Testimony
Before the House Majority Policy Committee
Hearing on "What Causes Inflation?"

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Chairman Causer and distinguished members of the Majority Policy Committee, my name is Christopher Hansford and I'm the Director of State Relations at the Cato Institute. I thank you for the opportunity to take part in today's hearing entitled, "What Causes Inflation?"

Inflation has caught the attention of the nation and the world, alike. The prices of food, gasoline, and general goods have been rising at historic rates as of late. In this testimony, I'll try to provide background information for better understanding how the consumer price index is used to measure inflation and what role the Federal Reserve has in handling inflation. And in closing, I'll also provide recommendations that may help relieve inflationary pressures within the Pennsylvanian economy.

Understanding the Consumer Price Index

What is the Consumer Price Index?

When considering questions of inflation, the most common indicator that economists turn to is the consumer price index, or CPI. The CPI is an index, or basket, of common goods and services provided by the U.S. Bureau of Labor and Statistics (BLS) that is used to measure price changes over time. With inflation defined as an increase in the *general level of prices*, the CPI therefore offers an insight into what inflation has been and where it might go.

To best approximate the general level of prices, the CPI includes around 94,000 prices that are surveyed and updated each month through a combination of in-person and remote data collection.[1] With the raw data in hand, the BLS distills that information down into groups (i.e.,

[1] U.S. Bureau of Labor Statistics, "Consumer Price Index: Data Sources," Handbook of Methods, https://www.bls.gov/opub/hom/cpi/data.htm; U.S. Bureau of Labor Statistics, "Consumer Price Index," https://www.bls.gov/cpi/.

food, energy, commodities, apparel, transportation, medical care, education, etc.). For instance, while year-to-year inflation was measured at 8.3 percent in April 2022, gasoline increased 43.6 percent and televisions decreased by 5.8 percent during the same time period.[2] The crucial distinction between these three rates is that while individual goods and services may rise and fall, inflation refers, as noted previously, to an increase in the general level of prices.

In most cases, “the CPI” is used to refer to the consumer price index for all urban consumers, or CPI-U, which covers the majority of the U.S. population (approximately 93 percent). However, there are other indicators worth considering as well. The consumer price index for urban wage earners and clerical workers, or CPI-W, focuses largely on those earning hourly wages. In addition, there is also the core CPI which excludes energy and food prices because they tend to be more volatile than the rest of the index. Additional measures include indexes for producers as well as custom indexes (i.e., to account for changes in spending habits during the pandemic).

How is the CPI Used to Measure the Economy?

Each month, when the BLS releases new CPI data, economists largely consider the data from two perspectives. First, there is the month-to-month change (Figure 1).[3] This short-term window isolates what is currently happening in the economy from both base effects and compounding.[4] In other words, it is more likely to reflect the real change—the change felt by consumers in their day-to-day purchases—occurring in the general level of prices.

