



The Outlook for US Inflation and Monetary Policy

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Is Inflation AWOL?

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

Unemployment rate (percent)	
Actual, February 2019	3.8
Projected, Blue Chip, 2020	3.7

Natural rate of unemployment (percent)	
Congressional Budget Office (CBO) (long-run)	4.6
Federal Open Market Committee (FOMC) (“longer-run”)	4.3
<i>Blue Chip Economic Indicators</i> (2025 projection)	4.3

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.

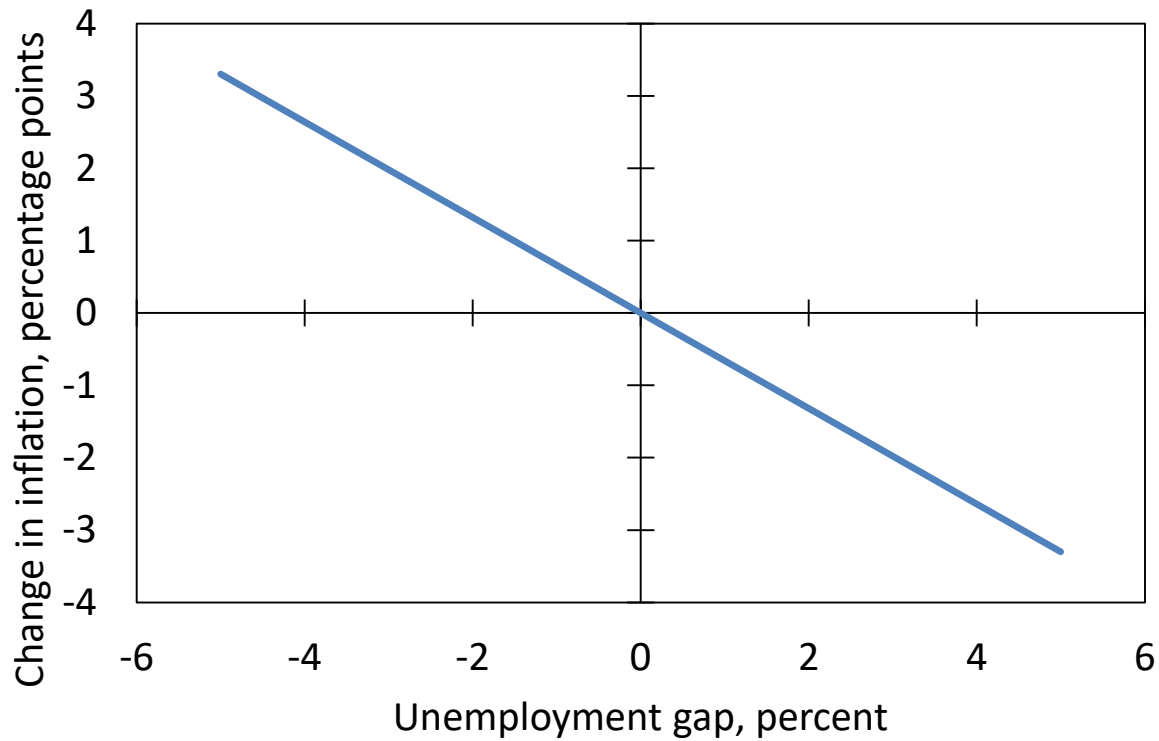
Q4/Q4, percent	FOMC core PCE Inflation	Blue Chip CPI Inflation
2018	1.9	2.2
2019	2.0	2.0
2020	2.0	2.2
2021	2.0	2.2

