hold them accountable if they don’t.” Unfortunately, the current system involves substantial credit subsidization that accrues in large part to higher education institutions, with few checks against the kind of aggressive tuition levels that have emerged in recent decades.

Competition Policies

The Administration and Congress can help fight inflation by encouraging competition in two other key sectors: telecommunications and air transportation.

Expanding 5G coverage would help bring inflation readings down through two mechanisms: quality adjustments and greater competition. Universal adoption of 5G would show up as a “quality adjustment” in inflation readings, the same way unlimited data plans did in 2017. The decision by companies to shift cellular plans to unlimited data translated into a double digit price decline in wireless telephone services. Currently, 5G expansion is hampered by concerns from air carriers that 5G could interfere with the radio altimeters of their aircrafts. The limitations on 5G near airports affect major cities, including New York City, and disproportionately affect the two largest cellular providers, Verizon and AT&T. With significant carriers still unable to offer universal 5G coverage, the firms with access to this part of the electromagnetic spectrum can compete for customers without necessarily competing on price. Universal expansion would force more price competition among cellular providers.

So how can Congress and the President act? First, Congress should pass the Bipartisan Innovation Act—which would appropriate money for wireless innovation that could be used to support aircraft technology upgrades for air carriers. The White House should urge the Department of Transportation and FAA to do everything in its power to speed up the authorization and compatibility testing of 5G with radar altimeters, which currently is not expected to conclude until 2023. These actions would help support universal 5G.

Finally, funding airport gate expansion would help drive down a disproportionate source of inflation over the last two months: airfares. While rising airfares likely reflects a full recovery from the pandemic and the outsized effects of jet fuel price spikes, increasing the number of gates would lower the barriers to entry for lower-cost carriers. Air travel demand is likely to remain elevated over the course of this year, and thus provides all the more reason to encourage price competition as soon as possible.

Conclusion

As Robert Frost once wrote, there is “no way out but through.” Myriad factors have caused inflation to rise to levels not seen in decades. Relying exclusively on the perverse mechanism of blunt interest rate increases could set back what has been an incredible jobs recovery. Instead, the Federal Government should use every tool at its disposal to relieve price pressures in a more equitable and relatively direct manner. We offer a framework here that includes necessary investment to boost production in key commodities, targeted demand reductions, and competition policies in two key sectors. In concert, these actions could dramatically reduce inflation over the coming years, without ending a historically strong labor recovery.