FEDERAL RESERVE BANK *of* ST. LOUIS

The Inflation Shock of 2021

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

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Introduction

Key themes

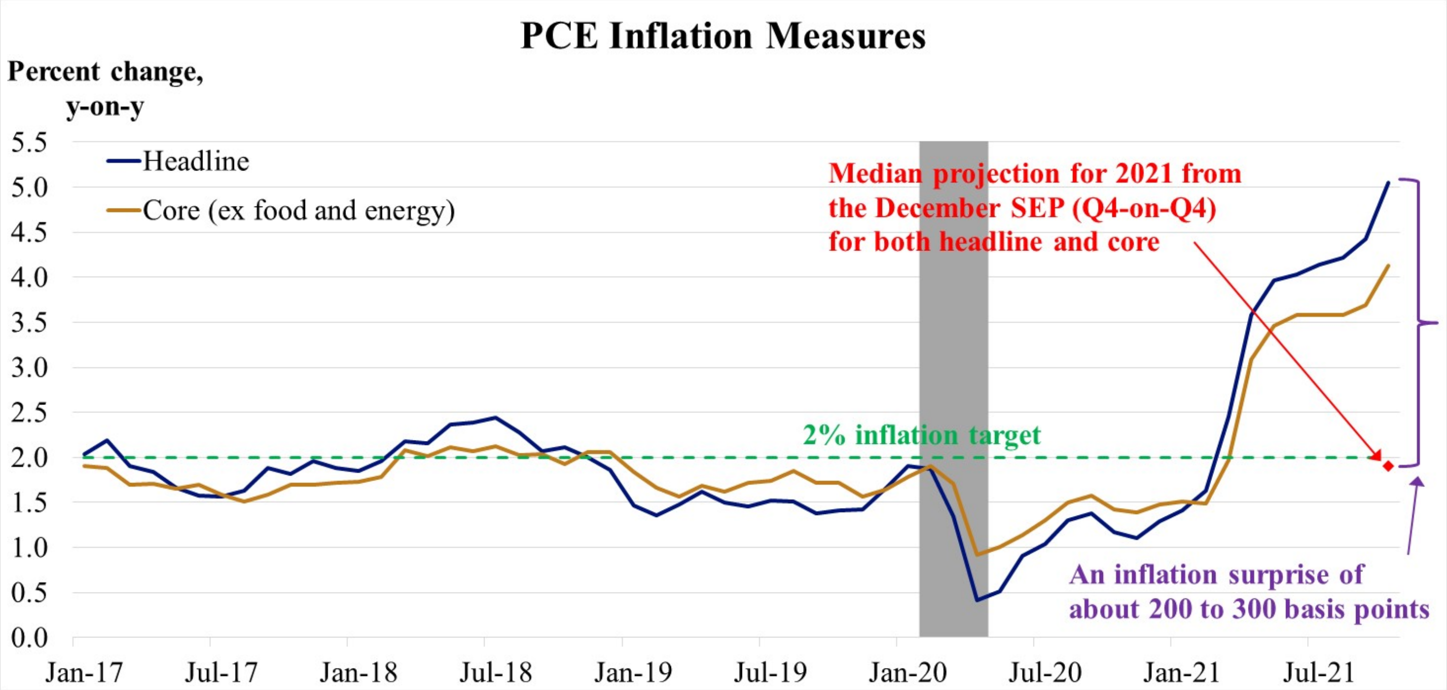
- There has been an unexpected inflation shock in the U.S. during 2021.
- U.S. monetary policy has so far remained very accommodative in response to the inflation shock.
- Asset price inflation has been substantial as well.
- U.S. real gross domestic product (GDP) has fully recovered.
- Labor markets are quite strong and likely to get stronger.
- Pandemic risk remains.
- These considerations suggest, on balance, that the Federal Open Market Committee (FOMC) should remove monetary policy accommodation.

An Inflation Shock in 2021

An inflation shock in 2021

- In December 2020, the inflation forecast in the Summary of Economic Projections (SEP) indicated that the median FOMC participant thought 2021 inflation would be 1.8% for both core and headline PCE inflation, below the FOMC's 2% target.
- Measured from a year ago, headline PCE inflation today is over 5%, and core PCE inflation is over 4%—well in excess of the FOMC's 2% target.
- This is the highest inflation in 30 years for both measures.