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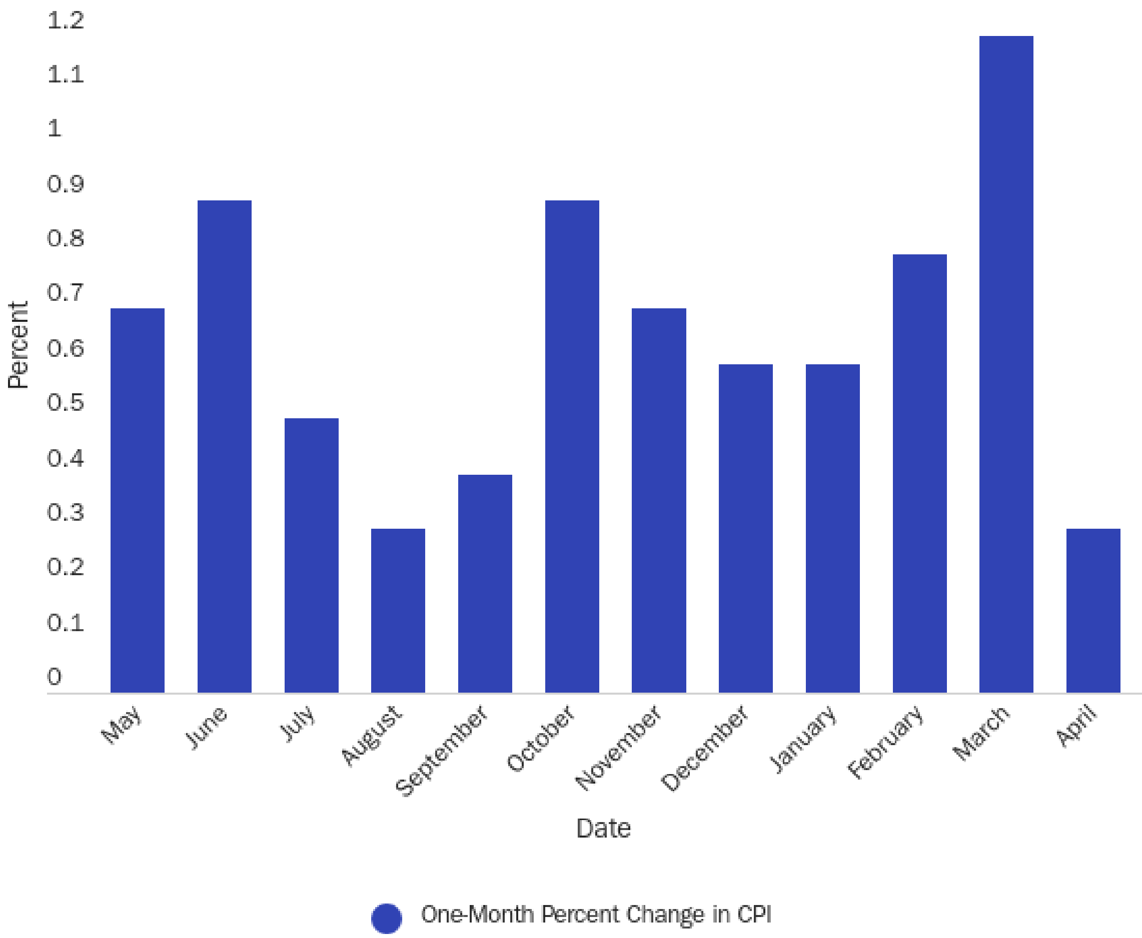
[2] U.S. Bureau of Labor Statistics, “Consumer Price Index – April 2022,” News Release, May 11, 2022, https://www.bls.gov/news.release/pdf/cpi.pdf.

[3] U.S. Bureau of Labor Statistics, “Consumer Price Index,” https://www.bls.gov/cpi/.

[4] Alan Reynolds, “The Mystifying Arithmetic of Year-to-Year Inflation Estimates,” Cato Institute, July 29, 2021, https://www.cato.org/blog/mystifying-arithmetic-year-year-inflation-estimates-4.

Figure 1

One-month percent change in CPI for All Urban Consumers (CPI-U), seasonally adjusted