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

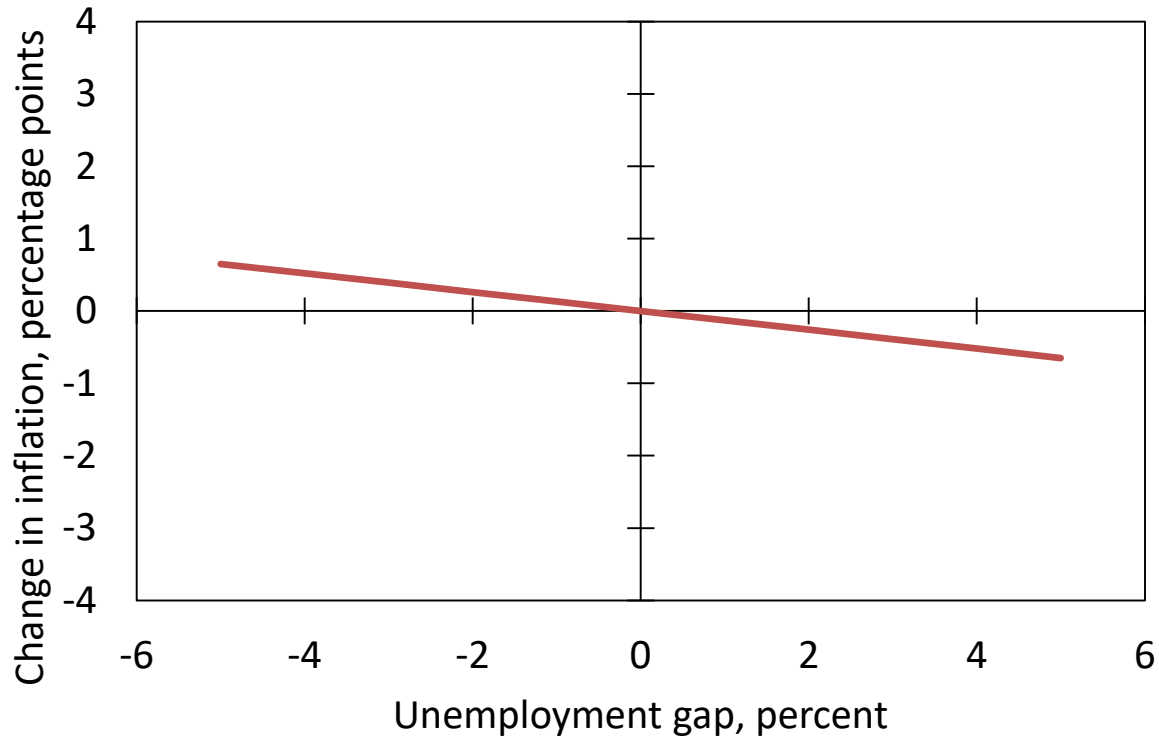


Source: Authors' illustration.



