Season 3 | Episode 3 (Pt 1 of 2)

Brace for Impact:
The Coming Pressures of Inflation

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James R. Harrigan & Antony Davies

Co-Hosts, *Words & Numbers* podcast

Full transcript

Guests:

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Announcer:

Welcome to Thrive, a Paychex business podcast, where you'll hear timely insights to help you navigate marketplace dynamics and propel your business forward. Here's your host, Gene Marks.

Gene Marks:

Hey everybody, it's Gene Marks. And today, I have two very, very special guests that have been joining me, James Harrigan and Antony Davies. Now, James is the senior editor at the American Institute for Economic Research and the F.A. Hayek Distinguished Fellow at the Foundation for Economic Education. And Antony is an associate professor of economics at Duquesne University in Pittsburgh and the Milton Freeman Distinguished Fellow at the Foundation for Economic Education. James and Antony are heroes of mine, I have been listening to their great podcast, called Words and Numbers, for quite some time now. What this podcast does is, it breaks down seemingly complicated economic things, really to the low, low level of understanding that I need, to really understand what's going on in the world around me. Some of my favorite episodes, they talked about, a look at taxes that disincentivize work, as well as, sort of, the perils of looking back at what we called the good old days and how some of that is a bit of a myth.

Gene Marks:
Those are just some of the examples of the great podcast that they do at Words and Numbers. You can find this podcast on Apple, Spotify, anywhere else, podcast are offered. They have a Patreon account, it's patreon.com/wordsandnumbers. And they also have a great book, Cooperation and Coercion, which you can find at cooperationandcoercion.com. This segment, we are talking about inflation, we all know that it's impacting our businesses. These two guys are going to break down why inflation is going up, what they expect in the future and by the way, it ain't good news. And finally, what maybe we can be doing as business owners to prepare ourselves and navigate ourselves around these times of higher prices. So, James and Antony are coming right up, I think you're going to love this conversation and we'll be back in a moment.

Gene Marks:
So, Antony and James, thank you very much for joining me.

James Harrigan:
Thanks for having us.

Antony Davies:
Thanks for having us.

Gene Marks:
So, episode 231 of your podcast, which I have a note here, aired July 14th of this year, "The Misinformation on Inflation." Inflation is a topic near and dear to our hearts, as people that are running small businesses. So, Antony, I'm actually going to start with you. What do you mean by the misinformation on inflation?

Antony Davies:
Well, part of it is, people will see a price rise, so you see the price of milk going up or the price of gas going up and someone says, "Oh, well, that's inflation." And that's not inflation. Inflation is a rise in the average price level. So, you could see actually the price of gas going down during a period of inflation. The individual prices aren't what matters, what matters is the average price level. And we've been seeing that, it's been constant, good Lord, for what — like, three decades? — at about 3%, give or take a bit. And what's disturbing is, since February of this year, we've seen some serious inflation. It's varied from a low of five and a half to a high of, I think, 8 or 9%, on an annualized basis, since February. And James and I have written about this in the past frequently that, we're on a collision course with inflation and people keep saying, well, "Where is it? Where is it? Where is it?" Well, I think it's starting to show now.

Gene Marks:
Why do you think we're on a collision course? James, go ahead.

James Harrigan:
No. Let Ant start here, this is more in his bailiwick than mine.

Gene Marks:
Okay.

Antony Davies:
Well, I think, we're on a collision course because what has happened is, the federal government has become unhinged from its constitution and this goes back to the 1930s. In becoming unhinged, all of a sudden, the federal government is doing things that it has no business doing, and in turn, that costs

money. Now, here's the problem for the politician. I, the politician, want to spend money, where am I going to get it from? I got to raise taxes. Well, the voters don't like that, so I can't raise taxes. So, I'll borrow. And politicians got away with borrowing a lot ever since the Reagan years but eventually you run up, again, against the voters, who's concerned that the debt is getting too high or, as in the case of the federal government today, you borrowed so much money, there's no place left on earth to borrow more.

