Observe and Adapt: Appropriate Monetary Policy in the Face of Inflation

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For 30-plus years, the inflation portion of the Federal Reserve's dual mandate has not been a serious concern for most Americans. Ever since Paul Volcker's Fed famously tamed the rampant inflation of the 1970s by raising interest rates well into double digits, inflation has rarely been higher than 3 percent, and often far lower. Indeed, in the eight years since the Fed established a 2 percent level of inflation for the core Personal Consumption Expenditures (PCE) price index as its target, inflation struggled to reach that level.

The COVID-19 pandemic changed that. As bars and restaurants closed, stores shuttered, and people stopped traveling, prices fell sharply. In April 2020, the core PCE price index posted its second largest one-month decline in the history of the series (going back to 1959), and in a few short months, its year-over-year growth rate had fallen by a full percentage point from 1.9 percent to 0.9 percent (from February 2020 to April 2020).

However, the rebound was fast and furious. By late 2021, inflation readings from the core PCE price index and its cousin, the Consumer Price Index, were at levels not seen since those Volcker years.

Though inflation had not been a problem for many years, the Atlanta Fed research staff and I recognized that it could again become a concern. Over the years, we continued to explore ways and develop tools to study and track inflation. With an eye toward training a bright light on the forces that shape inflation, in November 2020, we began to publish the [Underlying Inflation Dashboard](). Our economists had employed this tool for a while, and we made it public to share the important determinants of inflation that we monitor.

Our close attention to underlying inflation dynamics has yielded results. I stated in [the spring of 2021]() that we were on alert for signals that inflationary pressures could persist longer than most expected. We noted starting in early fall last year that upward price pressures had broadened beyond goods directly tied to the pandemic. In [this speech from early October 2021](), I noted that the inflationary episode was unlikely to pass quickly, offered that as policymakers we should thus cease describing it as "transitory," and, finally, argued that inflation warranted a more forceful policy response.

We have since continually canvassed business contacts across the Southeast about their experiences and plans in this higher inflation environment. One unmistakable theme has emerged: firms' responses to what at first seemed short-term problems like supply chain constraints and labor shortages could become permanent shifts that change the long-run trajectory of inflation.

Instead of simply waiting out supply and production problems, many executives are starting to seek new or redundant suppliers. These businesses are changing inventory systems from "just in time" to "just in case," and taking other steps to insulate themselves from future severe supply disruptions. Undoubtedly, many of these efforts involve tradeoffs between efficient, lean production methods and costlier but less vulnerable supply chain configurations. If enough firms take those types of decisions, then they could influence long-run inflation expectations and subsequently actual inflation.

My staff and I have been vocal publicly and within the Federal Open Market Committee about our inflation concerns. We are not alone in that stance, of course. The Committee has moved to quickly end its large-scale asset purchases, and many members including myself have publicly expressed support for taking further measures soon to remove emergency policy accommodation. The economy is strong enough that emergency levels of accommodation are no longer warranted, and, if left in place, they could fuel already-high inflation. So, the primary goal of these latest policy actions is to ensure that longer-run inflation expectations do not become dangerously untethered, lest elevated inflation become cemented into our economy for years to come.

Many of you probably wonder why we pay so much attention to what people think inflation will be. Put simply, the more likely it is that businesses and workers begin to believe that inflation will remain elevated, the more likely they are to alter their habits in ways that can lead to inflation. For example, should workers ask for markedly higher wages because they think the prices of groceries and other staples will rise significantly, then that can lead to increased costs that businesses pass through in the form of, yes, higher prices for those and other goods.

Expectations of high inflation, then, can be self-fulfilling. So, there is a real danger in expectations of inflation over the long haul becoming "unanchored," as we central bankers put it, from around 2 percent and rising to, say, 4 percent or higher.

Our Business Inflation Expectations survey and other sources show that longer-run inflation expectations among businesses and consumers in fact have climbed, but not enough to suggest that expectations are dangerously unanchored. Still, the mostly pandemic-induced episodic price pressures could grind on long enough to fundamentally alter expectations. I definitely worry about that.

In the coming months, I plan to be observant and adaptable as I consider where appropriate policy is going. I will closely observe the upcoming inflation data releases to see if elevated levels are persisting. I'll particularly home in on monthly inflation changes and will be looking to see if they decline steadily over the next couple of months.

As for being adaptable, I will adjust my view of appropriate policy based on my observations. If monthly price changes decline, the risk of longer-run inflation expectations becoming unanchored will fall, which will be good news indeed and should not warrant a change in what I think our policy approach should be, which is currently three interest rate hikes this year. By contrast, if monthly changes remain high or even increase, then inflation expectation risks will rise as well, which would lead me to adjust my view in the direction of more aggressive action. Again, in monitoring inflation, my watchwords are *observe* and *adapt*.