PIIE PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

What the Federal Reserve Should Do Now: An Elaboration

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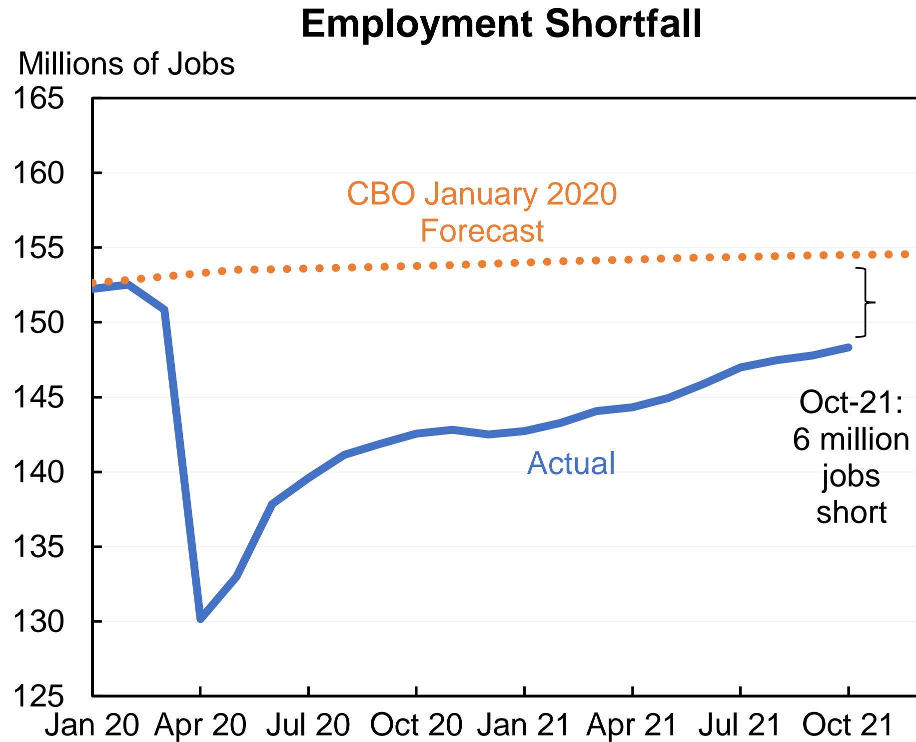
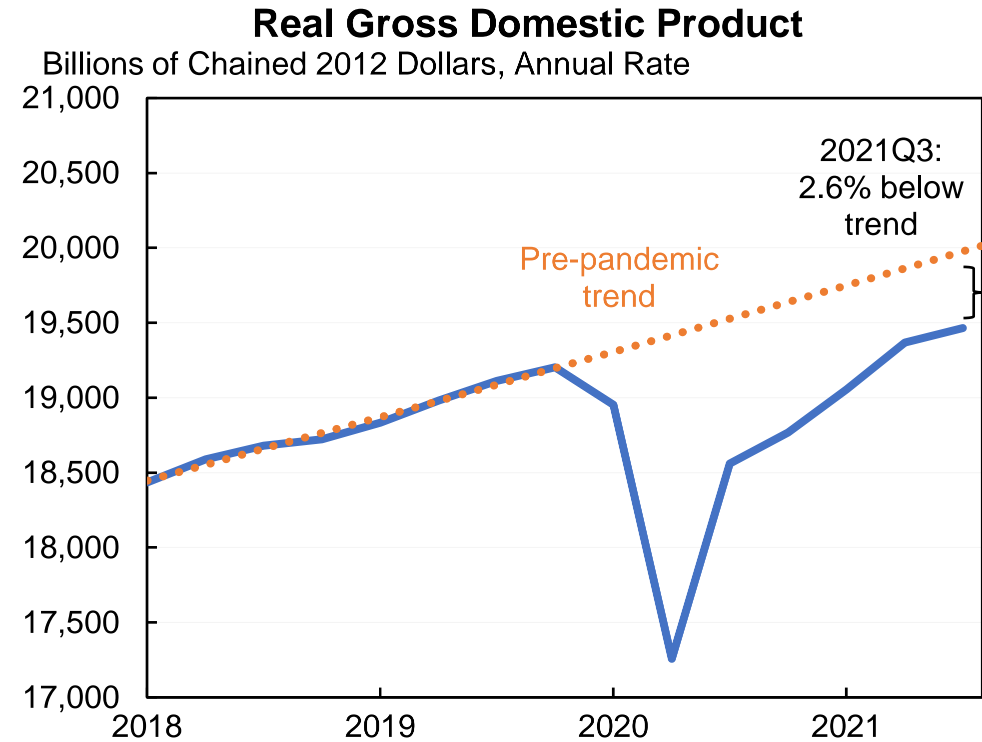
The Fed's Framework meets the data

- Monetary policy should remain expansionary
- Any one of the following are a reason to recalibrate:
    1. The economy is getting closer to maximum employment
    2. Monetary policy has de facto been loosening
    3. Inflation is high and likely at least partially persistent
- What the Federal Open Market Committee should do now:
    1. More realistic, balanced communications/forecasts
    2. Be clear about dual mandate and response to deviations/shortfalls
    3. Taper more quickly
    4. Set default of liftoff in 2022-H1 but alter if inflation and/or employment low

Employment and GDP still below trend





Note: Employment is nonfarm payroll employment, which excludes proprietors, self-employed, unpaid family or volunteer workers, farm workers, and domestic workers. Pre-pandemic trend for Real GDP based on log-linear regression for 2018Q1 to 2019Q4.
Source: Bureau of Labor Statistics and Bureau of Economic Analysis via Macrobond; Congressional Budget Office; author's calculations.

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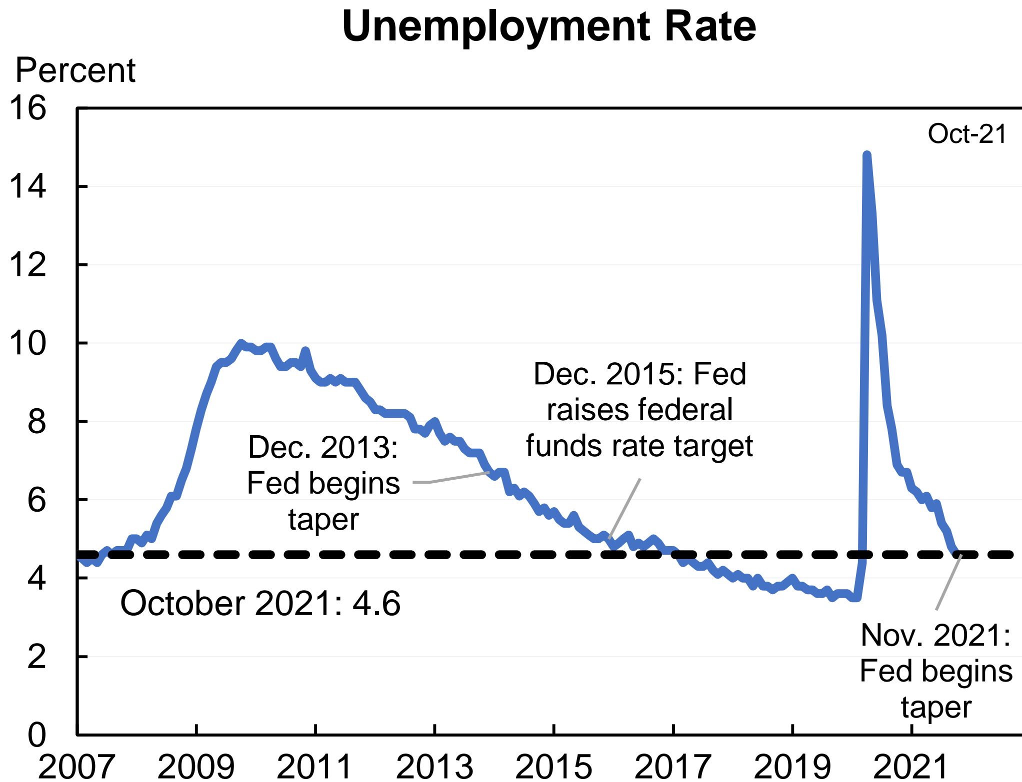
Policy shifted at an earlier stage last cycle



