



Is High Inflation a Risk in 2021?

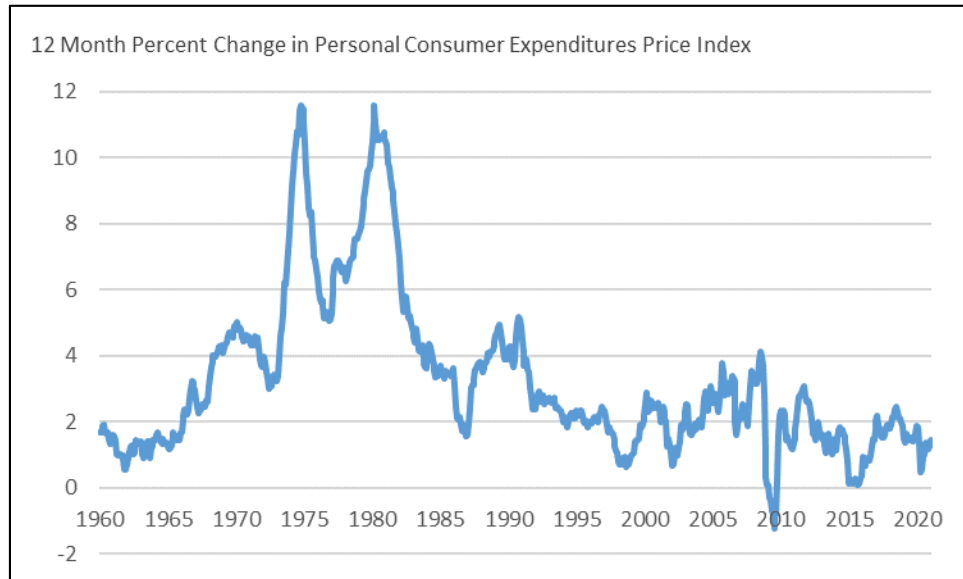
April 6, 2021

Assuming public health continues to improve, many economists project rapid economic growth in 2021. The unprecedented [fiscal](#) and [monetary](#) stimulus in response to the COVID-19 pandemic is also expected to continue in 2021. Some observers have questioned whether the combination of stimulus and rapid growth will result in [rising prices](#).

Historical Trends in Inflation

The economy experienced persistently [high inflation in the 1970s and early 1980s](#), last reaching double-digits in 1981 (see **Figure 1**). Most economists believe this high inflation was caused by overly expansionary monetary and fiscal policies, along with significant increases in energy prices. Additionally, as expectations of higher inflation became incorporated into consumer and business decisions, these expectations contributed to actual increases in inflation. The Federal Reserve (Fed) raised short-term interest rates significantly in the early 1980s, which successfully brought inflation down quickly, though at the cost of a recession.

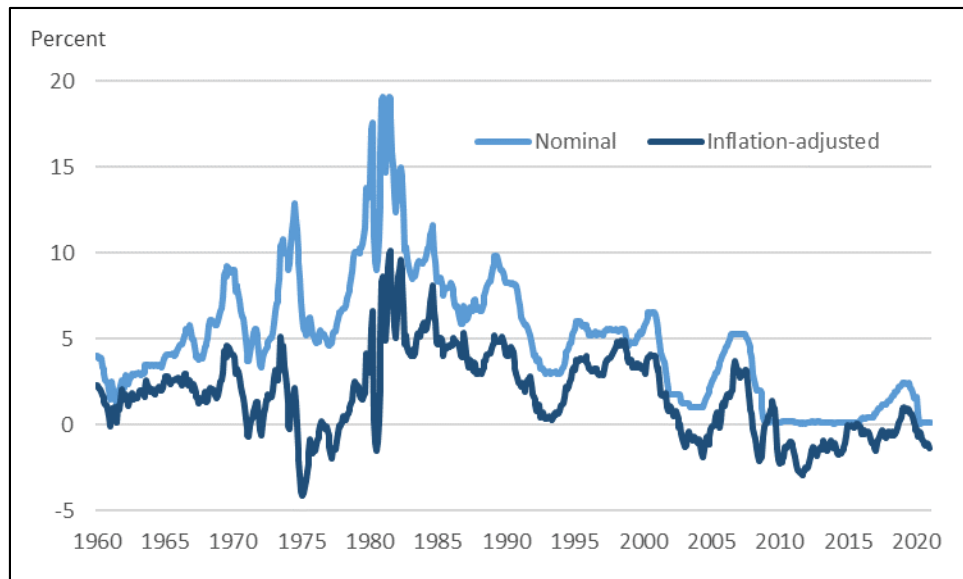
Figure 1. Inflation Rate
January 1960 to January 2021



Source: Federal Reserve Economic Data (FRED).

Since 1991, inflation has remained below 5%, and inflation expectations have been low and stable. Since the 2007-2009 Great Recession, inflation has mostly been below the Fed’s target of 2% (established in 2012) despite the fact that fiscal and monetary policy seem to have been more stimulative than they were in the high inflation period of the 1970s and early 1980s. Adjusting for inflation, however, lowers the real interest rate, making monetary policy more stimulative in the 1970s than it might appear. Figure 2 shows the Fed’s short-term interest rate—the federal funds rate—both nominally and adjusted for inflation.

