Inflationbusters

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Marketing Communication

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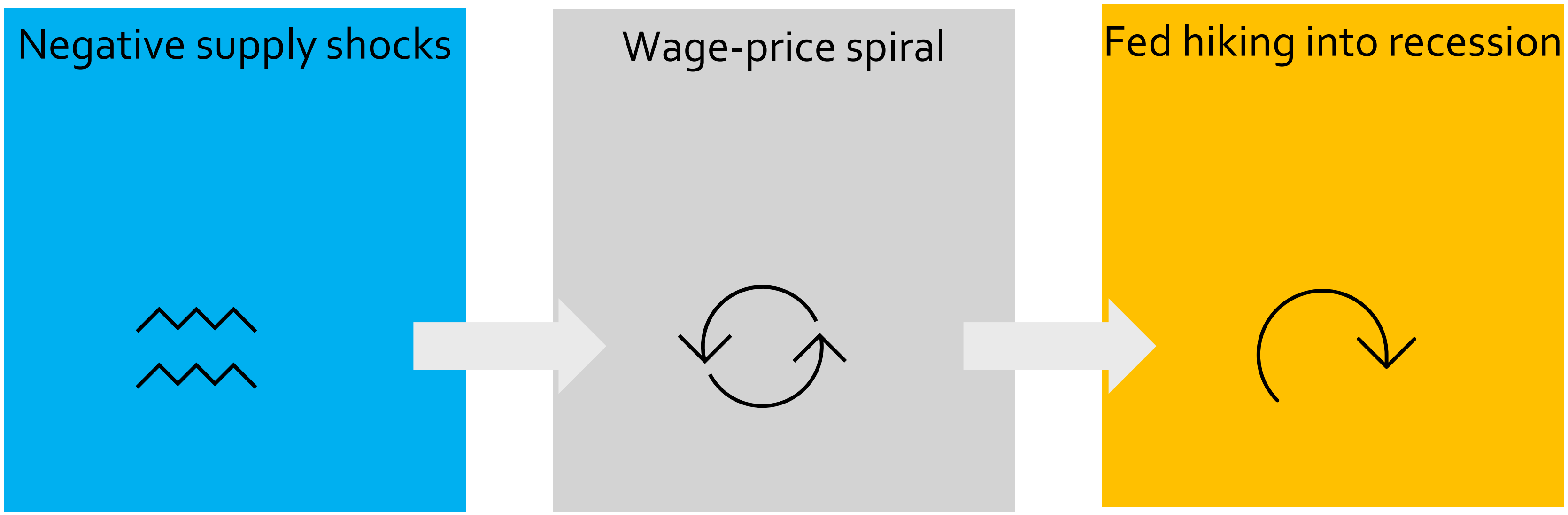
The rise and fall of inflation



Causes of inflation

Supply: Negative Shocks

- Supply chain bottlenecks
  - Restart after COVID lockdowns
  - Restructuring of global supply chains
- Labor shortages: temporary or permanent?
- Negative supply shock from Russian invasion of Ukraine

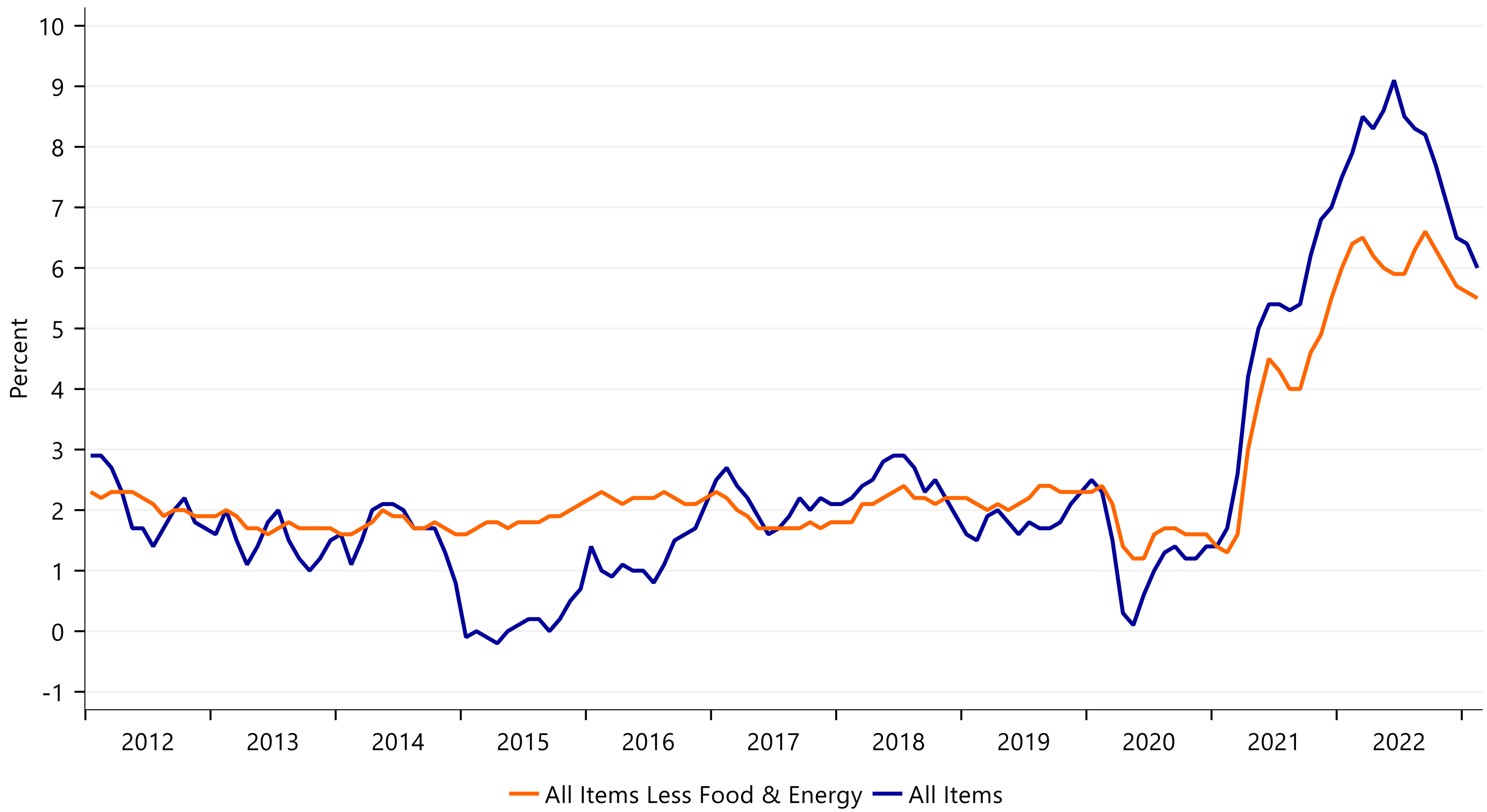
Demand: Too Much Stimulus?

