TEXAS A&M UNIVERSITY
Private Enterprise
Research Center

SPRING 2022

PERCSPECTIVES ON POLICY

THE FED'S SLOW REALIZATION OF THE INFLATION PROBLEM

Dennis W. Jansen and Andrew J. Rettenmaier

Amercans have come to expect low inflation and low interest rates. For the 30 years prior to the peak of the previous business cycle in February 2020, year-to-year monthly inflation rates based on the consumer price index (CPI) averaged 2.4% while the average based on the personal consumption expenditures (PCE) price index was 2%. The latter index is a broader measure of price level changes and is the Federal Reserve's preferred inflation indicator. The Federal Reserve's long run inflation target, adopted during Ben Bernanke's tenure, is 2%. For much of the past 30 years, inflation averaged at the Fed's target rate, admittedly with some variation especially around the time of the Global Financial Crisis.

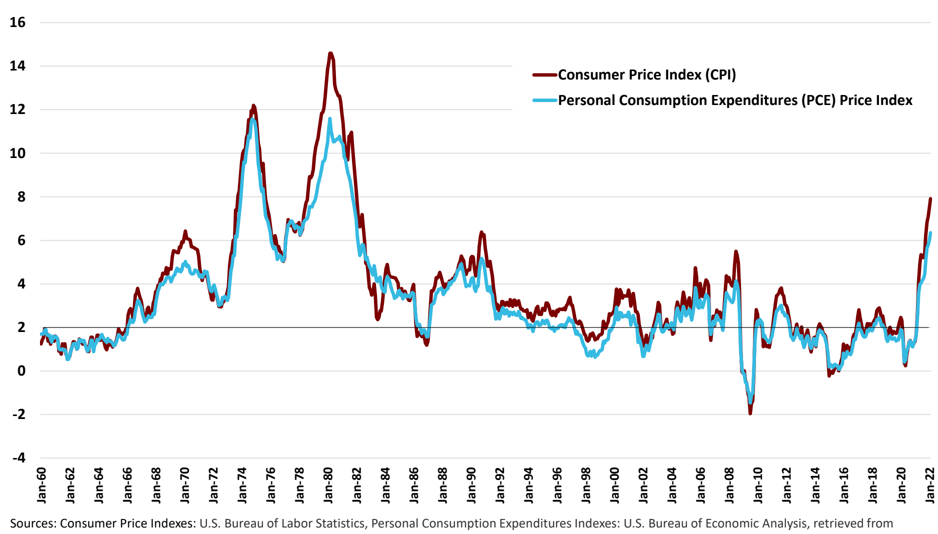
During the most recent business cycle expansion from June 2009 to February 2020, the PCE inflation rate averaged only 1.5% and the 30-year mortgage averaged 4.1%. Low, stable inflation rates allow businesses to plan for future costs of their labor, equipment, supplies, and capital more accurately. Stable, low inflation rates benefit families in budgeting for the future and are beneficial to retirees, particularly those who have defined benefit pensions that are not inflation-protected.

Although the Fed's goal is low, stable inflation, this has not been the case in recent months. From February 2021 to February of this year the CPI rose 7.9% and the PCE price index rose 6.4%. These are the highest inflation rates in the U.S. since 1982. Further, a look at the component items in these indices indicate that prices for goods and services were rising across the board.

A combination of fiscal policies that pumped resources into families' pocketbooks in response to the COVID-19 lockdowns, subsequent supply chain disruptions that continue to this day, and the impact from Russia's invasion of Ukraine all bear some responsibility for rising price levels. So far, wage gains have not kept up with rising prices even amid a tight labor market. In March 2020, the unemployment rate was 3.6%, just marginally higher than the February rate of 3.5%. With a tight labor market and rising prices, workers will eventually demand higher wages to restore purchasing power. Of course, the rising wage rates will increase business costs and eventually prices, and so this wage-price spiral will continue for some time.

Despite rising inflation rates that have far exceeded the Fed's 2% target for the past year, the Federal Reserve System, and in particular the Federal Open Market Committee (FOMC), has been slow to respond. At first, the Fed labeled the inflation transitory and appeared unconcerned, with no move to cut back on its asset purchases or to raise the interest rate on reserves. Even when it started to

FIGURE 1. INFLATION RATES



Sources: Consumer Price Indexes: U.S. Bureau of Labor Statistics, Personal Consumption Expenditures Indexes: U.S. Bureau of Economic Analysis, retrieved from Federal Reserve Bank of St. Louis.

acknowledge that inflation was not going to quickly return to the 2% target, the Fed continued to wait, only announcing a plan to cut down on its asset purchasing program in late 2021, with a statement that it would also be raising the interest rate on reserves in 2022.

