Here's when high inflation will come to an end

By Mark Zandi
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We can't catch a break. Since the Covid-19 pandemic struck in the spring of 2020, the United States has suffered hundreds of thousands of deaths due to the virus and lost millions of jobs. There was much hope the pandemic would soon be behind us when the vaccines were rolled out this spring, but no such luck. The Delta variant of the virus hit us hard this fall, costing more lives and doing more economic damage, this time by igniting long-dormant inflation.

The consumer price index, which measures prices paid by the typical consumer, is up 6.2% over the past year through October, the highest inflation rate in more than 30 years. Prices are up strongly for everything from gasoline to a pound of ground beef to a used vehicle, which is putting a heavy financial weight on already hard-pressed families struggling with the economic fallout from the pandemic. For a household earning the median income of almost $70,000 per year, the acceleration in inflation is adding an estimated nearly $200 per month to living costs.

But this uncomfortably high inflation isn't here to stay. It won't be lower a month or even three months from now, as quelling the chaos created by the pandemic will take time. But a year from now, as the pandemic recedes, inflation will be low enough that we won't be talking about it. The hair-on-fire discourse over high inflation is understandable, but it's overdone.

Consider that inflation is up in part because businesses that suffered a direct hit from the pandemic, such as clothing stores, hotels, rental car companies and restaurants, are simply restoring prices they slashed earlier in the pandemic to survive. This is a one-time adjustment in their prices. To understand the size of the impact, consider that consumer price inflation over the past two years through October, which abstracts from the wild pandemic-induced swings in prices, is up 3.7% annually. Still high, but much less than 6.2%.

The higher inflation is also the result of businesses only slowly increasing production in response to recovering demand. This isn't unusual coming out of a recession. Businesses are unsure whether the stronger demand has staying power and are cautious about ramping up production. And it takes some doing to get shuttered factories, oil rigs and hotels back up and running. But if history is a guide, the higher prices will convince consumers to buy less of what costs more and convince businesses to increase production given how much money can be made at these higher prices. Frictions that slow supply catching up with demand ease, and inflation moderates.

This dynamic is playing out in the global oil market. Prior to the pandemic, the world was consuming, and oil companies were producing, more than 100 million barrels of oil a day, and gas cost $2.50 a gallon. Today, because of the pandemic, the world is still consuming roughly 100 million barrels a day, but oil companies are producing even less, causing gas prices to soar to close to $3.50 a gallon. It's not that the oil industry doesn't have the capacity to produce more, but it likes the higher prices and is thus reluctant to increase production. But it won't take long before the juicy profits and competitive pressures entice the industry to increase output. Oil and gas prices will come back down, and instead of adding to inflation, they will become a drag on it.

There is no doubt that the gap between demand and supply, and thus inflation, will be much more persistent coming out of the pandemic. Global supply chains have been severely scrambled. Emerging economies, particularly in Asia, where many global supply chains begin, were especially hard-hit by the Delta wave. For example, Malaysian semiconductor plants were severely disrupted as infections surged in the country, forcing factories to shut down and upending vehicle production that depends on those chips across the globe. Vehicle inventories have never been lower in the US, and prices have surged.

The Delta wave also reshuffled the already topsy-turvy job market. Millions of workers weren't able to fill the near-record number of unfilled open jobs because they got sick, were taking care of the sick or fearful of getting sick. Employers have had no choice but to provide signing bonuses and higher pay to attract and retain workers, and then raise prices to help cover their higher labor costs. But as Delta fades and workers get healthy and return to work, the acute labor shortages and outsize pay increases will end, which means higher prices will too. What's more, workers who permanently lost jobs during the pandemic will find a new employer; parents who've been home tending to children in school online will return to work as schools continue to return to in-person learning; and parents with younger children will take jobs as children eventually get vaccinated and daycare becomes more widely available.

My inflation outlook could be Pollyannish, but only if inflation expectations — what investors, businesses, consumers and economists think inflation will be in the future — rise. If there is a widespread view that inflation will remain high, workers will demand higher wages to compensate and businesses will ante up, believing they can pass along their higher costs to their customers. This vicious wage-price spiral was behind the persistently high inflation we suffered 30 years ago. But there is no evidence that this is happening today. Investors' inflation expectations remain steadfast at just above 2%. This is spot-on with where the Federal Reserve Board, whose job it is to manage inflation, wants them.

All of this refutes the notion that the government spending and tax breaks to support the economy through the pandemic, including the American Rescue Plan this past March, are somehow behind the higher inflation. These factors certainly gave a boost to demand last spring, but that faded when the Delta variant gained momentum this fall. There is also no good way to connect the dots between the Build Back Better agenda, which is currently being debated in Congress, and higher inflation. The legislation provides support for public infrastructure and various social programs, and longer term, it is designed to lift the economy's growth potential, which will ease inflationary pressures.

The economy remains closely tethered to the pandemic. This summer's Delta wave of infections hurt growth and sparked inflation, but as infections subside, growth is already picking up and inflation will go back into hibernation.

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