

# The Initial Response to the Inflation Shock of 2021

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#### Introduction

#### **Key themes**

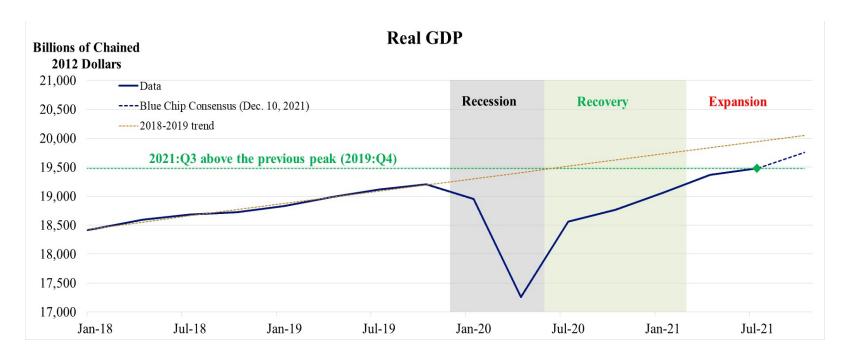
- The U.S. pandemic recession ended 20 months ago. U.S. real gross domestic product (GDP) has more than fully recovered, and labor market performance continues to improve.
- However, there was a significant unanticipated inflation shock in the U.S. during 2021.
- With the real economy strong but inflation well above target, U.S. monetary policy has shifted to more directly combat inflation pressure.
- Pandemic risk remains, but omicron variant cases are expected to subside in the weeks ahead.

## U.S. Real GDP Has Fully Recovered

#### Continued above-trend growth

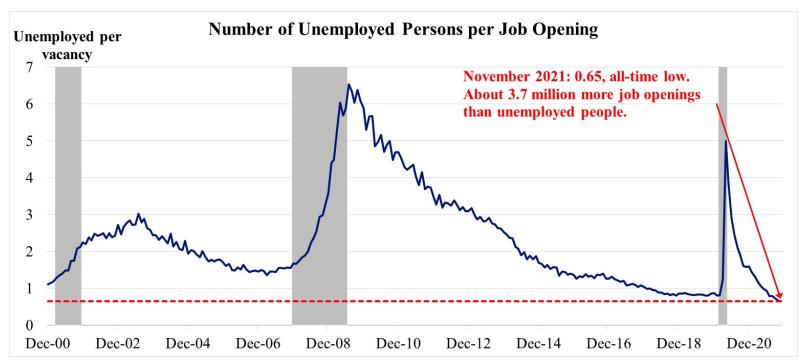
- The U.S. is currently in the expansion phase of the business cycle: National income is higher than it was at the previous peak and is poised to grow at an above-trend rate.
- Labor markets are very robust, according to key metrics.
- The labor force participation rate (LFPR) is sometimes cited as a relatively weak aspect of current labor market performance. However, the LFPR has been on a downward trend since 2000 and is not currently unusually low, once the trend is taken into account.

#### In the expansion phase



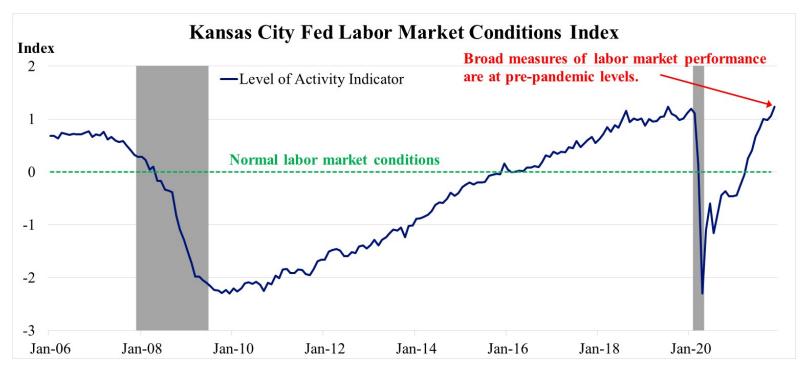
Sources: Bureau of Economic Analysis, Blue Chip Economic Indicators and author's calculations. The gray shaded area indicates U.S. recession. Last observation: 2021:Q3.