Core and headline inflation are running high

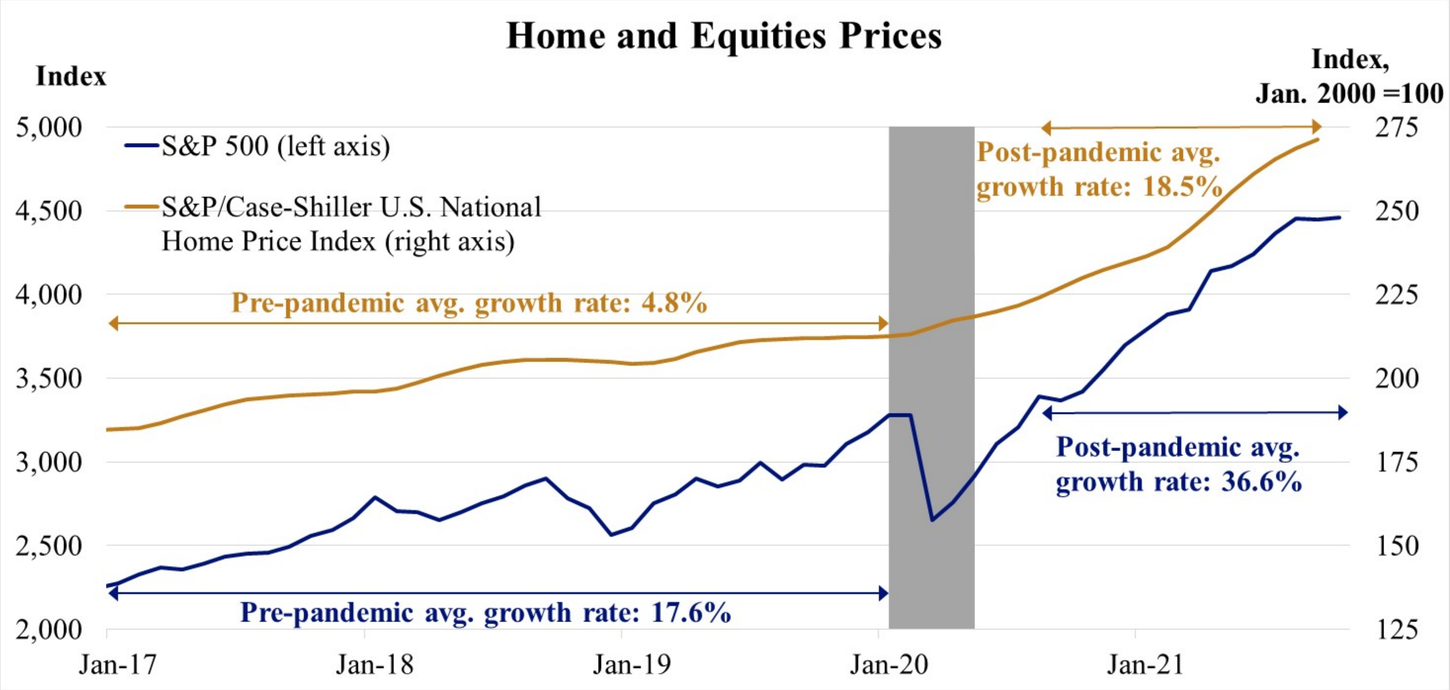


Sources: Bureau of Economic Analysis and Summary of Economic Projections (SEP). The gray shaded area indicates U.S. recession. Last observation: October 2021.

St. Louis Fed price pressures index is elevated

Source: Federal Reserve Bank of St. Louis. Last observation: November 2021.