The Phillips Curve

1995-2018, low inflation

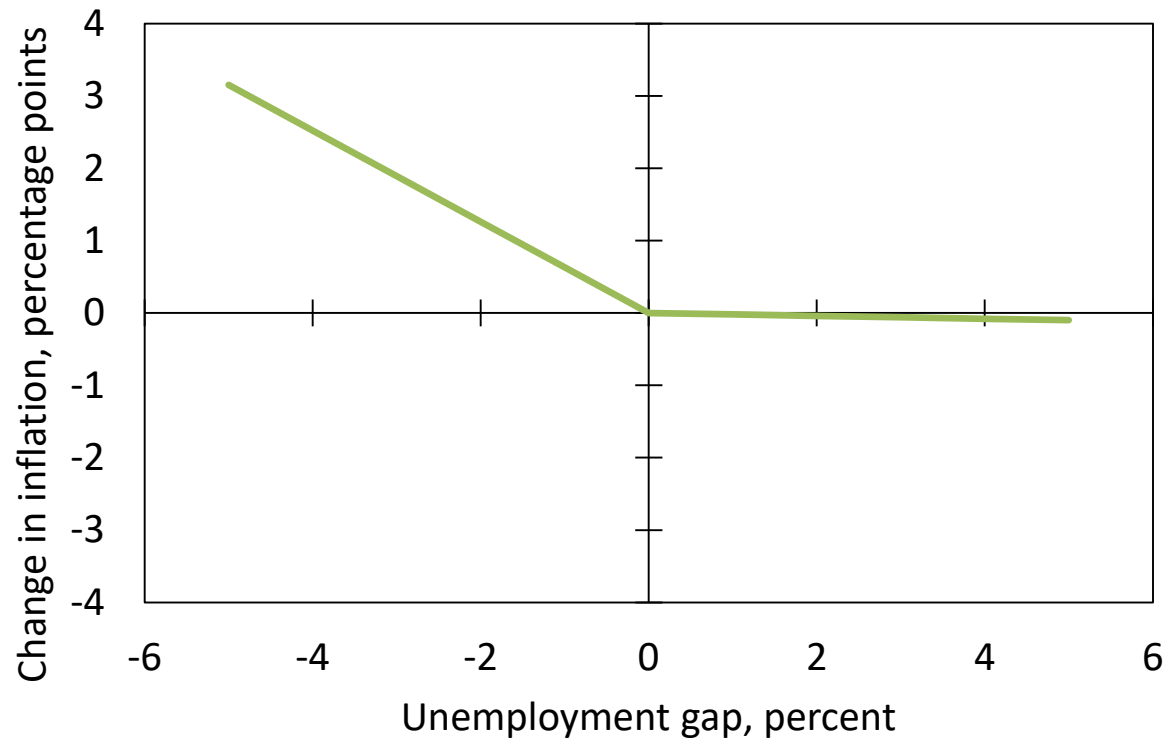


Source: Authors' illustration.



The Phillips Curve

1995-2018, low inflation



Source: Authors' illustration.

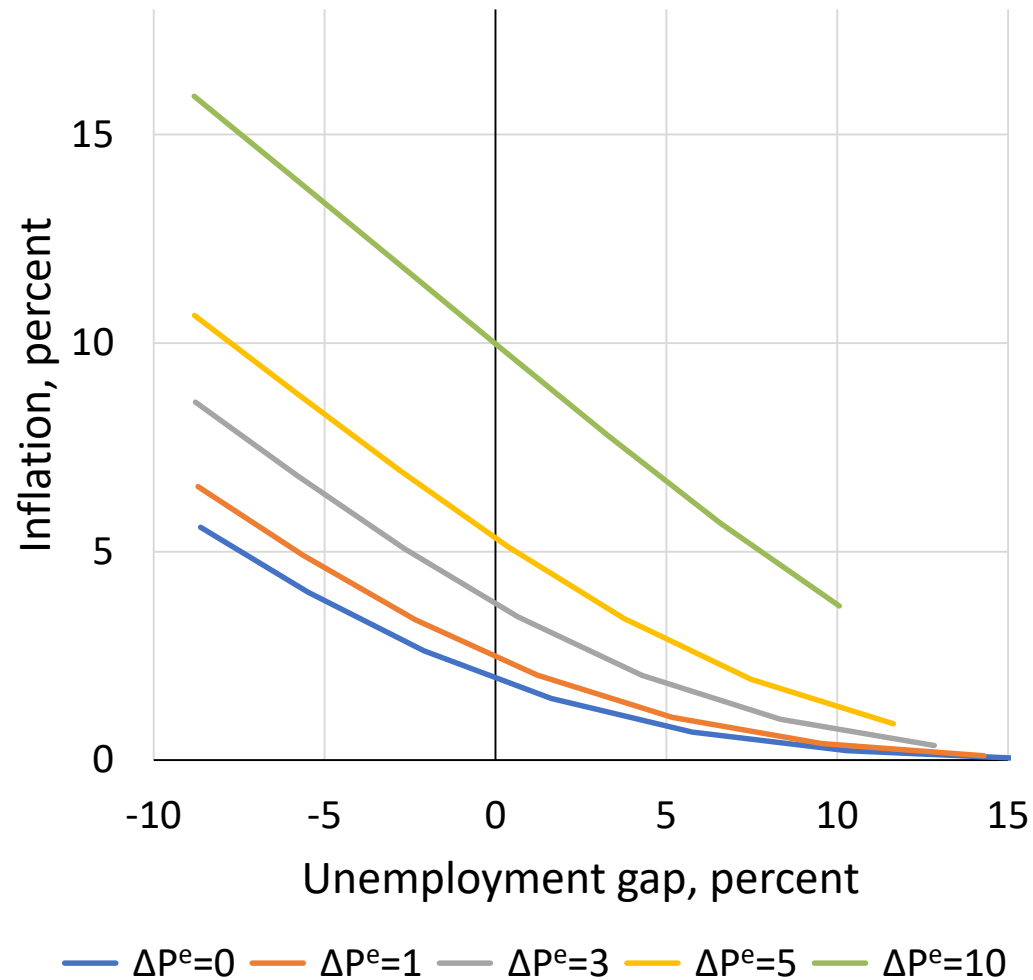


Downward Wage and Price Rigidity

- 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.