#### Many more job openings than unemployed



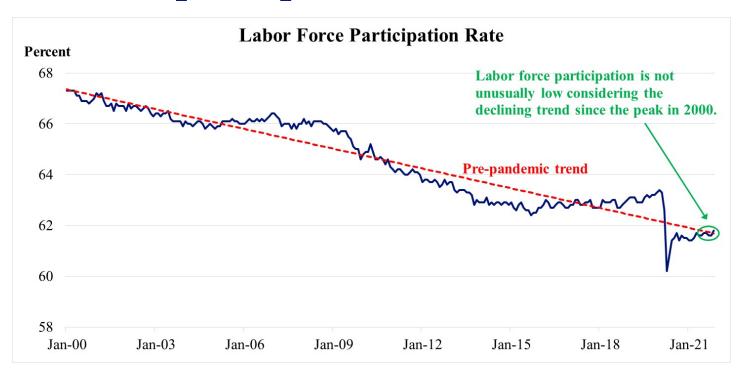
Sources: Bureau of Labor Statistics and author's calculations. Shaded areas indicate U.S. recessions. Last observation: November 2021.

#### A labor market conditions index



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

#### Labor force participation is on trend

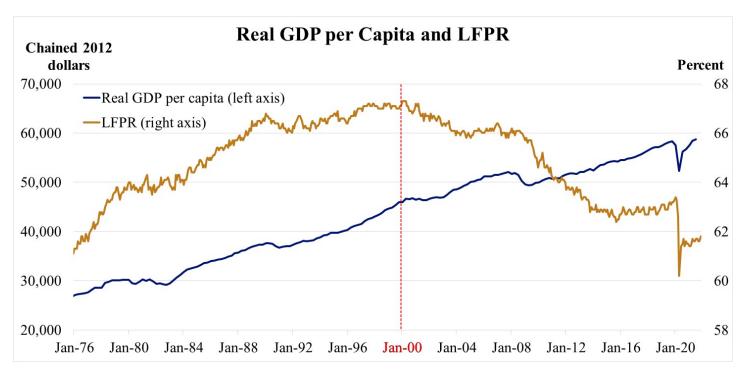


Sources: Bureau of Labor Statistics and author's calculations. Last observation: November 2021.

#### Labor force participation and standard of living

- The LFPR is not robustly correlated with a rising standard of living in the U.S. data.
- In 1976, the LFPR was about the same as it is today.
- From 1976 to 2000, the LFPR grew alongside of the U.S. standard of living (real income per capita), a positive correlation.
- But from 2000 until today, the LFPR declined while the standard of living continued to rise, a negative correlation.
- Changes in LFPR are not indicative of changes in the standard of living.

#### LFPR and living standards not closely correlated



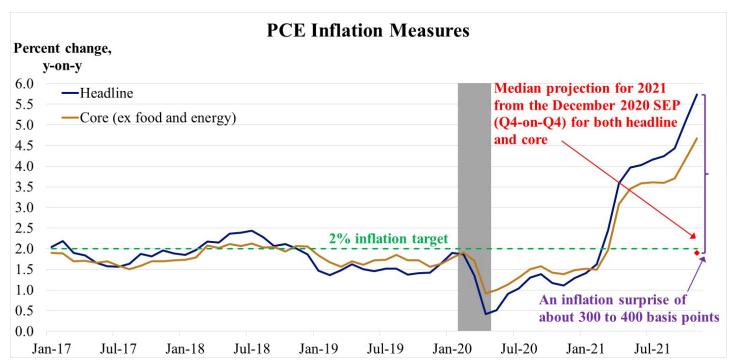
Sources: Bureau of Economic Analysis and Bureau of Labor Statistics. Last observations: 2021:Q3 and November 2021.