Antony Davies:
And what I mean by that is, the rate of growth of our federal debt exceeds the rate of growth at which lenders are willing to lend. Who takes up the slack? The Federal Reserve. The Federal Reserve prints the money, loans it to the federal government. But unlike the other lenders, when the Federal Reserve prints money and loans it to the federal government, then we get inflation. And I think what's going to be happening down the road is, we're paying for an overextended federal government through higher prices.

James Harrigan:
Yeah. And I don't think it's going to get any better. We're looking at a situation that, if you're old enough, it rivals or it will come to rival the end of the Carter years, beginning of the Reagan years, when we had double-digit inflation and double-digit unemployment. People said, until then, that that was impossible, so we crossed a Rubicon there. But it's interesting, right? Because if you take a step back and you look at the history of government spending, you find very interesting things. So, from the founding, 1787, until about 1928, government spending, as a fraction of all spending in the economy, is about three-and-a-half to four-and-a-half percent, it was a remarkably straight line. Enter Herbert Hoover and the progressive presidents that followed, and it starts going up precipitously, until it gets to — correct me if I'm wrong here — at about 30, 35%.

Antony Davies:
Yeah. I think all levels of government combined. Federal government, I think, we're around 20, 22.

James Harrigan:
Yeah. And that trend shows no indication of stopping.

Gene Marks:
James, what is Modern Monetary Theory and how does that dovetail into what you've just said?

James Harrigan:
All right. MMT, we actually... This was probably our least successful podcast episode.

Gene Marks:
Which is going to doom this one — is that what you're saying?

James Harrigan:
Well, yeah, because we invited an MMT expert on, and we all walked away after it was done, more confused than when we started.

Gene Marks:
Try to make sense of it for us.

James Harrigan:
I wish I could. I refer to it as "Magic Monetary Theory," right? Because it takes as a given that the federal government, or any government, really, could spend as much as it wants and there is never going to be any ramification for that — for all kinds of technical reasons that nobody can possibly understand or care about. Ant, I think I've done it fairly.

Antony Davies:
Yeah. I think, I mean, we all understand the basics, which is, they're saying that the Federal Reserve can print as much money as the federal government needs to spend, and you don't have to worry about inflation. Now, that has economists everywhere — with the exception of the MMT corner — scratching their heads, because that flies in the face of what we understand, right? And then when you push them on it, they'll say, "Well, but if you do get inflation, you can rectify the situation by raising taxes-" [crosstalk]

Gene Marks:
Raising taxes, yeah.

Antony Davies:
Thereby, siphoning money out of the economy. [crosstalk]

James Harrigan:
Because that always helps. [crosstalk]

Antony Davies:
That sounds all well and good until you realize that they've just pulled a sleight of hand. Because when the Federal Reserve prints money, hands it to the federal government, the federal government now spends it, you'd get inflation normally but no — the federal government's going to raise taxes to pull that extra money out of the economy, so we don't get inflation. What has just happened in the background is that you have changed the composition of GDP. That is, our economy is producing less of things that consumers want, and more of things that politicians and bureaucrats want. All you have done is crowded out the private sector, but the MMT people don't talk about that because all they look at is the GDP numbers. And yes, at the end, your GDP numbers will be the same — it just won't be GDP of houses and cars, it'll be GDP of border walls and tanks.

James Harrigan:
And as we got further into this ridiculous line of reasoning, you know, from the political side, I remember seeing one of the House of Representatives members say, "What we really should do is just make two coins that are worth a trillion dollars each."

Gene Marks:
Right.

James Harrigan:
And in her mind, this solved everything. But when you've gotten here, I don't know where else you can go. This is just patently absurd.

Antony Davies:
And what's going on here is what economists call monetary illusion, that is, people fixate on the dollars. And we, people, politicians, the media, consistently are susceptible to money illusion, when we say things about the rich are sitting on wealth and that should be recycled, that's money illusion. Talking about MMT, it's money illusion. And what money illusion is, is looking at the dollars to the exclusion of the goods and services. What matters is the goods and services, the dollars are simply a tool we use to move them back and forth.