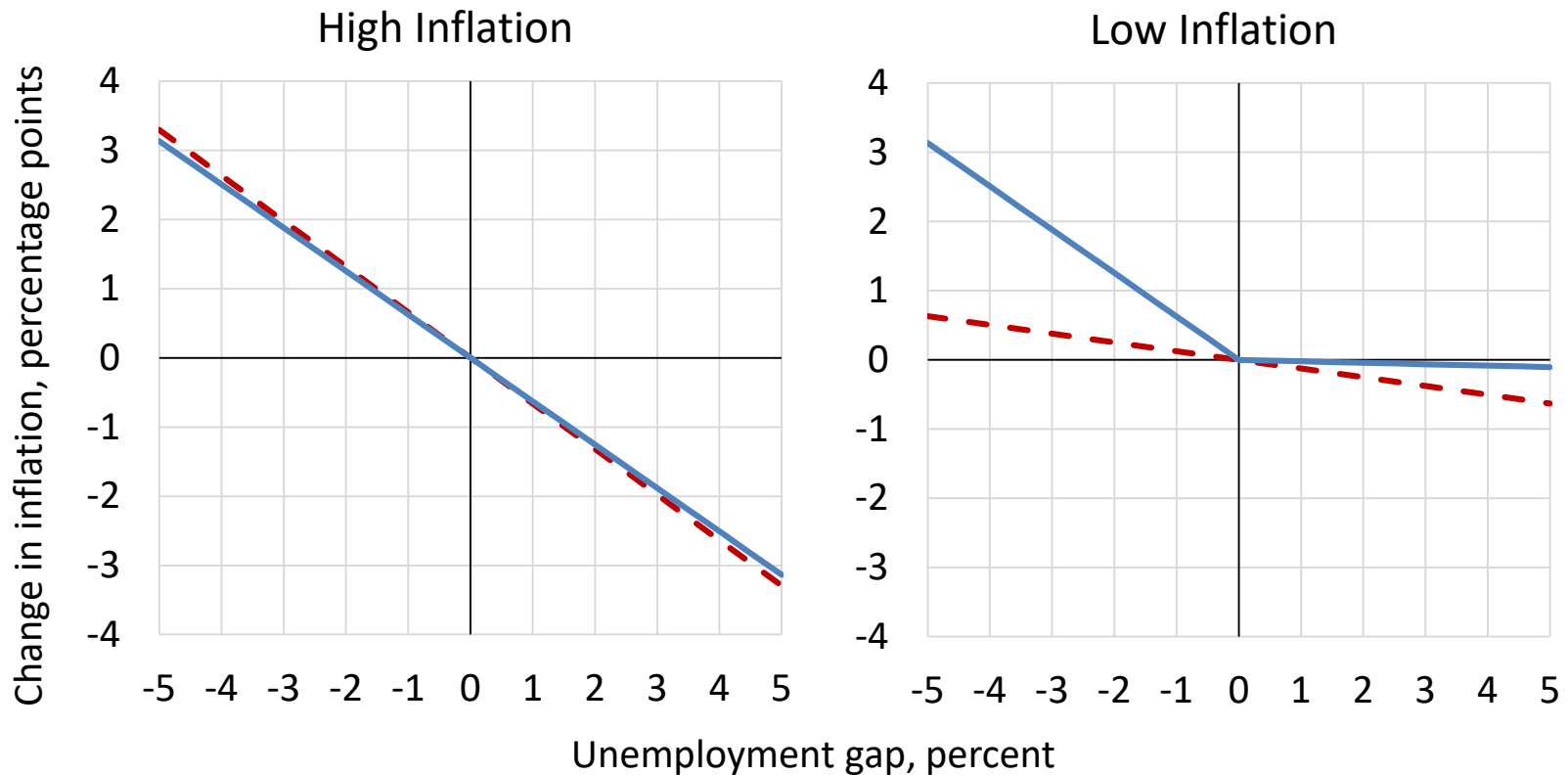
Low Inflation Bends the Phillips Curve



Source: Gagnon and Collins (2019, figure 2).