- Pent-up demand released when businesses reopen
- Demand impulse from fiscal policy
- Demand impulse from monetary policy

Base effects

- Low base after COVID outbreak

Peak inflation, but also persistent



Three categories of inflation

- Goods inflation: has fallen
- Housing inflation: rising, but expected to fall
- Core services ex housing: uncertain and related to nominal wage growth

Easing supply chain issues

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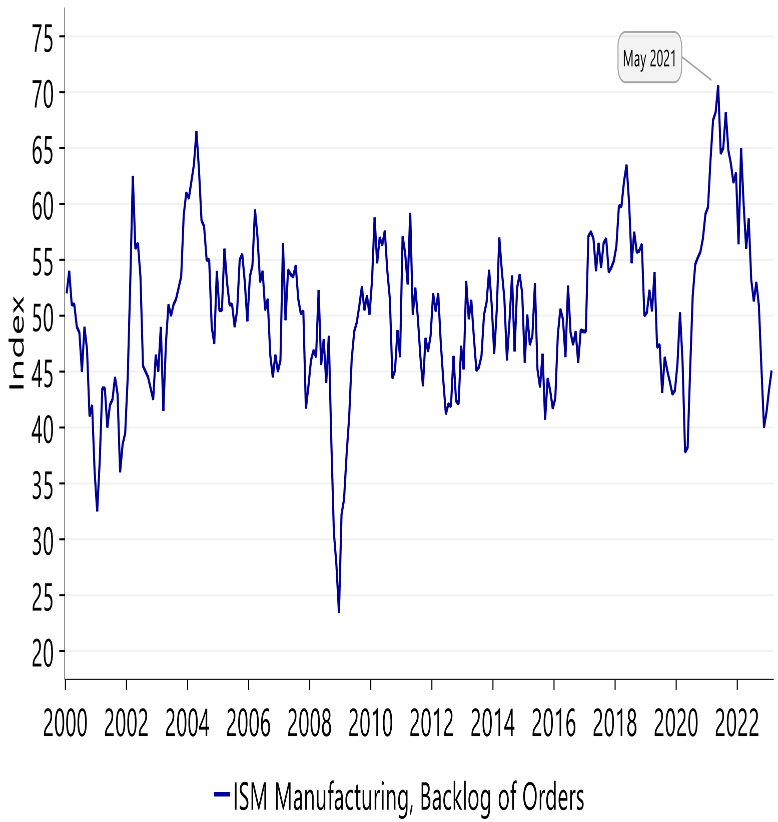
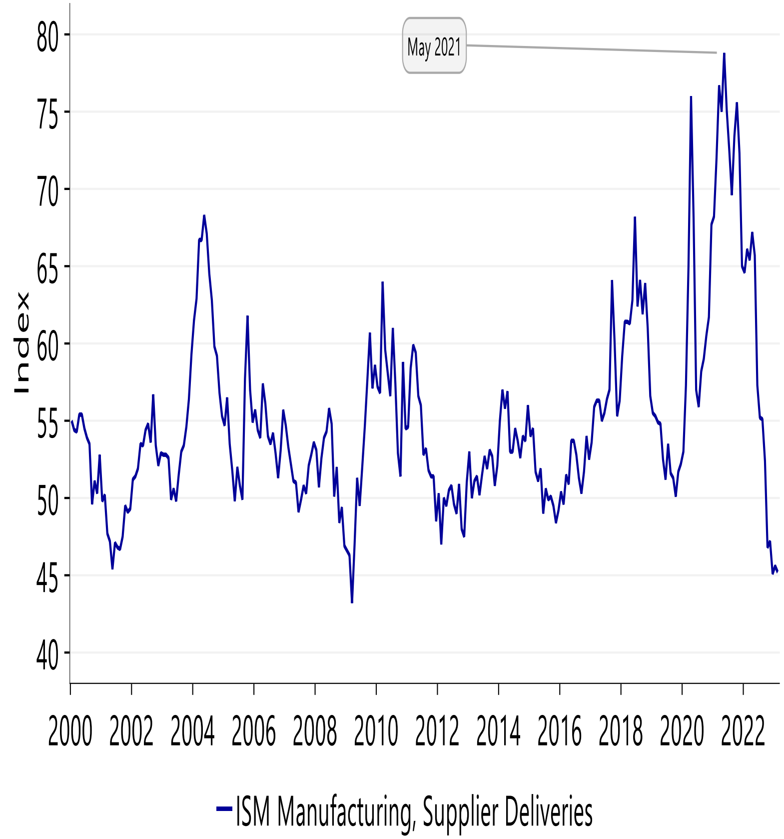
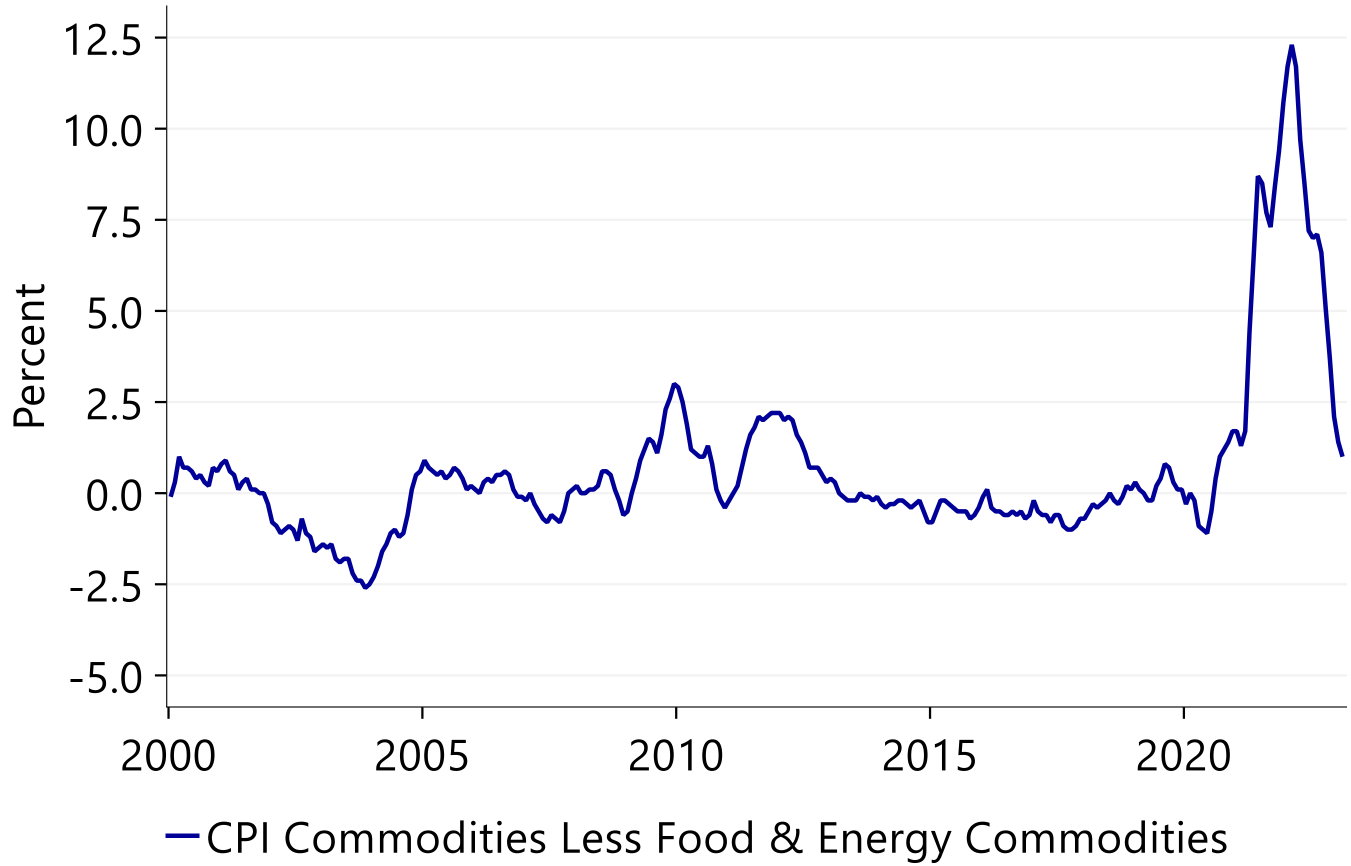
Backlog of orders