Gene Marks:
But I thought the idea of Modern Monetary Theory is that — as long as the ... whatever money's being printed by the Fed can be absorbed into the economy, and as long as it's the same currency — so we're not talking about Greece. So, you're just printing dollars and it's going out to American companies to build

buildings and infrastructure and roads, and provide those services, and all that. But it's being consumed by those companies, then the government can keep printing money to do that because the economy is able to absorb it. Isn't that what the theory is supposed to be about?

Antony Davies:
Yeah. And there's two points here. There is an argument that, if you printed the money and then just handed it to businesses that would invest in infrastructure ...

Gene Marks:
Right.

Antony Davies:
... in the future, down the road, our productivity would be so enhanced that our economy would've, in effect, grow into this enlarged money supply.

Gene Marks:
Right.

Antony Davies:
And that's fine, but it requires, first off, that when, after the money is printed, the government actually does hand it over to businesses, as opposed to spending it on whatever it spends on. And two, that the businesses, when they receive it, actually do invest in infrastructure expansion, this sort of thing. Which is actually the opposite of what we saw during the COVID stimulus. Businesses took the COVID stimulus money, and in aggregate — of course, the individuals vary — but in aggregate, they sat on it. They put it in financial markets. So, that's one thing. The other thing that's going on is, they talk about the U.S. Dollar being a reserve currency, that we're not going to suffer inflation because countries globally hold the dollar as a reserve.

Gene Marks:
Right.

Antony Davies:
And here's all that is saying, what it's saying is, if we inflate our currency, we can spread the inflation pain over — not just ourselves, but the rest of the planet. And so, we'll feel it less because the foreigners are going to be shouldering some of the burden.

James Harrigan:
Sure.

Antony Davies:
That's the only thing it means. And on top of that, the only reason we're a reserve currency is because the foreigners have said, "Look, there's the U.S. dollar, it's a stable currency — let's invest in it." The minute it ceases to be a stable currency, it will also cease to be a reserve currency.

James Harrigan:
There have been other reserve currencies that are reserve currencies no longer. The British pound comes to mind immediately, but that's by no means the only one. And I think what you see here is just a naked move to pass the pain to other places. And even so, there's still too much pain to go around, right?

Gene Marks:
Right.

James Harrigan:
And we're going to be looking at things, I think, in a radically different way really, really soon, because it's obvious that we're now in an inflationary period. It's impossible to claim that that's not the case.

Gene Marks:
So, okay. So, my takeaway is, not a big fan of Modern Monetary Theory. That's fine. So, okay. During COVID, the Treasury, with the help of the Fed, we had an increase of something like $4 trillion in our M2 money supply. Which, my understanding was that, that's a good thing. It was a lesson. And please, correct me guys if I'm wrong, but one of the lessons we've learned from the Great Depression is that, if the government could provide liquidity, particularly to our financial system, that helps the economy ride through potential recessions and depressions. And there was a lot of liquidity provided by the government during COVID. So, that was probably pretty good but now the Fed's balance sheet is very, very high and a lot of people are concerned that, because of the size of the balance sheet, that's going to cause inflationary issues. So, I guess, either James or Anthony — I don't know which one of you guys want to comment on that — is that one of the factors that are in play here?

Antony Davies:
Yeah. I think that's the case. We were, kind of, caught between a rock and a hard place. If you're going to take it as gospel, that lockdown was a good idea, then- [crosstalk]

Gene Marks:
And by the way, I heard the episode — the cost of doing all that. So, takeaway: No, it wasn't a good idea but okay, we'll carry on.

