Inflation Undermines Democracy

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"The founder of Soviet Communism, Vladimir Lenin, is said to have declared that the best way to destroy the capitalist system was to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate, but they confiscate arbitrarily; and, while the process impoverishes many, it actually enriches some…Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction."

That's a quote from the great British economist John Maynard Keynes. Many people think that Keynes was pro-inflation. But that's not true. Keynes lived through the 1920s and saw what hyperinflation did to Poland, Russia, Austria, and especially Germany, where the hyperinflation of 1923 shook the faith of the German people in democracy, with disastrous results. Keynes advocated balanced government budgets except in times of serious recession or depression.

The fundamental cause of inflation in an economy is an excess of demand over supply. Excessive demand can be caused by a number of things, including an excessive government budget deficit, too much money printing, or wage-push inflation which is accommodated by the government.

In the U.S., in 2021 and 2022 inflation took off, reaching a high of 9% in 2022, the highest rate of inflation since the early 1980s. The cause of this inflation was excessive demand colliding with restrained supply. As we all recall, the supply of goods from Asia was severely restrained in 2020 by the worldwide Covid pandemic. Even in late 2020, when countries began to lift factory closure orders, the ships and the ports between Asia and the US west coast were overloaded and backed up, with dozens of container ships waiting to unload outside Los Angeles and Long Beach ports. In addition, U.S. factories took time to catch up to the backlog in orders. There was a notorious fire at a Japanese chipmaking facility dedicated to chips for automobiles exacerbated the constraints on automobile production in the US.

On the demand side, the federal government enacted three separate measures to support people during the Covid pandemic. The third of those, the $1.9 trillion American Rescue Plan, was too much spending at precisely the wrong time, when the country was going back to work and people were rushing out to use their savings to purchase goods. That led to a surge in the prices of goods, everything from the food at the grocery store to home appliances to new cars.

These forces led inflation to reach 9% in 2022. Could this have been prevented? Yes, obviously. On the demand side, the American Rescue Plan should have been much smaller, Larry Summers said 75% smaller way back in February 2021. On the supply side, the situation is more complicated. Clearly the U.S. needs more domestic sources of manufactured goods and that's something I've been working hard on for several years.

Nor was the 9% headline rate of inflation the whole story. The prices of some categories of consumer goods shot up by much more. For example, in [December 2022,] the price of eggs was up by 59% year-on-year; the price of margarine was up 44%; airfares were up 28% and even the humble lettuce was up 25%.

These high inflation rates hurt several groups severely. I want to mention two groups: senior citizens and politicians.

Many seniors live on a fixed income. The average social security payment in the U.S. is now $1,976 a month. According to a study by University of Massachusetts economists, that covers just 68% of basic living expenses for an elderly single person who rents their home. For seniors, food makes up a large share of their expenses and the 2021-22 inflation hit food severely, and there is little sign that prices will come down. Rents and the cost of drugs continue to rise. According to the National Council on Aging, 14% of people over 65 live in poverty today. They say "Aging with dignity should be a right for all," and I think that's right.

Other expenses paid by the elderly also continue to rise. Despite Medicare, Medicaid, and Part D prescription drug plans, seniors still pay significant copays for prescription drugs. Study after study has shown that a significant percentage of seniors either don't fill prescriptions or don't adhere to the recommended dosage, in other words they take fewer pills than they are supposed to, perhaps taking a pill every other day to make the prescription last longer. These expenses continue to rise, even while broad inflation is subsiding.

Another critical expense is home health care and related services. This is vital for a large and growing number of seniors. The latest federal data shows that the cost of care for the elderly at home rose by 9.5%, year on year in December 2024. That's on top of all the inflation of 2021 and 2022. That's one of the highest rates of inflation for any sector in the 14-page BLS report that came out two weeks ago.

I also want to point out that politicians suffer from inflation too. We can cite four elections where the party in power was voted out of office due in part to inflation. That happened in 1968 to LBJ, in 1976 to Gerald Ford, again in 1980 to Jimmy Carter, and finally as we all know, just two months ago in 2024. Each time there were other factors at work too, but each time, it's very clear that part of the thought process of the American voter was: "many things happen in the world that are out of politicians' control, but inflation is one thing they can control and if they screw that up, it's time to turf them out of office."

I wish more politicians would learn that lesson.

So what can be done about inflation? Most important, we need to get the federal budget deficit down. The best way to think about inflation is: are we as a nation consuming more than we produce, or are we keeping within our budgets? For over 40 years, this nation has run trade deficits, meaning we borrow billions of dollars from abroad to consume more than we produce. For 24 consecutive years, the federal government has run a large budget deficit, meaning the federal government spends billions, actually now trillions of dollars more than it takes in in revenue. Under the Biden administration, the federal budget deficit reached levels that were unprecedented for peacetime.

A budget deficit of 7% of GDP is far too high. We need to cut government spending aggressively. I applaud incoming Treasury Secretary Scott Bessent's 3% target for the federal deficit. That will ease inflationary pressures, and reduce interest rates. There are so many things the federal government does badly, and often talks about doing but does not actually do, that we need to take an axe to many of these programs.

Further, I would say that I am a strong advocate of an independent Federal Reserve. The Federal Reserve needs a laserlike focus on the macroeconomic balance in the economy. Past Fed chairmen like Paul Volcker and Alan Greenspan have shown us this is achievable. As we all know, in 2021, the Federal Reserve took its eye off the ball.

I would also say that supply-side reforms can make prices less rigid and less likely to rise. Areas of the economy where more competition and/or deregulation can reduce costs include defense equipment providers, prescription drugs, the oil and gas industry, and mineral production and processing.

We need to make it more economic for people to go to work, so we can increase the supply of labor and restrain the cost of labor. We can do this by fixing the tax and welfare system to provide more incentives to work.

Note that I don't say we should open up our borders to more imports. We currently import far too much. Restraining imports will stimulate domestic production, helping to improve the supply-demand balance. We need more domestic production of goods and services and more competition.

So I would say to the Republicans: don't be afraid to cut spending and shake up the civil service. But don't cut taxes until you know you can reduce the budget deficit. And by the way, new tariffs and spending cuts will play a large role in enabling you to reduce taxes AND cut the budget deficit.

To the Democrats, I would say two things: first, it's fine to initiate new programs when you are confident that voters support them. But you must pay for them directly, with revenue. Expanding the deficit is simply another way to debauch the currency, to use Keynes's phrase. And that inevitably leads to inflation, distrust of politicians, and endangers people's faith in their government.

Finally, I want to say that I am very disappointed in the Democratic economists who advised Biden, some of whom I know personally. Not one of them has yet to come out publicly and say plainly: <u>we goofed</u>. We caused that inflation and we have learned our lesson. The economics of inflation is really not that hard. Keynes believed that in times of a strong economy the government should run a surplus, not a deficit. There was really a lot less distance between Maynard Keynes and Milton Friedman than many people claim. Economists need to be less partisan and more honest about what we see out in the real world.

Thank you Mr. Chairman.