

Project Syndicate

China Is Missing from the Great Inflation Debate

Mar 31, 2021 [James K. Galbraith](#)

Once again, massive fiscal spending in the United States has invited warnings of inflation and triggered dark memories of the 1970s. But these fears are based on a model that has since been obliterated by economic realities – not least the rise of China, which has fundamentally reshaped the US and global economies.

AUSTIN – The scale of US President Joe Biden’s American Rescue Plan (ARP) – \$1 trillion in spending for this year, another \$900 billion after that, plus a \$3 trillion infrastructure and energy program that has been promised – has [spooked](#) many macroeconomists. Are their fears justified?

The bank and bond-market economists, having cried wolf before, can be disregarded. A year ago, many of them warned that the \$2.2 trillion Coronavirus Aid, Relief, and Economic Security (CARES) Act would incite hyperinflation by massively increasing the money supply. It didn’t happen. More notable among the critics are neo-Keynesians like [Lawrence H. Summers](#) of Harvard University and his numerous [acolytes](#). Summers has a different analysis. It was his uncle, Paul Samuelson, who with fellow future-Nobel laureate Robert Solow launched the [Phillips curve](#) in 1960. This simple model offered some of the most successful empirical predictions in economic history during its first decade, and has been an economic rule of thumb ever since. Drawing on data from late-nineteenth-century Britain and the postwar United States, the Phillips curve postulated an inverse relationship between inflation and unemployment: as one fell, the other would rise. This is what seems to be bothering Summers today. The various rescue and federal support packages are indeed enormous, with the ARP alone accounting for about [6%](#) of GDP. The full scale of federal spending is even larger, reaching [13% of GDP](#) by one estimate. By comparison, the conventionally estimated “[output gap](#)” (the amount of slack in the economy) comes to only one-quarter of that, perhaps less. Moreover, the official unemployment rate, at [6.2%](#), is not terribly far from the 4% level conventionally thought to represent “full employment.” Those receiving government relief payments are concentrated at the bottom of the income distribution, and thus should, in theory, spend more and save less of the cash disbursement, especially given that many households already have some savings held over from the CARES Act. By old-fashioned Phillips-curve logic, the new “stimulus” could drive the unemployment rate down to full employment and the inflation rate up from 0.6% in 2020 to at least 2-3%. But the Phillips curve has had a rough ride since 1969. For about 25 years after that, the dominant economic thinking held that it was not a downward-sloping curve but a vertical line, at least “in the long run.” The implication was that any attempt to reduce unemployment below a “natural rate” or “non-accelerating inflation rate of unemployment” (NAIRU) would produce hyperinflation. Summers, I’m fairly sure, has more confidence in American capitalism than this view implies; and yet, he always hewed close to this skittish school of thought.

Reality, on the other hand, actually obliterated the Phillips curve. From the early 1980s – and unmistakably from the mid-1990s onward – no inflation could be found, and lower unemployment did not tend to bring it on. The relationship is not vertical or downward-sloping, but flat, which is to say it doesn’t

exist – if it ever did. I pointed this out in a 1997 article titled “[Time to Ditch the NAIRU](#).” Twenty-one years later, the distinguished neo-Keynesian [Olivier Blanchard](#) got around to asking essentially the same question in the same journal: “[Should we Reject the Natural Rate Hypothesis?](#)”

What happened? The answer can almost, if not quite, be summed up in a single word: China. From the early 1980s, the US dollar began to rise, crushing America’s Midwest industrial base and trade unions. The ensuing collapse of world commodity prices – and the Soviet Union with them – set the stage for China to emerge as the world’s leading purveyor of manufactured consumer goods. Meanwhile, the forces that drove up US consumer prices after 1970 – including dollar devaluations, oil-price spikes, and cost-of-living adjustments for manufacturing workers (which were passed along in the form of higher prices) – all disappeared. Since full employment had never been the culprit, the full employment of the late 1990s and in the run-up to the COVID-19 pandemic did not bring back inflation. Moreover, there is no longer a tendency for oil-price fluctuations to feed through to wages and other prices, because American jobs now are mainly in services, where the price of labor is the price you pay. But won’t China now take advantage of high US demand to push up prices? No, because Chinese firms fear losing market share to other countries, and because [China’s economic ethos](#) prizes not profit maximization but social stability, [steady production growth](#), and cost reductions through learning and new technologies. Such firms will not alienate their customers by jacking up prices to exploit a little extra demand. There may be some backlogged orders and delayed deliveries, and some price increases due to higher shipping costs and higher wages in China. But the only real inflationary danger comes from those fanning the flames of war with China. War is always inflationary; a war with our largest goods supplier would be an inflation nightmare. Short of that, US households are not suffering from a shortage of smartphones, dishwashers, and running shoes. What they lack is confidence and security. Hence, much of the Biden money will not go to China at all. It will go toward saving, in order to cover future rent, mortgages, utilities, and debt repayment.

Yes, some will be spent on services that were missed over the past year, reviving jobs in those sectors to a degree. Some will be used for housing maintenance, repairs, or upgrades – expenses that were neglected when people feared incurring the extra cost of a plumber, electrician, or painter. And some will go toward building new houses, as is already happening.

As for the rest, a good part will go into purchases of stocks, bonds, and real estate – especially land, suburban homes, and rural retreats made precious in the pandemic. It is mainly here that prices will rise, further enriching those who already own such assets. The wealth gap, already enormous, will grow larger. Because stocks and bonds, existing houses, and land are not newly produced consumption goods, these price increases will not figure in the indices that measure inflation. We will have to watch for them in the S&P 500 and on the real-estate platform [Zillow](#), where rising prices are duly celebrated as a good thing. The larger lesson is twofold. First, the mainstream neo-Keynesian macroeconomics of the 1960s is not a useful guide for understanding a US economy that has become fully enmeshed with the rest of the world and fundamentally reshaped by China’s rise. Second, America’s problems of inequality and precarity are not really issues of material scarcity. They reflect an unsustainable maldistribution of wealth and power.