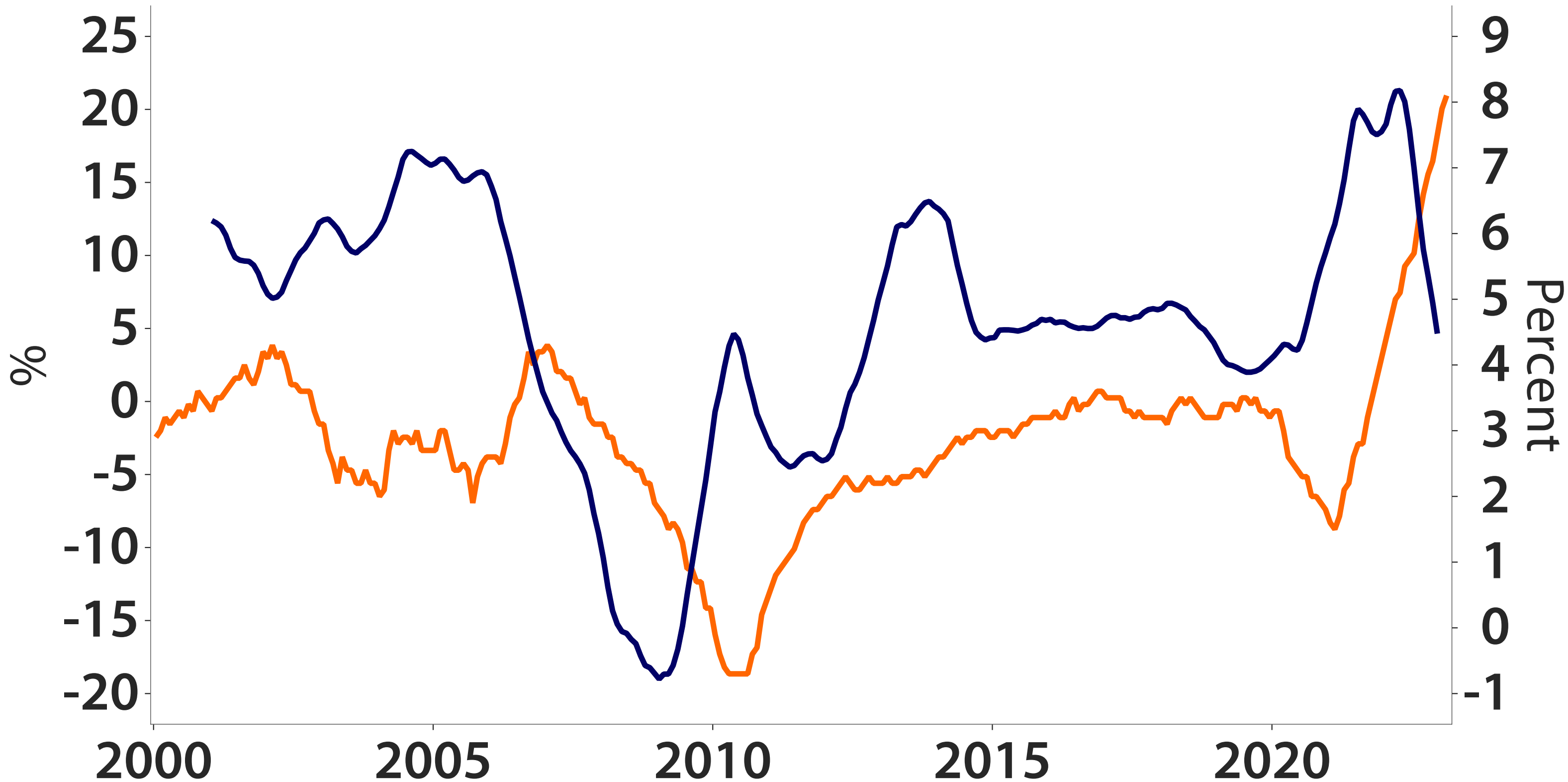
Lead time for suppliers to deliver orders



Goods inflation has fallen

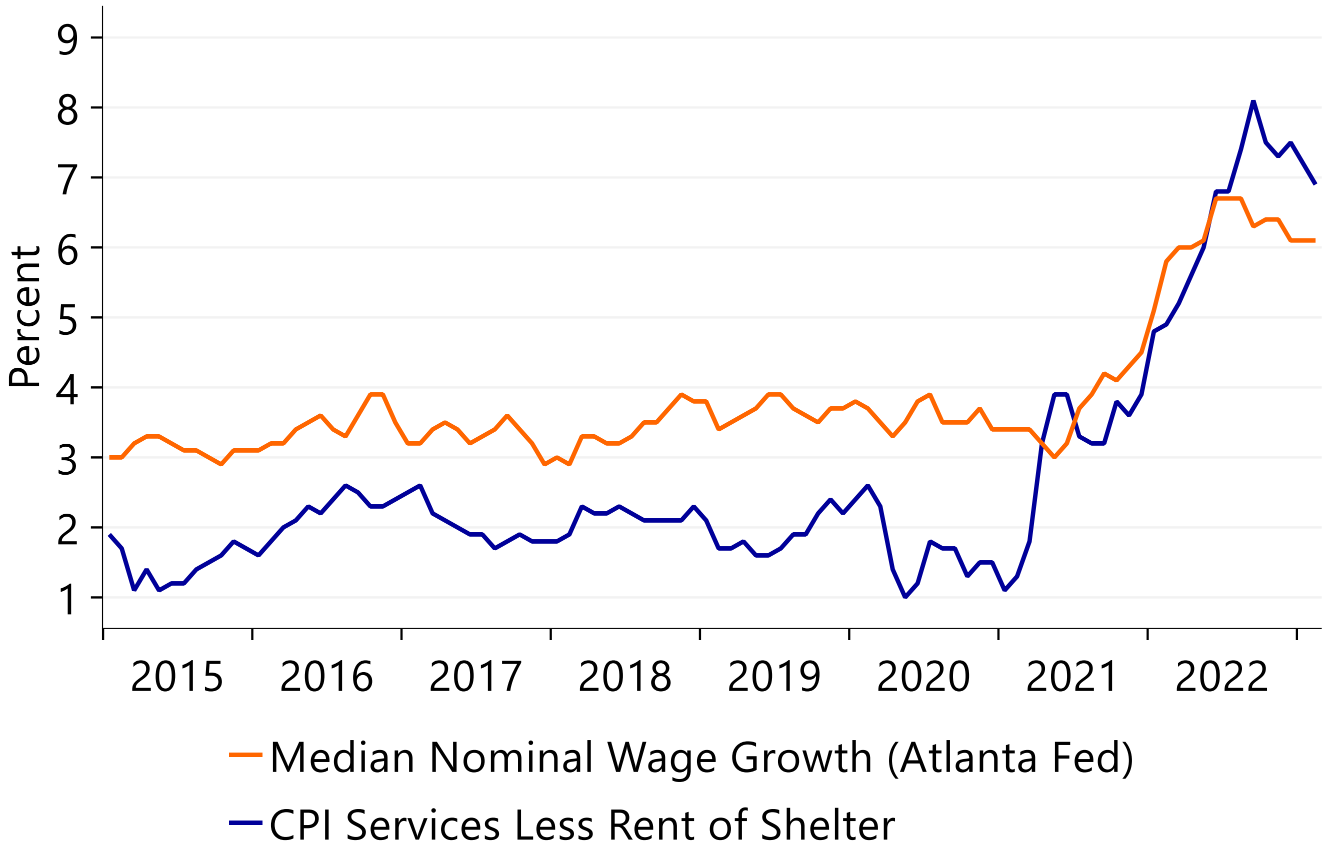


Housing inflation expected to fall



–S&P/Case-Shiller Composite-20 Home Price Index, lhs [c.o.p. 1 year]
–CPI, Shelter, Change Y/Y, rhs