Asset price inflation is also substantial



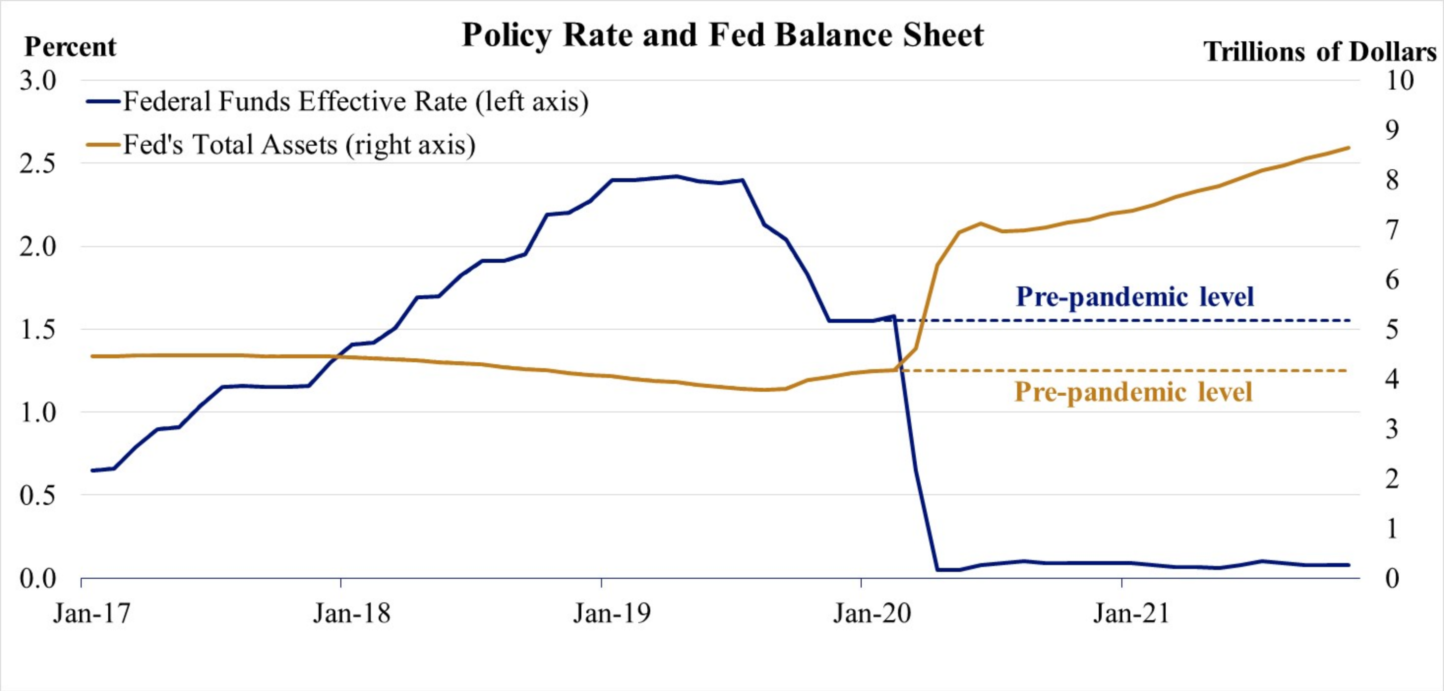
Source: S&P Dow Jones Indices LLC. The gray shaded area indicates U.S. recession. Growth rates are annualized monthly percent changes. Last observations: November 2021 and September 2021.

U.S. Monetary Policy Has Remained Accommodative

Monetary policy has remained accommodative

- Monetary policy has remained accommodative even in the face of the inflation shock.
- The recession ended about 19 months ago, but the FOMC's policy settings are still largely the same as when the recession began.
- In particular, the Fed's balance sheet is still growing, and the policy rate remains near zero.

Monetary policy stance



Source: Board of Governors of the Federal Reserve System. Last observation: November 2021.

