
Inflation Dynamics and the Monetary Policy Response

Charles L. Evans
President and Chief Executive Officer
Federal Reserve Bank of Chicago

Money Marketeers of New York University, Inc.
New York City, NY
May 17, 2022

FEDERAL RESERVE BANK OF CHICAGO

The views expressed today are my own and not necessarily those of the
Federal Reserve System or the FOMC.

Inflation Dynamics and the Monetary Policy Response

Charles L. Evans

President and Chief Executive Officer

Federal Reserve Bank of Chicago

I. Introduction and disclaimer

- A. Thank you for the invitation to speak to you this evening. The last time I was here, back in 2017, was for a dinner event not unlike this one.¹ At the time, no one had heard of Covid, and my overwhelming monetary policy concern was the long-term undershooting of our 2 percent inflation target and the importance of getting inflation up to our symmetric target. Well, things sure do look different now!
- B. In my remarks today, I will first set the stage by describing recent economic developments before delving more deeply into my thinking on underlying inflation dynamics and the implications for monetary policy.
- C. In a nutshell, inflation is clearly much too high and monetary policy must be repositioned to address this. The exact path for policy will depend on the evolution of the economy. But from where we sit now, I support returning the federal funds rate to neutral expeditiously. My current assessment of neutral is in the range of 2-1/4 to 2-1/2 percent. And it may be necessary to bring rates somewhat above neutral for a time to return

¹ Evans (2017).

inflation to the Federal Open Market Committee's (FOMC) 2 percent average inflation target.²

- D. Before I begin, I am obliged to remind you that the views I share with you today are my own and do not necessarily represent those of my colleagues on the FOMC or others in the Federal Reserve System.

II. Economic overview

- A. Though gross domestic product (GDP) declined a bit in the first quarter of the year, underlying economic momentum continues to be strong. Importantly, growth in household consumption and business fixed investment continued at a solid pace last quarter. The top-line GDP number instead was held back by large reductions in business inventory investment and net exports.

1. As for inventories, firms continued to rebuild stocks at a hefty rate last quarter, but the pace fell short of the extremely rapid stockbuilding that took place in the fourth quarter of 2021.
2. And the net export decline in part reflected a surge in imports, which themselves were satisfying domestic demand for consumption, investment, and inventory restocking.
3. So when I look at the GDP data in conjunction with other indicators of economic activity—notably the strong labor market and healthy

² For price stability, the FOMC seeks inflation that averages 2 percent over time, as measured by the Price Index for Personal Consumption Expenditures (PCE) from the U.S. Bureau of Economic Analysis.

household and business balance sheets—I see a good foundation for further solid growth.

B. Given how bleak the situation appeared in the spring of 2020 when much of the economy had shut down with the onset of the pandemic, our progress these past couple of years has been truly remarkable. How did we get here?

1. Businesses showed ingenuity in finding ways to operate safely. The health care sector was able to develop and deploy vaccines extremely rapidly. And fiscal and monetary policymakers provided crucial support through prompt and massive policy actions.
2. By the second quarter of last year, activity in the U.S. had surpassed its pre-pandemic level, and despite periodic new waves of infections, underlying growth has remained quite solid since then.

C. In terms of the labor market, after peaking near 15 percent early in the pandemic, the unemployment rate declined quickly and was a very healthy 3.6 percent in April—essentially back to the low level we experienced before the Covid crisis. And by a number of other measures, such as unfilled job openings at businesses and the rate at which people quit their jobs for other opportunities, the labor market is downright tight. Many of my business and community contacts complain of difficulties in hiring and retaining workers, though increasing pay and other adjustments seem to be alleviating some of these issues.

- D. Even so, the number of people actually employed is still well below pre-pandemic trends, as many workers who left the labor force during the pandemic have not reentered the labor market. Today labor force participation continues to be held down by factors such as fewer retirees reentering the workforce than in the past and Covid-related matters, including health concerns or childcare issues. Furthermore, inflows to the labor force from immigration have been quite low.
- E. As the pandemic recedes further, strong labor market conditions will likely draw many of those still sitting on the sidelines back into the workforce. This should help alleviate some labor market pressures. But the timing and extent of this return are open questions.

III. Inflation dynamics

- A. This brings me to a discussion of what is on everyone's mind—inflation.
- B. Our preferred inflation gauge is the annual change in the Price Index for Personal Consumption Expenditures (PCE). After more than a decade of sub-2 percent inflation, it has risen quite quickly from a very low 1.3 percent in 2020 to 6.6 percent in the most recent April data. What is behind this rapid run-up?
- C. Some of it is directly related to the pandemic. With people forced or choosing to spend more time at home, households shifted their spending from services, such as travel or dining out, toward goods, such as appliances for home improvement projects or consumer electronics.

- D. Many businesses struggled to keep pace with this strong demand, particularly as they faced Covid-related disruptions in production and supply chains. Labor shortages due to the drop in participation were part of the story, too.
- E. These factors first showed through to inflation in early 2021, as activity began to normalize. Prices rose sharply for goods that were especially sensitive to supply chain problems and for services that were just beginning to reopen from the pandemic shutdowns.
1. Motor vehicles were a prime example. In the early stages of the pandemic, the demand for cars plummeted and their prices actually declined. However, with high demand for personal as opposed to public transit and low borrowing costs, vehicle demand quickly turned around.
 2. Automakers were unprepared for the surge: Expecting a severe and prolonged recession, they had substantially scaled back their production plans and ordered fewer of the microprocessors that are ubiquitous in vehicles today.
 3. As a result of a dearth of chips and other shortages, auto and truck production has been severely curtailed. With constrained supply running into robust demand, motor vehicle prices have risen more than 17 percent over the past year.