Source: Bureau of Labor Statistics via Macrobond

Reason to raise nominal rates later than the last cycle:

- *Monetary policy may have tightened prematurely last time (although debatable)*

Reasons to raise nominal rates sooner than the last cycle:

- *Real rates are much lower*
- *Inflation is much higher*
- *Unemployment improving more quickly*
- *Openings much higher*
- *Fiscal policy more expansionary*

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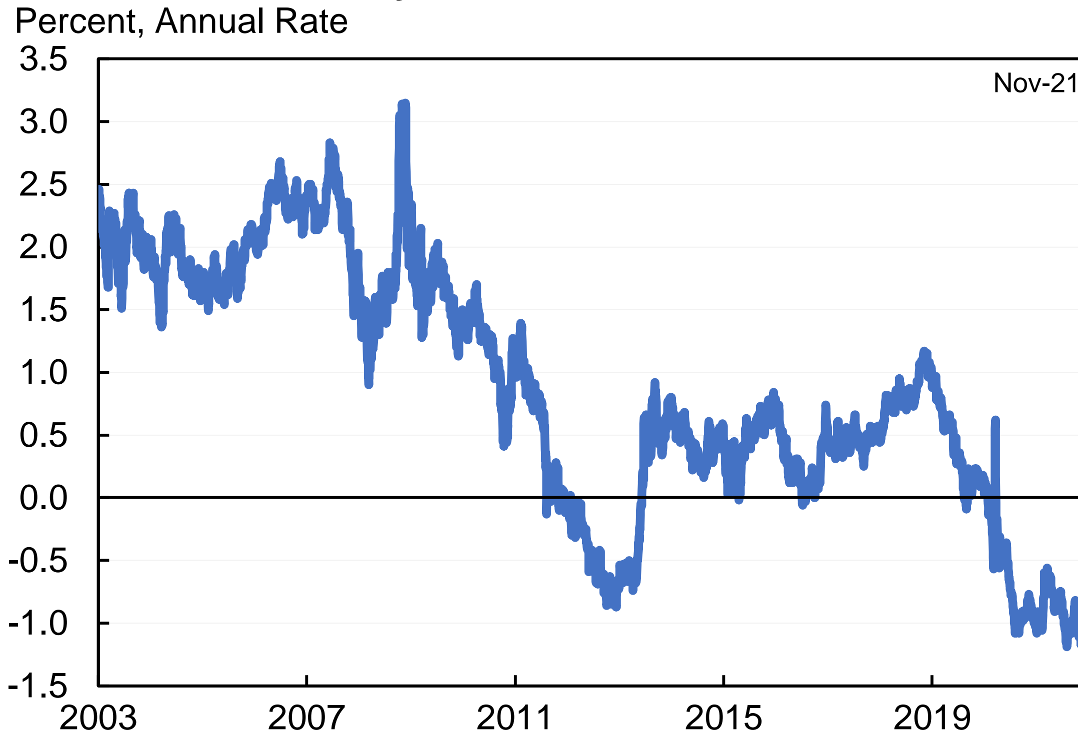
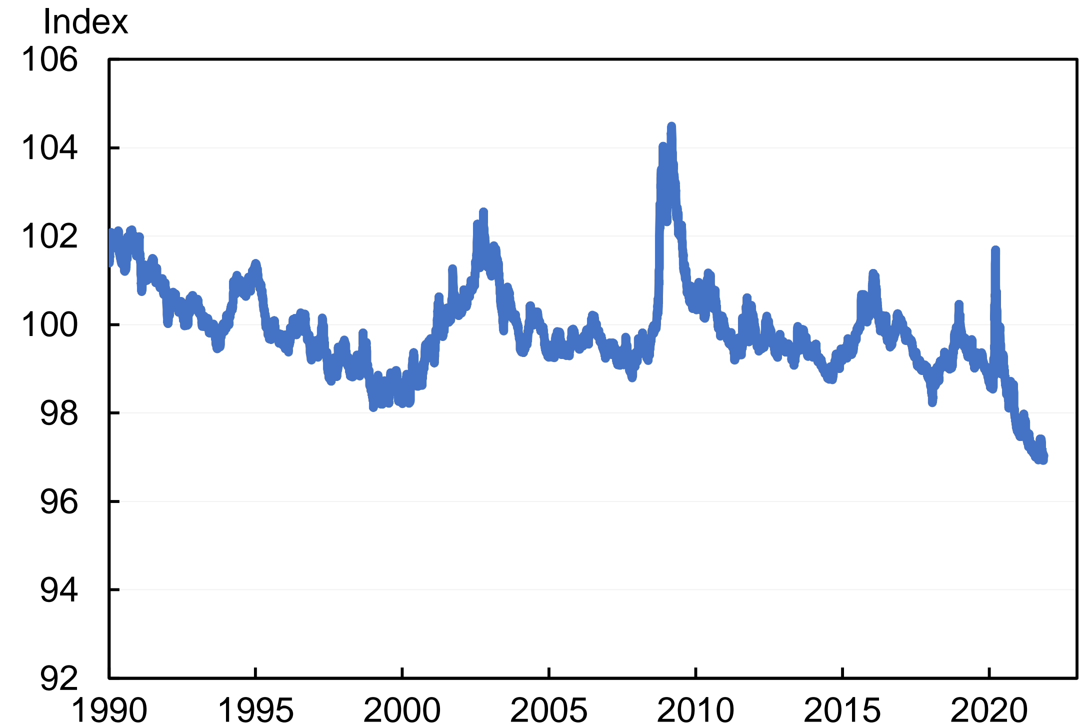
Monetary policy has continued to ease





Source: Board of Governors of the Federal Reserve System via Macrobond and Goldman Sachs Investment Research.

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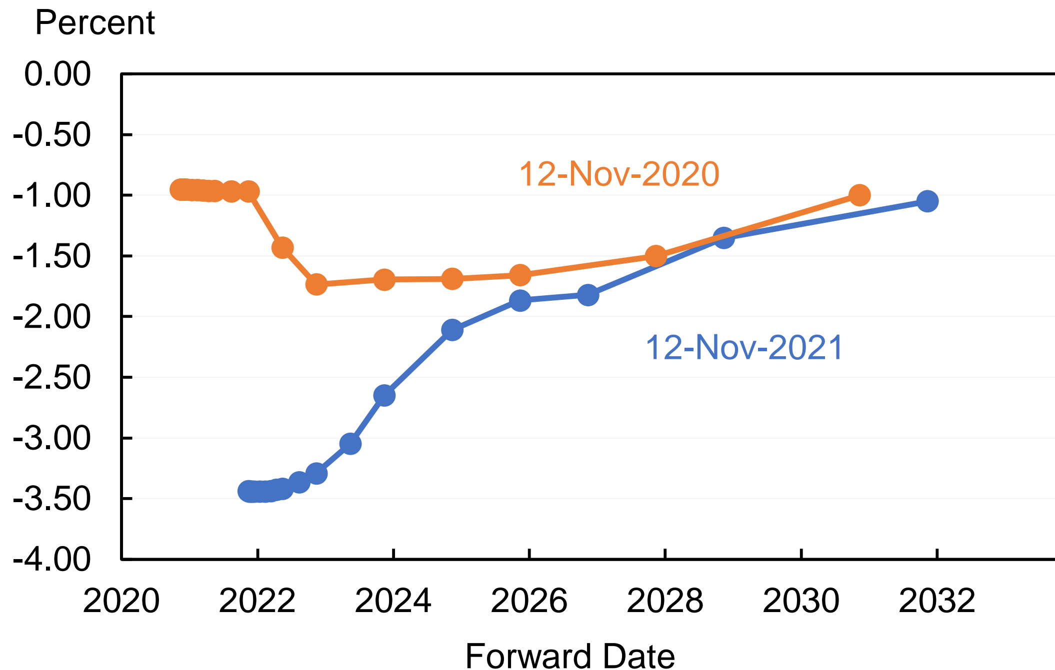
Real FFR path is lower now than last year



The Fed has shifted expectations for nominal policy—with the market now pricing in about 50 basis points more of rate hikes.