Antony Davies:
So, the next, the next best thing is to do what they did, which is, let's do some stimulus spending. Now, in my opinion, the better thing to do was not to have the lockdown in the first place, but I'm an economist, not an epidemiologist. So, if you look back to what happened during the 1930s, the United States went through a period. We go through the Depression and the Federal Reserve, at the time, is afraid of inflation, cuts back on the money supply. And at the same time, that there were price controls in place. So the government, on the one hand, is heavily controlling the economy. On the other hand, the Federal Reserve is starving it of dollars, and that caused, what would've been otherwise, a financial phenomenon, something exactly like we saw in 1987 —

Gene Marks:
Right.

Antony Davies:
— when the stock market crashed by the same percentage as it crashed in '29. It caused what, otherwise, would've been a financial phenomenon, to jump into the goods and services market. And then you've got real pain of: we can't produce stuff and people are unemployed. And if you want a good counter example, look at, basically, the rest of the world. The rest of the world, the other developed countries, did not go through 10 years of Great Depression. Why? They didn't have the Federal Reserve.

Gene Marks:
Fair enough. Okay. So, let's pivot a little bit while we're still talking about inflation. I mean, we've talked about the government influences on this and the increase in the money supply and how we're, kind of, heading down that road. But all we do hear about right now is supply chain issues. And, again, James, I'm going to point this question to you, but if you want to defer to Anthony, that's fine. The producer price index was

just released a week or two ago, they said the producer price index had increased on an annualized basis, about 8.3%. I mean, guys, every one of my clients that are in the manufacturing distribution world are reporting back to me that their cost of materials have gone up triple, quadruple, quintuple the amount.

Gene Marks:
I mean, as we know, the price of lumber, although it's decreased recently, has increased something like 90% over the past year. The price of iron and steel have also increased, at the same level. Shipping prices — the cost of a container has gone up five times what it was a year ago. And then we hear that, like, well, producer price index has only increased 8.3%. So, I guess, my question is, why would that number be so much lower, when I'm hearing from everybody that price increases seem to be so much higher? And do you see this still as an indication that core material price are going to continue to go up — we're going to be seeing this for many months to come? So, James, I'll let you have at that one.

James Harrigan:
Yeah. And honestly, when I step back and I take a look at all the things that we like to take a look at, housing prices seem to be the one thing that — it's just killing everybody, right?

Gene Marks:
Yeah.

James Harrigan:
And that's the one thing out there that seems to draw from every one of categories that you mentioned, right? So, there's no escape there. And I think there's no escape in a number of other smaller things too. But boy, where I am in Tucson, the cost of homes is up roughly one third in the past 6, 8 months. Well, lumber is more expensive, it varies here and there — but it's so too, every other building material. And I'm starting to see it at the grocery store, I'm starting to see it at the convenience stores, all the stores I go to. All of a sudden, prices are ticking up everywhere, but not enough to be shocking to anyone — and I wait for that to come — but the housing market has been shocking.

Antony Davies:
Yeah. And I, I think part of what might be at play here is inventories. And I was astounded by the PPI numbers, they're a multiple of the CPI numbers — and the CPI numbers are disturbing enough, on their face. And I can't help but point a finger of, at least, partial blame to the expanded unemployment benefits.

James Harrigan:
Right.

Antony Davies:
And it's understandable. We're in this situation where our unemployment was 14% at the peak, and we want to do something to help people and so, we have this expanded unemployment. I think we hit that way too hard, to the extent that,, if you run the numbers, the typical American earning $15 an hour is better off just staying home and saying, "No, I'm unemployed —"

James Harrigan:
Right.

Antony Davies:
"— I'm actually better off on the expanded unemployment benefits than I am working." So, take that and multiply it by lesser skilled manufacturing jobs, and all of a sudden, you've got a serious manufacturing problem: the people can't produce stuff. And I'm seeing this all over the place. I went to buy a bike, of

all things, and the guy at the bike store says, "No, you're going to have to wait about a year, because the producers aren't producing the stuff." I wanted to get new siding on my house — young guy had a new business, he'd been in business for a year, we had it all arranged. I called him up. I said, "Okay, I'm going to pull the trigger on the siding, come on, and do it." He said, "No, I'm actually going out of business." I said, "What's going on?" He said, "It's not the clients. I've got plenty of clients. I can't get anybody to work for me."

