PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

A US Monetary Regime Change
What Difference to Overheating?

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Will the Fed face overheating? How will they react?

The critical point in the overheating debate is **whether the Fed will need to cause a recession** in 2023-24 in order to cope with inflation pressures. No harm, no foul.

This is the **first credible inflation threat** in decades, and the Fed has announced **a shift in strategic framework**, so a number of steps to address in making a forecast:

What is the nature of the Federal Reserve's regime shift

How much inflation will appear when

How will the FOMC react to that inflation and when

What happens to the economy when the FOMC does react

What is the nature of the Federal Reserve's regime shift?

A thoughtful deliberate process from Powell @JH '18 through *FedListens* to August '20

Learnt from mistakes and from longstanding critiques, inspired by Greenspan mid-1990s

Key elements:

- Do not rely upon - let alone trust - estimates of unobservable r* and U*
- Focus on broader measures of labor market slack, notably LFP, vs U3
- Re-assess what the relative risks (cost, likelihood) are of inflation vs unemployment
- ➡ Wait until macroeconomic outcomes are seen before responding with policy

This constitutes a major shift from canonical inflation targeting 1995-2019 (& I approve)

Does the Fed's regime shift matter to the inflation outlook?

There are arguably two schools of thought about inflation and monetary policy

#1: Central banks' counter-inflationary credibility is the primary determinant of medium-term inflation outcomes. Anchored expectations alone mean low inflation.

#2: Economic fundamentals (wage bargaining power, fiscal credibility) are the primary determinant of medium-term inflation outcomes. Expectations track those with a lag.

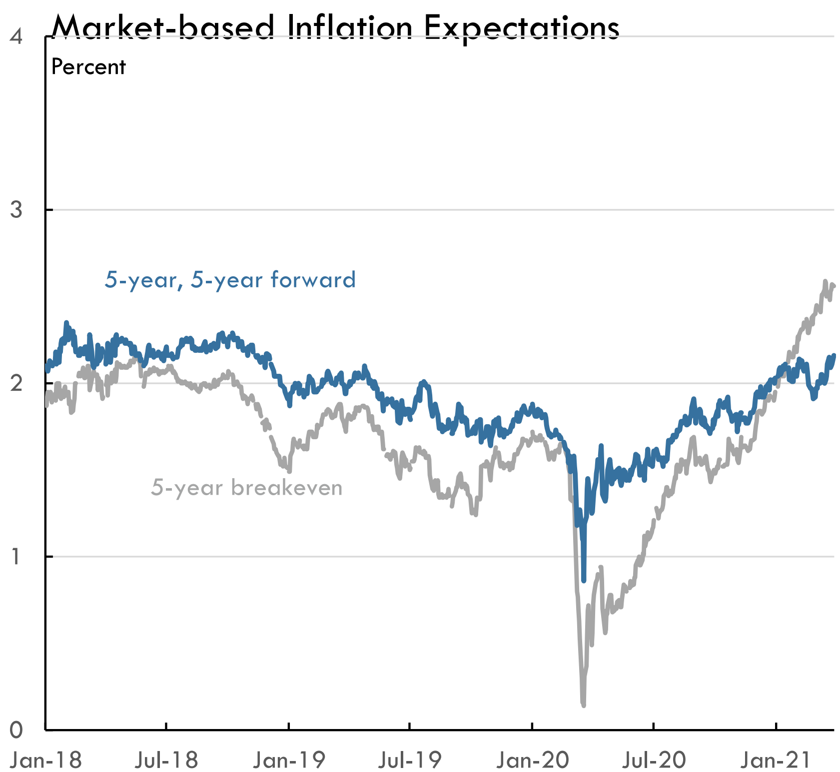
Realistic policy allows for both, but it must make a call about **how fragile inflation expectations are to policy expectations, and inflation outcomes are to expectations**

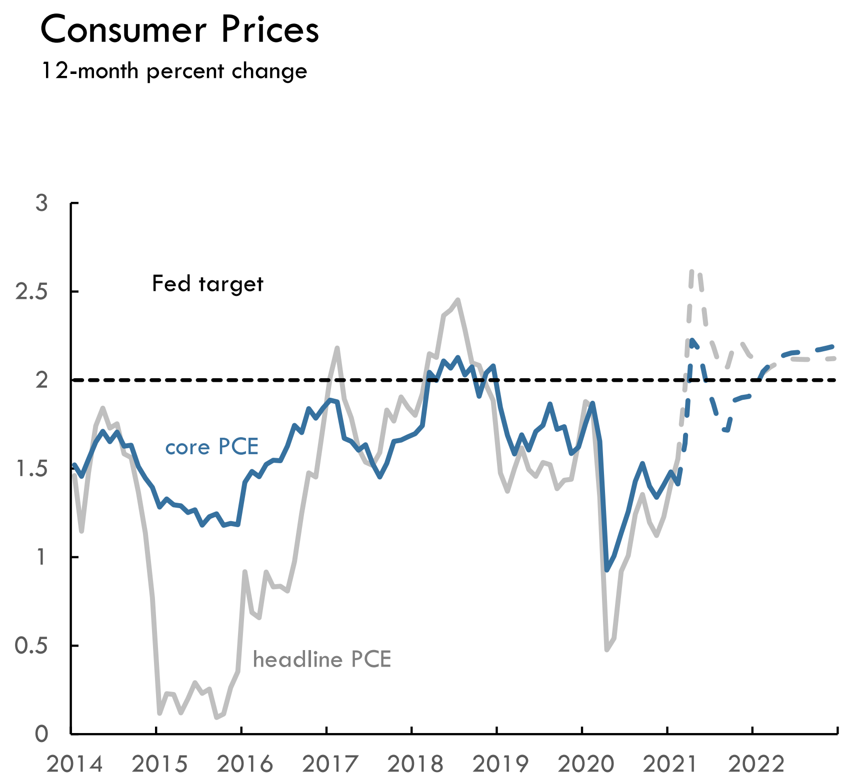
This is a religious question – either you believe that the 1970s are relevant data or not