But, expected inflation has risen even more than 50 basis points.

As a result monetary policy has de facto loosened with policy not keeping up with changing expectations.

Source: Bloomberg Professional Service; author's calculations.

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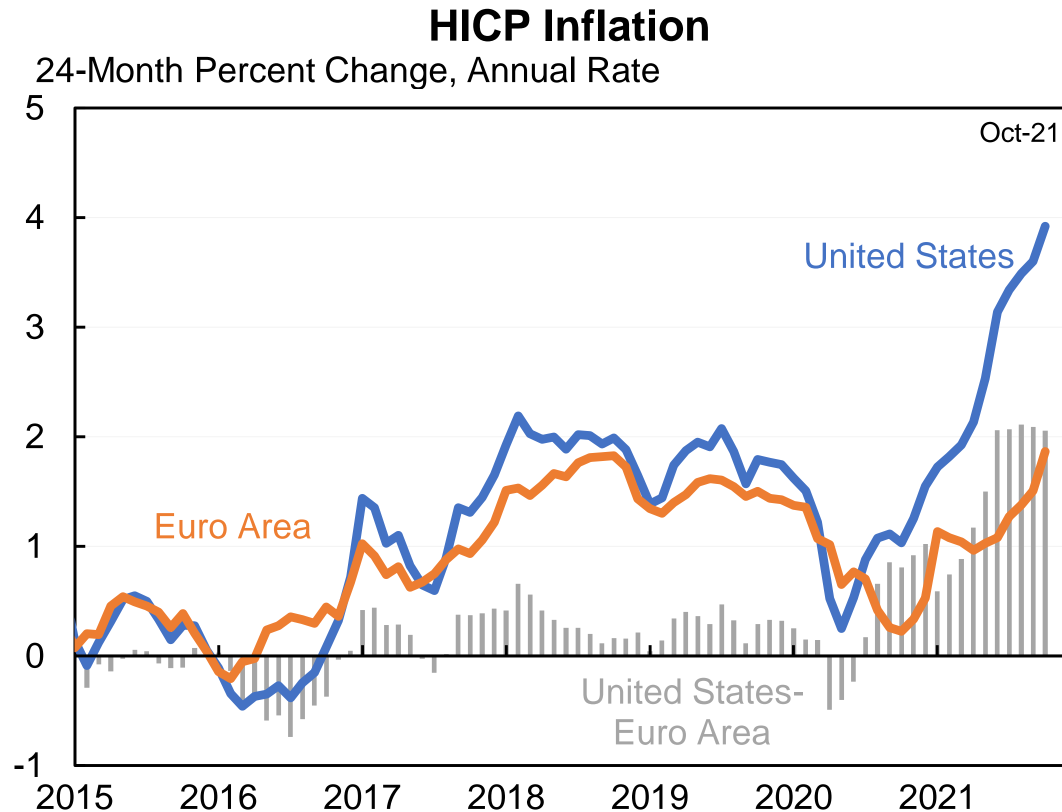
Inflation rising everywhere but more In US



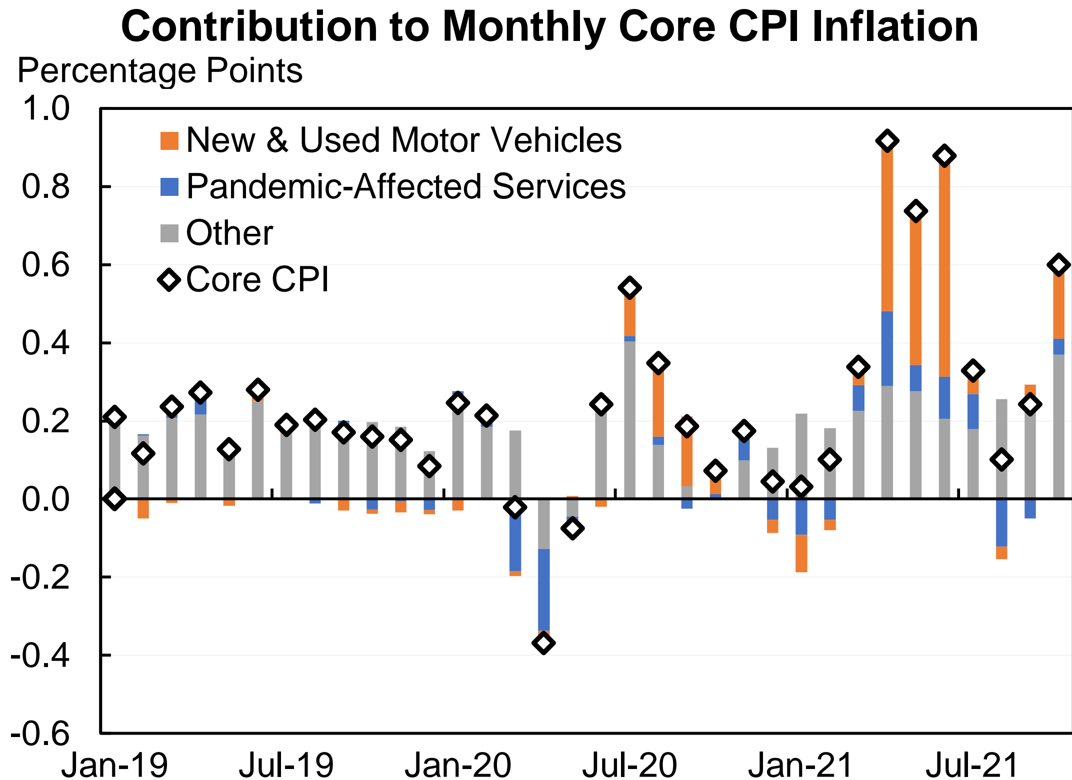
Inflation in euro area is more "base effects," still below 2 percent for the last 24 months.

Many complex differences like timing of reopening, supply shocks could affect U.S. more than euro area.

But, euro area inflation also in part reflects its own expansionary policy and a spillover from U.S. fiscal policy.

Note: HICP is Harmonized Index of Consumer Prices. Latest value for the United States is estimate based on change in CPI for October.
Source: Eurostat and Bureau of Labor Statistics via Macrobond; author's calculations.

Broad categories of inflation elevated



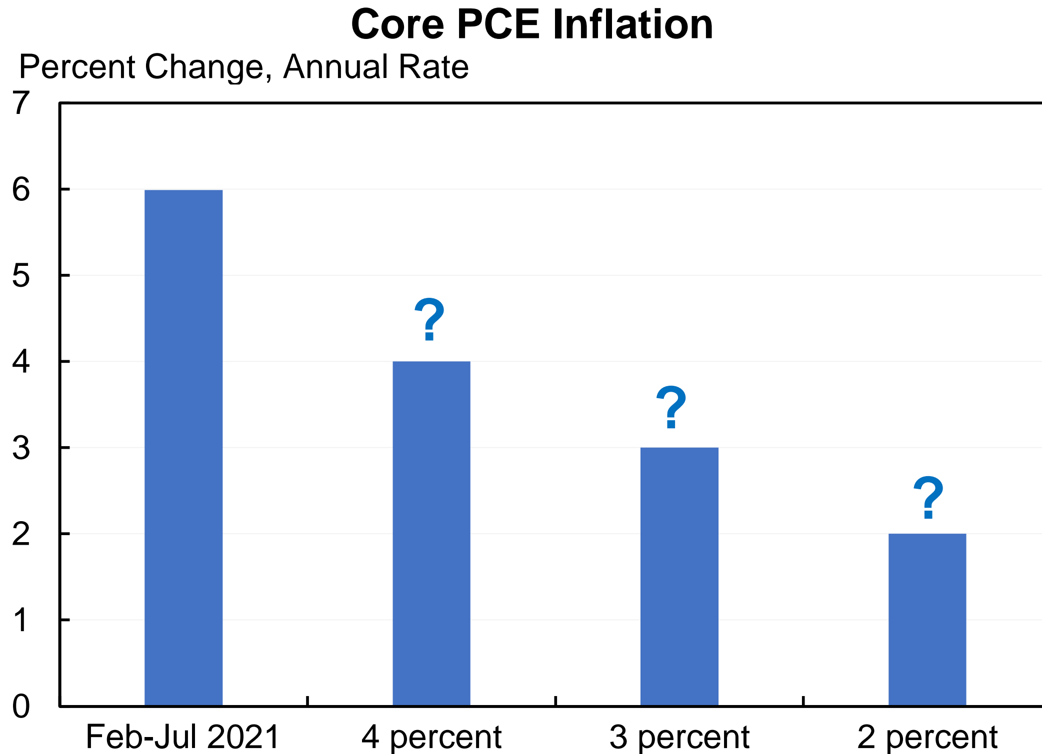
A lot of the inflation in April, May, June and October was cars. This is unlikely to continue at this pace and could even reverse.

