Inflation Strikes Back
The Response of the Fed

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Panel Discussion

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"Inflation Strikes Back: Drivers and Policy Reactions"

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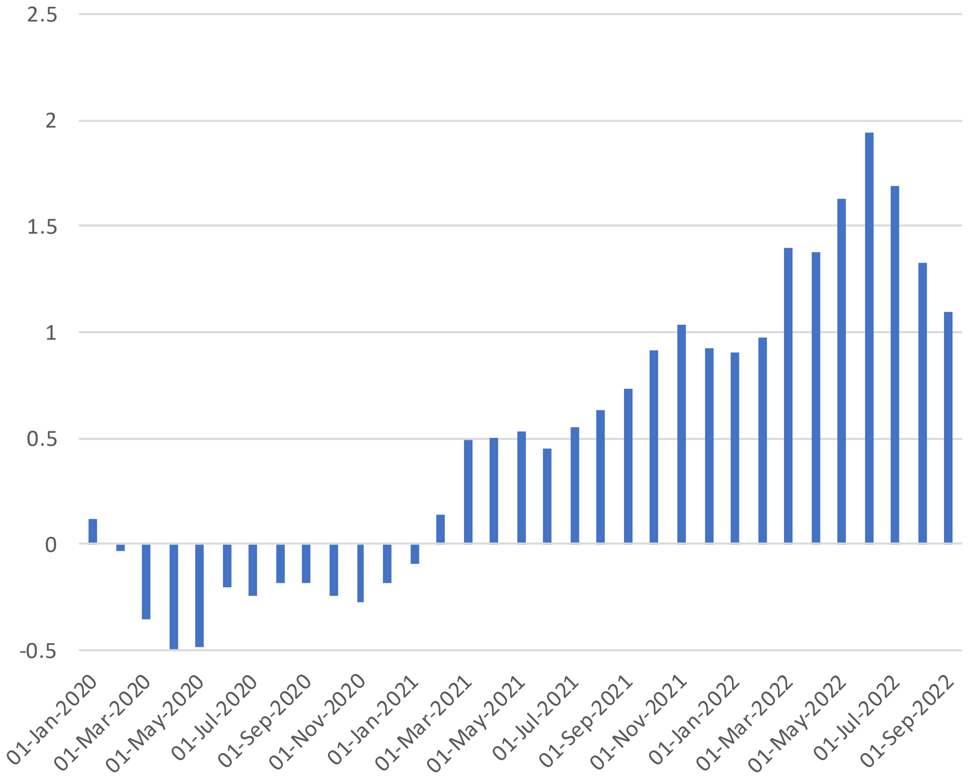
Recent dynamics of US PCE inflation

From below target to escalation in 2021

BEA: Headline and core PCE inflation, y-o-y



Non-core inflation

Layers of inflation: the onion metaphor*

- *Outer layer*: prices of globally traded commodities - lumber, steel, grains, and oil
  - Demand surged for these as economies reopened
- *Middle layer*: price of products—esp. durable goods like appliances, furniture, and autos
  - Had been affected by severe supply-chain disruptions
- *Innermost layer*: underlying inflation
  - Reflects the overall balance between supply and demand in the economy
    - Has contributed to the large amount of price rises with high potential of becoming entrenched

*See this speech

Layers of inflation: the onion metaphor*

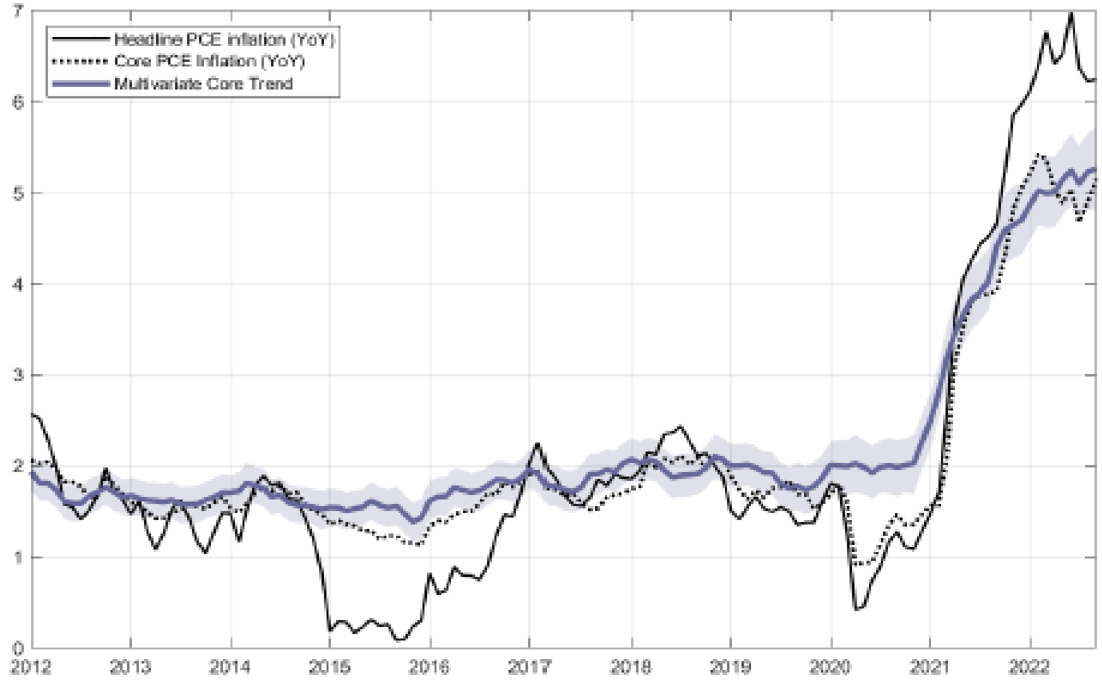
- *Outer layer*: prices of globally traded commodities - lumber, steel, grains, and oil
  - Demand surged for these as economies reopened
    - ✓ Many commodity prices now retreating, as global growth slows down

