CROWE

Center for Research On the Wisconsin Economy

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# Inflation Trends… and Predictions (?)

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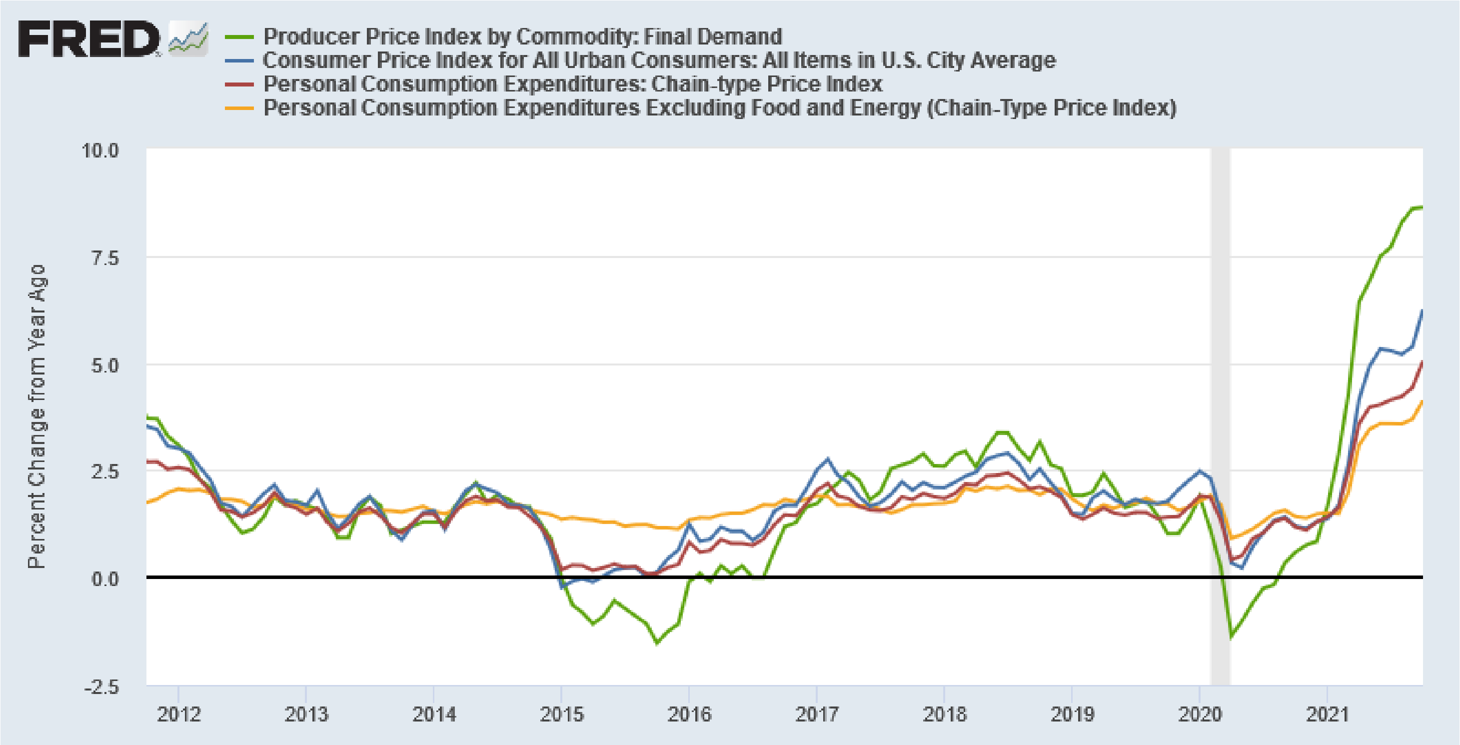
# Inflation no Longer Seems so Transitory




PPI: 8.6%, CPI: 6.2%, PCE: 5.0%, Core PCE 4.1%

# Theories of Inflation

- **Micro 1:** Price gouging, greed, and profits
- **Micro 2:** Specific factors driving price increases: “supply chain”
- **Macro/Monetary:** Too many dollars chasing too few goods. Expansionary monetary policy coupled with expansionary fiscal policy
- **Macro/Real:** Aggregate supply shocks accommodated by policy. Monetary policy chose to focus on employment over inflation in allowing inflation to take off. Belatedly moving toward tighter policy.