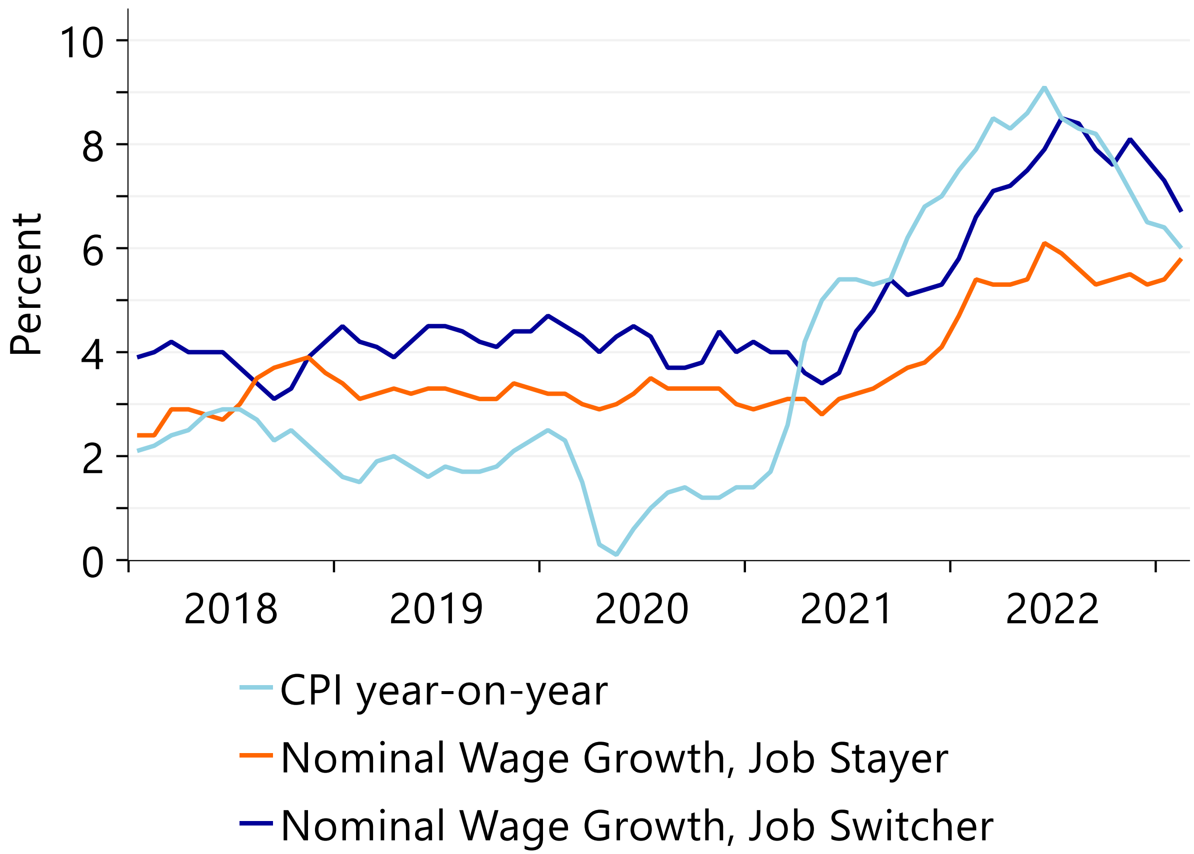
Core services ex housing inflation = wildcard



Wage-price dynamics: theory

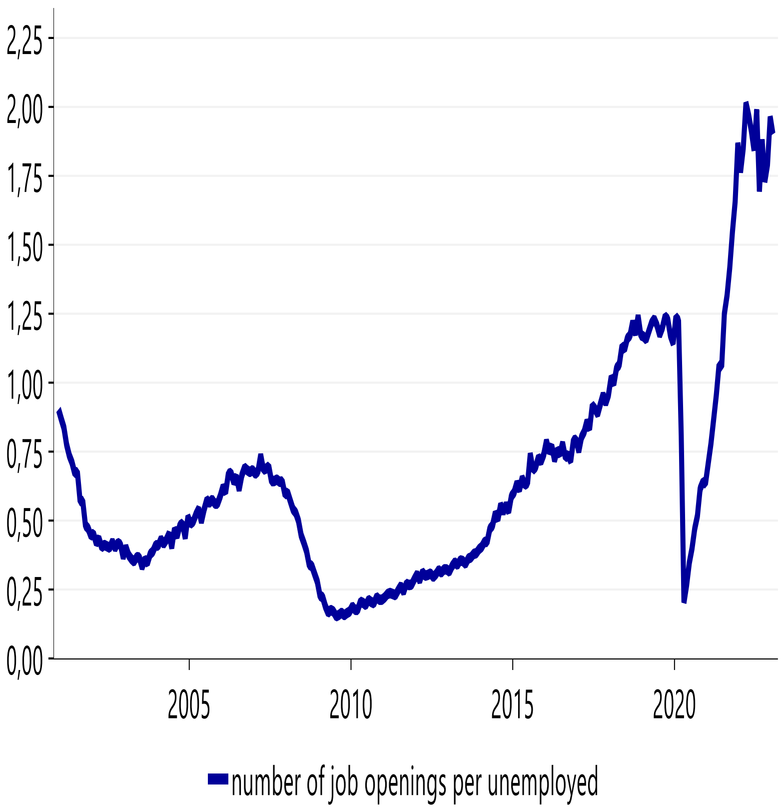
- Prices -> Wages: Inflation expectations + Wage bargaining power
- Wages -> Prices: Mark-up pricing (pricing power)
- If causality occurs in both directions, then there is a positive feedback loop (wage-price spiral)
- The wage-price spiral can be
  - Decelerating: inflation falls back to 2% target
  - Accelerating: inflation continues to rise