U.S. Real GDP Has Fully Recovered

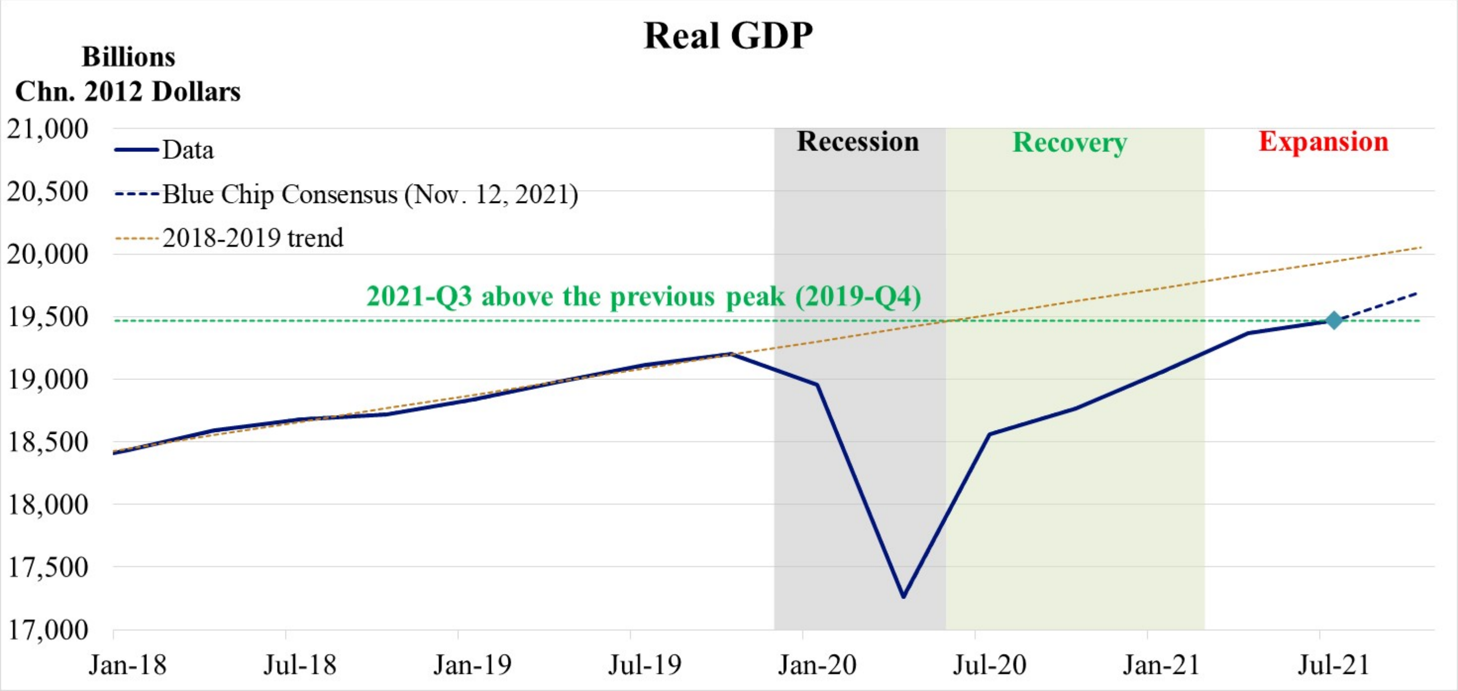
Why so accommodative?

- Monetary policy this accommodative might be justified if the real economy had not yet recovered.
- However, real GDP has already passed the pre-pandemic peak and is slated to move considerably higher.
- In addition, many labor market measures indicate very tight labor market conditions.