#### **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 Federal Open Market Committee (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 is currently 5.7%, and core PCE inflation is 4.7%—well in excess of the FOMC's 2% target.
- This is the highest inflation in more than 30 years for both measures.

#### Core and headline inflation are well above target



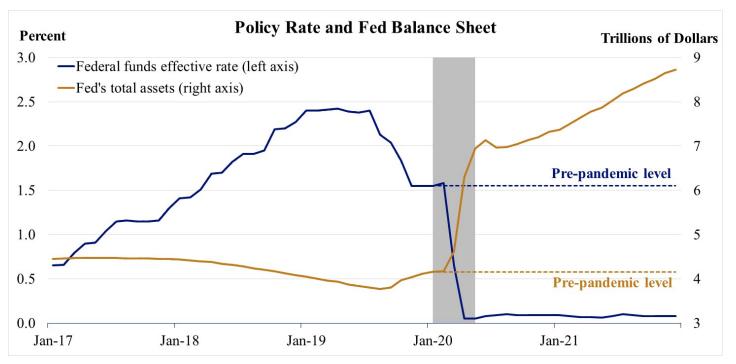
Sources: Bureau of Economic Analysis and Summary of Economic Projections (SEP). The gray shaded area indicates U.S. recession. Last observation: November 2021.

### The Initial Response to the Inflation Shock

#### The monetary policy response

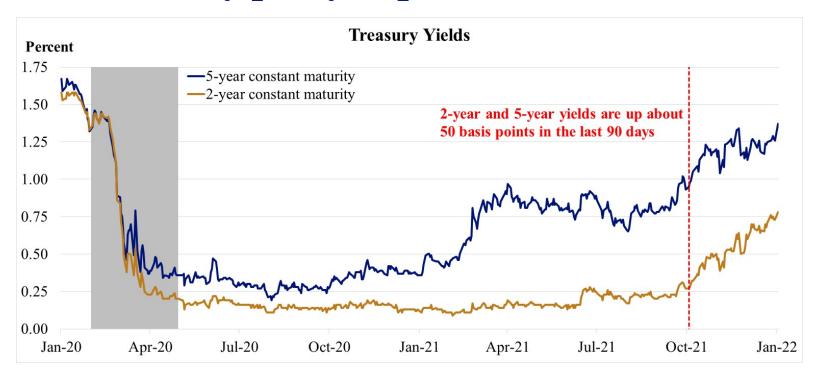
- At the time of the pandemic recession, the FOMC moved the policy rate to near zero and began large outright purchases of Treasury securities and agency MBS.
- These policy settings largely remain intact today.
- However, the FOMC recently agreed to phase out asset purchases by mid-March and also penciled in more policy rate increases for 2022 than previously anticipated.
- These steps have had an impact on financial market pricing, according to recent trading: 2-year and 5-year Treasury yields have increased about 50 basis points in the last 90 days or so.

#### The monetary policy stance



Source: Board of Governors of the Federal Reserve System. The gray shaded area indicates U.S. recession. Last observation: December 2021.

#### The monetary policy impact so far



Source: Board of Governors of the Federal Reserve System. Last observation: Jan. 3, 2022.

#### Possible next steps for monetary policy

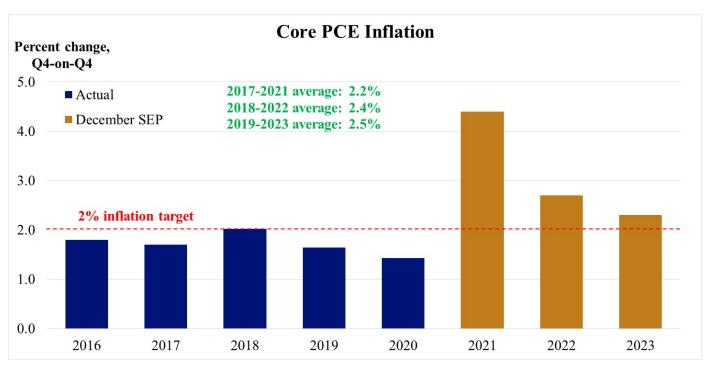
- The FOMC took steps at the December 2021 meeting to be in a better position to control inflation over the forecast horizon if inflation does not naturally moderate as much as currently anticipated.
- Asset purchases will come to an end in the months ahead, but the FOMC could also elect to allow passive balance sheet runoff in order to reduce monetary accommodation at an appropriate pace.
- The FOMC could begin increasing the policy rate as early as the March meeting in order to be in a better position to control inflation.
- Subsequent rate increases during 2022 could be pulled forward or pushed back depending on inflation developments.