Wage-price dynamics: reality

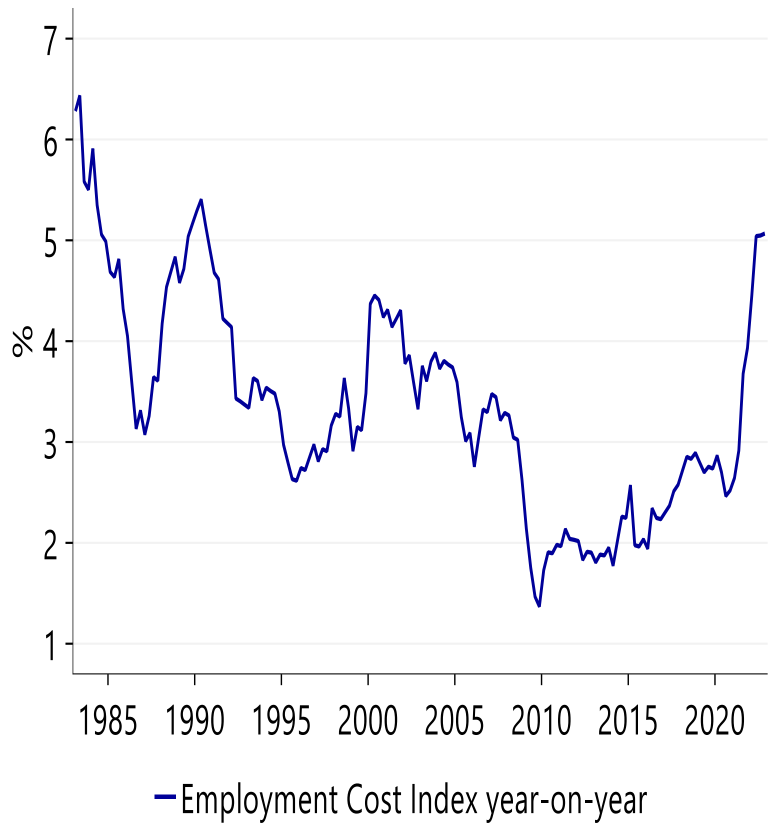


Labor shortages and rising costs

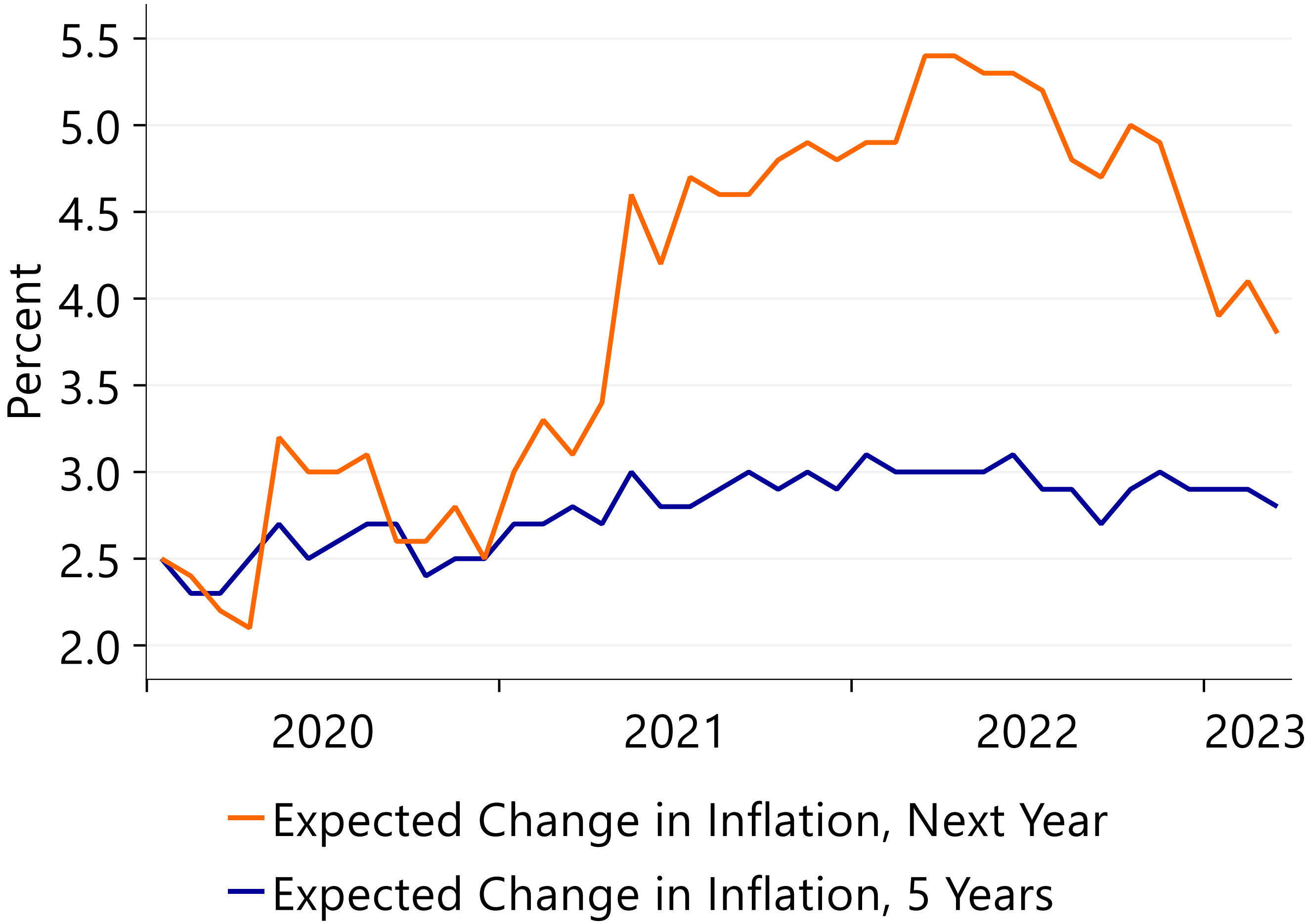
Tight labor market



Rising labor costs



Receding fear of entrenchment



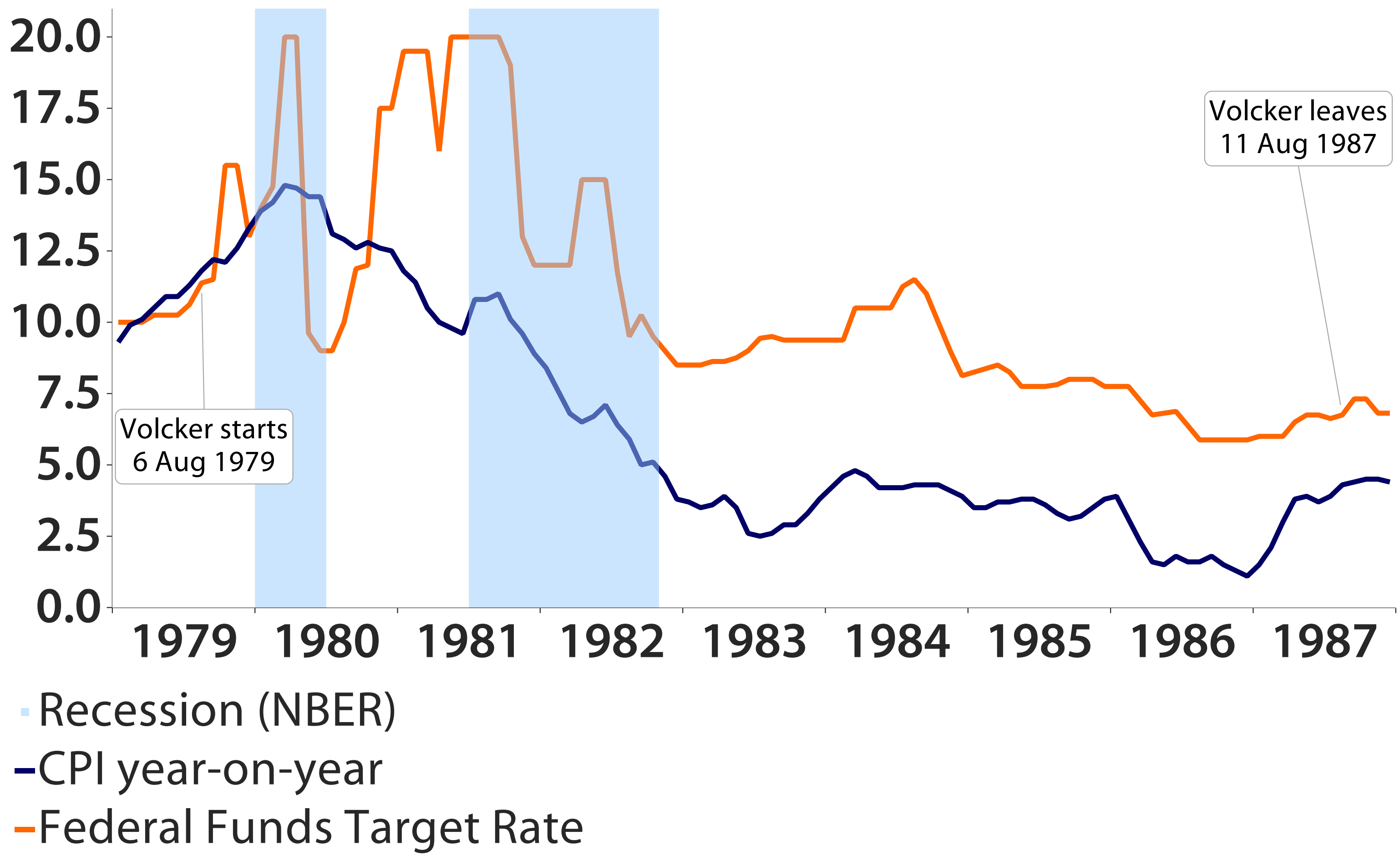
Inflationbusters

- Inflation may have peaked, but remains persistent and well above the 2% target
- Nominal wage growth is the key remaining inflation risk
- Terminating/preventing a wage-price spiral requires an increase in labor market slack (unemployment)
- Hence the Fed is likely to hike the economy into recession, a soft landing is difficult to achieve

Fed's change in priorities

- Fed has dual mandate: price stability and full employment
- However, FOMC *prioritized* price stability over full employment at June 2022 meeting
- The FOMC fears that elevated inflation could become *entrenched* if the public began to question the resolve of the Committee
- Powell: price stability is a *pre-condition* for sustainable full employment
- In other words: first get inflation under control, then take care of the real economy

