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# Economist: Higher prices will ease by this time next year

By Mark Zandi
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Long-dormant inflation has suddenly come back to life, putting a heavy financial weight on already hard-pressed American families struggling with the economic fallout from the Covid-19 pandemic. But hyperventilated rants about how uncomfortably high inflation is here to stay are misplaced. As the pandemic recedes, so too will inflation.

The drama is understandable. Inflation, which measures how fast prices for the goods and services we buy are rising, has taken off. The widely followed consumer price index, which measures prices paid by the typical consumer, is up 5.3% over the past year through June. This is the highest inflation rate since summer 2008. Back then, surging oil prices were the issue, as the cost of regular unleaded gasoline soared above $4 a gallon — an all-time record. FYI: Gas prices today are just over $3 a gallon. Prior to 2008, one must go back to the George H.W. Bush administration, about 30 years ago, to find inflation as high as it is today.

But it is wrong to get all worked up over today's high inflation. It will soon abate. Businesses that suffered a direct hit from the pandemic (airlines, hotels, clothing stores and restaurants, for example) are simply restoring prices they slashed early on to survive the pandemic. This is a one-time adjustment. To see how big an impact this is having, consider that consumer price inflation over the past two years, which abstracts from the wild pandemic-induced swings in prices, is up 3% annually. Still on the high side, but much less so.

It is also typical for inflation to get a temporary bump on the way out of a recession. Demand picks up right after economic downturns, but supply is slow to catch up, and prices spike. This happened after the financial crisis a decade ago. Businesses are unsure whether the improved demand has staying power and are cautious about ramping up production. It takes some doing to get shuttered factories, mines, hotels and global supply chains back up and running. The last thing they want coming out of a recession is to be wrong-footed about demand.

If history is our guide, higher prices quickly convince consumers to buy less of what costs more. And, given how much money can be made at these higher prices, businesses figure out how to iron out their supply-chain issues and increase production. Frictions that made it difficult for supply to catch up with demand are resolved, and prices moderate.

The lumber industry is the poster child for this dynamic. Prices went parabolic as sawmills couldn't keep up with the soaring demand from all the new homebuilding and do-it-yourselfers fixing up their homes while sheltering in place. But lumber prices have tumbled in recent weeks as homebuilders balked at the higher prices and delayed building until lumber becomes more affordable. Moreover, investment in new sawmill production is picking up. Lumber prices are still higher than they were pre-pandemic, but that won't be the case a year from now.

To be sure, the disconnect between demand and supply is likely to be more persistent coming out of the pandemic. Global supply chains are badly scrambled, and the pandemic is still raging in many parts of the world, especially in emerging economies, where many supply chains begin. Sorting it all out will take more than a few months. But the sorting has begun.

Steady inflation expectations — what investors, businesses, consumers and economists think inflation will be in the future — are also a reason to be sanguine. Inflation becomes a pernicious problem when there is the widespread belief that inflation will remain high, and workers demand bigger wage increases to compensate. Businesses then pass on their higher labor costs in even higher prices. A dreaded wage-price spiral takes hold. This vicious cycle was behind the high inflation we suffered over 30 years ago.

Inflation expectations are higher today than pre-pandemic, but this is a feature, not a bug. The Federal Reserve Board was concerned that inflation expectations and inflation were too low; both were consistently below the Fed's 2% inflation target. Not anymore. According to the most recent Philadelphia Federal Reserve's survey of professional economists, inflation over the next decade is expected to be just over 2% — precisely what the Fed wants.

There has also been handwringing that the record number of unfilled open jobs and pressure on employers to provide signing bonuses and higher pay to help fill them will force businesses to raise prices. But the acute labor shortages won't last much longer. Workers that permanently lost their jobs during the pandemic, likely because their employers failed, have needed time to find a new employer and figure out a new work arrangement. Parents stuck at home with the kids when schools were online will come back to work in the new school year once their kids go back to in-person learning. Those who have been caring for elderly parents or sick family members or friends won't need to do this much longer and will go back to work, given that Covid cases, though on the rise, are much lower than they were at the height of the pandemic.

Since the pandemic hit, businesses have also figured out ways to significantly increase worker productivity, lowering costs and easing pressures to raise prices. It often takes big changes in the way businesses are organized and operate to take full advantage of the technology and investments they've made. They are reticent to do this when things are going well and often apply the "if it ain't broke, don't fix it" philosophy. The pandemic gave many businesses no choice but to fix things. They have made big changes, and it shows in the higher productivity.

If everything sticks roughly to script, inflation will moderate to between 2% and 3% by this time next year. Not too hot. Not too cold. Just right.

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