The FOMC meets regularly during the year, and at four of its meetings – December, March, June and September – it provides projections of inflation rates and other economic variables for the current year and for future years as well. These projections provide a glimpse into what the FOMC members were thinking when they sat down to vote on the conduct of monetary policy.

Back in December of 2019, pre-pandemic, the Fed projected an inflation rate for 2020 of 1.9%. At their March 2020 meeting, when there would typically have been projections, the FOMC found itself dealing with the initial month of the pandemic, with widespread reductions in economic activity hastened by government restrictions on business operations and social gatherings. Projections were not provided at that March meeting, but they were provided at the June 2020 meeting. At that time, the year-to-date inflation rate had already been observed to be -1.6% (annualized) based on observations of the PCE price index through April. (This two-month lag is typical of the issues facing policy makers.) In any case, the FOMC in June 2020 projected that inflation for the entire year of 2020 would be 0.8%. Interestingly, this could only happen if the inflation rate for the rest of 2020, May – December, averaged 2.0% (annualized).

In September 2020, the FOMC met again and supplied with data on PCE-inflation of 0.7% annualized from January through July. At that meeting, the FOMC projected inflation for the entire year of 2020 to be 1.2%. This would have required the inflation rate, annualized, to be 1.9% for August through December.

In the last meeting of 2020, in December, the FOMC had PCE-inflation data through October and observed an annualized inflation rate to date of 1.1%. The FOMC projected that inflation would be 1.2% for 2020. They were not far off at this point. When the actual realized inflation rate for 2020 was finally known, which was not until the very end of January 2021, it turned out to have been 1.3%. But note how the FOMC's projections evolved over the year, from initially being 1.9%, then 0.8% after observing the initial impacts of the pandemic, then rising to 1.2% for the September and December meetings.

Meanwhile during 2020 the FOMC was also making projections for the inflation rate in 2021. These started at 1.6% at the June meeting and ended at 1.8% at the December meeting. Basically, the FOMC projected that inflation would almost return to its 2% target in 2021.

This brings us to forecasts for 2021. In December 2020, as mentioned, the FOMC projected inflation in 2021 to be 1.8%. At the March 2021 meeting, the FOMC had observed inflation for only January of 2021; it was running at a 3.8% annual rate. The FOMC raised its projection of inflation for 2021 to 2.4%, an acknowledgement of rising prices. That FOMC projection, and the January inflation rate of 3.8%, means that the Fed was projecting an annual inflation rate of 2.3% for February – December of 2021.

In June 2021 the FOMC had data on inflation through April and had observed inflation at an annual rate of 5.3%. The FOMC raised its projection of inflation for the year to 3.4%, a further acknowledgement of rising prices, but also a projection indicating that the FOMC thought the inflation in the remainder of the year would decline to 2.5%, so that even with 5.3% during the first four months, the slower projected inflation for the next eight months would leave the rate for the year at 3.4%. The Fed was indeed projecting a 'transitory' inflation.

By September, the FOMC had data on inflation through July, and it was now at a 5.6% annual rate. At this point the FOMC raised its projection of inflation for the year to 4.2%, again signaling that the FOMC thought the inflation rate for the remainder of the year would be significantly lower, at 2.3%, so that the yearly total would only be 4.2%.

It is interesting that for all of these meetings, the projection of inflation one year ahead, for 2022, was nearly at the long run target. It was 2% in March, then 2.1% in June, then 2.2% in October. In essence, the FOMC was projecting little change in 2022 inflation based on what it saw in 2021.

Finally, at the December 2021 meeting, the FOMC had data through October and saw that inflation continued to be at a 5.6% annual rate. At this point, the FOMC raised its projection for the yearly 2021 inflation rate to 5.3%, which still would imply a 2.8% annual rate for November and December. The FOMC also raised its projection for year 2022 inflation to 2.6%.

When the whole-year 2021 inflation data finally came out in late in January of 2022, the PCE-inflation rate for 2021 was 5.6%. The Fed had been behind the curve in its projections for the entire year.

Now we are in 2022. The FOMC in December 2021 had projected 2.6% inflation for 2022. At its March 2022 meeting it had available an inflation rate based on what happened to the PCE price index in January 2022, and the January price rise implied an annual inflation rate of 7.1%. The FOMC modified its projected inflation rate for 2022 to 4.3%, a sharp increase over the 2.6% projection made in December. The FOMC also raised its projection for 2023 inflation to 2.7%. This projection implies that the FOMC thinks inflation for February – December will be at a 4.1% annual rate. This seems overly optimistic to many observers, but time will tell.