U.S. GDP poised to grow at an above-trend rate

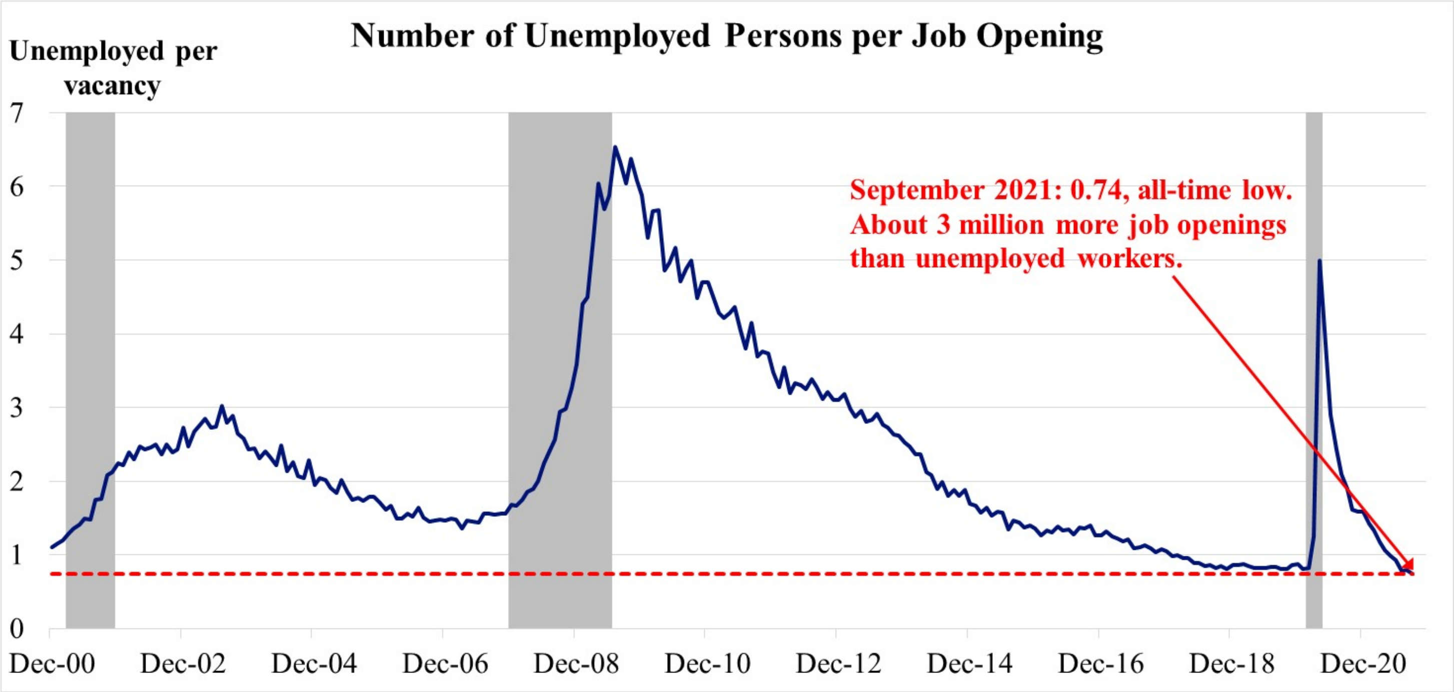
- Business cycles have a clear traditional definition. Periods of declining output are called “recessions.”
- Periods of increasing output following a recession are called “recoveries” until the previous peak is attained.
- Periods beyond the previous peak are called “expansions.”
- The U.S. is currently in the expansion phase of the business cycle: National income is higher than it was at the previous peak and is poised to grow at an above-trend rate.

In the expansion phase



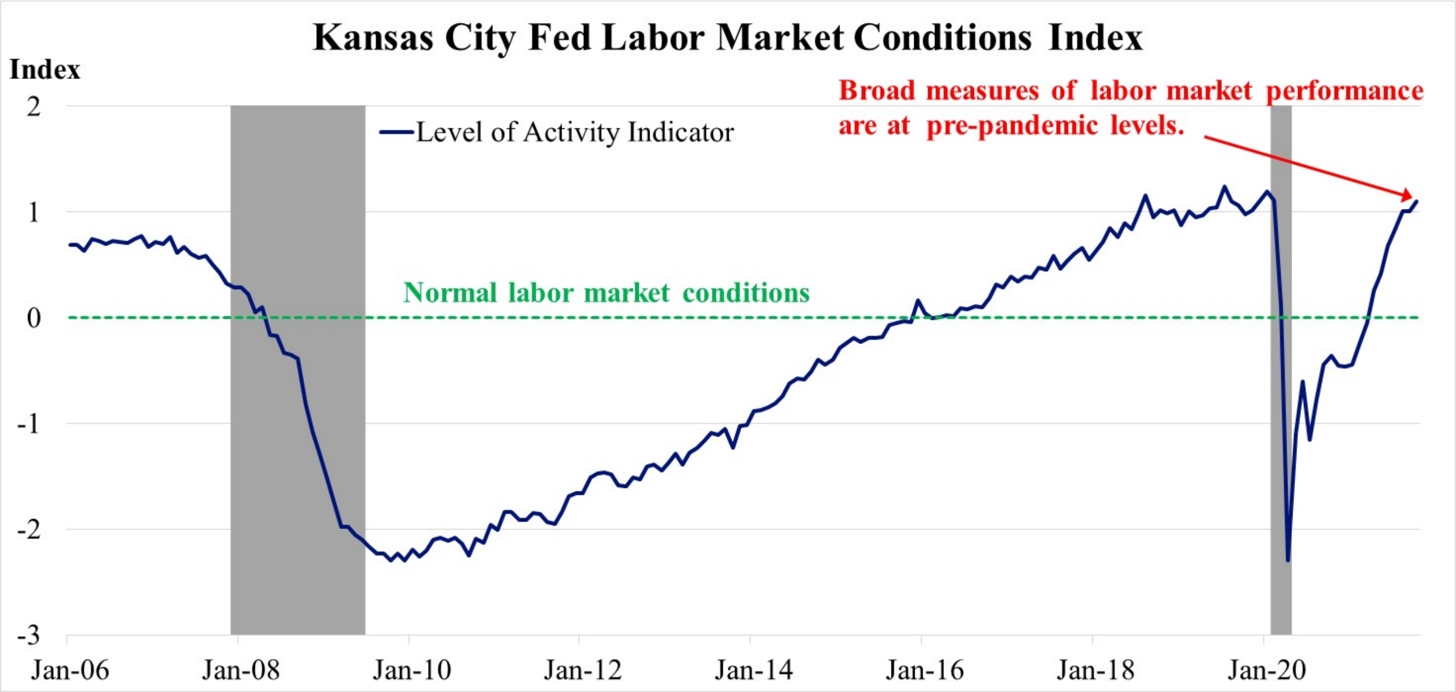
Sources: Bureau of Economic Analysis, Blue Chip Economic Indicators and author's calculations. The gray shaded area indicates U.S. recession. Last observation: 2021-Q3.

