FEDERAL RESERVE BANK *of* ST. LOUIS

Getting Ahead of U.S. Inflation

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Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee.

Introduction

Key themes

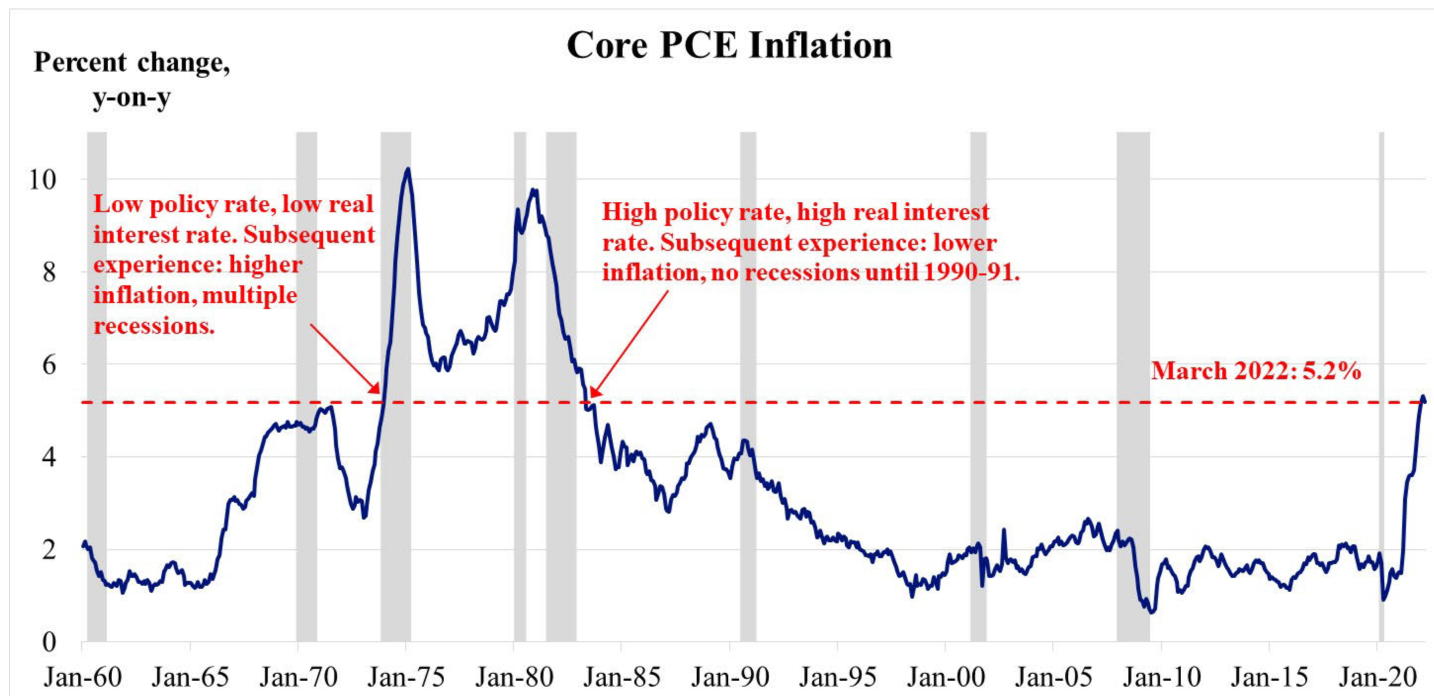
- U.S. inflation is comparable to levels seen in 1974 and 1983.
- U.S. inflation expectations could become unmoored without credible Fed action, possibly leading to a new regime of high inflation and volatile real economic performance.
- Modern central banks are more credible than their 1970s counterparts and use forward guidance.
- Credible forward guidance means market interest rates have increased substantially in advance of tangible Fed action.
- In fact, key market rates have already moved above a pre-pandemic benchmark, which may help encourage a soft landing in the U.S.

Inflation Is Comparable to 1974 and 1983

Core inflation is comparable to 1974 and 1983

- Core personal consumption expenditures (PCE) inflation from one year earlier was 5.2% in March, which is the most recent reading.
- There have been two other times since 1960 when this measure of inflation has been close to this level.
- One was 1974, and the other was 1983.

Core PCE inflation since 1960



Source: Bureau of Economic Analysis. The gray shaded areas indicate U.S. recessions. Last observation: March 2022.

Monetary policy in 1974

- The 1974 FOMC, which was confronting a core PCE inflation rate similar to today's, liked to talk about nonmonetary factors affecting inflation.
- The FOMC kept the policy rate relatively low in the face of rising inflation.
- The associated ex-post real interest rate was relatively low.
- The subsequent experience was that core PCE inflation was above 5.2% for nearly 10 years.
- The real economy was also volatile with multiple recessions.