- *Middle layer*: price of products—esp. durable goods like appliances, furniture, and autos
  - Had been affected by severe supply-chain disruptions
    - ✓ Those disruptions are moderating (see GSCPI index)

- *Innermost layer*: underlying inflation
  - Reflects the overall balance between supply and demand in the economy
    - Has contributed to the large amount of price rises, with high potential of becoming entrenched
    - ➢ Aggregate demand still strong, demand for labor and services exceeds supply

*See this speech

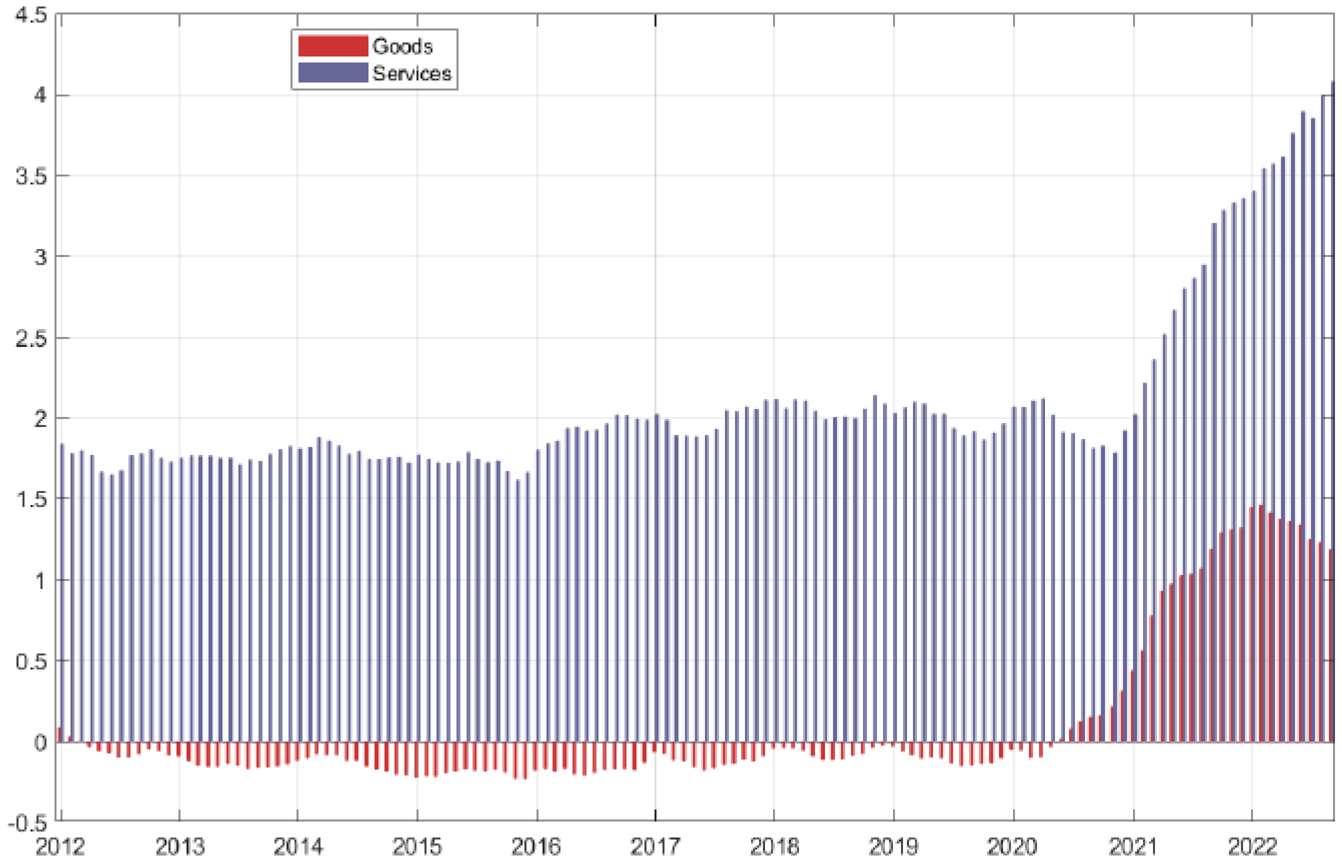
Focusing on the innermost layer: the trend



Source: BEA; NY Fed Research

- Sectoral approach
  - Fit a monthly trend /cycle model to 17 major PCE aggregates
- Allow common and sector-specific trends
- Multivariate Core Trend (MCT): Aggregate sectoral trends weighted by their expenditure shares