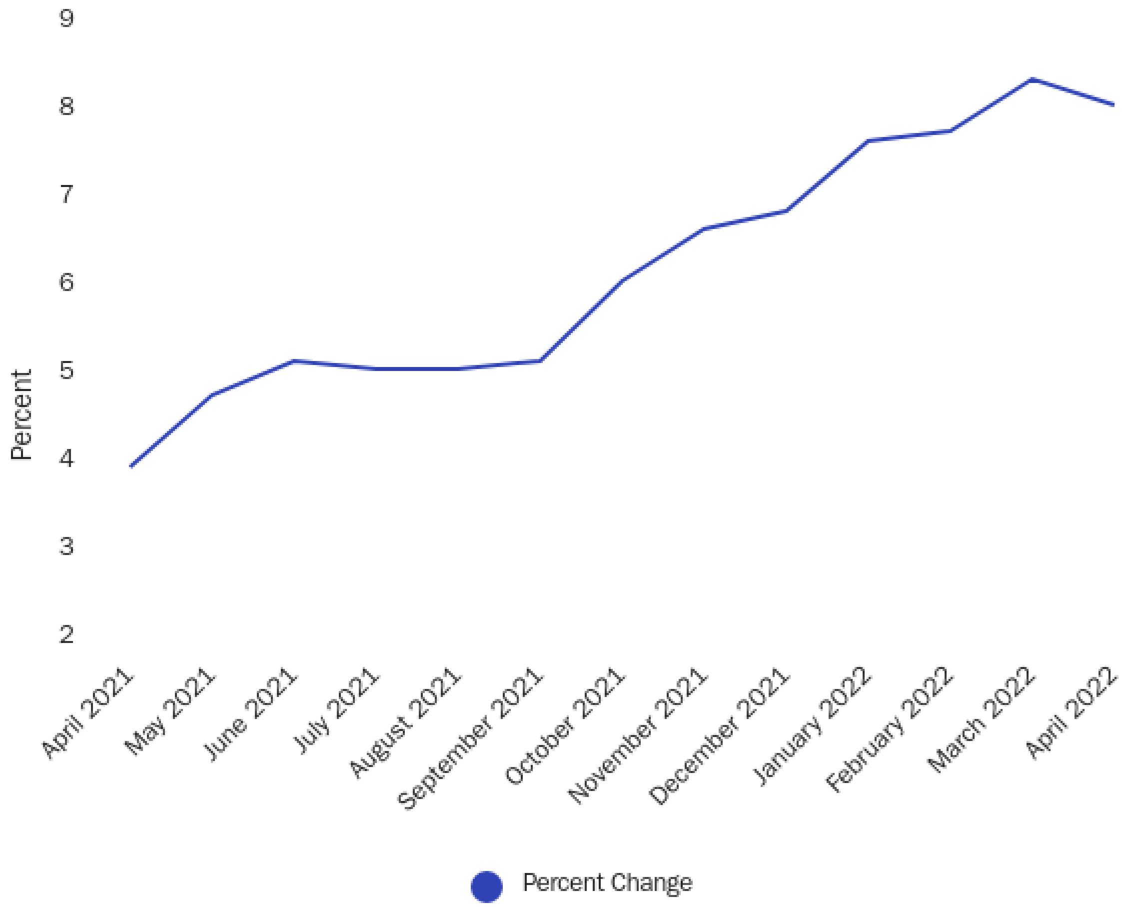
Source: U.S. Bureau of Labor and Statistics

Second, economists turn to the year-to-year change. As the name suggests, this comparison involves looking at how the CPI has changed over the last twelve months (Figure 2). While this measure has its flaws,[5] it routinely used in assessing the direction of the economy and it is the most commonly cited figure in media headlines.

[5] Alan Reynolds, "The Mystifying Arithmetic of Year-to-Year Inflation Estimates," Cato Institute, July 29, 2021, https://www.cato.org/blog/mystifying-arithmetic-year-year-inflation-estimates-4.

Figure 2

12-month percent change in CPI for All Urban Consumers (CPI-U), seasonally adjusted



Source: U.S. Bureau of Labor Statistics

Understanding the Role of the Fed

To understand the Federal Reserve's (Fed's) role amidst inflation, it's important to begin with its congressional mandate: to maintain stable prices and maximum employment. The Fed does not set either the inflation or interest rates, but it does try to steer those rates by using monetary policy. As new data on inflation (i.e., the CPI) emerges, the Fed makes decisions about the appropriate course of action.

For example, during times of high inflation, the Fed will use contractionary monetary policy to tighten the money supply. In other words, the Fed will try to pull money out of the system so there are fewer dollars in the system chasing the same number of goods in services. In periods of low inflation or even deflation, the Fed will do the opposite.

The Fed's current framework is referred to as flexible average inflation targeting, or FAIT. Under this framework, the Fed seeks to target an average inflation rate of 2 percent. Unfortunately, however, the Fed has not shared with the public how exactly it calculates that average. For instance, it could be an average over two periods, or it could be an average over 200 periods. Because of this lack of information, the public has no way to verify the Fed's success in achieving an average of 2 percent.