#### 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**



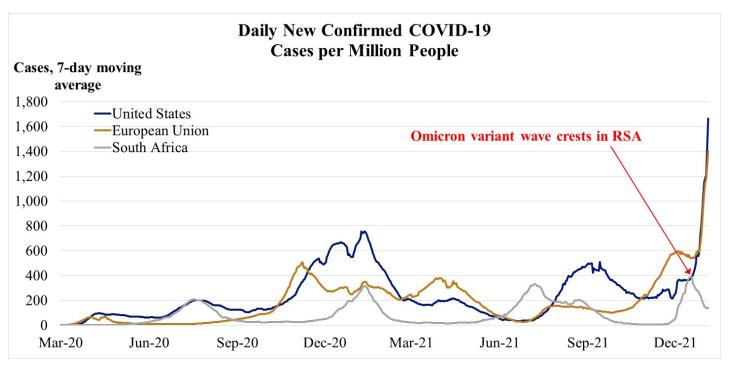
Sources: Bureau of Economic Analysis, Summary of Economic Projections (SEP) and author's calculations. Last observation: 2020:Q4.

#### **Omicron Risk**

#### Pandemic risk from the omicron variant

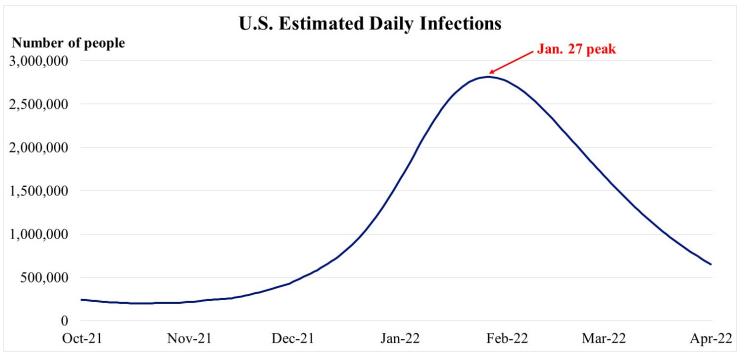
- A new COVID-19 variant (omicron) was first identified in the Republic of South Africa (RSA), a country with a vaccination rate below 30%.
- This variant became dominant, and confirmed cases rose dramatically.
- However, confirmed RSA cases peaked in recent weeks and have been falling since.
- The omicron variant is becoming dominant in the U.S. and Europe, and confirmed cases are rising dramatically.
- However, confirmed cases in the U.S. are projected to follow the pattern observed in the RSA.

#### **Confirmed COVID-19 cases**



Sources: Center for Systems Science and Engineering at Johns Hopkins University and Our World in Data. Last observation: Jan. 4, 2022.

#### Omicron variant wave expected to crest



Source: Dec. 21, 2021, reference scenario projection from the Institute for Health Metrics and Evaluation, University of Washington.

#### **Conclusion**

#### Implications for current monetary policy

- U.S. inflation has surprised substantially to the upside in an environment where measures of real economic activity and labor market performance are expected to remain robust.
- There has been an initial U.S. monetary policy response to the inflation shock, and this response is already reflected in financial market pricing.
- The FOMC is in good position to take additional steps as necessary to control inflation, including allowing passive balance sheet runoff, increasing the policy rate, and adjusting the timing and pace of subsequent policy rate increases.

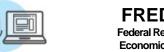
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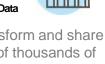
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