Many more job openings than unemployed



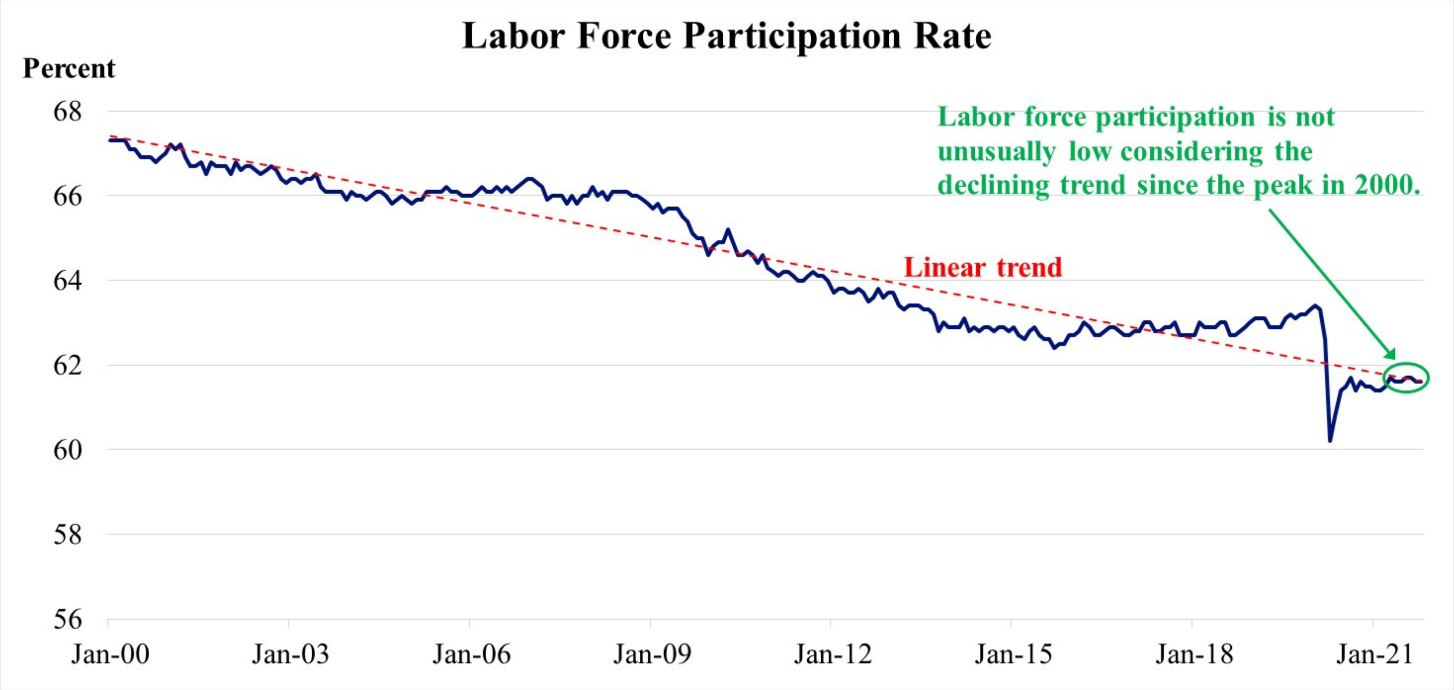
Sources: Bureau of Labor Statistics and author's calculations. Shaded areas indicate U.S. recessions. Last observation: September 2021.