Monetary policy in 1983

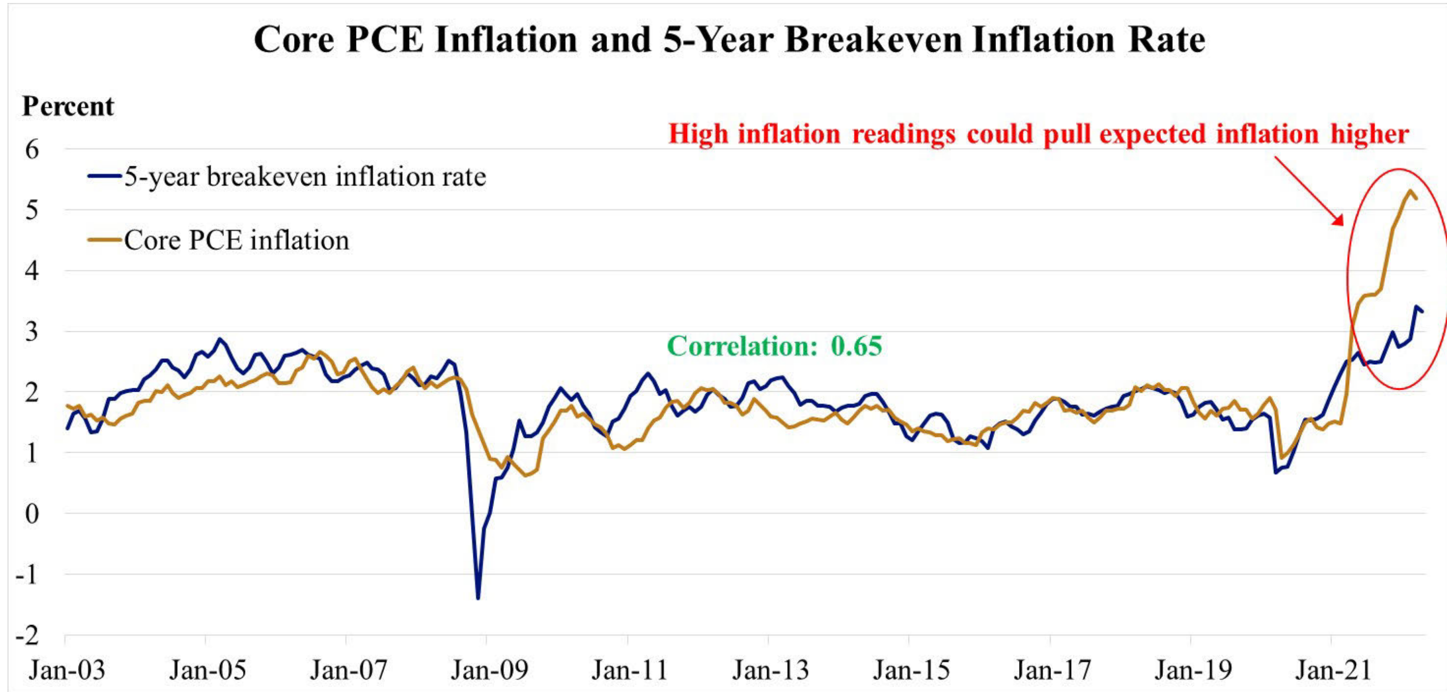
- The 1983 FOMC, which was also confronting a core PCE inflation rate similar to today's, had a different approach to monetary policy and spoke more about monetary factors affecting inflation.
- The FOMC kept the policy rate relatively high in the face of declining inflation. The associated ex-post real interest rate was relatively high.
- The subsequent experience was that core PCE inflation was below 5.2% for the next 10 years.
- The real economy also stabilized with no recession until 1990-91.
- The contrast between the 1974 and 1983 experiences convinced many that it was important to "get ahead" of inflation.

Risks to Inflation Expectations

Inflation expectations

- The current U.S. macroeconomic situation is straining the Fed's credibility with respect to its inflation target.
- In economic theory, expected inflation and actual inflation should be closely related.
- The current divergence between actual inflation readings and TIPS-based expected inflation will have to be resolved, possibly resulting in still higher inflation expectations.

Actual and expected inflation



Sources: Federal Reserve Bank of St. Louis and Bureau of Economic Analysis. Last observations: March 2022 and April 2022.