Although the Fed has not been sitting completely idle during this time, [6] it's important to be clear that the Fed is not a savior for the economy and monetary policy is not a panacea. As Norbert Michel has warned in the past, it cannot be overlooked that the current inflation is a result of both the global COVID-19 pandemic *and* the corresponding government's response.[7] Regarding the pandemic, there are businesses still operating in a reduced form or that never recovered at all and thus the total output of the economy is limited (i.e., there are fewer goods and services available). Regarding the government's response, aside from shutting down much of the economy and leading to the direct failure of many businesses, there is also the unprecedented degree of stimulus spending to consider (i.e., more dollars available in the economy). This combination of fewer goods and services and greater dollars chasing those goods and services is indeed fertile ground for inflation. But it also means that policy that seeks to counter inflation must seek to address both factors. And for that reason, it is important that targeted policies are used.[8]

What Can Be Done

With this understanding of inflation and the Fed's role amidst it, I want to leave you with three recommendations that may help to relieve the pressures on Pennsylvanian's wallets and purses.

1. **Remove regulatory barriers that hinder economy opportunity.** On the federal level, reducing both tariffs and trade restrictions has been routinely cited as an opportunity to lower prices.[9] Yet, there are also numerous opportunities to reduce barriers on the state level.[10] For example, nurses should be granted greater independent practice authority. Likewise,

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[6] Last month, the Fed announced an increase of its interest rate target in what will likely be a series of increases. In addition, it will also begin to unwind its balance sheet. Board of Governors of the Federal Reserve System, "Federal Reserve Issues FOMC Statement," Press Release, May 4, 2022, https://www.federalreserve.gov/newsevents/pressreleases/monetary20220504a.htm.

[7] Norbert J. Michel, "Inflation: A Brief Look Back, and A Path Forward," Cato Institute, November 19, 2021, https://www.cato.org/blog/inflation-brief-look-back-path-forward.

[8] Norbert J. Michel, "Inflation: A Brief Look Back, and A Path Forward," Cato Institute, November 19, 2021, https://www.cato.org/blog/inflation-brief-look-back-path-forward; Scott Lincicome, "Is President Biden Trying to Boost Inflation?," The Dispatch, May 4, 2022, https://www.cato.org/study/free-trade.

[9] Scott Lincicome and Alfredo Carrillo Obregon, "The (Updated) Case for Free Trade," Cato Institute, May 19, 2022, https://www.cato.org/study/free-trade.

[10] Norbert J. Michel, "Many Consumer Prices Are High: Time to Eliminate Government-Imposed Economic Roadblocks," Heritage Foundation, August 20, 2021, https://www.heritage.org/monetary-policy/report/many-consumer-prices-are-higher-time-eliminate-government-imposed-economic.

Pennsylvania should scale back and eliminate some of the laws governing the sale of wine and spirits.[11]

2. **Reduce government spending.** As noted in the Cato Institute's index of personal and economic freedom in the 50 states, Pennsylvania should "[reduce] spending, especially on parking lots, public buildings, public welfare operations, and employee retirement benefits, which are high by national standards."[12] There is no clear lack of consumer demand or job opportunities, so government spending will likely delay recovery.

3. **Reduce taxes.** In tandem with reducing spending, reducing taxes can help to lower the operating costs of both small and large businesses.

While these steps may be relatively small in contrast to the federal policy that is also needed, they are steps that could help nonetheless to relieve the inflationary pressures on the Pennsylvanian economy.

Thank you for the opportunity to provide this information, and I welcome any questions that you may have.

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[11] Chris Edwards, "Liquor-License Rules Are Crippling Restaurants at the Worst Possible Time," National Review, September 19, 2021, https://www.cato.org/commentary/liquor-license-rules-are-crippling-restaurants-worst-possible-time; Chris Edwards, "Entrepreneurs and Regulations: Removing State and Local Barriers to New Businesses," Cato Institute, May 5, 2021, https://www.cato.org/policy-analysis/entrepreneurs-regulations-removing-state-local-barriers-new-businesses; Victor Skinner, "Heated Hearing Focuses on Pennsylvania's Liquor Monopoly," The Center Square, https://www.thecentersquare.com/pennsylvania/heated-hearing-focuses-on-pennsylvanias-liquor-monopoly/article_e334be46-7d68-11ec-9277-abc9f9a0d691.html.

[12] Cato Institute, "Pennsylvania - #14 Overall," Freedom in the 50 States, https://www.freedominthe50states.org/overall/pennsylvania.