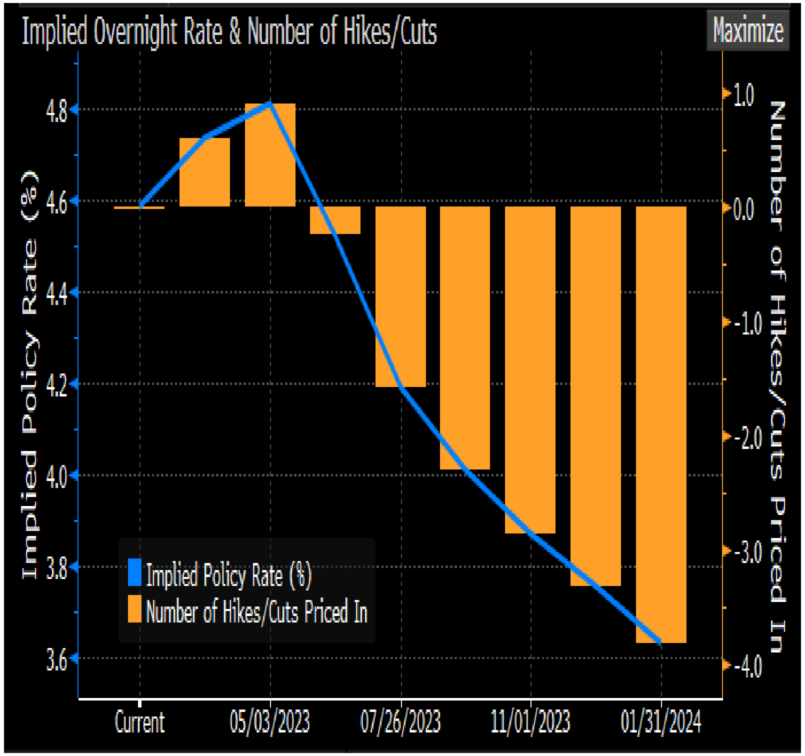
The Volcker years



Anti-pivot code words

Regarding a pivot (rate cuts) in 2023, Powell has repeated:

- *It is likely that restoring price stability will require holding policy at a restrictive level for some time.*
- *History cautions strongly against prematurely loosening policy.*
- *We will stay the course until the job is done.*



Fed's change in reaction function

Greenspan, Bernanke, Yellen, Powell 1	*Volcker, Powell 2*
Recession	Inflation
↓ "Fed put"	↓
Slash policy rates	Raise rates until recession causes inflation to fall back to 2%
	↓
	If inflation is under control then cut rates

Recessions reconsidered

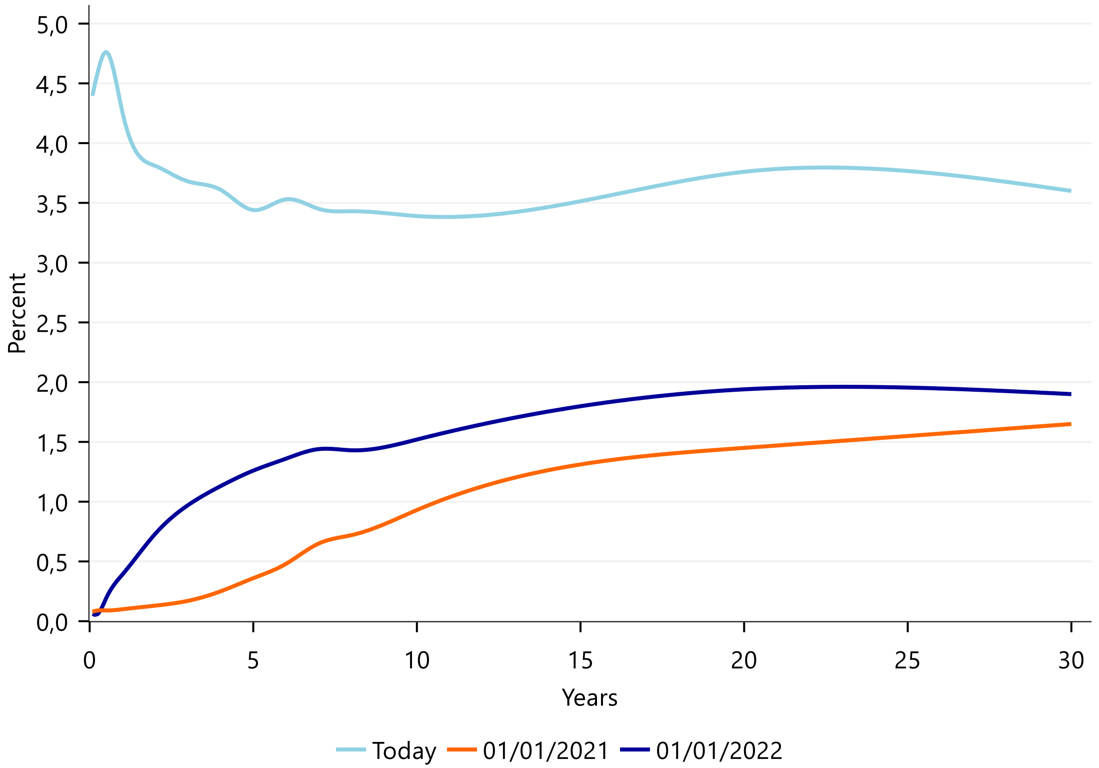
Greenspan, Bernanke, Yellen, Powell 1

- Recession is something to be averted by rate cuts

Volcker, Powell 2

- Recession is the necessary evil that will squeeze inflation out of the economy
- Recession is a means to an end (of elevated inflation)
- Recession is collateral damage in the fight against inflation