What does all this mean? First, the FOMC has been very slow to recognize the rising inflation rate. Their projections for inflation in 2021 were ratcheting up slowly over the year, always lagging behind the inflation rate that was already observed. The FOMC continually projected a decline in inflation in the coming months relative to recent experience, and they were continually proven wrong. The FOMC stubbornly clung to the 'transitory' description, and this pattern of projections indicates that the FOMC did not waiver from that belief that the inflation rate would quickly slow down.

It is possible that the recent high inflation rates are indeed transitory. Possible evidence supporting transitory inflation are long-term interest rates that, while rising, are still historically low. The 30-year fixed term mortgage rate averaged 4.7% this past week while the market yield on 30-year constant maturity U.S. Treasuries averaged 2.5%. It is unlikely that these rates would remain this low if there were widespread expectations of continued 7% inflation.

Perhaps this explains the Fed's tardiness in responding to the rising inflation. Other indicators suggest that the inflation rate is will not quickly revert to the target rate. Wages have risen but have not kept up with inflation. Labor markets are tight. Real wages, i.e. inflation-adjusted wages, should be rising, not falling. For that to happen, wages need to rise faster than prices for some time. But rising wages will raise business costs – labor's share of GDP is typically about 60% – and there will be a continuing wage-price spiral that will not end quickly. In addition, other macro events will occur, such as the uncertainty associated with the ongoing war in Ukraine and supply chain issues. Finally, expectations of higher inflation tend to be partially self-fulfilling, and various measures indicate that household expectations of inflation have risen. All of these point to inflation concerns that the FOMC must treat seriously.

Economics has a phrase, 'revealed preference,' to indicate that the behavior of an economic actor, be it an individual or a business, will reveal more about that entity's underlying preferences than any survey or opinion poll. It is the economic version of the statement that 'actions speak louder than words.' Well, let's summarize the Fed's actions. The Fed talks as if inflation is a huge problem that bears careful attention. Yet while inflation was rising to rates not seen in thirty years, the FOMC kept delaying taking any action, implicitly trusting, or hoping, that the inflation problem would go away on its own. It was not until late in 2021 that the Fed announced it would slow down and eventually end its bond-buying program, and it was not until March 2022 that the FOMC made a decision to raise its interest rate on reserves. These long delays in the Fed response to inflation are not indicative of a Fed that sees ongoing and rising inflation rates as an emergency. The Fed seems to have revealed what it really thought about inflation, and now it – and the rest of us – are left to deal with the resulting mess.

Date of FOMC Meeting	Fed Projection of Inflation for Entire Current Year	Fed Projection of Inflation for Future Year	Observed Inflation Year-to-Date at Time of FOMC Meeting (annualized)	Implied Fed Projection for Inflation for Remainder of Current Year (annualized)	Actual Realized Inflation Rate for the Entire Year (observed after the fact, in February of the following year.)
	INFLATION for 2020				
12/11/2019	1.9%	--	na	na	--
03/03/2020	na	na	2.3%	na	1.3%
06/10/2020	0.8%	1.6%	-1.6%	2.0%	1.3%
09/16/2020	1.2%	1.7%	0.7%	1.9%	1.3%
12/16/2020	1.2%	1.8%	1.1%	1.7%	1.3%
	INFLATION for 2021				
12/16/2020	1.8%		na	na	--
03/17/2021	2.4%	2.0%	3.8%	2.3%	5.8%
06/16/2021	3.4%	2.1%	5.3%	2.5%	5.8%
09/22/2021	4.2%	2.2%	5.6%	2.3%	5.8%
12/15/2021	5.3%	2.6%	5.6%	3.8%	5.8%
	INFLATION for 2022				
12/15/2021	2.6%			na	--
03/16/2022	4.3%	2.7%	7.1%	4.1%	na

TEXAS A&M UNIVERSITY
Private Enterprise
Research Center
Texas A&M University
4231 TAMU
College Station, TX 77843-4231

PERCSPECTIVES ON POLICY SPRING 2022

Founded in 1977 through the generosity of former students, corporations and foundations, the Private Enterprise Research Center pursues a dual mission of supporting academic research at Texas A&M University and developing market-oriented solutions to public policy problems.

TEXAS A&M UNIVERSITY
Private Enterprise
Research Center

For archived newsletters, visit
perc.tamu.edu

Private Enterprise Research Center
Texas A&M University
4231 TAMU
College Station, TX 77843-4231
(979) 845-7559
perc@tamu.edu