A labor market conditions index



Source: Federal Reserve Bank of Kansas City. Shaded areas indicate U.S. recessions. Last observation: October 2021.

Labor force participation on trend



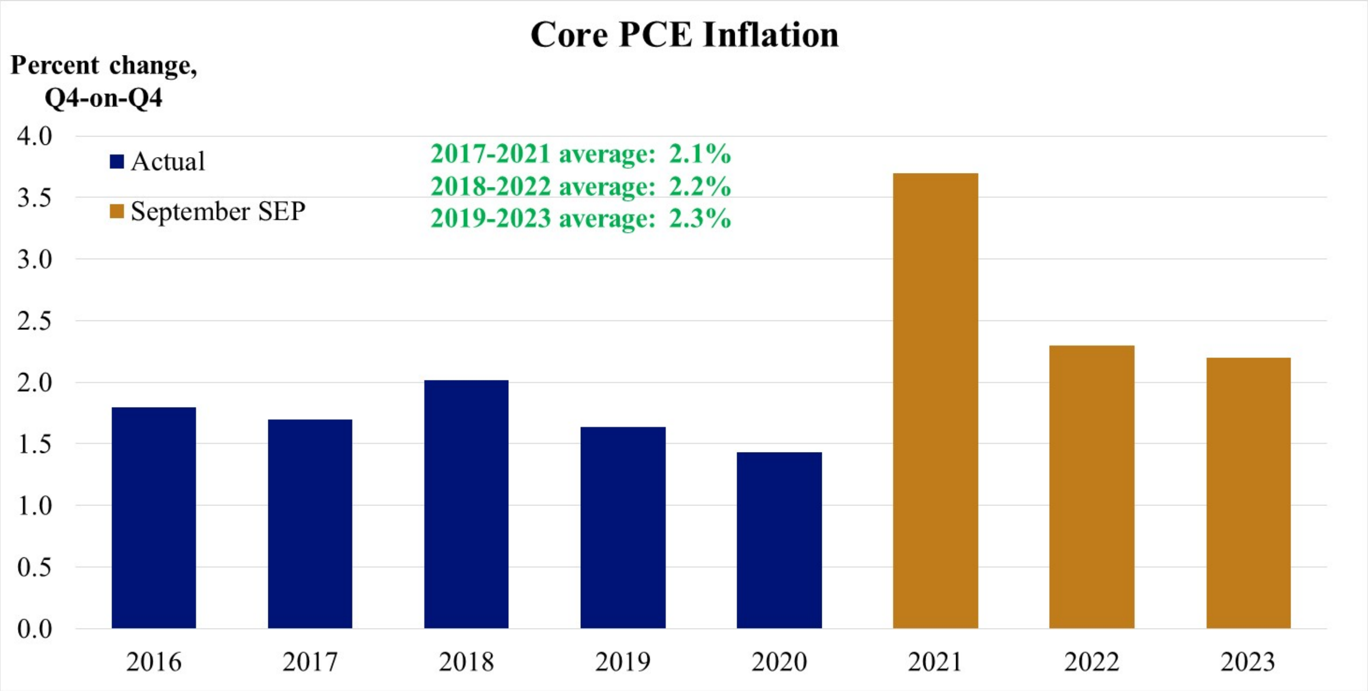
Sources: Bureau of Labor Statistics and author's calculations. Last observation: October 2021.

The FOMC's New Framework

The new monetary policy framework

- The FOMC’s new policy framework was announced in Chair Powell’s Jackson Hole speech in August 2020.
- A key aspect of the new framework is the desire of the FOMC to allow inflation to run above the 2% target for some time to make up for past misses of the inflation target to the low side.
- It now appears that the FOMC will be able to achieve this result with an appropriate monetary policy over the next several years.

