Inflation Risks and Monetary Policy

Andrew Levin
Dartmouth College & NBER
February 2022

Prepared for the Shadow Open Market Committee (SOMC) meeting on February 11, 2022. These remarks solely reflect the views of the presenter and should not be interpreted as reflecting the views of any other person or institution.
Basic Principles of Monetary Economics

- The stance of monetary policy is gauged by the nominal interest rate minus inflation, which is universally referred to as the real interest rate.

- The extent of tightness or accommodation is gauged relative to the equilibrium real interest rate ($r^*$).

- These principles are emphasized here:

### Measures of Inflation

(annual rates, percent)

<table>
<thead>
<tr>
<th>Indicator</th>
<th>2019 Average</th>
<th>Latest 6 Months</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Core PCE</td>
<td>1.7</td>
<td>5.0</td>
<td>+3.3</td>
</tr>
<tr>
<td>Core CPI</td>
<td>2.2</td>
<td>5.8</td>
<td>+3.6</td>
</tr>
<tr>
<td>Narrow Core CPI (ex. food, energy, shelter, used cars)</td>
<td>1.4</td>
<td>4.7</td>
<td>+3.3</td>
</tr>
<tr>
<td>Federal Funds Rate</td>
<td>2.2</td>
<td>0.1</td>
<td>-2.1</td>
</tr>
<tr>
<td>Real Fed Funds Rate</td>
<td>0.5</td>
<td>-4.9</td>
<td>-5.5</td>
</tr>
</tbody>
</table>
The Stance of Monetary Policy during the Great Inflation

Source: Levin and Taylor (2013), figure 4.6
Assessing the Inflation Outlook

- **Goods Prices**: supply chain tangles will only be unraveled gradually, just like an auto traffic jam.

- **Services Prices**: subsidence of omicron will likely expand demand faster than supply.

- **Shelter**: see Levy (2022).

- **Nominal Wage Growth**: workers seeking cost-of-living increases in a robust job market.

- **Consumers** expect inflation this year at 7%, which is crucial for wage and price setting.
Container Ship Congestion at the Ports of LA and Long Beach

Assessments of Consumers’ Expected Inflation Rates

Source: Federal Reserve Bank of New York
The Evolution of Consumers’ Inflation Point Forecasts

Source: Federal Reserve Bank of New York
Average Hourly Earnings of Production & Nonsupervisory Workers

Source: Federal Reserve Bank of New York
Monetary Policy Implications

- Price stability cannot be achieved by following an *ad hoc* “meeting-by-meeting” approach to FOMC decisions and communications.

- The FOMC needs to move promptly to a neutral stance to ensure that it doesn’t keep adding fuel to the inflationary inferno.

- Achieving a neutral stance within the next year will almost surely involve raising the fed funds rate to 4 or 5 percent, and perhaps even further.

- The FOMC urgently needs to start following a transparent and systematic policy strategy.