Two Versions of the Phillips Curve

(based on core CPI inflation)



--- Shifting linear — Low inflation bend

Source: Gagnon and Collins (2019, figure 6).



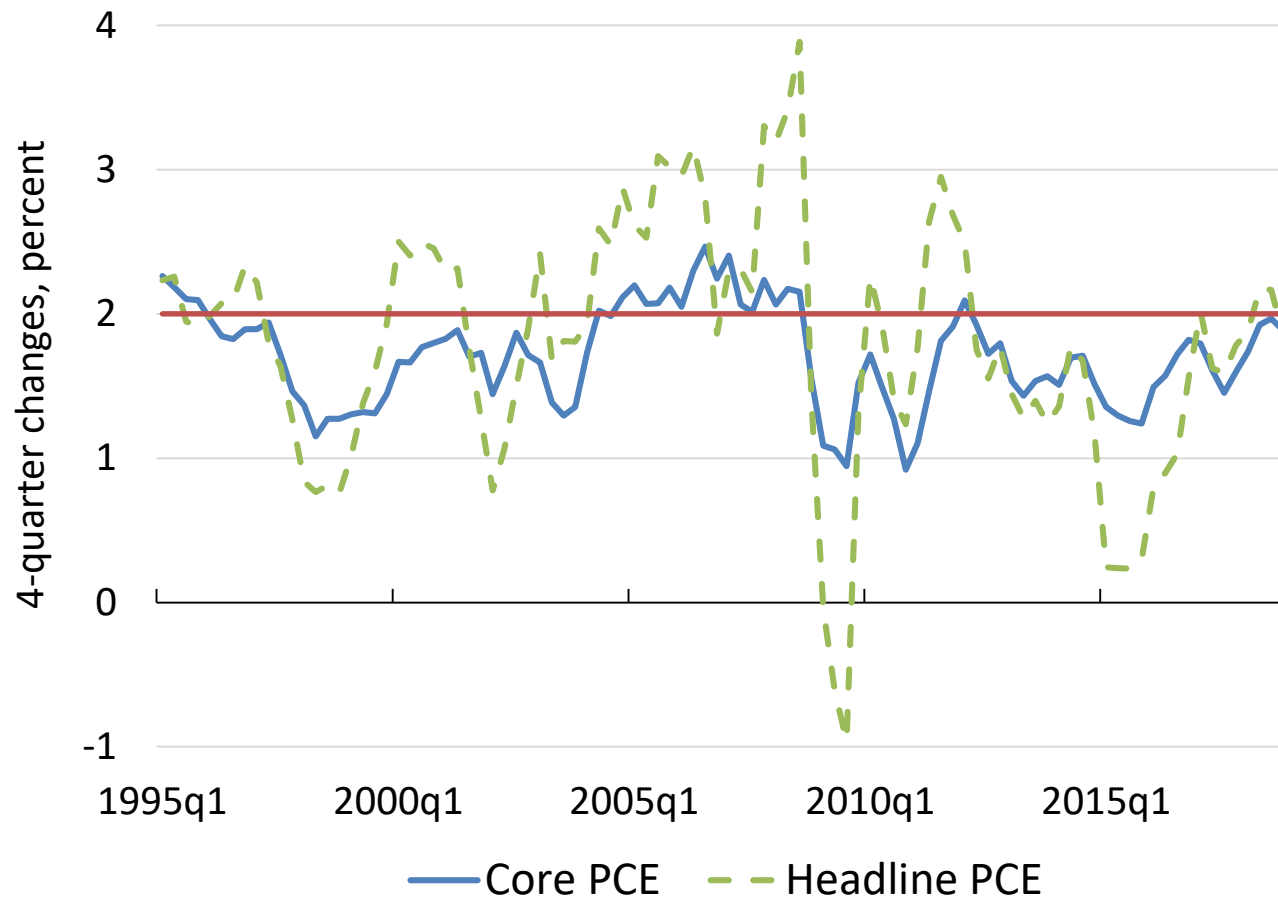
The Rest of the Model

$$\Delta P_t = \gamma GAP_t + \alpha + \beta \Delta P_{t-1}$$

- Accelerationist model $\beta=1$: Inflation builds on itself
 - Phillips curve describes **change** in inflation
- Anchored model $\beta=0$: Inflation returns to a fixed anchor
 - Phillips curve describes **level** of inflation
- Inflation moved from anchored before 1967 to accelerationist in 1967-94 to anchored in 1995-2018.