The price of pandemic-affected services is still below trend.

The "other" component has remained stable/rising, consistent with 3 to 4 percent inflation.

Note: Pandemic-affected services includes admissions, airfare, and hotels.
Source: Bureau of Labor Statistics via Macrobond; author's calculations.

Inflation likely to fall, but by how much?



Reasons at least <u>some</u> elevated inflation is transitory:

- *Largest fiscal expansion is over*
- *Supply chains will improve*
- *Handoff from goods to services*
- *Labor force will at least partly return*

Source: Bureau of Economic Analysis; Author's calculations.

Why inflation could remain elevated

1. Continued high demand
2. Supply takes time to return to normal
3. Price of shelter and other services accelerate
4. Tight labor markets
5. Faster wage growth and higher inflation expectations

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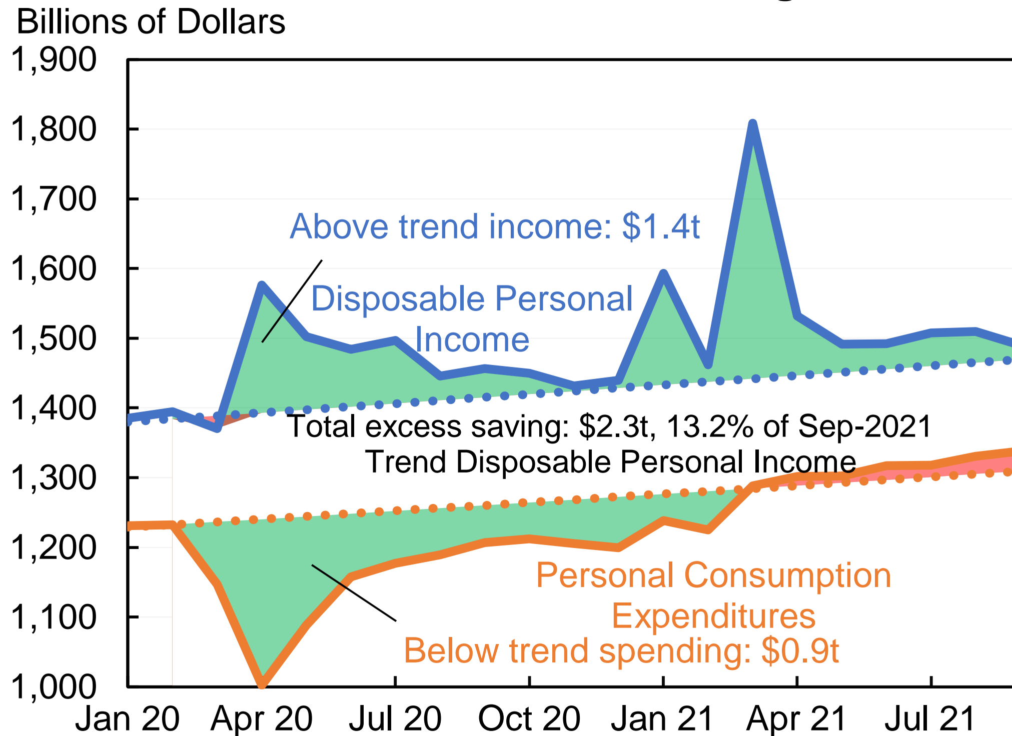
Consumers have $2.3t in excess saving



Bank account balances are higher than pre-COVID, even more so for lower-income households.

Goods spending remaining highly elevated even while services spending recovers.

Lagged effects of monetary policy.

Note: Pre-pandemic trends based on log-linear regression for Jan-18 to Dec-19.
Source: Bureau of Economic Analysis via Macrobond; author's calculations.

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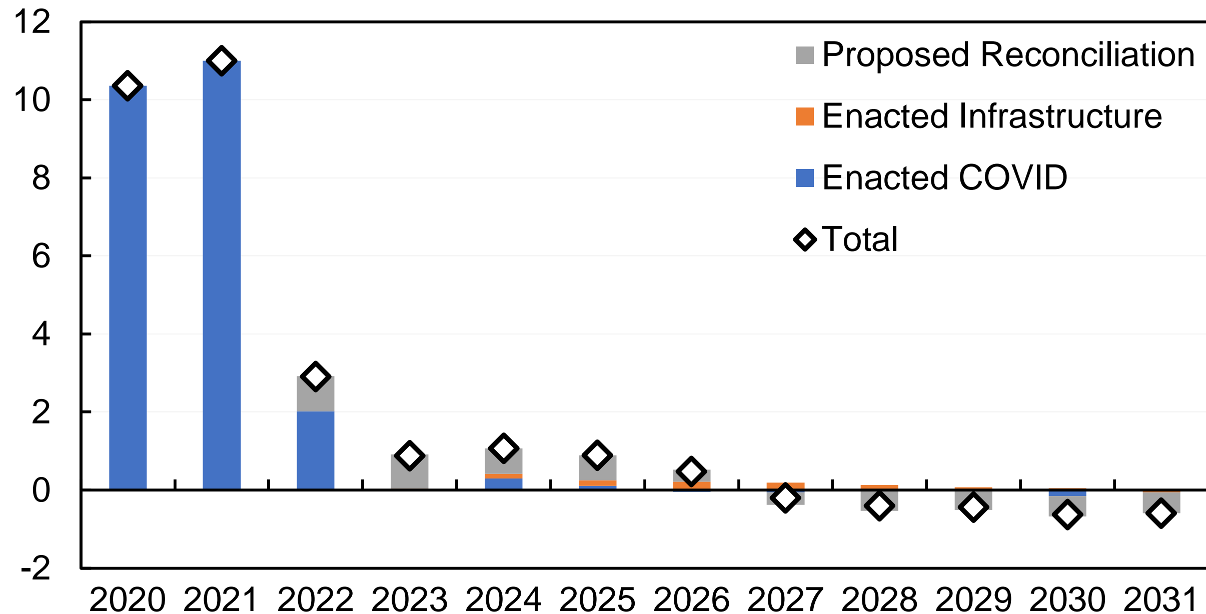
Fiscal policy adding less to inflation in 2022