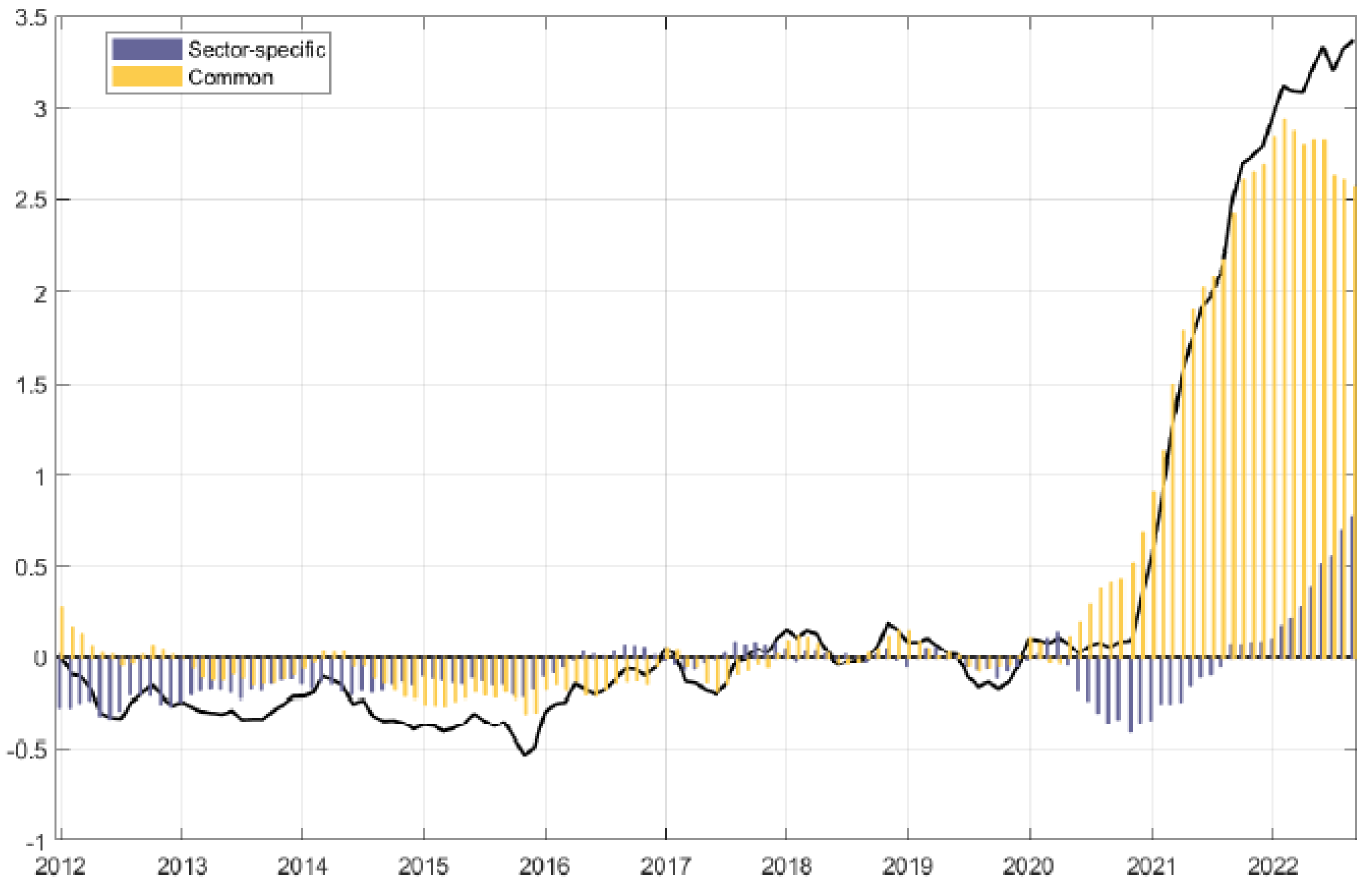
Where does the trend come from?



Source: BEA; NY Fed Research

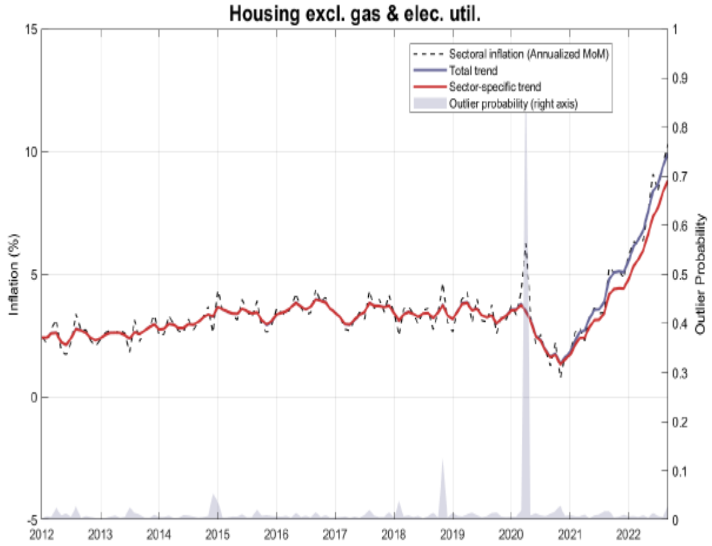
- Persistence is high in both core goods and core services
- Trend in core goods inflation appears to have peaked but
- Trend in core services inflation has continued to rise

How broad-based is persistence?