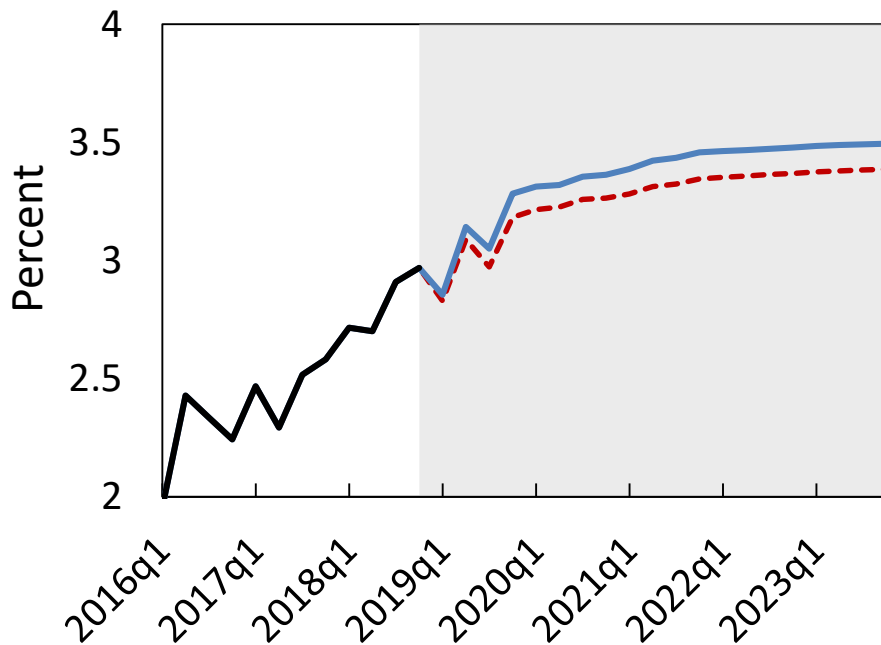
Is Inflation Anchored Too Low?



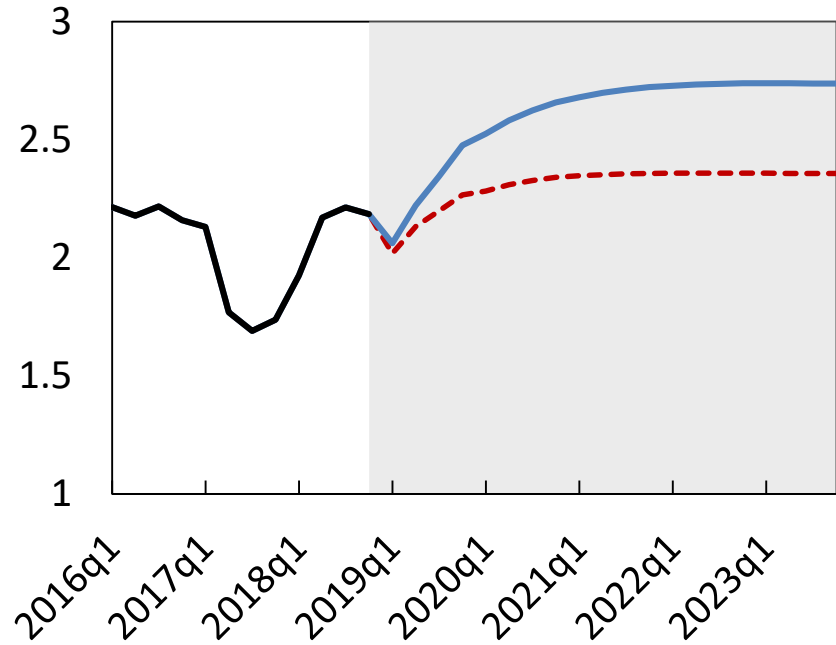


Projections with Anchored Inflation Models

ECI (4-quarter change)