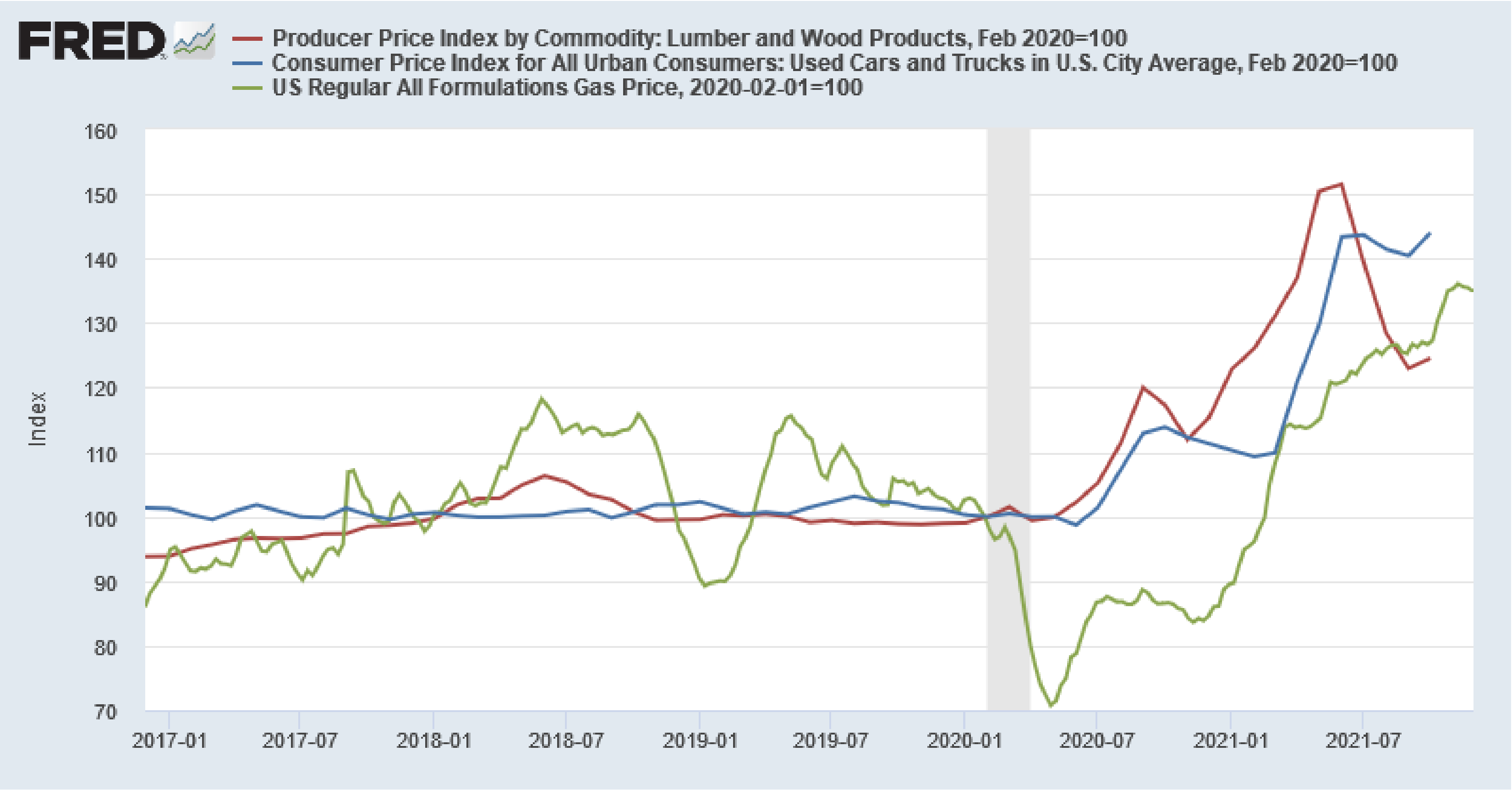
# Micro 1: Price Gouging and Greed

**Elizabeth Warren**
@SenWarren

Wondering why your Thanksgiving groceries cost more this year? It's because greedy corporations are charging Americans extra just to keep their stock prices high. This is outrageous.