Yield curve inversion: (NBER-approved) recession on horizon



Inversions precede recessions

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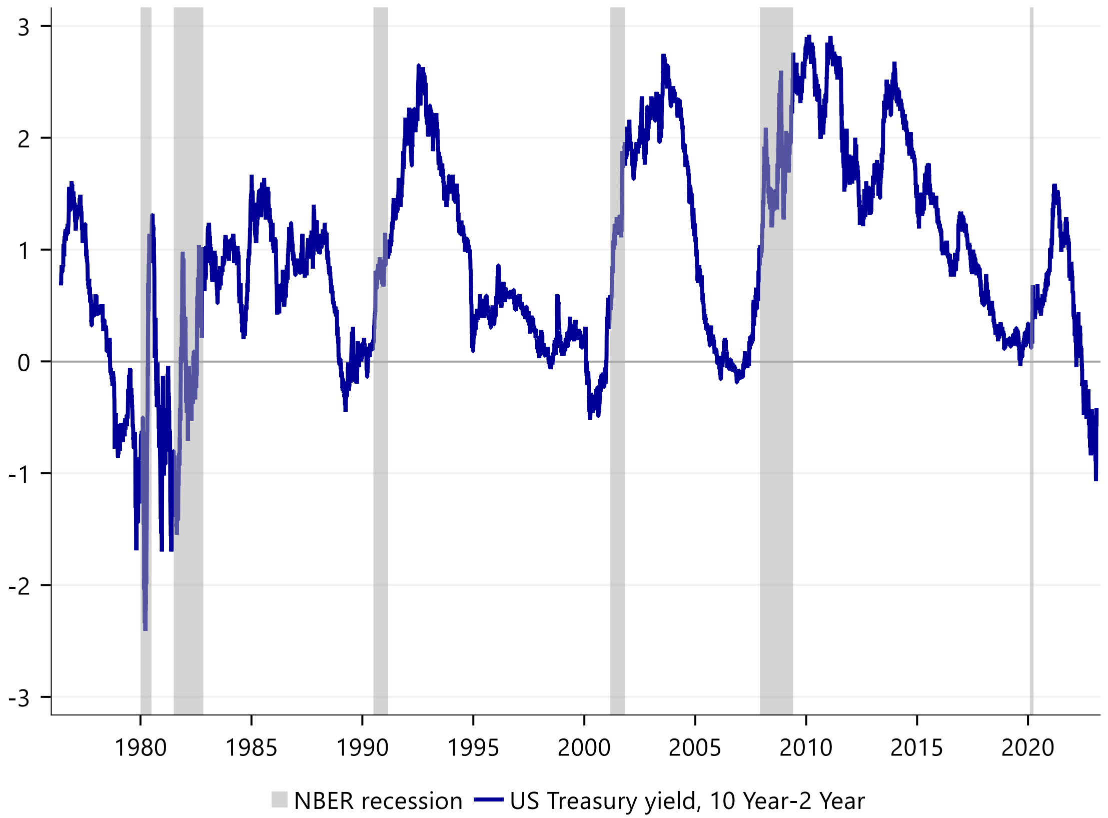


Banking turmoil

- Runs on midsize US banks:
  - Silicon Valley Bank
  - Signature Bank
  - First Republic

- Fed's response:
  - Bank term funding program
  - More frequent dollar swap operations

- Impact:
  - Adds to recession risk
  - Complicates Fed's monetary policy

Multiple goals, multiple instruments

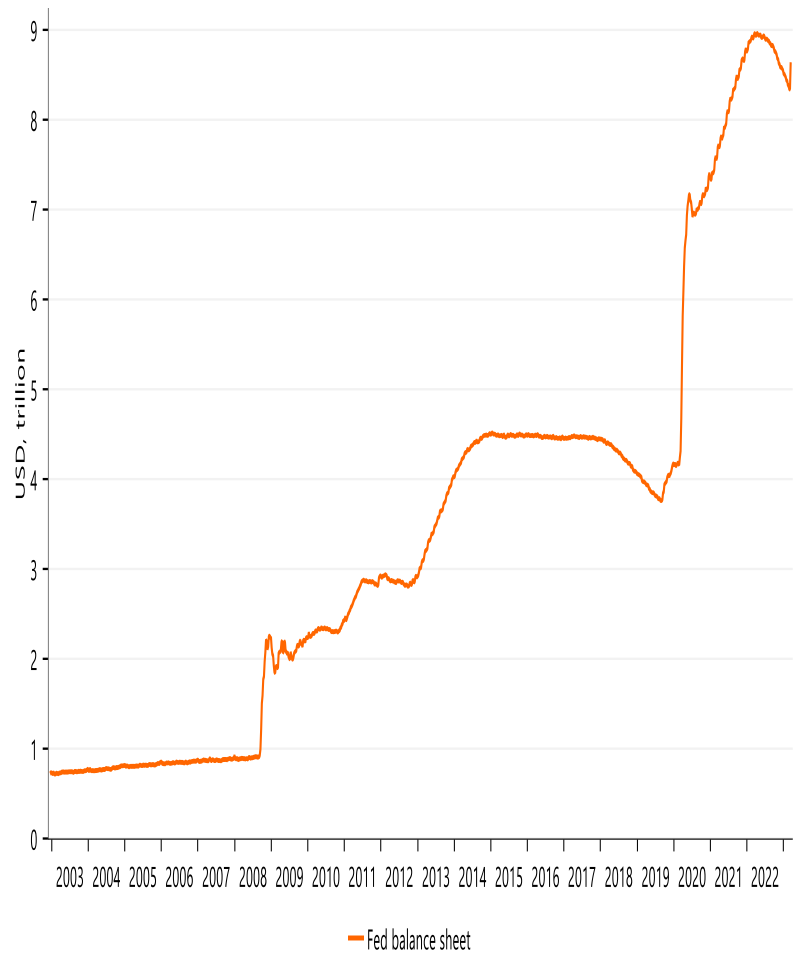
Goals: Instruments:	Price stability	Maximum employment	Financial stability
Federal funds rate	√	No priority	
Balance sheet	?	No priority	?
Discount window, Bank term funding (lender of last resort)			√

