The Outlook for US Inflation and Monetary Policy

Joseph E. Gagnon
April 2, 2019
Is Inflation AWOL?

• Unemployment is projected to be below its natural rate in 2019 and 2020.

<table>
<thead>
<tr>
<th>Unemployment rate (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual, February 2019</td>
</tr>
<tr>
<td>Projected, Blue Chip, 2020</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Natural rate of unemployment (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Congressional Budget Office (CBO) (long-run)</td>
</tr>
<tr>
<td>Federal Open Market Committee (FOMC) (“longer-run”)</td>
</tr>
<tr>
<td><em>Blue Chip Economic Indicators</em> (2025 projection)</td>
</tr>
</tbody>
</table>

Note: FOMC data are median values from the Summary of Economic Projections from the March 2019 FOMC meeting. Blue Chip data are the consensus (average) values from the March 2019 survey.
Is Inflation AWOL?

• Yet inflation is projected to be low and stable.

<table>
<thead>
<tr>
<th>Q4/Q4, percent</th>
<th>FOMC core PCE Inflation</th>
<th>Blue Chip CPI Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>1.9</td>
<td>2.2</td>
</tr>
<tr>
<td>2019</td>
<td>2.0</td>
<td>2.0</td>
</tr>
<tr>
<td>2020</td>
<td>2.0</td>
<td>2.2</td>
</tr>
<tr>
<td>2021</td>
<td>2.0</td>
<td>2.2</td>
</tr>
</tbody>
</table>

Note: FOMC data are median values from the Summary of Economic Projections from the March 2019 FOMC meeting. Blue Chip data are the consensus (average) values from the March 2019 survey.
The Phillips Curve

1967-94, high inflation

Source: Authors’ illustration.
The Phillips Curve

1995-2018, low inflation

Source: Authors’ illustration.
The Phillips Curve

1995-2018, low inflation

Change in inflation, percentage points vs. Unemployment gap, percent

Source: Authors’ illustration.
Downward Wage and Price Rigidity

• Even in good times, some firms have weak sales.
  – These firms raise price less than average.
  – Other firms raise price more than average.

• To allow average inflation to approach 0, some firms must cut wages and prices.

• Many firms resist cutting wages and prices.
  – They may accept lost sales and layoffs instead.

• Downward wage and price rigidity bends the Phillips curve when inflation is low.
Low Inflation Bends the Phillips Curve

Source: Gagnon and Collins (2019, figure 2).
Two Versions of the Phillips Curve
(based on core CPI inflation)

High Inflation

Low Inflation

Source: Gagnon and Collins (2019, figure 6).
\[ \Delta P_t = \gamma GAP_t + \alpha + \beta \Delta P_{t-1} \]

- Accelerationist model \( \beta = 1 \): Inflation builds on itself
  - Phillips curve describes \textit{change} in inflation

- Anchored model \( \beta = 0 \): Inflation returns to a fixed anchor
  - Phillips curve describes \textit{level} of inflation

Is Inflation Anchored Too Low?
Projections with Anchored Inflation Models

Source: Gagnon and Collins (2019, figure 8).
Projections with Accelerationist Inflation Models

Source: Gagnon and Collins (2019, figure 9).
US Monetary Policy Dilemma

- Fed chair Jerome Powell expressed doubt last month that inflation expectations are anchored at 2 percent.
- The abrupt pause in expected rate hikes may reflect concern about the risk of another undershoot.
- Some overshooting of 2 percent target may be useful in raising the inflation anchor to 2 percent.
- The Fed is likely to hit the zero bound on its short-term interest rate tool in the next recession.
  - QE can help, but possibly not as much as Fed would like.
  - Inflation may undershoot and unemployment may be too high.
The Fed’s Ongoing Review of Its Policy Strategy

• Monetary policy can achieve its goals better by intentionally overshooting the inflation target after an undershoot at the zero bound.
  – Bernanke, Kiley, and Roberts (2019)

• If the Fed moves in this direction, it may not resist some modest overshooting of its inflation target next year.

• Better to switch to the new policy strategy before the next recession hits.
  – A new promise to raise future inflation during a recession may not be fully credible.
Is Inflation AWOL?

• FOMC and private forecasts may underpredict inflation.
• A modest overshoot of the Fed’s target by 2020 is likely.
• This may be an “error” that is welcomed by the Fed.

<table>
<thead>
<tr>
<th>Q4/Q4, percent</th>
<th>FOMC core PCE Inflation</th>
<th>Blue Chip CPI Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>1.9</td>
<td>2.2</td>
</tr>
<tr>
<td>2019</td>
<td>2.0</td>
<td>2.0</td>
</tr>
<tr>
<td>2020</td>
<td>2.0</td>
<td>2.2</td>
</tr>
<tr>
<td>2021</td>
<td>2.0</td>
<td>2.2</td>
</tr>
</tbody>
</table>

Note: FOMC data are median values from the Summary of Economic Projections from the March 2019 FOMC meeting. Blue Chip data are the consensus (average) values from the March 2019 survey.
References

