Inflation Risks and Monetary Policy

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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:**

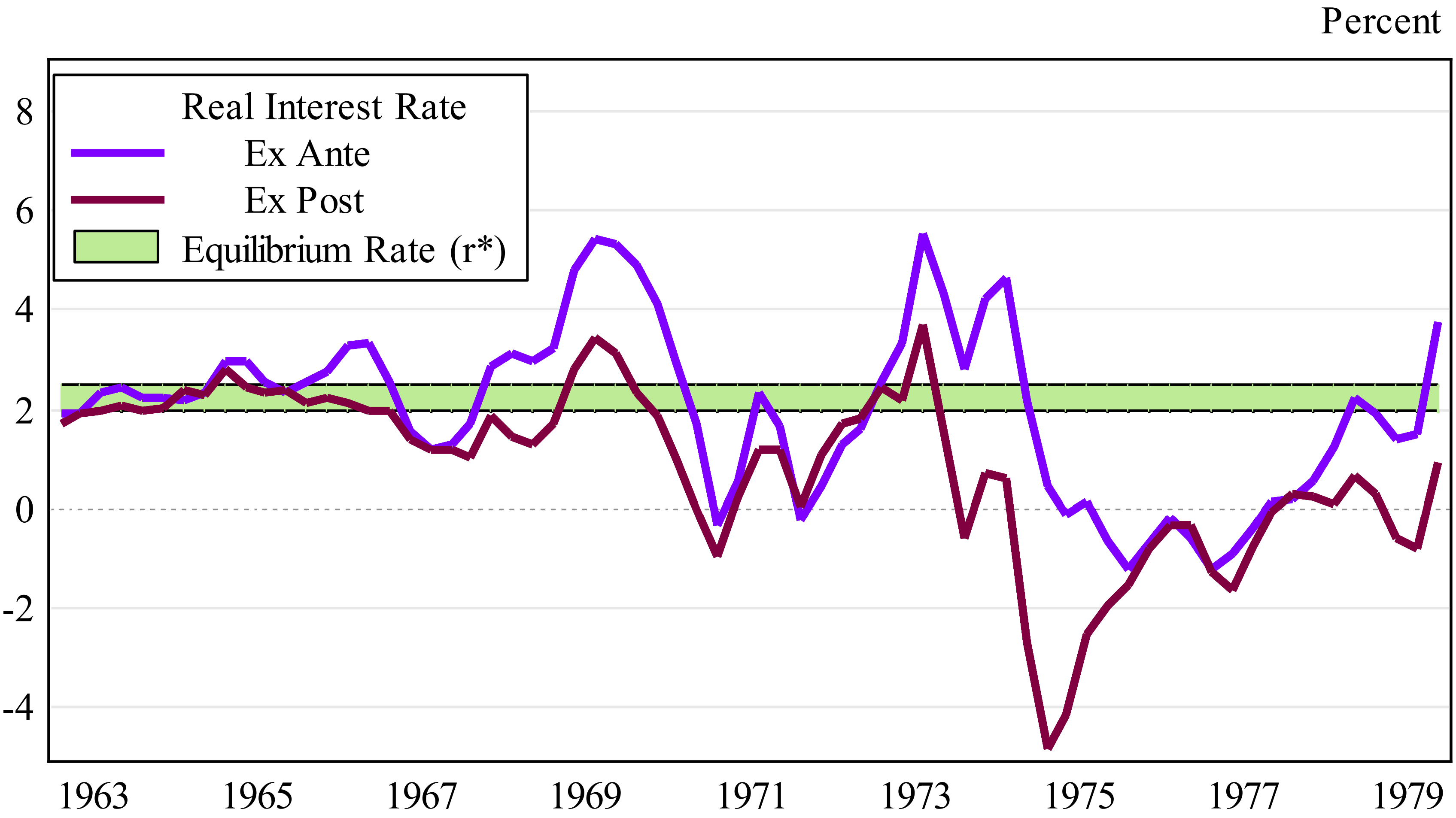
https://www.federalreserve.gov/monetarypolicy/monetary-policy-principles-and-practice.htm

Measures of Inflation

(annual rates, percent)