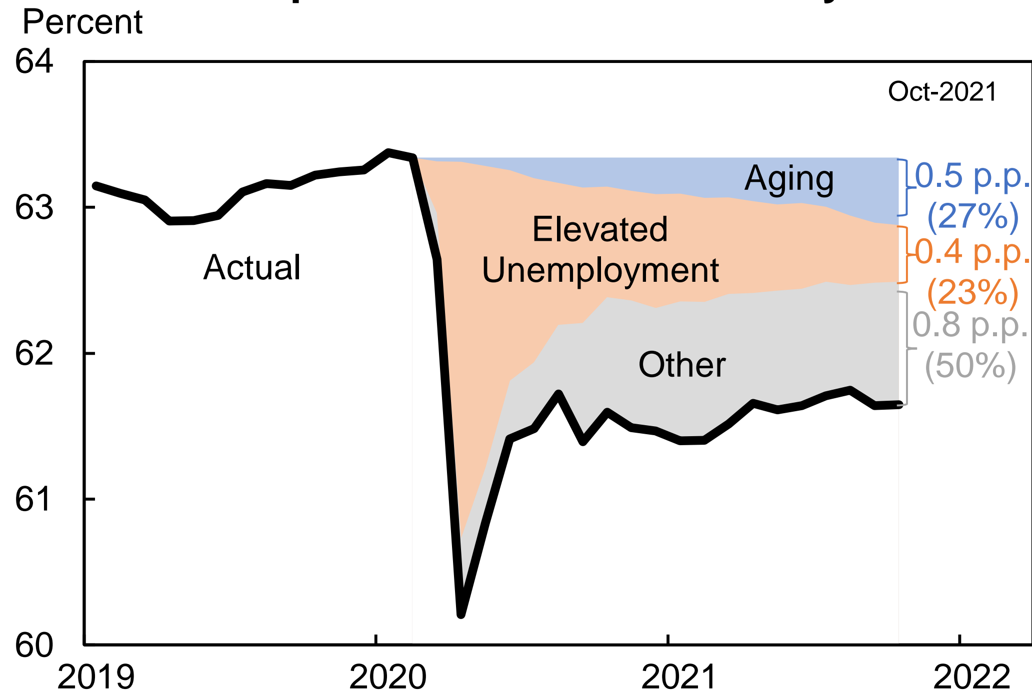
Fiscal policy in 2022 is a very large contraction relative to 2021. All else equal that should push inflation down from its 2021 rate.

But, fiscal policy in 2022 is a large expansion relative to pre-COVID trajectory. Should continue to put upward pressure on inflation.

Fiscal policy after 2022 is roughly neutral and Fed has time to offset.

Source: Calculations based on Congressional Budget Office; Joint Committee on Taxation; Moody's Analytics.

The decline in labor force participation



The biggest supply constraint in the U.S. economy is the labor force.

No one understands the exact causes or trajectory forward. But unlikely to be fully resolved very quickly.

As a result of this and other supply-chain issues, supply is likely to remain below pre-COVID trends for at least another year.

Source: Bureau of Labor Statistics via Macrobond; author's calculations.

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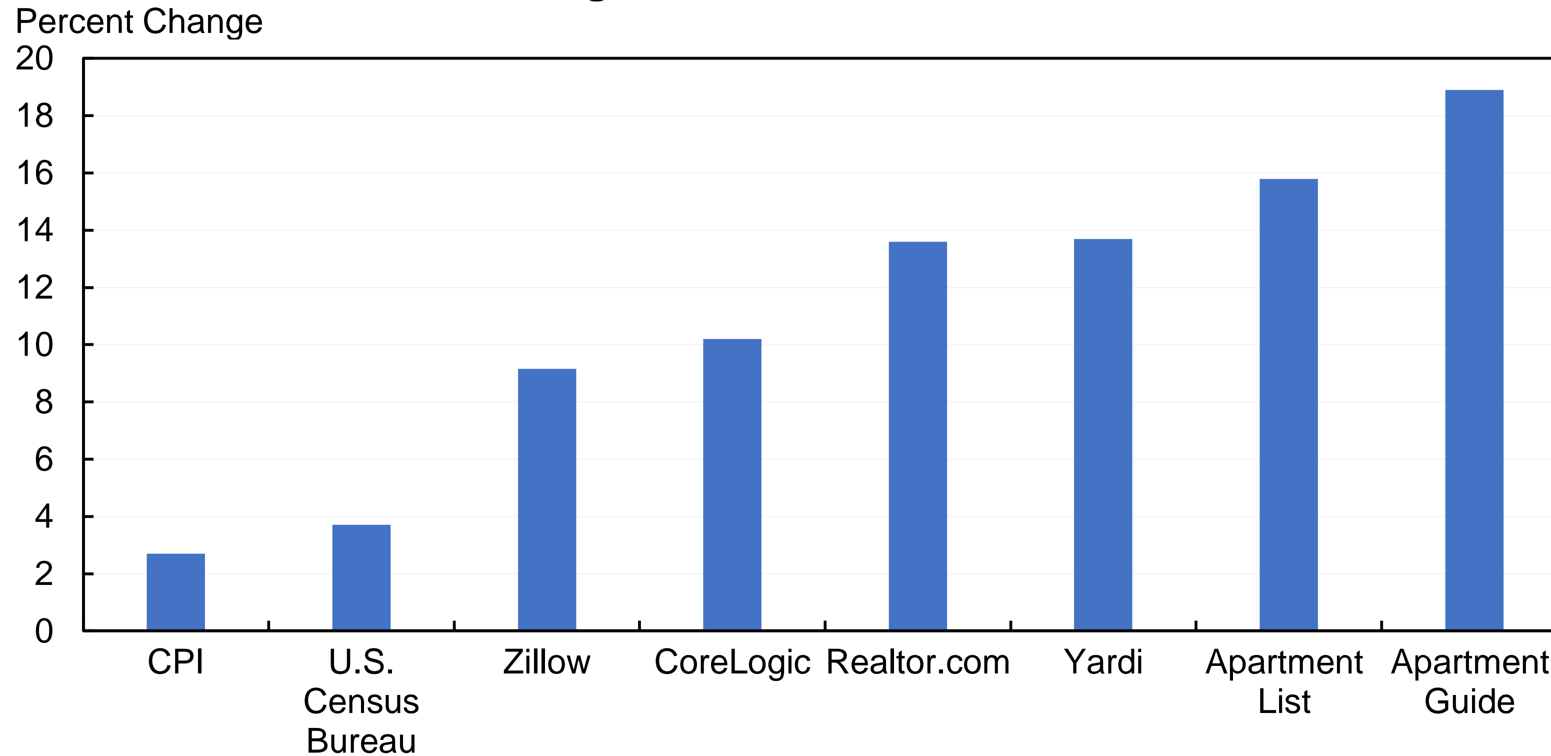
Rent increases not fully in CPI yet

