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.
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

St. Louis Fed price pressures index is elevated

The price pressures measure suggests a larger than 80% probability that inflation will exceed 2.5% over the next 12 months.

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

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

A labor market conditions index


Broad measures of labor market performance are at pre-pandemic levels.

Normal labor market conditions

Index

Level of Activity Indicator

Jan-06  Jan-08  Jan-10  Jan-12  Jan-14  Jan-16  Jan-18  Jan-20

-3  -2  -1  0  1  2
Labor force participation on trend

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

Source: 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

Daily New Confirmed COVID-19
Cases per Million People

Cases, 7-day moving avg.

- United States
- European Union
- South Africa

Omicron variant cases rising in RSA

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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