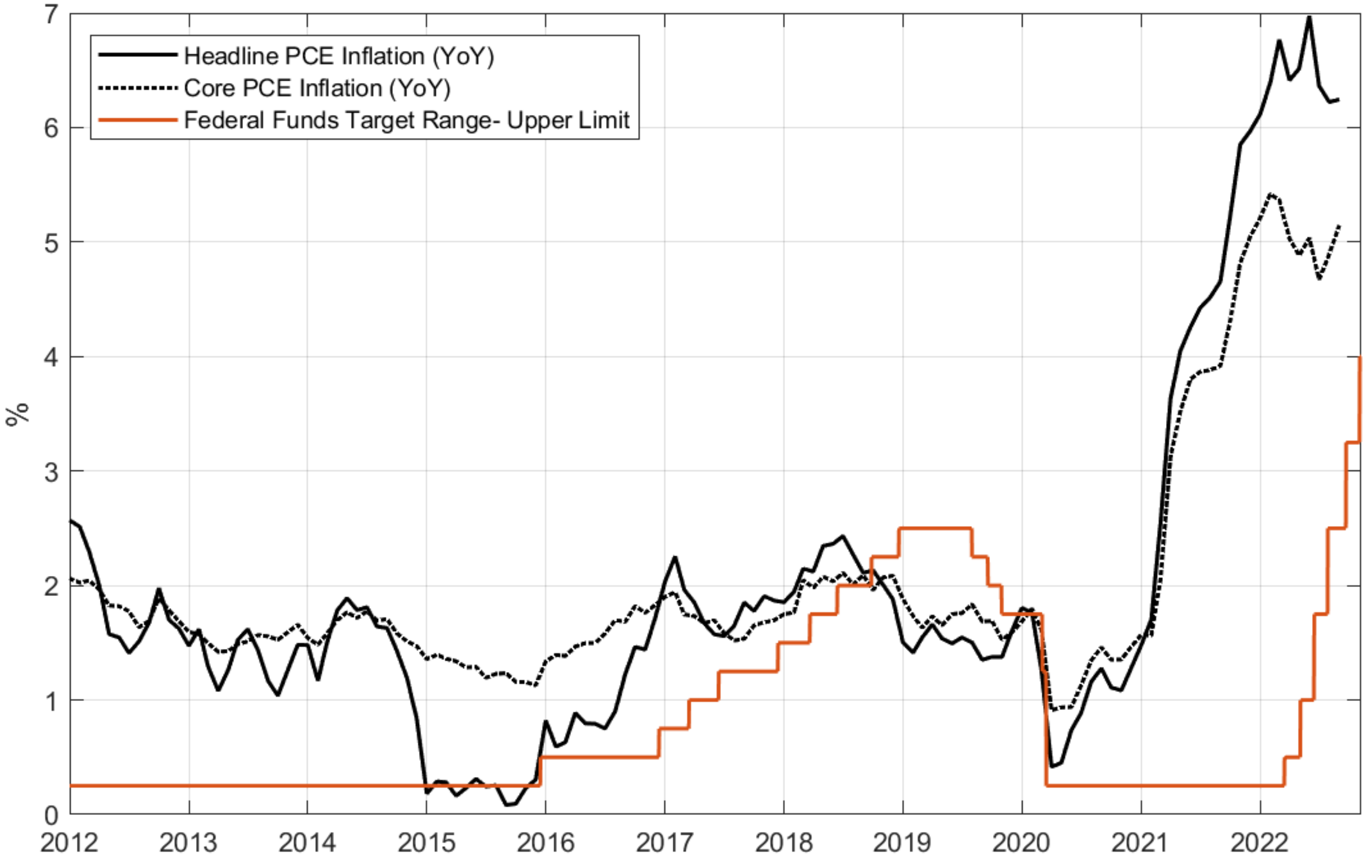
Source: BEA; NY Fed Research

- The common component dominates the overall trend
- But there is some sector-specific trend in services
  - Particularly the housing ex-util



How has the Fed reacted?

PCE inflation and the FFR



Timeline of policy response to Covid-19 shock

- ***Covid-19 hits March 2020***: FFR cut rapidly to the ZLB in first half of the month

- ***Guidance***: the Committee expects “to maintain this target range until it is confident that the economy has weathered recent events”

- ***Further policy measures in March 2020***:
    - Asset purchases begin, including Treasury securities and agency MBS, later extended to include agency commercial MBS

Timeline of policy response to Covid-19 shock

- ***Covid-19 hits March 2020***: FFR cut rapidly to ZLB in first half of the month
  - The FFR remains at the zero bound until *March 2022*

- ***Guidance***: the Committee expects "to maintain this target range until it is confident that the economy has weathered recent events"
  - This guidance language will remain in place until *Sept 2020*

- ***Further policy measures in March 2020***:
  - Asset purchases begin, including Treasury securities and agency MBS, later extended to include agency commercial MBS
    - Tapering of AP announced in Nov 2021, begins in *Dec 2021*

