Inflation and Monetary Policy

Federal Reserve Bank of Chicago
Economic Club of Michiana
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Inflation is too high

**Consumer price index**
(12-month percent change)

Note: Core ex. ‘special factors’ removes from core prices some selected categories where pandemic related shifts in demand and/or specific supply chain disruptions have had a major influence on prices, namely: used motor vehicles, new motor vehicles, household furnishings and supplies, airfares, and hotel and motel accommodations. Together these categories have had a weight of about 11 percent in core CPI since the pandemic started. CPI calculations for August 2022 use July 2022 relative importance weights as published in the August CPI release.

Source: BLS via Haver Analytics, staff calculations
Questions

▪ How did we get here?

▪ What lies ahead?
  – For monetary policy
  – For economic activity

▪ What are the risks and challenges?
Covid: deep recession and quick recovery

Real GDP growth
(percent change, annual rate)

Unemployment rate
(percent, SA)

Source: Bureau of Economic Analysis via Haver Analytics

Source: Bureau of Labor Statistics via Haver Analytics
The labor market is unusually tight

Source: Bureau of Labor Statistics via Haver Analytics
Some workers have not returned to the labor market

Older workers remain on the sidelines

**Labor force participation by age**
(indexed, Feb. 2020 = 100)

Source: Bureau of Labor Statistics via Haver Analytics
Wages are up but have not kept up with inflation

Employment cost index: civilian workers

(percent change, year-over-year)

Note: Real ECI is nominal ECI deflated by the price index for total personal consumption expenditures.
Source: BLS via Haver Analytics
Supply chain issues have been a challenge

Federal Reserve Bank of New York Global Supply Chain Pressure Index
(standard deviations from average)

High demand for goods contributes to imbalances

Real personal consumption expenditures
(indexed, Feb. 2020 = 100)

Source: Bureau of Economic Analysis via Haver Analytics
How do we bring inflation down?

- Get demand and supply in better balance

- Need restrictive monetary policy to slow demand
  - Returning inflation to the 2% target will require a slowdown in growth and some increase in unemployment

- Supply chain repair will help

- **Policy goal:**
  - Bring inflation back to 2% without causing unnecessary pain
Monetary policy has tightened rapidly

Federal funds rate (percent)

Actual

Longer-run projection

Sources: Federal Reserve Board Division of Monetary Affairs; FOMC Summary of Economic Projections via Haver Analytics
Impact of tighter monetary policy

**National financial conditions index**
(> 0 = tighter than average)

**Single-family housing starts**
(thousands of units, SAAR)

Sources: Federal Reserve Bank of Chicago and U.S. Census Bureau via Haver Analytics
What lies ahead?

- Tighter monetary policy
- Slowing growth
- Some increase in unemployment
- Inflation moderating toward 2% target
Monetary policy is expected to tighten further.

**Federal funds rate path**

(Percent)

- **Actual**
- **September 2022 median SEP**
- **Longer-run projection**

*Sources: Federal Reserve Board Division of Monetary Affairs; FOMC Summary of Economic Projections via Haver Analytics*
Quantitative tightening is also underway

Projected baseline balance sheet holdings
($ trillions)

Source: Board of Governors of the Federal Reserve System, July 15, 2022
Growth is expected to be low

Real GDP Growth and Median SEP
(percent change, annual rate)

Source: Bureau of Economic Analysis and FOMC Summary of Economic Projections via Haver Analytics
Unemployment is expected to rise modestly

**Unemployment Rate and Median SEP**

(percent, SA)

Source: Bureau of Labor Statistics and FOMC Summary of Economic Projections via Haver Analytics

September 2022
Inflation is expected to moderate

Total and core PCE price indices and median SEPs
(12-month percent change; Q4/Q4 for SEPs)

Source: Bureau of Economic Analysis and FOMC Summary of Economic Projections via Haver Analytics
Outside forecasters are similar to the FOMC

<table>
<thead>
<tr>
<th>Median Private-Sector Forecasts of Key Indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>GDP</td>
</tr>
<tr>
<td>Unemployment</td>
</tr>
<tr>
<td>PCE</td>
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<td>Core PCE</td>
</tr>
</tbody>
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Notes: Private forecaster median projections as of October 6. GDP growth and inflation rates are Q4/Q4. Unemployment is the projected rate in Q4 of each year.

Sources: Various private forecasters; staff calculations
Monetary policy tradeoffs

- **Aim:** Full employment and price stability

- If raise rates too slowly and/or to a level that isn’t restrictive enough → inflation will stay elevated

- If raise rates too quickly and/or to a level that is too restrictive → unemployment will go up a lot and there will be a recession

- Threading a needle
Long-run inflation expectations appear anchored

<table>
<thead>
<tr>
<th>Michigan survey of inflation expectations (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 year ahead</td>
</tr>
<tr>
<td>5-10 years ahead</td>
</tr>
</tbody>
</table>

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<tr>
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</tr>
</thead>
<tbody>
<tr>
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<td>5 years ahead</td>
</tr>
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Source: University of Michigan via Haver Analytics; Federal Reserve Board
Financial market risk has increased

MOVE Index
(daily average)

VIX Index
(monthly average of daily close)

Source: Bank of America Merrill Lynch via Haver Analytics

Source: Wall Street Journal via Haver Analytics

September 2022
Threading the needle on inflation

- **Helps**
  - Workers on the sidelines return to the labor market
  - Consumption patterns normalize and take pressure off supply chains
  - Supply backlogs get worked out
  - Job postings go down, wage growth slows

- **Hinders**
  - Global conflict or other shocks intensify supply disruptions
  - Wage growth accelerates and fuels inflationary pressures
  - Long-run inflation expectations increase
Summing up

- Sharp, rapid decline followed by sharp, rapid recovery

- Inflation has increased and inflation pressures have broadened

- Rapid tightening of monetary policy and more to come

- Forecast is that we thread the needle: bring inflation down with only modest costs in terms of growth and unemployment

- Risks abound