Getting Ahead of Inflation

Credibility and forward guidance

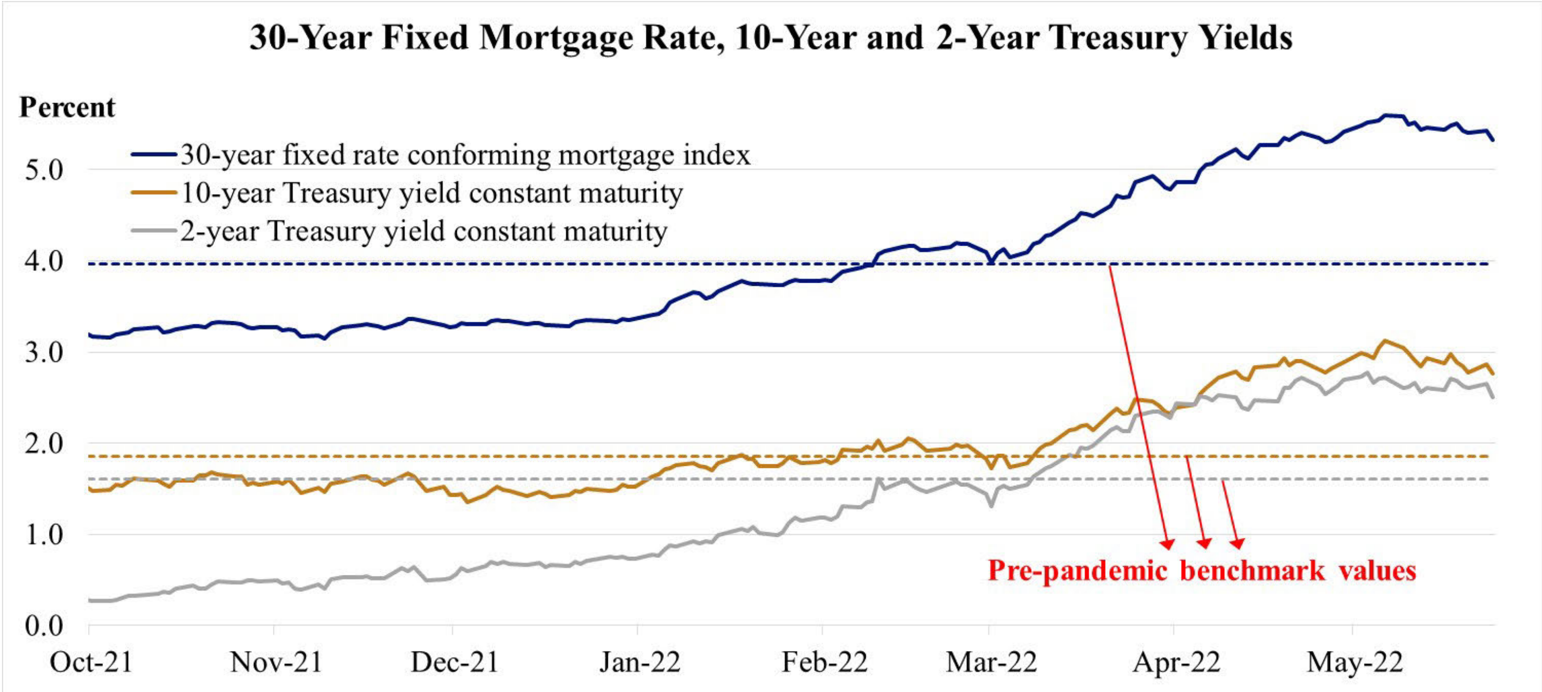
- Modern central banks have considerably more credibility than they did in the 1970s, much of it stemming from an explicit commitment to inflation targeting, and they also make more use of forward guidance.
- As a result, indications of future policy rate increases are incorporated into current financial market pricing before policy actions are taken.
- This has been a key factor in current market pricing, as the 2-year Treasury yield and the 30-year mortgage rate have increased substantially.
- The Fed still has to raise the policy rate sufficiently *ex post* to ratify the forward guidance previously given.

The pre-pandemic benchmark

- Before the pandemic, at the end of 2019, the U.S. economy was growing at 2.6%, the headline PCE inflation rate was 1.5%, and the unemployment rate was 3.6%.[†]
- The policy rate associated with these outcomes was 1.55%.[‡]
- Policy was not expected to change much going forward as of the fourth quarter of 2019. Accordingly, the 2-year Treasury yield was 1.61%.[‡]
- Longer-term rates were moderate, with the 10-year Treasury yield at 1.86% and the 30-year fixed rate mortgage at 3.96%.[‡]
- This may provide a practical benchmark for where the constellation of rates may settle once inflation comes under control in the U.S.

[†] *Real GDP growth and inflation are Q4-over-Q4 values. Unemployment is the December 2019 value.*
[‡] *Interest rates are monthly averages of daily data for December 2019.*

Market pricing based on Fed credibility



Sources: Optimal Blue and Department of the Treasury. Last observation: May 24, 2022.