The Fed is acting as though the shift in regime will not dislodge inflation expectations

I think this is right, but as I said at the time (June '19, Sept '20), the announcement wasn't going to raise inflation expectations either – **Actions not guidance are what matter**

Like the Fed Dots, inflation forecasts are for very little increase





Source: US Bureau of Economic Analysis; Haver Analytics; Dynan's forecasts

How much inflation will appear when in the US?

The calm over short-term inflation is right normatively, but seems excessive as a forecast

The 2021-2022 inflation outlook has **a lot of upside risks** (in decreasing likelihood order):

- Base effects (already shown) on headline CPI in 2021 and speed effects
- **Pent-up demand for health care** (already largest contributor to Core PCE inflation at 3.5% yoy in Feb)
- Supply (trade and energy) bottlenecks
- Multiplier on fiscal stimulus to be delivered 2021Q2 – 2022Q2
- **Potential jump in velocity and investors' animal spirits** (good aspects of AJP infrastructure)
- Possibly reaching the (hypothesized) kink in the Phillips Curve

Some desirable effects, but they push my **Headline CPI forecast to 3.25%+ for 2021-22**

How will the FOMC react to that inflation and when?

The Fed's strategy says wait to raise rates until labor force participation is close to pre-pandemic levels, or wages have risen for a while, or inflation expectations get unanchored.

- The first two should begin to show by mid-2022, but can be waited upon longer
- **Inflation expectations, however, are likely to be volatile around an upward trend**

The FOMC majority will try to look through one-time shocks to inflation, and they will say so repeatedly. They should. But will they be able to sustain that stance?

- **Observed productivity outcomes will be key**, and are highly uncertain
- Level of return to formal labor force by prime-age women also is critical
- **Financial market expectations of inflation should be ignored, but will not be**

I expect that restraint will not be sustainable beyond year-end 2022 (hope I am wrong)

How might the Fed manage expectations short of raising rates?

The hubbub from some quarters over the Fed needing to manage expectations about policy in response to the recent rise in interest rates is silly. Powell says relax.

But markets can be silly for longer than central bankers have hair to pull out in frustration

What could be done in terms of actions instead of just guidance

- US Treasury and Fed improve plumbing for Treasuries market
- Macroprudential tightening on NBFI and on residential real estate
- Downplay expectations and play up productivity/LFP as indicators to watch
- Keeping policy option of Yield Curve Control on the table

What is unlikely to be done

- Tinkering with the asset purchases/balance sheet long before rate hikes – serves no purpose

What happens to the economy when the FOMC does react?

The critical point in the overheating debate between Krugman and Summers at Markus' Academy (Feb 17) was the dispute over **whether the Fed could soft land** if necessary

The more one thinks that inflation is driven by outcomes not by expectations, the costlier it is to stop inflation if momentum builds, but also the more lead time to act

- Are the 1970s necessitating the Volcker disinflation the relevant example?
- I agree with Gagnon – the post-Korean War boom is a better analogue for today
- As many have pointed out, the mid-1970s inflation had been building for a decade, with structures of greater labor bargaining power, widespread price and wage indexation, a negative productivity shock, significant oil price shocks, dollar decline, fiscal politics breaking down…

So, even if the Fed does decide to raise rates by 2023Q1, a small hike (ca.100 bps) should be all that is needed to re-anchor inflation expectations.

Sources for worry even if the Fed holds its nerve

As I have argued for some time, **a high-income democracy** issuing debt in its own currency **only gets sustained inflation when there is political breakdown**

Looking at what has made Japan's rising public debt sustainable, along with the U.S. and other cases, there are two key enabling factors:

- A credible threat that the legislative process can raise taxes if needed
- An absence of credible threat that households will move savings into foreign currencies

The political ability of the U.S. Congress to sustainably raise taxes as needed is in doubt. This is why the AJP inclusion of meaningful lasting pay-fors is useful.

Financial fragility from raising rates may make a soft landing harder. Regulatory success in making the banking system more resilient must extend to other aspects.