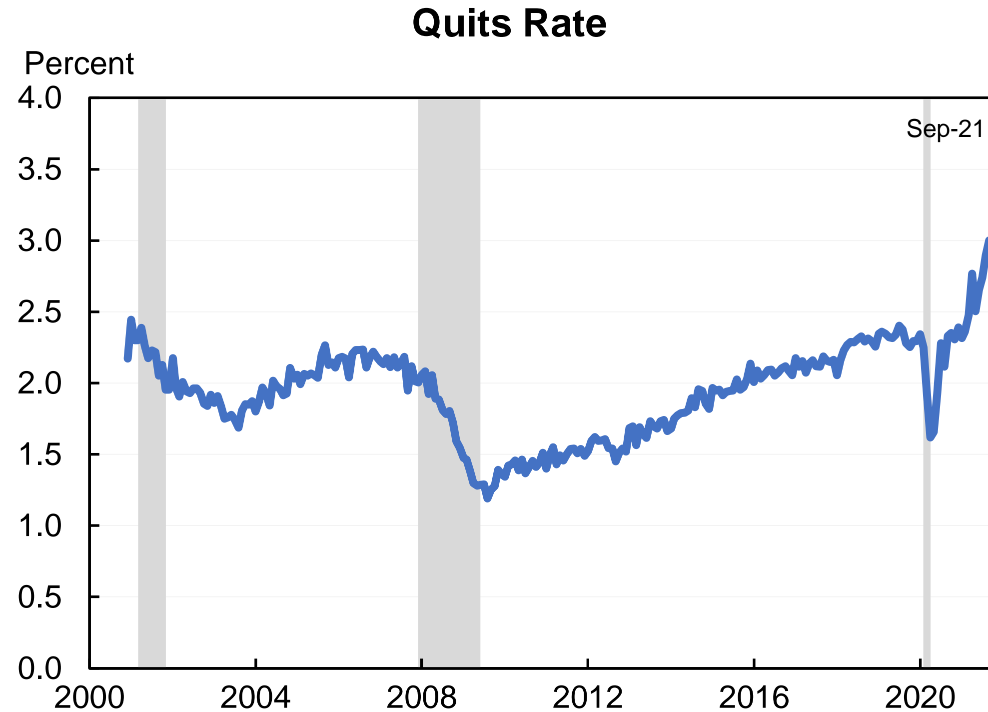


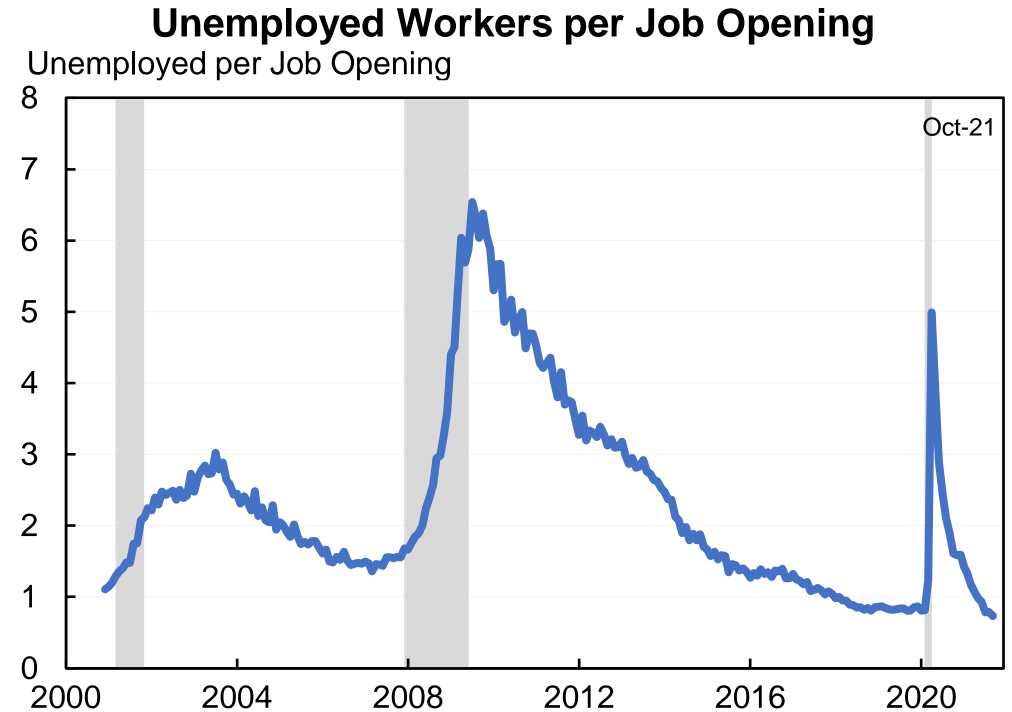
Macro considerations are the best way to think about inflation.

But from a micro, bottom-up perspective still have some additional sources of inflation like rent, airfares, hotels and possibly health.

Note: Data for October 2021, except for CoreLogic, Realtor.com, and Zillow, (September 2021) and U.S. Census Bureau (2021Q3).
Source: Apartment List National Rent Report, Bureau of Labor Statistics (CPI, Rent of Primary Residence), U.S. Census Bureau (Median Asking Rent), Zillow Observed Rent Index via Macrobond; Apartment Guide Rent Report (2-bedroom); CoreLogic Single-Family Rent Index; Realtor.com Median Rent; Yardi Multifamily Average Asking Rents; author's calculations.

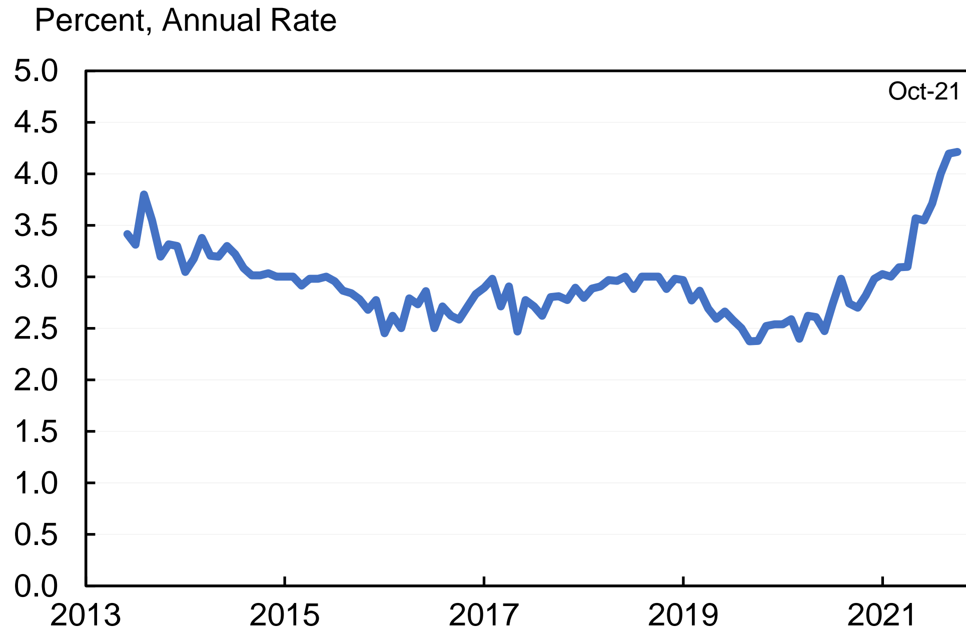
A very tight labor market with record quits

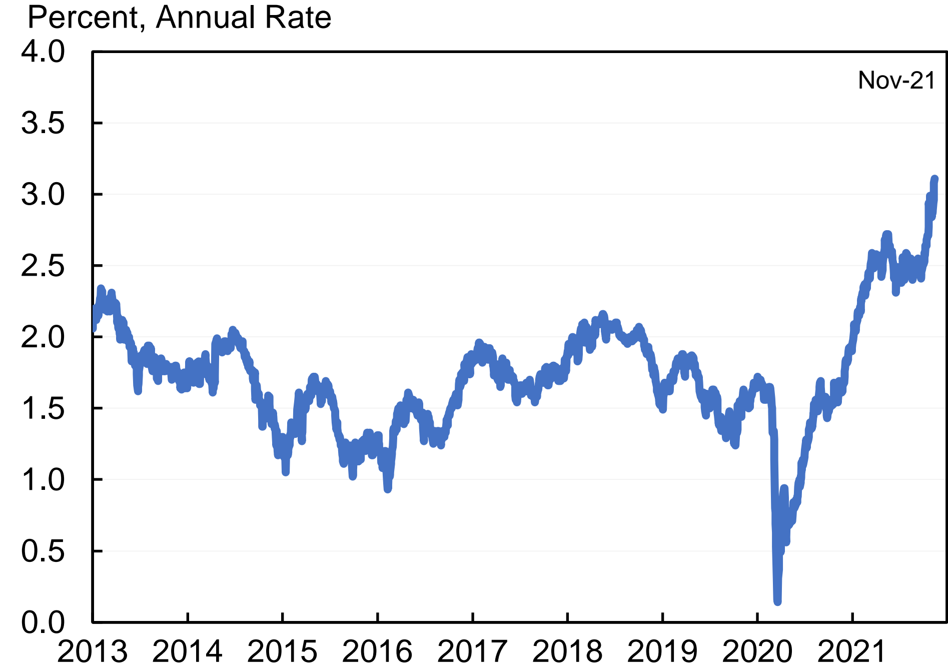




Note: Quits rate is quits as a percent of total employment. Job openings for October 2021 are estimated based on growth in Indeed Hiring Lab job postings. Shading denotes recession.
Source: Bureau of Labor Statistics via Macrobond; Indeed Hiring Lab; author’s calculations.