Market rates above pre-pandemic benchmark

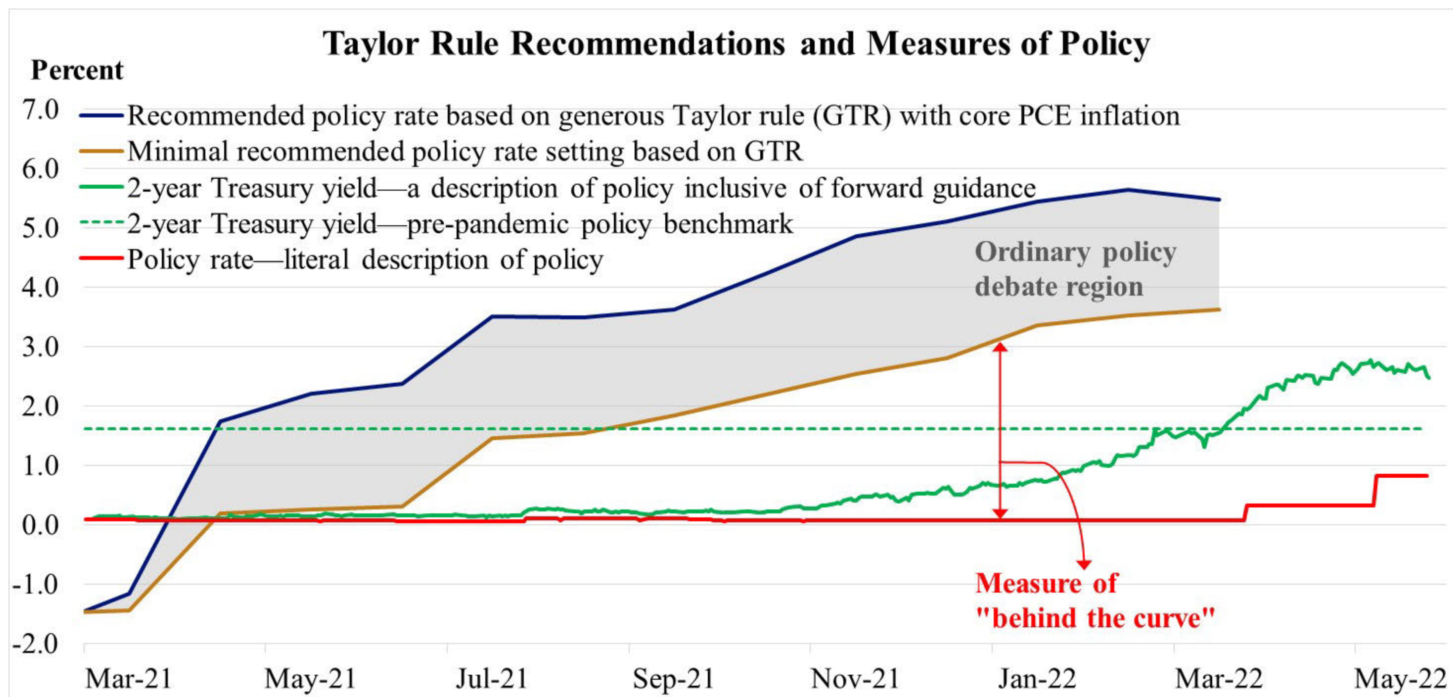
- The fact that market interest rates have moved above their pre-pandemic benchmarks while the policy rate has not can be read as an illustration of the effect of credible forward guidance.
- The Fed still has to follow through to ratify the forward guidance previously given, but the effects on the economy and on inflation are already taking hold.
- As I have stressed, U.S. inflation is far above target, which means that market rates will have to move well above their pre-pandemic benchmarks this year before converging back to lower levels in subsequent years. But how far?

Minimal Taylor-type rule calculation

- In a recent talk, I suggested a minimal Taylor-type rule calculation, which recommended a policy rate of 3.63%.†
- The calculation involved various judgments concerning the elements of a minimal Taylor-type rule.
- The calculation gives an idea of where the FOMC may need to move the policy rate to address the inflation problem now taking hold in the U.S.
- The 2-year Treasury yield, which embodies forward guidance by the Fed, has been trading around 2.6%, still somewhat short of the minimal level to bring inflation under control.

† *See J. Bullard, "Is the Fed 'Behind the Curve'? Two Interpretations," May 6, 2022, remarks delivered at the How Monetary Policy Got Behind the Curve and How to Get Back conference at the Hoover Institution, Stanford, Calif.*

Forward guidance is helping



Sources: Bureau of Economic Analysis, Congressional Budget Office, Department of the Treasury, Federal Reserve Bank of New York, Federal Reserve Bank of Dallas and author's calculations. Last observations: March 2022 and May 24, 2022.

Conclusion

Getting ahead of inflation

- Inflation in the U.S. is far above target and is at levels last seen in the 1970s and early 1980s.
- This situation is risking the Fed's credibility with respect to its inflation target and its associated mandate to provide stable prices in the U.S.
- Modern central banks have more credibility and use more forward guidance than their 1970s counterparts.
- Forward guidance is helping the Fed move policy more quickly to the level necessary to keep inflation under control.

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