Tom Barkin

Why We Care About Inflation

May 10, 2022

Tom Barkin
President, Federal Reserve Bank of Richmond

Cecil County Chamber of Commerce

Highlights:

- Since the mid-'90s, inflation has been low and stable. But no one is forgetting inflation today. At first, inflationary pressures seemed temporary, driven by pandemic reopening or supply chain challenges like chips in cars. But the inflationary news just keeps coming.
- All of this has depressed consumer sentiment, and business sentiment has fallen too. So, we need to get inflation under control.
- I see inflation coming down on two paths. A number of these pandemic-era pressures will eventually settle. At the same time, interest rates will impact demand and expectations. And, as we act, we send messages to consumers and firms that will manage their expectations for future inflation. All this will take a little time, but make no mistake, we are on the case.

It's great to be with you in person today — and thank you to Debbie and Sharon for inviting me and that nice introduction. I want to spend today talking about inflation. These are my views alone and not those of any of my colleagues on the FOMC or in the Federal Reserve System.

I grew up in the '60s and '70s — an era when inflation emerged and then became omnipresent and painful. A wage and price freeze left supermarket shelves bare. Twin oil crises led to panic at the pump. President Ford issued Whip Inflation Now buttons. You couldn't go anywhere without hearing the Bee Gees — it was a tough time. By the mid-'70s, core Personal Consumption Expenditure (PCE) inflation reached 10.2 percent — nearly twice as high as what it is today.

But in the early '80s, the Fed under Paul Volcker actually did whip inflation. Of course, things got bad before they got better — it was the ultimate hard landing: Unemployment reached nearly 11 percent in 1982. The economy fell into not one, but two recessions. But since the mid-'90s, inflation has been low and stable. And the Fed learned a hard lesson: the role inflation targeting plays in delivering anchored inflation expectations, thereby creating a healthy foundation for the economy.

I have a theory that memory matters. Recessions happen every 8-10 years because that's how long it takes for a leadership team to rotate, believe they know better and then repeat the errors of their predecessors. Real estate lenders overreach every 15-20 years (1970s, 1990s, 2000s) as credit officers turn over and memories fade. The Roaring '20s, the Go-Go '60s and the internet bubble of the early 2000s perhaps demonstrated that market memories only last 30-40 years. And after 30 years of price stability, maybe the same thing happened with inflation. Prior to the pandemic, the focus was on how to move inflation up, not down. The Phillips curve came into question. Virtually no professional forecaster predicted the high, persistent inflation we've been experiencing.

Well, no one is forgetting inflation today. The most recent Consumer Price Index is 8.5 percent. The headline PCE, our preferred metric, is 6.6 percent. Core PCE is at 5.2 percent. Demand is strong and looks to remain robust, fueled by healthy business and personal balance sheets, the need to replenish low inventories and state governments that are flush with cash. Supply chains have been overwhelmed, and suppliers are struggling to bring them back into balance. Labor markets are also tight: Unemployment has dropped to 3.6 percent. In addition, the pool of available labor has shrunk: 1.2 million fewer workers are in the workforce, and immigration remains well below its pre-COVID-19 trend.[1] As a result, price pressures are everywhere. Inflation is high, persistent and broad-based.

At first, inflationary pressures seemed temporary, driven by pandemic reopening or supply chain challenges like chips in cars. But the inflationary news just keeps coming, whether it is a severe winter storm in Texas, a fire at a chip plant in Japan, a ship lodged in the Suez Canal or a backlog in Long Beach. And, of course, most recently, we've seen commodity price shocks coming out of the conflict in Ukraine and new lockdowns in China. These have made inflation the headline of the day — as of May 1, the *Wall Street Journal* has had an inflation story on its front page 25 times this year. And on social media, a widely shared post jokes that in 2020 we couldn't leave the house because of COVID-19; now, we can't leave because of skyrocketing gas prices.