James Harrigan:
Yeah. And Ant and I have talked about this before, and it may come as a shock to people who have heard us or read something we've written, but we were pretty solidly behind a lot of the payouts that the government made, right? On the logic that, well, this was a problem created by the government and various state governments in the first place. And if that's true, then everybody who's out on the tiles personally, is an innocent victim.

Antony Davies:
Right.

James Harrigan:
Right? So, the best thing under those circumstances is likely government action — and this, from two guys who almost never say such a thing, right? We always want government to do less, not more. But people had real pain here, and that real pain was parlayed into a rather comfortable life for a lot of people who now don't want to work. And I can't say I blame them, if they can get more sitting at home than they can out in the workforce.

Gene Marks:
Well, some of these benefits are, as we're speaking right now, have run out — the added federal supplements. So, there's no question. Hopefully, with Delta, people will gradually feel more comfortable coming back to work, obviously, a lot of big companies are pushing it. Although, I have to tell you, I drive around to my clients in the Philadelphia area, the parking lots at the industrial parks and the office parks, they're pretty full. I mean, smaller businesses, people are coming into work, it's like the larger companies seem to be afraid to, maybe it's liability reasons or bad PR, but they're afraid to have their employees come back.

Gene Marks:
Which brings me to my final question related to inflation. And we've talked about materials, consumer price index, the government effect on this. There's wages, right? I mean, there is a shortage of workers right now, we know that. There's 11 million unfilled jobs out there. To me, is that not just simple supply and demand? When we know the supply is low, we know that there is still high demand for product and manufacturers and a lot of my clients are busy. They're going to have to pay more for workers and I think that's going to be a fact for the foreseeable future. I mean, what do you guys think about that?

Antony Davies:
Yeah. And I agree with that, it is supply and demand. But the demand for labor, in a sense, if we want to call it that, is being artificially jacked, because what employers have got to do now is not simply, as usual, compete amongst each other for a limited workforce, they've got to compete amongst each other and compete against the government that's paying people not to work.

James Harrigan:
Right. That's right. And that's a really difficult fight to win. And I think it's a little worse than that too, Ant, because we've trained people to understand what's probably going to happen next. And they think that

they can wait it out, they think they don't have to go to work, and sooner or later, they'll just get some kind of enhanced federal benefit to fix it for them down the road. And you see just how difficult this gets.

Antony Davies:
I think you're right, James. And I think that continues until people look around and realize, that stuff's disappearing.

James Harrigan:
Right.

Antony Davies:
I go to my beloved Sheetz, the gas station, and I get the jalapeno poppers that I absolutely love. They've been gone — no jalapeno poppers. And now there's no mozzarella sticks anywhere, in any of the Sheetz.

James Harrigan:
Yeah.

Antony Davies:
This is a production problem.

James Harrigan:
Yeah.

Antony Davies:
And it's a production problem, not because we don't have cheese and jalapenos, it's because we don't have workers.

James Harrigan:
Right. Buying things during the time of COVID was very, very difficult, right? We couldn't find any number of things, and people were hoarding because that behavior made sense. But if you go now into one of the big giant places, — like, I have a Sam's Club membership, and you walk up and down the aisles. Almost everything is back, but every week, something different isn't —

Gene Marks:
Right.

James Harrigan:
— and you get these rolling shortages. And when people put it together — and I don't think they have yet — when people put it together, they're going to start hoarding again. And that's going to unloose all kinds of problems.

Gene Marks:
All right. So, let's wrap up this conversation on inflation with, at least, some advice from you guys. I mean, I know you guys are a couple of academics, but we're speaking to business owners here, right? So, you know, I'm running a business, I have 10 employees in my company but I've lots of clients with lots more employees. I'm going to pick on you, Antony, first. If you were running a smaller midsize business in an era of rising prices, tell me what you think you might be doing to try and mitigate some of those costs.