Key policy shift in August 2020

- Initial response to the crisis followed previous approach to downturns
- However, in August 2020 Fed announces outcome of “Strategy Review”
  - Conducted over 2019 and 2020
  - Addresses challenges of low interest rate environments

- Major changes to the ‘Longer-Run’ Statement
  - On employment:
    - Maximum employment is defined as broad-based and inclusive goal
    - Policy decisions informed by assessment of *shortfalls* of employment from max. level
  - On price stability
    - Target defined as an ‘average of 2 percent over time’
    - Implies inflation overshooting to make up of periods of persistent undershooting

Tolerance for moderately higher inflation

- Language of September FOMC statement reflects the new strategy
  - FFR maintained at ELB; *forward guidance* signals ELB for long, while APs continue
- Forward language for asset purchases (Dec.) reinforces accommodative stance
  - AP will continue until '*substantial further progress*' has been made toward the goals

- Inflation data ticks up
  - Subdued until March 2021, jumps in April
  - April PCE data show headline inflation at 3.6% and core at 3.1%.
- The Committee attributes price increases to '*transitory*' factors
  - June 2021 SEP projects core inflation around 3% for 2021, down to 2% in 2022

Tolerance for moderately higher inflation

- Language of September FOMC statement reflects the new strategy
  - FFR maintained at ELB; *forward guidance* signals ELB “until labor market conditions have reached level consistent with the Committee’s assessment of max. employment” and inflation up to 2% and “on track to moderately exceed 2% for some time”
- Forward language for asset purchases (Dec.) reinforces accommodative stance
  - AP will continue until ‘*substantial further progress*’ has been made toward the goals

- Inflation data ticks up
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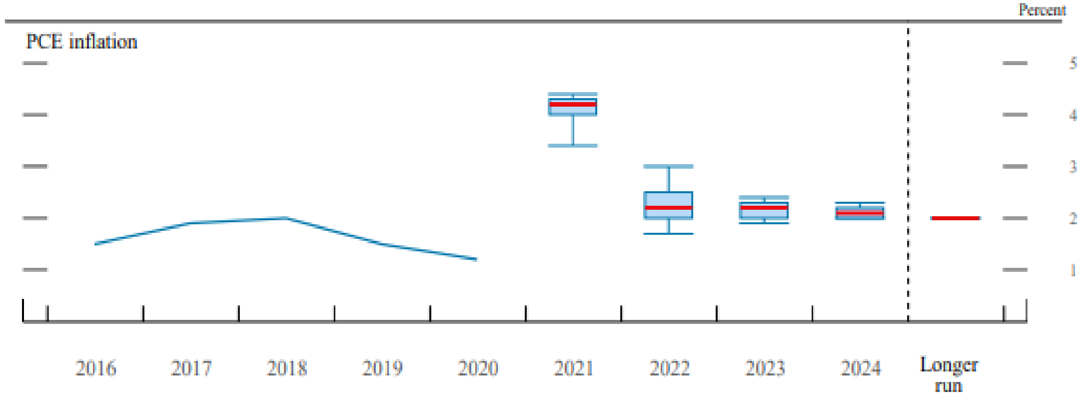
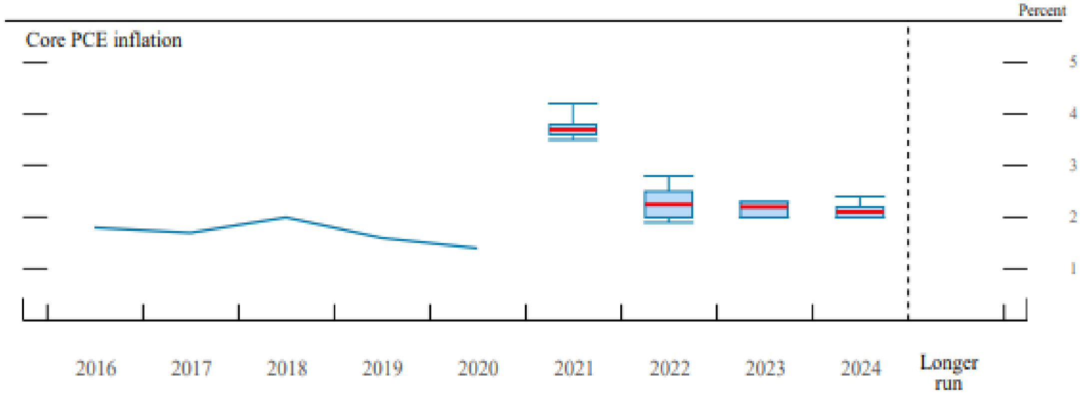
September 2021 SEP





- Sept 2021 FOMC statement : inflation is elevated, (PCE runs at 4.2%) largely reflecting transitory factors

- Projections still show core inflation at 2% in 2022, despite running 4% at year-end
  - *"can look through elevated price changes"*

- Committee maintains accommodative stance
  - Despite a decline of unemployment to around 5%, '*substantial further progress*' towards the goals not yet achieved

The pivot: purchases, language, rates

- **Nov 2021**: ‘substantial enough progress’ has been achieved
  - Committee announces a reduction in the pace of asset purchases
  - FFR remains at the ELB (in line with previous sequencing of tools)