Average inflation targeting



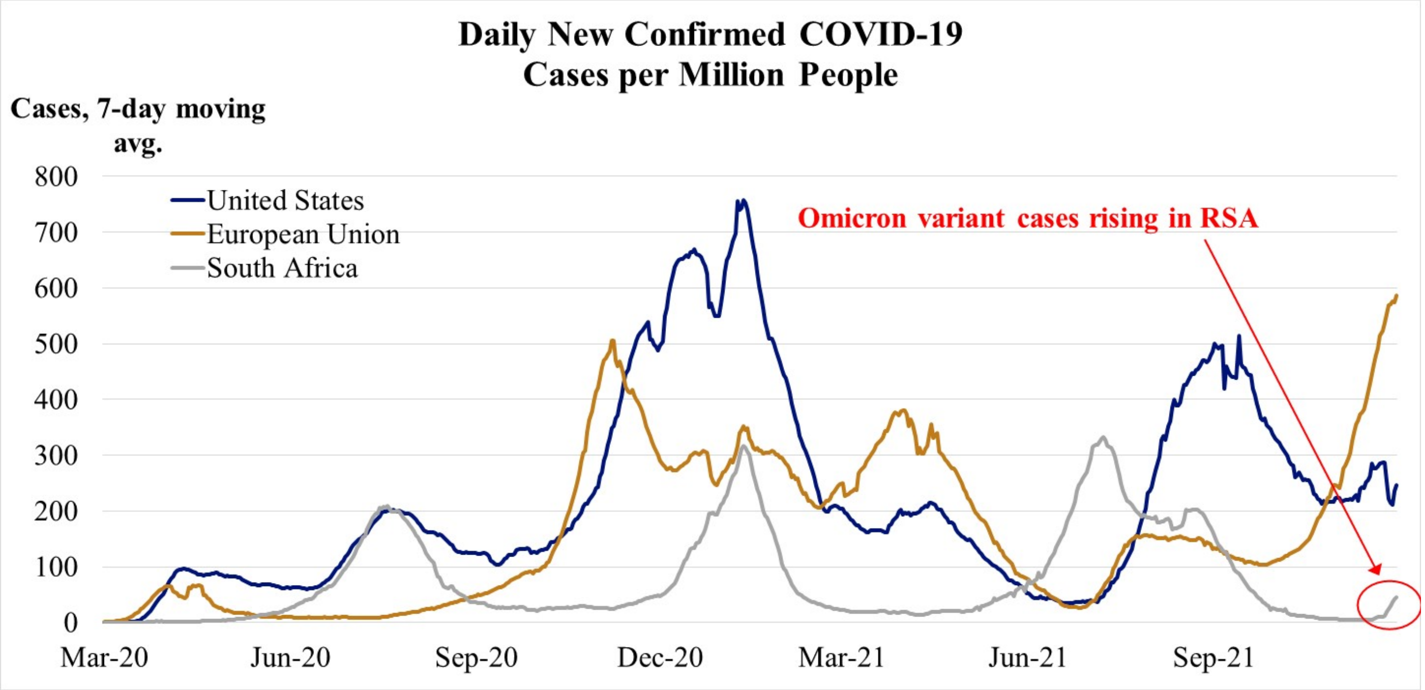
Sources: Bureau of Economic Analysis, Summary of Economic Projections (SEP) and author's calculations. Last observation: 2020-Q4.

Pandemic Risk Remains

A new COVID-19 variant

- A new COVID-19 variant (omicron) was recently first identified in South Africa.
- It is too soon to provide a meaningful assessment of the impact on the public health situation or on the economy in the U.S.

Confirmed COVID-19 cases



Sources: Center for Systems Science and Engineering at Johns Hopkins University and Our World in Data. Last observation: Nov. 30, 2021.

Conclusion

Implications for current monetary policy

- U.S. inflation has surprised substantially to the upside during 2021, in an environment where measures of real economic activity are generally robust.
- Monetary policy settings, however, largely remain as set during the recession in March and April 2020, when inflation was below target and measures of real activity were very weak.
- These considerations suggest that the FOMC at upcoming meetings may want to consider removing accommodation at a faster pace.

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