4. Home appliances are another example. With people spending more time at home, homeowners tackled long-delayed repairs and undertook new home improvement projects. Furthermore, low mortgage rates and pandemic-related relocations boosted the demand for housing. Demand for home furnishings accelerated accordingly, and prices for these items are running 10 percent higher than they were a year ago.
5. There is a different story coming from the service sector. Early in the pandemic people avoided traveling, and prices for hotel rooms plummeted. However, as the economy reopened and more people began to travel again, that quickly changed: Over the past 12 months, prices for lodging away from home have risen more than 20 percent.

IV. Why did I pick these three items? Well, each has an easily identifiable pandemic-related reason to explain the large price increases they experienced. Also, price changes in these items had a big impact on the top-line inflation numbers—and so, too, they could contribute substantially to reductions in inflation as the particular factors I just noted are unwound. Let me give you some numbers to illustrate.

A. Between February 2021 and February 2022, 12-month core Consumer Price Index (CPI) inflation shot up from 1.3 percent to 6.4 percent and has stayed near that pace since.³

1. Almost half of this pickup reflected outsized gains in prices for the three items I just mentioned—new and used motor vehicles, home furnishings and supplies, and hotel and motel accommodations—which together account for only about 15 percent of the core CPI.
2. So what about the flip side? I expect we will see meaningful relief from the pressures related to chip shortages, clogged supply chains, the shift to goods consumption, and reopening effects. This relief should provide a substantial deceleration in the overall core price index. For example, if the price levels for the three items I highlighted did not change at all over the next year while price increases for all other items stayed the same, then core CPI inflation would drop to about 3-1/2 percent. This would surely get everyone's notice.

V. Monetary policy must adjust

- A. Even improvements like these won't be enough on their own. Other pricing challenges remain.

³ Measures of core inflation strip out volatile food and energy components.

- B. First, supply chain issues have proved stubbornly difficult to solve. And as the Russian invasion of Ukraine and further Covid disruptions in China remind us, unexpected events can generate even further supply-side problems.
- C. And, second, we still have the other 85 percent of core CPI to deal with. Inflation for these items moved up from about 1-1/4 percent in February 2021 to almost 4-1/2 percent in April 2022—well above the CPI-equivalent of the Federal Reserve’s average 2 percent target for total PCE inflation.
- D. Now, surely supply chain factors played some role in pushing up these prices, so alleviating bottlenecks will also help restrain cost pressures on the 85 percent bucket as well. And all sectors should benefit from further recovery in labor force participation leading to an easing of labor shortages.
- E. With that said, monetary policy still has a critical role to play in addressing this 85 percent bucket. Policy needs to moderate the strong demand pressures underlying the broad-based run-up in prices. Policy also needs to act to keep longer-run inflation expectations in check; inflation will be much more difficult to bring down if households and businesses start thinking current outsized increases in wages and prices are the new norm. So far these increases seem like adjustments to the unusual circumstances we have faced in the past two years. Indeed, although short-run measures of inflation expectations are quite high, longer-run expectations appear in line with our 2 percent average inflation target.

- F. So, clearly, interest rates need to rise and we need to reduce the size of our balance sheet. How much adjustment will ultimately be needed? That is a tough question to answer.
- G. The current fed funds rate is far below a neutral setting—which, as I mentioned before, I think is in the range of 2-1/4 to 2-1/2 percent. So policy needs substantial repositioning.
1. I favor a front-loaded adjustment in the fed funds rate toward the neutral range. I think front-loading is important to speed up the necessary tightening of financial conditions, as well as for demonstrating our commitment to restrain inflation, thus helping to keep inflationary expectations in check.
 2. And given how far policy is below neutral today, the risks to our employment mandate of moving expeditiously seem modest.
 3. The FOMC's half percentage point increase in the funds rate at our May meeting is consistent with this approach, as is the initiation of balance sheet reduction that is coming in June.
- H. After front-loading our initial tightening, I am hopeful we can transition to a more measured pace of rate increases.
1. With inflation dynamics uncertain, this measured pace would give us time to monitor supply chains, assess inflation dynamics, and evaluate the impact of less accommodative monetary policy on the labor market.

2. If we need to, we will be well positioned to respond more aggressively if inflation conditions do not improve sufficiently or, alternatively, to scale back planned adjustments if economic conditions soften in a way that threatens our employment mandate.
- I. It is too early to know what the outcome of that calculus will be. But with the current degree of inflationary pressures, I could see the need to take policy somewhat beyond neutral to achieve our price stability mandate. Given the current strength in aggregate demand, strong demand for workers, and the supply-side improvements that I expect to be coming, I believe a modestly restrictive stance will still be consistent with a growing economy.

VI. Conclusion

- A. We will learn a lot in the months ahead about how both monetary policy tightening and supply-side adjustments are influencing inflation. Monitoring and assessing inflation pressures and balancing risks to growth will be crucial for judging the appropriate path for policy over this time.
- B. As always, monetary policymakers can best achieve our dual mandate objectives of price stability and maximum inclusive sustainable employment by staying focused on our goals and clearly communicating our strategy for achieving them. I am sure that those principles will serve us at the Federal Reserve well as we maneuver through the uncertain months ahead.

C. Thank you, and now I look forward to your questions.

Reference

Evans, Charles L., 2017, "Monetary policy challenges in a new inflation environment," speech for the Money Marketeers of New York University, Inc., New York, June 19, available online, <https://www.chicagofed.org/publications/speeches/2017/06-19-17-monetary-policy-challenges-in-a-new-inflation-environment-money-marketeers>.