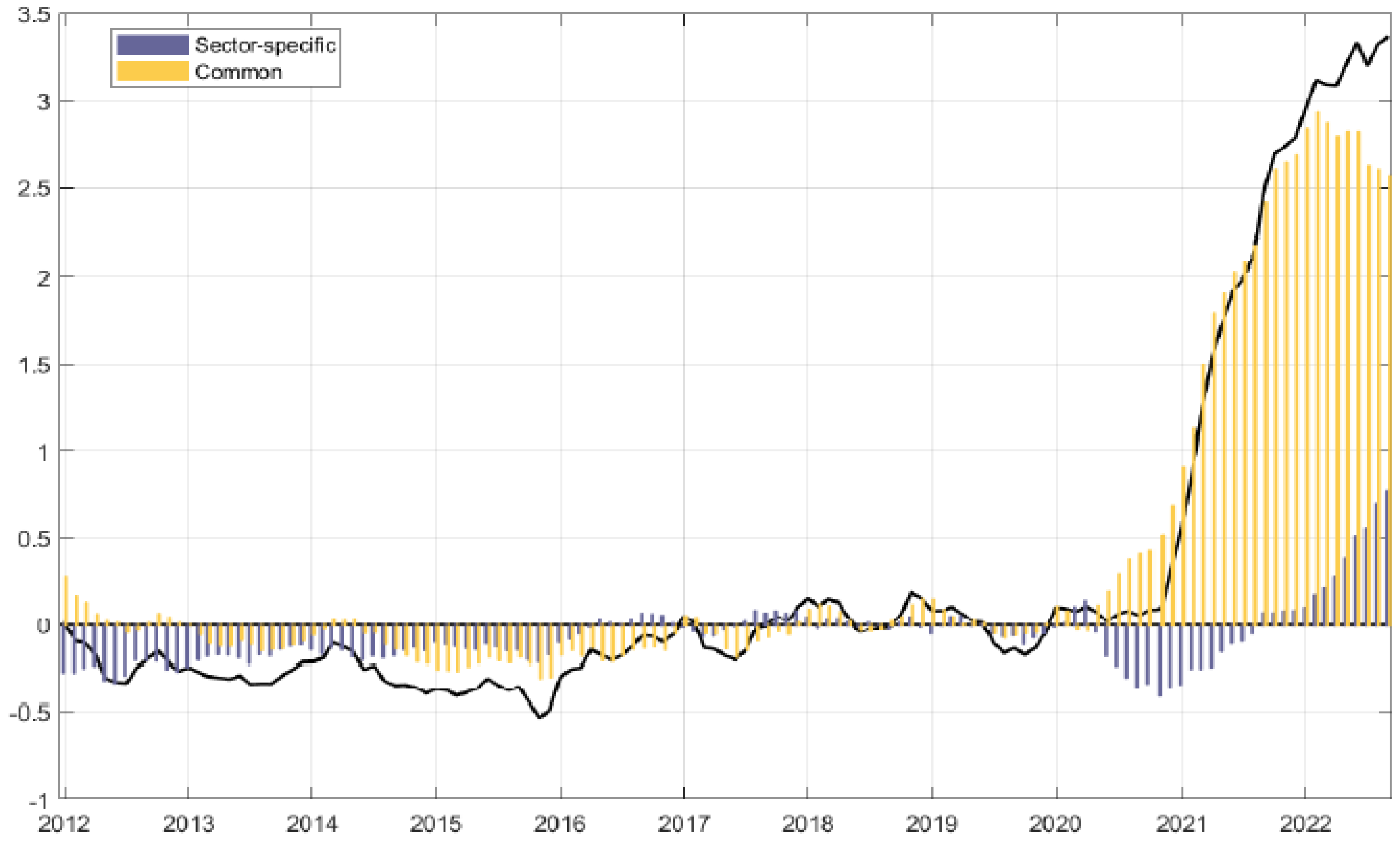
- **Dec 2021**: the statement language drops the word ‘transitory’
  - Elevated levels of inflation attributed to ‘Supply-demand imbalances’
  - But FFR remains in the 0-.25% range, as labor market conditions not yet reached “levels consistent with the Committee’s assessments of max employment”
  - Tapering of asset purchases commences

- **Tightening cycle starts and rapidly accelerates**
  - Rate lift-off in March
  - Small first step, then a steep path (+50bp in May and four 75bp rises each meeting)
  - Reduction of holdings of Treasury and agency debt and MBS starts in June

Did it take too long?