- Also Biden Admin investigation into price gouging in energy markets
- **But why is greed more of a problem now than before?**

# Micro 2: Focus on Specific Goods & Factors



# Relative Prices vs. Inflation

- Supply chain problems have increased **relative prices** of (some) goods
- But some prices which surged earlier have fallen or stabilized lately
- Inflation is when the **aggregate price** level increases
- Hard for producers (& consumers?) to distinguish relative & aggregate or supply from demand shocks
- With a central bank that is credibly committed to price stability, relative price increases of some goods met with **decreases** of others.
- Complications: policy not perfect, nominal rigidities (sticky prices) keep some prices from adjusting.
- There are **always** temporary special factors (and forecasts of easing)

# Supply Chain vs Oil Shocks

- Thought experiment: replace “supply chain” with “OPEC” in news
- **1973:** OPEC embargo hit in October. By December CPI was up 8.9% & FOMC that month voted to **ease** to offset oil shock. In 12 months following, inflation hit 12.1%, while real GDP fell 1.9%.
- **March 1979:** CPI inflation was 10.3%. FOMC**: "A significant easing of rapid rise in prices was suggested... recent increases in prices represented temporary factors."** Voted to keep policy unchanged. In following 12 months inflation hit 14.6% & real GDP fell 0.8%.

# Policy Response Matters

Mr. Hayes dissented from this action because, with the problems of inflation increasing rather than abating and with the monetary aggregates apparently growing more rapidly in 1973 than the Committee had considered desirable, he favored a continuation of the current degree of monetary restraint without noticeable relaxation unless signs of weakening in the economy became more apparent. He believed that, while there was not much that monetary policy could do to relieve the economic problems arising from the oil shortage, a premature easing of policy could exacerbate the problems of inflation.

# The Fed Struggles with the Dual Mandate

"Suppose we faced a very different economic environment: Imagine that inflation was running at 5% against our inflation objective of 2%. Is there a doubt that any central banker worth their salt would be reacting strongly to fight this high inflation rate? **No, there isn't any doubt**. They would be acting as if their hair was on fire. We should be similarly energized about improving conditions in the labor market."

– Charles Evans, President of the Chicago Fed in 2011

# Fed Chair Powell Today

Most forecasters, including at the Fed, continue to expect that inflation will move down significantly over the next year as supply and demand imbalances abate. It is difficult to predict the persistence and effects of supply constraints, **but it now appears that factors pushing inflation upward will linger well into next year**. In addition, with the rapid improvement in the labor market, slack is diminishing, and wages are rising at a brisk pace.