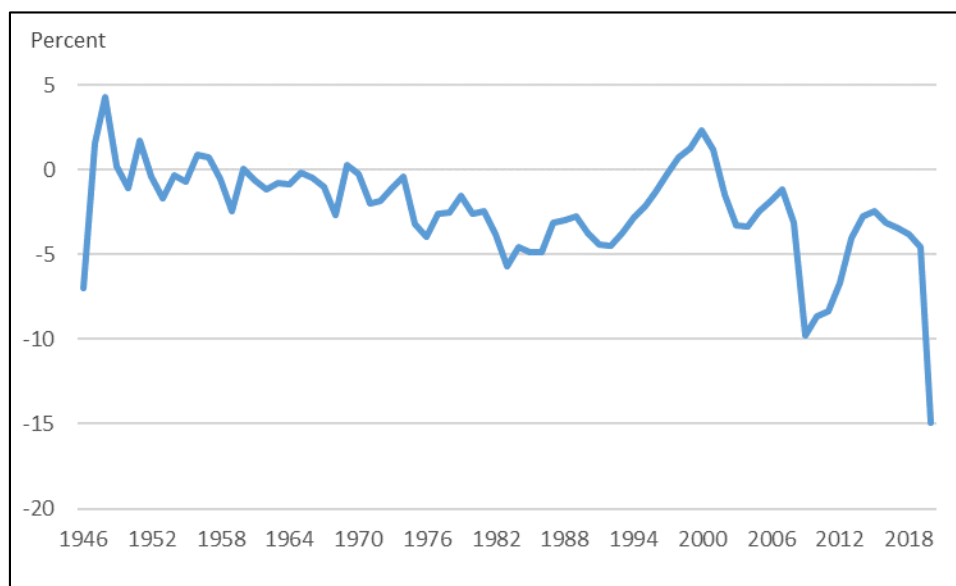
Figure 2. Federal Funds Rate
January 1960 to February 2021



Source: CRS calculations using FRED data.

The Fed kept short-term interest rates near zero from late 2008 to late 2015 and again in 2020 in response to the pandemic. The Fed has also made large-scale asset purchases (popularly called “[quantitative easing](#)”) during both periods, resulting in historically rapid growth in the money supply. At the same time, [federal budget deficits have been larger](#) as a share of GDP from FY2009 to FY2012 and in FY2020 than at any time since World War II (see [Figure 3](#)).

Figure 3. Federal Budget Balance as a Share of GDP
FY1946-FY2020



Source: Office of Management and Budget.

The recent period of low inflation despite stimulative fiscal and monetary policies is likely due, in part, to the 2007-2009 Great Recession and the COVID-19-induced recession—the two deepest recessions since the Great Depression. In both downturns, rapidly falling output and rising unemployment made a rise in inflation unlikely. Although historically large, fiscal and monetary stimulus were unable to fully offset these economic shocks. Even when unemployment became low in the years preceding the pandemic, inflation was contained, and inflationary expectations remained stable. [Globalization, technological innovation, demographics, and various other factors](#) have been offered as additional forces countering inflationary pressures.

2021 Outlook

Many observers expect a combination of rapid economic growth and the continuation of highly expansionary monetary and fiscal support in 2021, raising concerns over the potential for higher inflation. For example, the Fed has [pledged](#) to keep short-term interest rates at zero until the economy reaches full employment and inflation is modestly above 2%—which Fed leadership does not expect until 2023 at the earliest. On the fiscal side, the [budget deficit is projected to be around 15% of GDP in FY2021](#) following the enactment of the American Rescue Plan Act of 2021 (P.L. 117-2).

[Some economists](#) believe that P.L. 117-2 is too large relative to the *output gap* and will result in the [economy overheating](#), with the potential for a significant [increase in inflation](#). The output gap is the difference in actual output and potential output (i.e., what the economy is capable of producing when it is at full employment). Even though the output gap is currently large, and therefore inflationary pressures are low, rapid growth and too much fiscal and monetary stimulus could cause actual output to overshoot

potential output, causing the economy to overheat. Further, it is uncertain if potential output will return to its pre-pandemic trend. Lockdowns, social distancing, and [fears of being infected](#) disrupted production in 2020. While some of those disruptions have been alleviated, others remain in place. Thus, output in 2021 may be much closer to potential than the pre-pandemic trend would indicate, given prevailing health-related barriers to economic activity. If so, the likelihood of inflation rising could be higher.

Another unusual development in this recession is that [personal income has risen](#) because of the various income support measures included in recent fiscal stimulus packages. As a result, and in part because spending opportunities were constrained by the health situation, the personal saving rate rose from 7.5% in 2019 to 16.3% in 2020. Once health conditions normalize, consumers may spend down some of this savings, which could cause the economy to overheat.

Despite these concerns, most forecasters and policymakers [expect](#) inflation to remain low. Fed leadership [projects](#) that inflation will rise modestly to 2.4% in 2021 before decreasing to 2%. But if an overheating economy caused inflation to rise too quickly or be persistently high, fiscal and monetary policy could, in principle, be tightened (through reduced deficits and higher interest rates, respectively) until inflation was contained. This would run the risk of causing another recession, however. Thus, whether a long-term rise in inflation would be prevented depends on policymakers' willingness to tighten policy sufficiently if necessary. (The fact that [inflationary expectations](#) have remained low suggests that investors believe they would, and it makes it easier to avoid a long-term rise.) The Fed is statutorily required to maintain price stability. Its current plans to modestly overshoot its inflation target and keep interest rates at zero until full employment is restored are untested, however, and raise questions about the Fed's willingness to raise rates if inflation rose before full employment was restored. Likewise, Congress might find it difficult to quickly reverse fiscal stimulus were high inflation to persist.

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