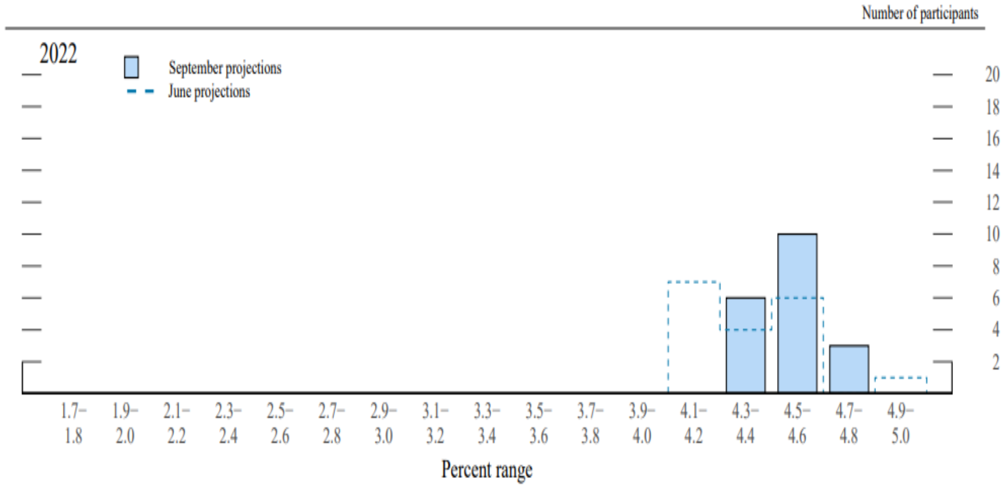
- **Tension between the two goals, especially in light of the new strategy**
  - Unemployment declined rapidly, but was still around 5% in Aug 2021, progress towards the goal of an inclusive and broad-based employment *not yet substantial*
  - Policy committed to *run a hot labor market*, can *look through the elevated price changes*
- **Mismeasurement of economic slack**
  - Traditional measures of labor market tightness less reliable in the post-pandemic environment, particularly problematic in light of emphasis put on labor market progress under the new strategy
- **Promise not to withdraw accommodation until measurable progress was reached**
  - Pitfalls of applying lessons of the review to a very different situation
- **Large changes in sector-specific inflation**
  - Made it hard to detect the emergence of a common surge in inflation (back to the trend)

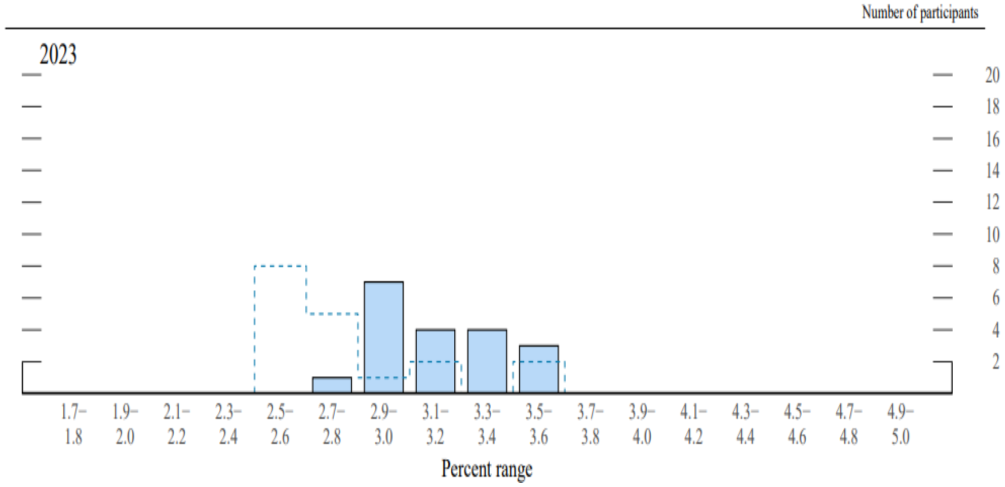
Back to the trend components



Where is the Fed now?