Antony Davies:
Well, I could tell you one thing — and I underline, I'm not a financial advisor — but I could tell you one thing I would definitely be doing, and that's leveraging. Borrowing as much as I could at fixed interest rates,

long-term. So, get 30-year fixed interest rates, I'm paying 3, 4%, whatever, that's fine, and park that money because when inflation hits and interest rates start going up to 5, 6, 7%, you invest that money that you're sitting in and you're living off of the Delta in the interest rate and it's not even your money.

Gene Marks:
And by the way, I need to jump in there. Just recently, with President Biden's new COVID action plan, they've tweaked the terms of the Economic Injury Disaster Loan program, where now small businesses can borrow up to 2 million, and use the proceeds to pay down other debt, that's a new thing.

Antony Davies:
Right.

Gene Marks:
And because of that, those are, like, to your point, 30-year fixed rate of 3.7, 5%, which could look pretty genius a few years from now, if interest rates, like you think, could be going up.

Antony Davies:
And this goes back to our earlier point, that the intent, of course, is to make this money available so businesses invest in infrastructure.

Gene Marks:
Yeah.

Antony Davies:
They're largely not going to do that. They're going to do, make financial plays using this money.

James Harrigan:
Right. And when you think about it Ant, buying a house right now is difficult, but who wins in a time of inflation? And the answer is always, people who hold the most debt. So, following right behind you, I would be looking at my debt thinking, how can I get more of that? Which is counterintuitive, but you know, I bought a bigger house than I had any business buying just recently, because I knew — beyond a shadow of a doubt, in my own mind — that inflation was going to pay for that mortgage, and I wasn't. Now, there'd be a few years upfront where I'm on the hook for it. But I remember my father buying a house on a 30-year fixed, in the mid '60s. And by the time he was at his last 10 years of mortgage, it was so ridiculous that everybody thought about it as free, right? It was $80, $100 a month, something like this. It was laughable, and the bank would call him every month or two saying, "Can you just please pay this off?" And he would say, "Look, if it's that important, you pay it off."

Gene Marks:
Right.

Antony Davies:
Right.

James Harrigan:
And there's something about that, when you look out on the landscape right now, that's exactly what's going to happen. And it's hard to crack your way in, if you're a first-time home buyer, for instance, and you're looking at the inflated prices in the housing market. But you might be better off paying them, because in the end, after 30 years, at an interest rate so low, as to be incomprehensible, I got a 2.8% loan. That's ridiculous, right?

Antony Davies:
James said earlier that, we will be looking at a redo of the 1980s, the interest rates we saw then. And the difference is, in 1980s was a blip. I don't think this is going to be a blip.

James Harrigan:
I think that's right.

Antony Davies:
But nonetheless, I point everyone to my finance professor when I was in college, who said that, at the height of the interest rates in 1980s, he had a CD. He got a long-term CD, at 15% interest. [crosstalk]

James Harrigan:
Right. And he lost money. [crosstalk]

Antony Davies:
And like your father, James. Yeah, the bank was constantly calling him in the 1990s saying, please cash this in! He said, "No, it's 15% on a CD."

James Harrigan:
In '81, '82, you could have gotten a CD at about 16%. Meanwhile, inflation took more than that away from you. So, you'd wrap up all your money in a CD, and you'd actually lose money doing it.

Gene Marks:
We've ran out of time and yet I can't, I just have to ask this one final question. And Antony, let me point it to you though is, we've talked about all the terrifying things about inflation but isn't there good inflation? Is this all bad?

Antony Davies:
That's a really hard question to answer.

Gene Marks:
Yeah.

Antony Davies:
Economists will tell you that, 1 to 2% inflation is good. I have problems with that. I think any inflation is stealing from people's savings but I can understand the argument — 1 to 2% inflation, take that for what it's worth.

Gene Marks:
Okay. Fair enough. Guys, thank you very much for joining me, great conversation and appreciate your time.

Gene Marks:
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