Why is the US inflation so high?

The US is experiencing the most rapid inflation in 40 years. As of October 2022, the US consumer price index (CPI) inflation was 7.7% YoY and the personal consumption expenditures (PCE)price index inflation was 6.2% YoY, well above the Federal Reserve target of 2% (Figure 1). As a result, the Federal Reserve has been aggressively tightening monetary policy in an effort to bring inflation under control. This article will explore the key underlying drivers behind the high inflation in the US.

**Expansionary Monetary policy**

Milton Friedman famously said that, “Inflation is always and everywhere a monetary phenomenon.” After the COVID-19 outbreak, the federal reserves launched unprecedented monetary stimulus, including quantitative easing and cutting the interest rates to zero, to cushion the negative economic and market impacts of the pandemic. Its balance sheet expanded from about USD 4 trillion to about USD 9 trillion. M2 growth accelerated from around 4-6% in 2019 to a peak of 27% in early 2021, an increase of about four times (Figure 2). By comparison, the CPI inflation also quadrupled from about 2% before the pandemic to more than 8% now.

**Strong consumer demand**

Since the onset of the COVID-19 pandemic, the US government has passed around USD 6 trillion of federal fiscal stimulus, including direct checks to low- and middle-income individual and unemployment benefits. Household income was boosted by fiscal stimulus checks, while spending was depressed by the public health restrictions during the pandemic. As a result, households built up their savings dramatically. Aladangady, Cho, Feiveson, and Pinto (2022) estimate that U.S. households accumulated about USD 2.3 trillion in savings in 2020 and through the summer of 2021. The excess savings generated excess consumer demand and put upward pressure on inflation. According to the estimate of de Soyres, François, Maria Santacreu, and Young (2022), US stimulus during the pandemic contributed to a 2.5 ppt increase in excess inflation in the United States.

**Supply chain constraints**

After the COVID-19 pandemic, consumers increased their spending on goods as their savings were boosted by massive fiscal transfers. On the other hand, they reduced spending on face-to-face services because of social distancing measure. As a result, spending on consumer goods has rebounded strongly after the pandemic and has already exceeded its pre-pandemic trend, while spending on services consumption has recovered much more slowly (Figure 3). However, the pandemic has caused serious supply chain disruptions for goods as manufacturing companies faced labor shortages, soaring shipping costs, and frequent lockdowns (Figure 4). A restricted goods supply is unable to meet this unexpected increase in demand, leading to supply bottlenecks and prices increases.

**High energy and food prices**

The Russia-Ukraine conflict has disrupted gas and food supplies and caused energy and food prices to rise sharply (Figure 5). Among the eight major categories in the CPI, transportation and food have seen the highest price inflation (Figure 6).

**Labor shortage**

The shortage of workers after the pandemic has caused wages to rise rapidly (Figure 7), which boosts consumer spending and leads to price increases for labor intensive services. As of October 2022, the labor force participation rate was 62.2%, down from a pre-pandemic peak of 63.4% in January 2020 (Figure 8). This 1.2-percentage-­point drop in the labor force participation rate corresponds roughly to a net decrease of 3.2 million workers in the U.S. economy, compared with the pre-pandemic period. [[1]](#footnote-1) An increase in the retirements of older workers is a key reason the labor participation rate has remained low. Due to housing and financial asset price appreciation on unprecedented monetary and fiscal stimulus, between Q4 2019 and Q2 2022, the net worth of US households has grown by about USD26.1 trillion, about 113% of US GDP (Figure 9). Rising asset values have enabled more older workers to retire early and withdraw from the labor force. As a result, the labor force participation rate for workers aged 55+ is still below its pre-pandemic level (Figure 10).

References:

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1. This calculation uses as a reference point the civilian noninstitutional population as of September 2021, which was equal to 264.5 million people. [↑](#footnote-ref-1)