Balance sheet normalization on auto-pilot

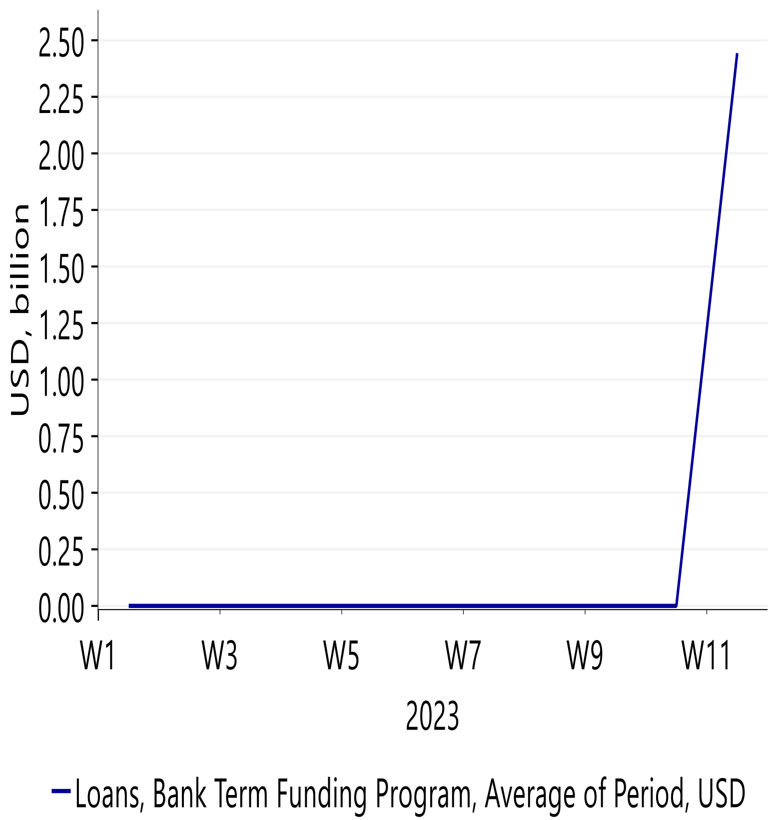
- Fed is fighting inflation primarily by raising the target range for the federal funds rate, but in the background monetary policy tightening is taking place through the balance sheet

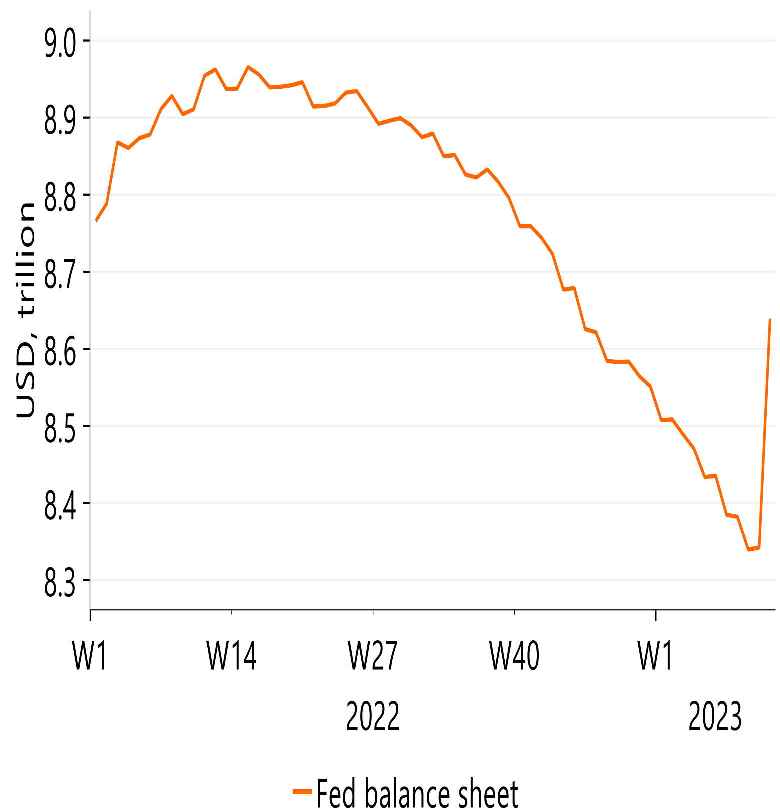
- The balance sheet reduction schedule has remained unchanged since September, with the pace of reduction at $95 billion per month

  - $60 billion in Treasury securities
  - $35 billion in agency debt and agency MBS



Liquidity provision reverses balance sheet normalization





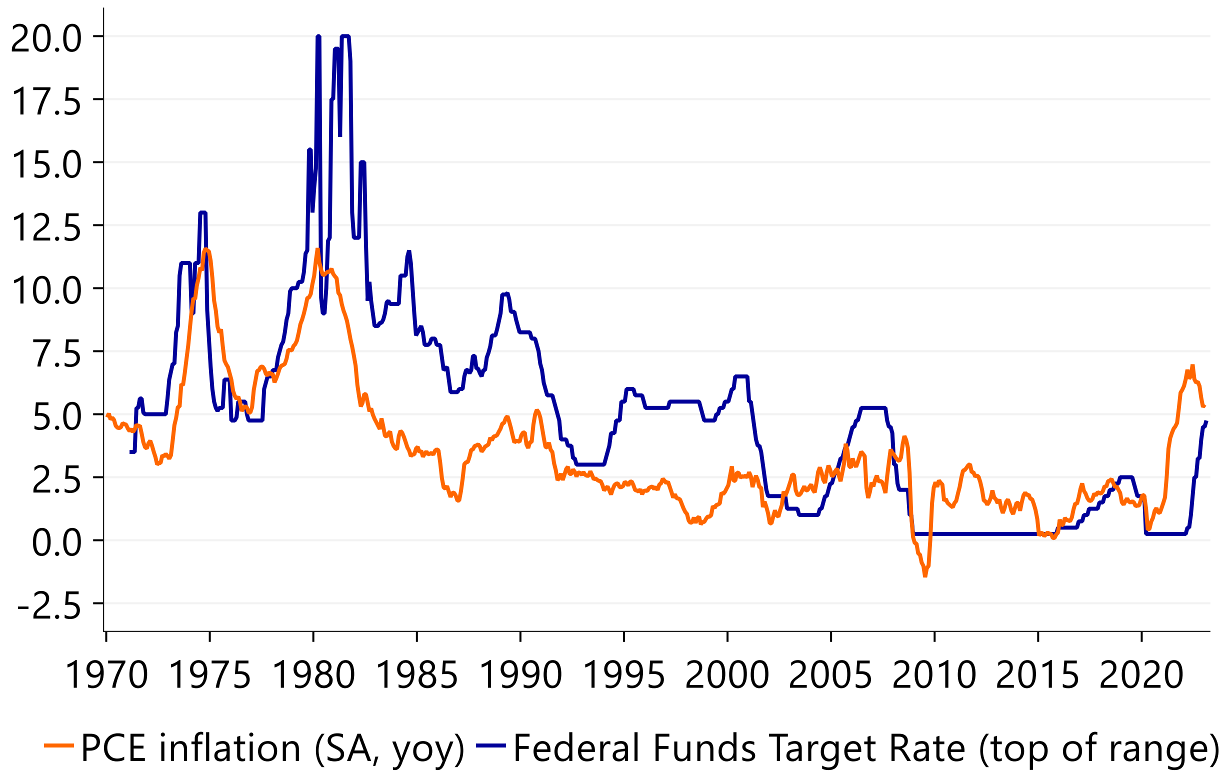
Has monetary policy become ineffective?

- Monetary policy = change real interest rates to steer real aggregate demand:

- Taylor rule (assume unemployment = target or irrelevant):
  - inflation > target -> real policy rate > neutral policy rate
  - Inflation < target -> real policy rate < neutral policy rate

- However, if financial instability prevents Fed from raising real policy rate above the neutral policy rate, then monetary policy is ineffective: central bank cannot use policy rate to control the economy

Real fed funds rate still negative



Conclusion

- Last year, Fed prioritized price stability over maximum employment
- Current financial instability complicates Fed's monetary policy to stamp out inflation
- Fed prefers to use other tools than the policy rate to address financial instability (lender of last resort, balance sheet?)
- However, if financial instability forces Fed to terminate hiking cycle, then monetary policy has become ineffective:
  - either inflation gets out of control
  - or inflation falls because of banking crisis (instead of monetary policy transmission to real economy, but still as a result of Fed's hiking cycle)

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