Core CPI (4-quarter change)



--- Shifting linear — Low inflation bend

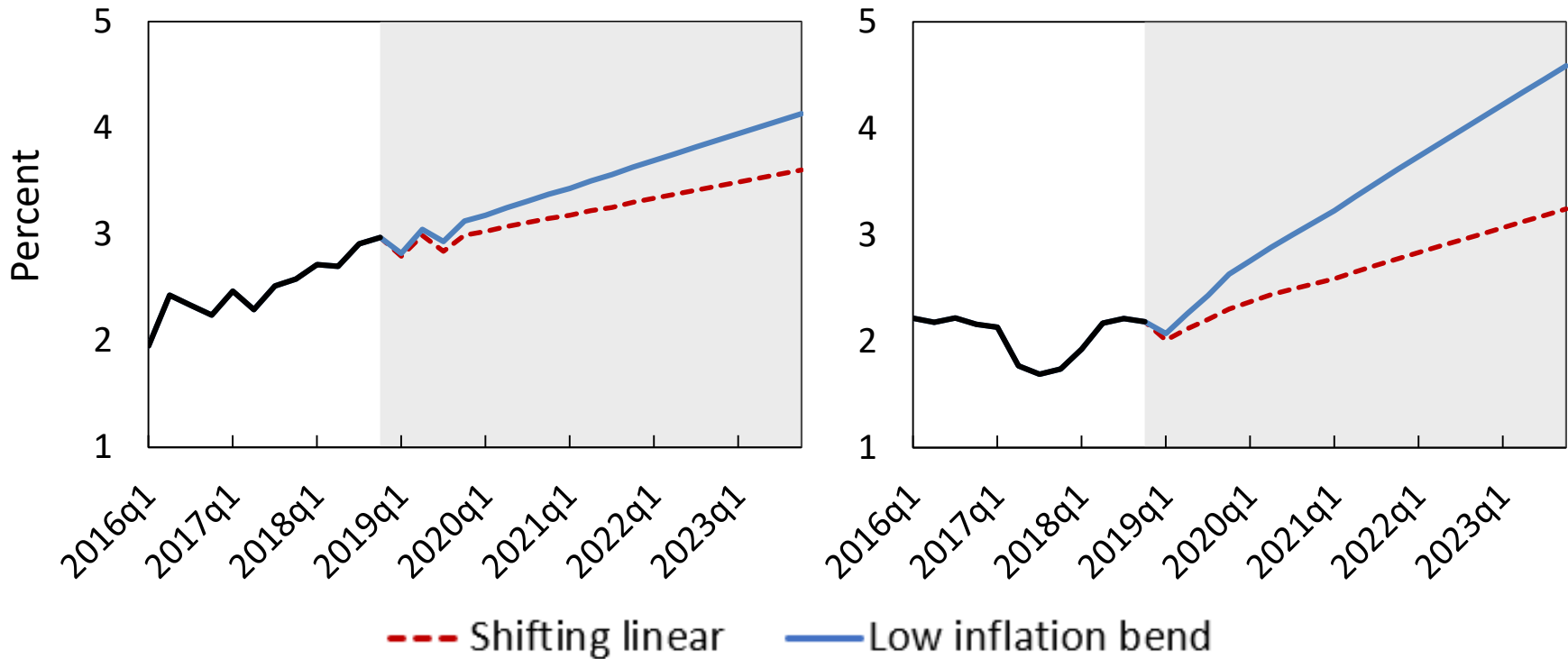
Source: Gagnon and Collins (2019, figure 8).

Projections with Accelerationist Inflation Models



ECI (4-quarter change)

Core CPI (4-quarter change)



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.

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References

Bernanke, Ben, Michael Kiley, and John Roberts. 2019. Monetary Policy Strategies for a Low-Rate Environment. Finance and Economics Discussion Series No. 2019-009. Washington: Board of Governors of the Federal Reserve System.

Gagnon, Joseph, and Christopher Collins. 2019. Low Inflation Bends the Phillips Curve. PIIIE Working Paper No. 19-6. Washington: Peterson Institute for International Economics.

Phillips, Alban. 1958. The Relation between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1861-1957. *Economica* 25: 283-99.