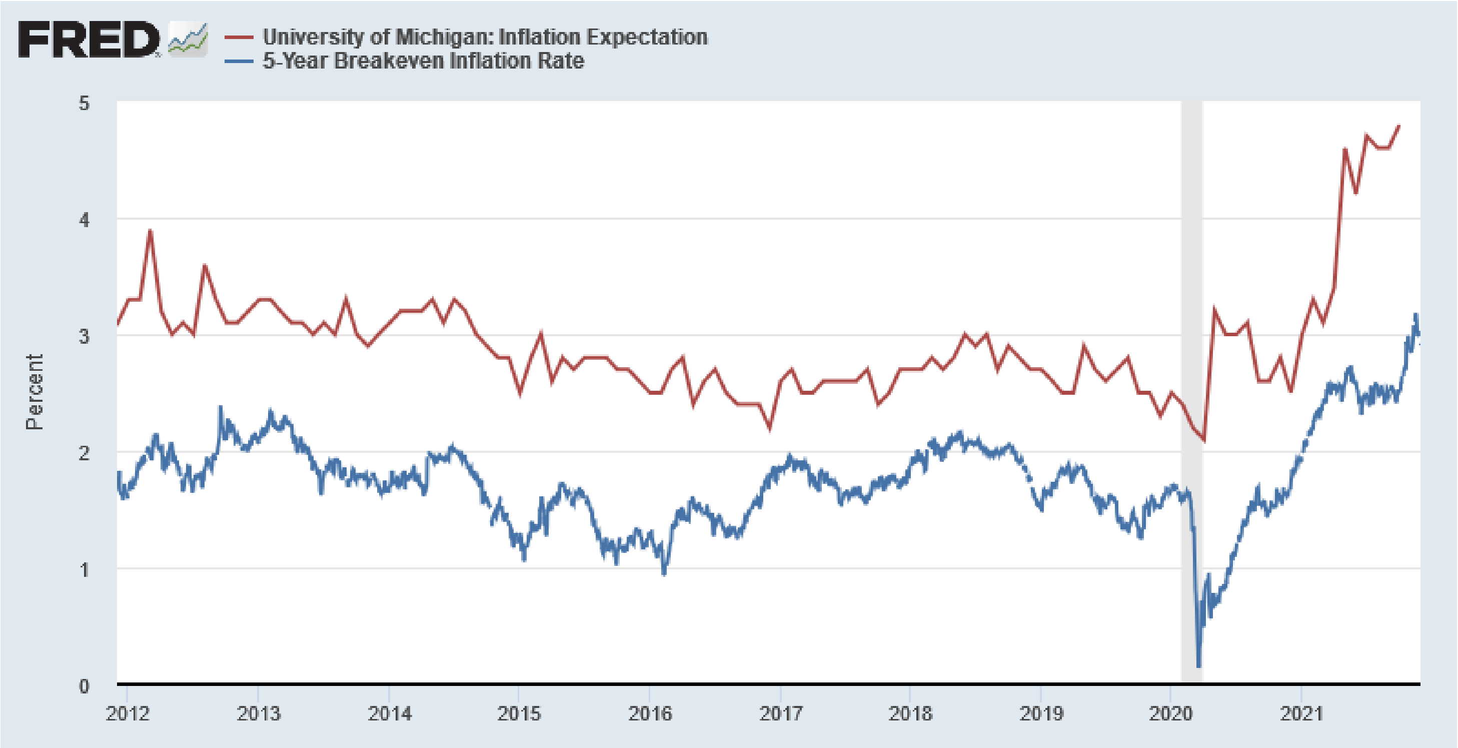
We understand that high inflation imposes significant burdens, especially on those less able to meet the higher costs of essentials like food, housing, and transportation. **We are committed to our price-stability goal**. We will use our tools both to support the economy and a strong labor market and to prevent higher inflation from becoming entrenched.

The recent rise in COVID-19 cases and the emergence of the Omicron variant pose **downside risks to employment and economic activity and increased uncertainty for inflation**. Greater concerns about the virus could reduce people's willingness to work in person, which would slow progress in the labor market and intensify supply-chain disruptions.

# Inflation Causes Wealth Redistribution

“This study quantitatively assesses the effects of inflation through changes in the value of nominal assets.…**The main losers from inflation are rich, old households, the major bondholders in the economy. The main winners are young, middle-class households with fixed-rate mortgage debt.** Besides transferring resources from the old to the young, inflation is a boon for the government and a tax on foreigners. Lately, the amount of U.S. nominal assets held by foreigners has grown dramatically, increasing the **potential for a large inflation-induced wealth transfer from foreigners to domestic households**.” Doepke & Schneider (2006)

# Some Movement in Inflation Expectations




Michigan: 4.8%, NY Fed: 5.7% 1-year, 4.2% 3-year. 5-year Breakeven: 2.9%

# Fearless Forecasts

- **Inflation likely to remain high** well into next year but at lower rate (~4% by summer). Labor market & supply chain pressures to continue.
- **Fiscal pressure to abate**. BBB fate uncertain (and less inflationary). More stimulus unlikely (unless another downturn). Long term fiscal problems remain but still strong demand for US government debt.
- **Monetary policy finally waking up**: Fed to taper faster than planned (Mar possible). Could see 3 rate hikes next year (starting in June).
- Monetary policy tightening **won't significantly slow the economy**: easing off gas rather than slamming on brakes. Growth slows to <3%
- Risks: policy still behind the curve, another turn in COVID