Inflation expectations up





Source: Federal Reserve Bank of New York and Board of Governors of the Federal Reserve System via Macrobond.

How the Federal Reserve should recalibrate

1. More realistic, balanced communications/forecasts

2. Be clear about dual mandate and response to deviations/shortfalls

3. Taper more quickly

4. Set default of liftoff in 2022-H1 but alter if inflation and/or employment low

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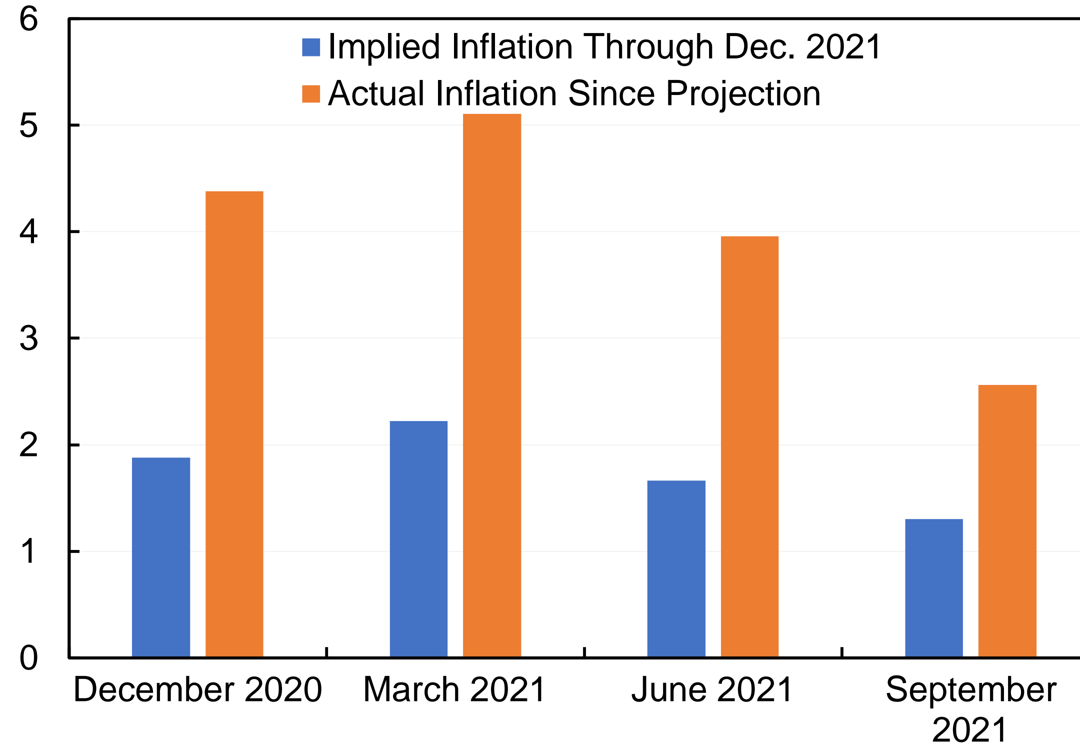
1. More realistic forecasts



Note: Actual inflation since projection through September 2021. Assumes that actual values were known through month prior to forecast.
Source: Bureau of Economic Analysis via Macrobond and via Federal Reserve Bank of St. Louis, ALFRED; Board of Governors of the Federal Reserve System; author's calculations.

2. Be clear about dual mandate

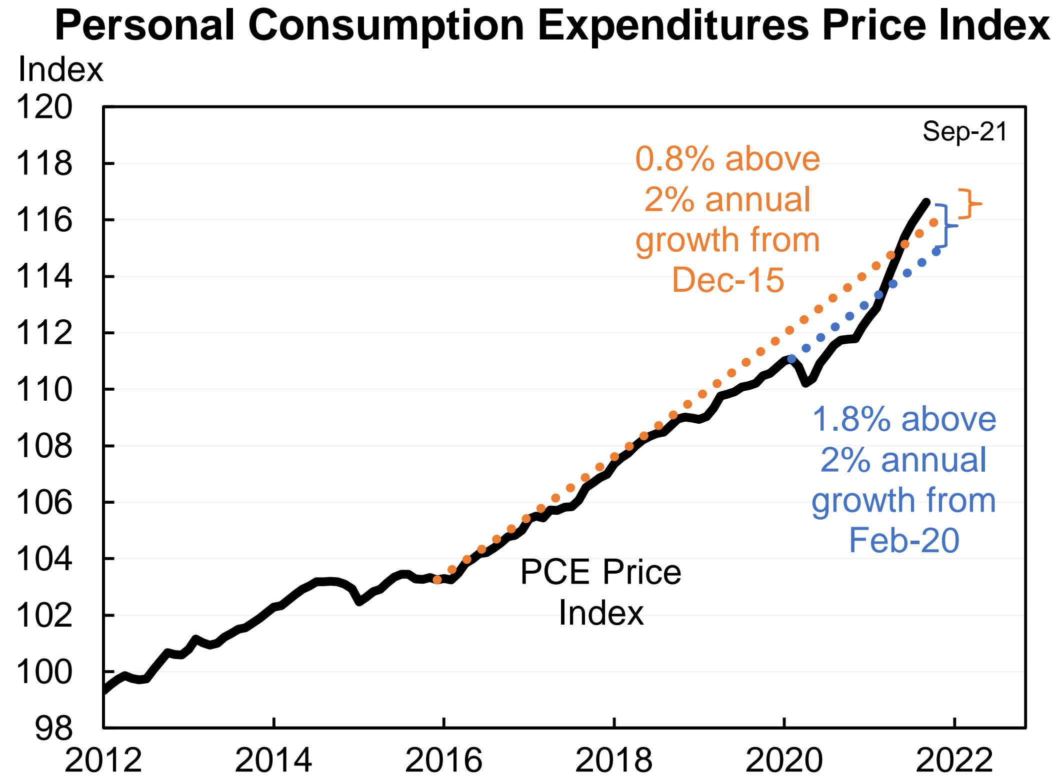
Framework:

"The Committee's employment and inflation objectives are generally complementary. However, under circumstances in which the Committee judges that the objectives are not complementary, it takes into account the employment shortfalls and inflation deviations..."

Statement:

"The Committee… expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time."

Inflation > 2% backward-looking average



Source: Bureau of Economic Analysis via Macrobond; author's calculations.

3 & 4. Accelerate taper & set default lift-off

- Accelerate taper and be done with asset purchases by March
- Reverse default: Fed will raise rates unless It is surprised by lower inflation and/or lower employment

Possible new default: liftoff in 2022-H1 and three hikes in 2022.

Raising the inflation target, eventually

- Inflation target should be higher due to the fall in the neutral interest rate.
- Would suggest either a 2 to 3 percent range or 3 percent.
- Better done as part of the next framework review.
- The steps I outlined would likely to continue to still have inflation overshoot the 2 percent average target

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There are also risks of doing too much

1. With relatively inelastic supply expansion goes more into prices than output/employment
2. Surprising inflation hurts real wage growth
3. Hard landing would hurt vulnerable workers most
4. Low interest rates create financial stability risks
5. Unnecessary volatility from the disconnect between expectations and policy