Sept 2022 SEP
Inflation forecast distribution shifts to the right



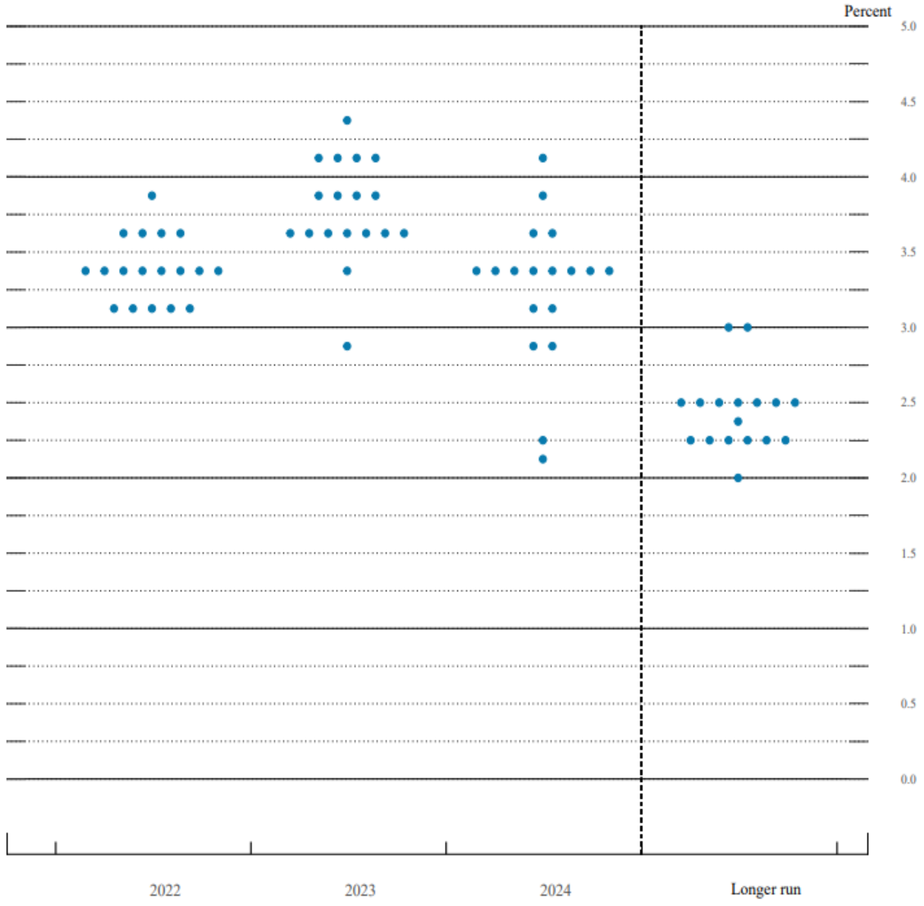


Percent

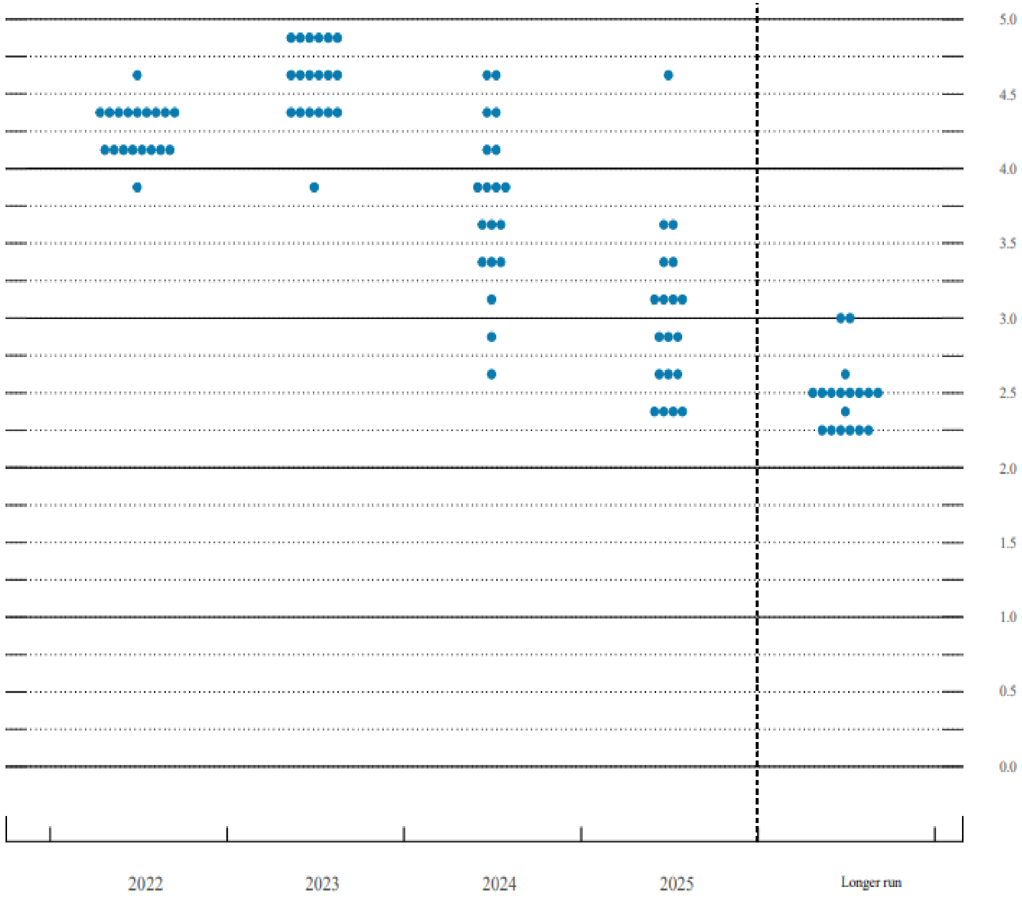
Variable	Median[1]				
	2022	2023	2024	2025	Longer run
Change in real GDP	0.2	1.2	1.7	1.8	1.8
June projection	1.7	1.7	1.9		1.8
Unemployment rate	3.8	4.4	4.4	4.3	4.0
June projection	3.7	3.9	4.1		4.0
PCE inflation	5.4	2.8	2.3	2.0	2.0
June projection	5.2	2.6	2.2		2.0
Core PCE inflation[4]	4.5	3.1	2.3	2.1	
June projection	4.3	2.7	2.3		
Memo: Projected appropriate policy path					
Federal funds rate	4.4	4.6	3.9	2.9	2.5
June projection	3.4	3.8	3.4		2.5

And so did the policy path

June 2022



Sept 2022



FOMC participants' assessments of appropriate monetary policy: Midpoint of target range

Current Fed's thinking

November FOMC statement introduces new guidance

- Reinforces the commitment to inflation fight
  - "The Committee decided to raise the target range for the federal funds rate to 3-3/4 to 4 percent. The Committee anticipates that *ongoing increases* in the target range will be appropriate in order to attain a stance of monetary policy that is *sufficiently restrictive* to return inflation to 2 percent over time."
- Opens the door to slowing the pace of tightening
  - "In determining the pace of future increases in the target range, the Committee will take into account the *cumulative tightening* of monetary policy, the *lags* with which monetary policy affects economic activity and inflation, and economic and financial developments."