All of this has depressed consumer sentiment. In the most recent Michigan Survey, the overall index of consumer sentiment (April - 65.2) was at levels last seen in the aftermath of the Great Recession and is below where it was at the height of pandemic lockdowns. That is remarkable given the strength of the economy and the job market. But sentiment is being driven heavily by inflation. Respondents expect the year-ahead inflation rate to remain high at 5.4 percent. The last two months have had the highest expectations since 1981. Thirty-eight percent say they're in a worse financial position than they were a year ago. Buying conditions for purchasing a car, a house or an appliance are at their lowest levels since the early '80s.[2]

Business sentiment has fallen too. In the Richmond Fed's most recent CFO Survey (conducted in partnership with Duke and the Atlanta Fed), optimism about the U.S. economy dropped nearly 6 points from the fourth quarter of 2021. CFOs cited cost pressures and inflation as their top concerns. When looking at small-business owners, optimism is even lower. In March, owners who expect better business conditions over the next six months dropped to the lowest level in the survey's history. Like the CFOs we surveyed, inflation was their top business problem.

We now remember that people thoroughly dislike inflation. Workers who feel they have earned their wage gains feel arbitrarily pinched at the gas pump. Homeowners like their sale price but can't believe their purchase price. Businesses work to capture value through pricing but feel they're being taken advantage of by suppliers. They feel powerless in the face of cost increases that tax their revenues, earnings and appreciation they have worked to achieve.

Why do people hate inflation? Well, no one likes to deal with change, and we haven't had to think about inflation for over a generation. And no one remembers the '70s fondly. Inflation creates uncertainty — as prices rise unevenly across sectors and over time, it becomes unclear when is the right time to spend versus save and where to invest. Inflation is also inherently redistributive — in the '70s, those who owned a house with a cheap mortgage benefitted; those on fixed incomes didn't. Those who had wages indexed to inflation did better than those who didn't. And inflation adds to your workload. It takes effort to shop around for better prices. Businesses have to handle complaints from unhappy customers, negotiate with insistent suppliers and address any resulting margin pressure. Finally, Robert Shiller taught us that people feel inflation erodes their standard of living by diminishing their buying power, whether it raises their nominal income or not. Higher prices mean you can buy less.

The pain of inflation tends to hit low- and fixed-income populations the most. Low-income households dedicate a higher percentage of their wages to consumption than those with higher incomes. There are estimates that the average U.S. household will have to spend over $5,000 more this year compared to last year for the same consumption basket, and that impacts those who have a tighter monthly budget.

To be clear, not everyone loses with inflation. We have sectors where nominal wages are up well in excess of inflation, like leisure and hospitality. We have a lot of homeowners whose houses are worth much more than they could have imagined. And a number of firms reported record profits last year. But it doesn't matter — everyone hates inflation.

So, we need to get inflation under control. Congress has given us this mandate. And it's time.

We can't do much about short-term price surges. Think of it like the aftermath of a hurricane. Lumber prices increase temporarily as demand spikes for materials to make necessary repairs. Raising rates wouldn't lower lumber prices when people need to rebuild their homes. Instead, when supply catches up to demand, these price movements reverse themselves.

But in the medium term, our moves matter. So, we have begun a tightening process. We raised interest rates 25 basis points in March and then another 50 basis points in May. We also announced our plans to reduce our balance sheet, starting on June 1. During his press conference, Chair Powell noted that additional 50 basis point increases could be on the table in coming meetings as we work to normalize rates.

We will do what we need to do to contain inflation. But how exactly will our rate moves do that? I see inflation coming down on two paths. A number of these pandemic-era pressures will eventually settle. Chips will finally get into cars, and car prices will come down. Labor force participation will continue to rise as COVID-19 eases. Ports will open up as consumers rotate back from goods to services. At the same time, interest rates will impact demand and expectations. Borrowing rates have already risen, and that will affect investment levels and spending on interest-sensitive items like houses and cars. And, as we act, we send messages to consumers and firms that will manage their expectations for future inflation. All of this will take a little time, but make no mistake, we are on the case.

You might ask if this path requires a Volcker-like recession. Not necessarily. At 83 basis points, we are still far from the level of interest rates that constrains the economy; for my colleagues on the FOMC, this neutral rate is in the range of 2-3 percent. And before the Great Recession, the economy handled rates even higher than that. Once we get in the range of the neutral rate, we can then determine whether inflation remains at a level that requires us to put the brakes on the economy or not.

Inflation is high. It has real costs to both individuals and businesses. By contrast, getting inflation closer to the target rate creates the certainty that enables growth and supports maximum employment. That's why we care, and that's why we are tackling it.