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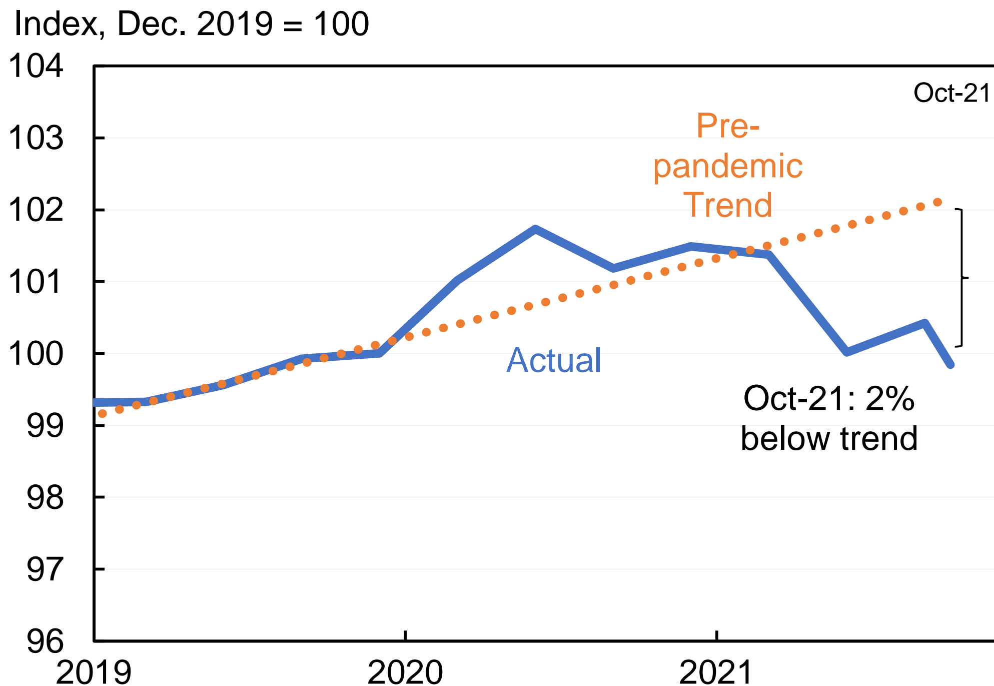
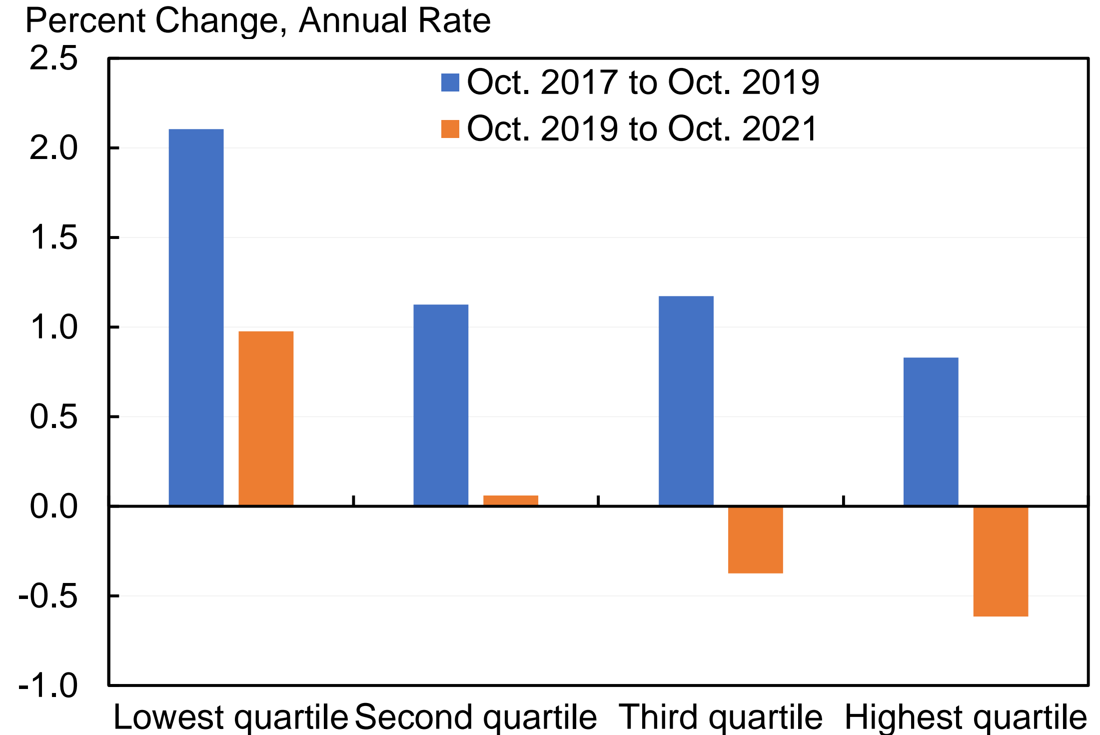
Real wages have fallen behind





Note: Pre-pandemic trend based on log-linear regression for Mar-18 to Dec-19. Employment Cost Index after September 2021 extended using change in average hourly earnings for all private workers. Deflated by consumer price index. Atlanta Fed Wage Growth Tracker deflated by CPI-U inflation.

Source: Bureau of Labor Statistics via Macrobond; Federal Reserve Bank of Atlanta; author's calculations.

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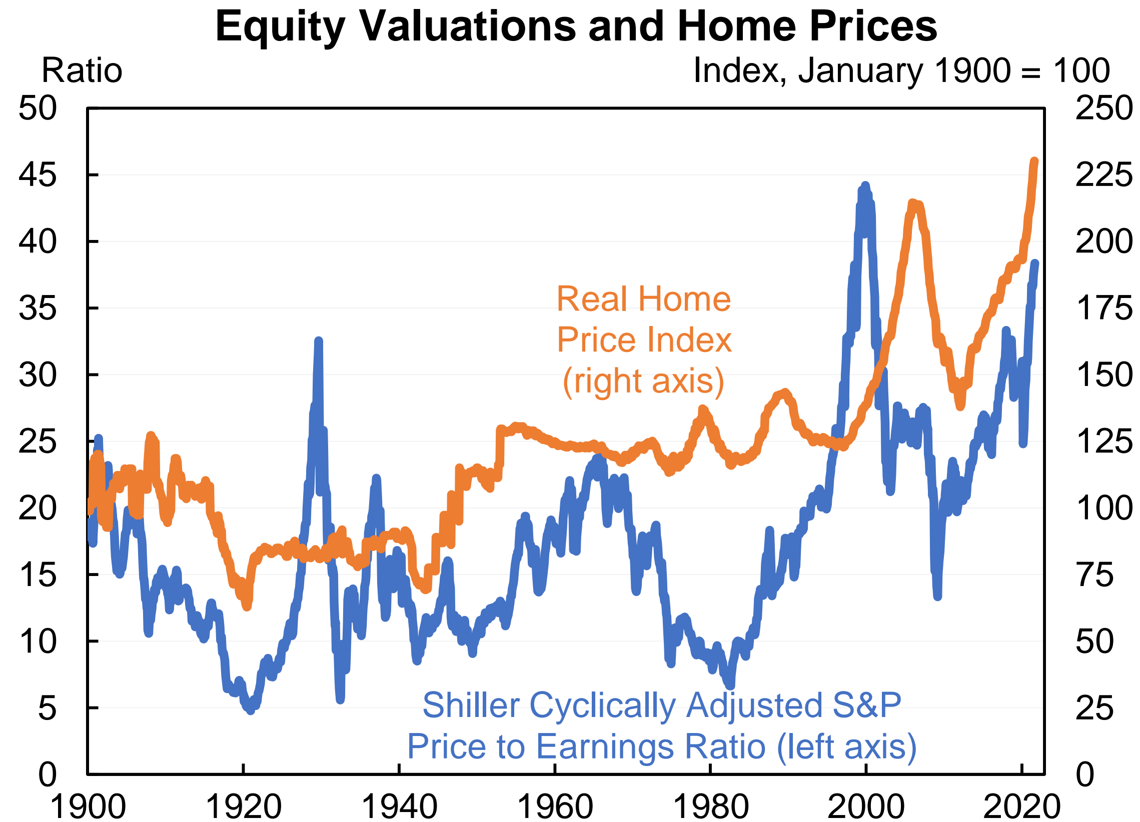
Frothy asset markets?



Note: Real Home Price Index is S&P Case-Shiller National Home Price Index deflated by Consumer Price Index.
Source: S&P, Robert Shiller, and Bureau of Labor Statistics via Macrobond; author's calculations.

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