Indicator	2019 Average	Latest 6 Months	Change
Core PCE	**1.7**	**5.0**	**+3.3**
Core CPI	**2.2**	**5.8**	**+3.6**
Narrow Core CPI (ex. food, energy, shelter, used cars)	**1.4**	**4.7**	**+3.3**
Federal Funds Rate	**2.2**	**0.1**	**-2.1**
Real Fed Funds Rate	**0.5**	**-4.9**	**-5.5**

The Stance of Monetary Policy during the Great Inflation

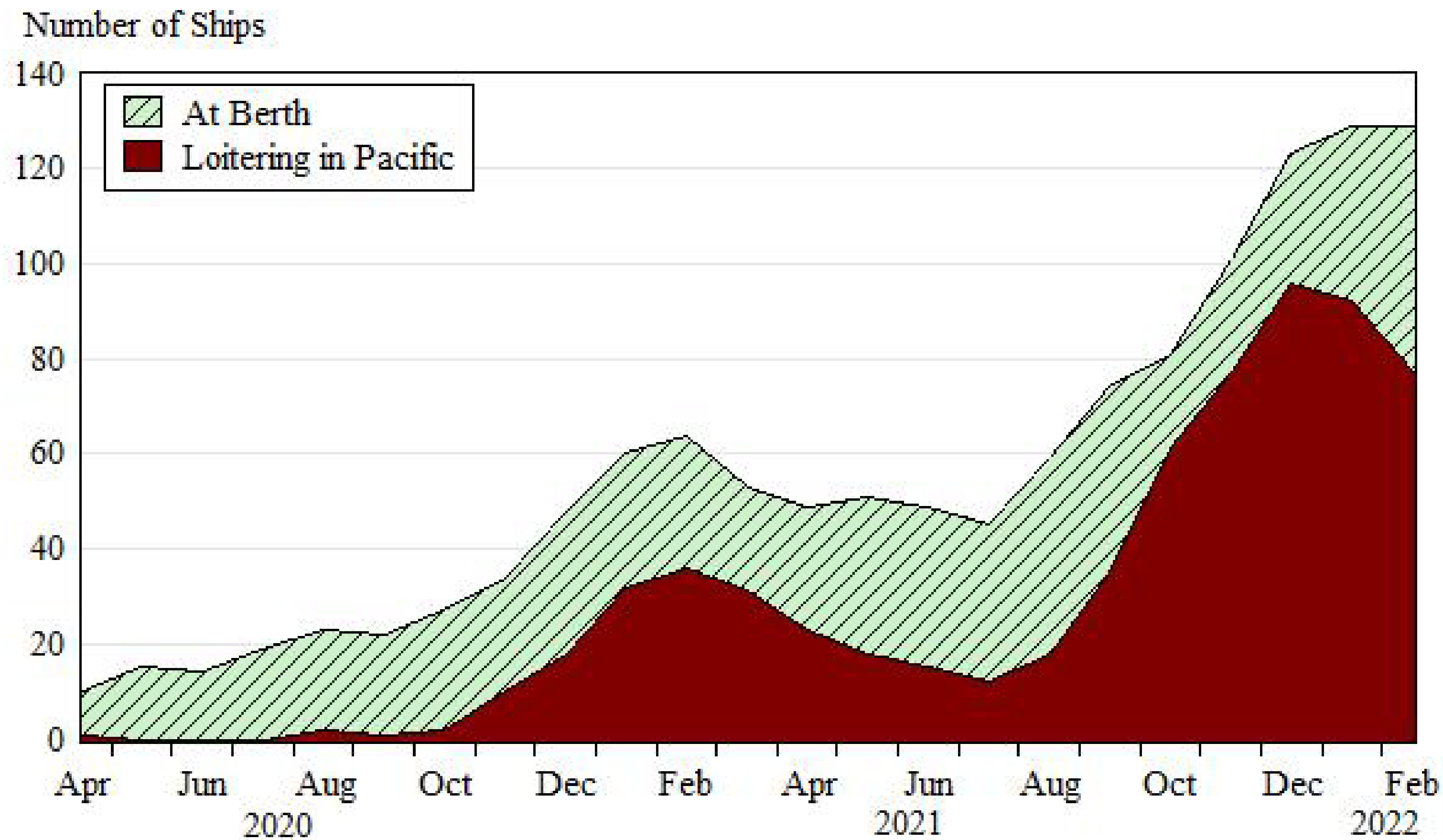


Source: Levin and Taylor (2013), figure 4.6

Assessing the Inflation Outlook

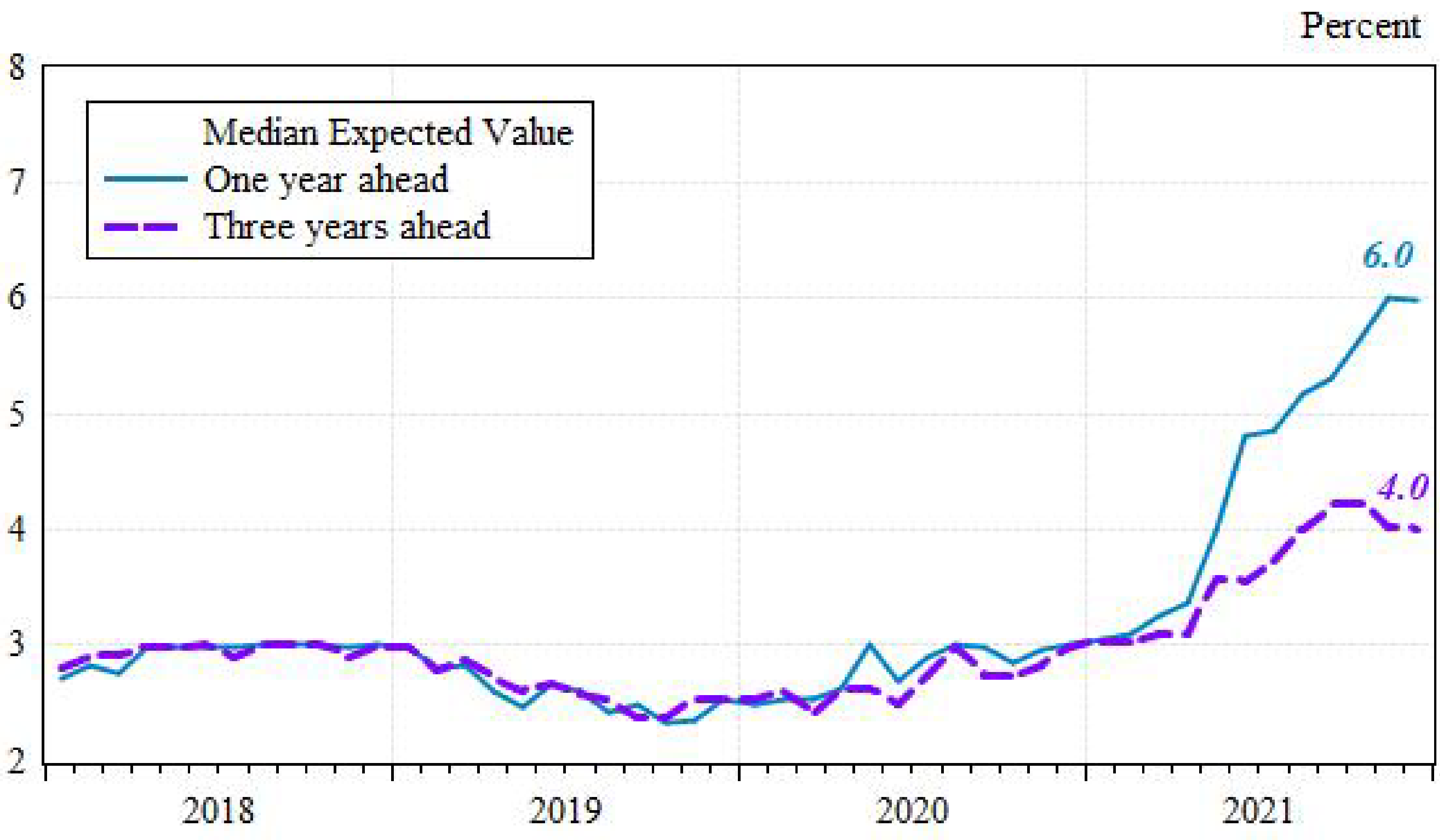
- **Goods Prices**: supply chain tangles will only be unraveled gradually, just like an auto traffic jam.
- **Services Prices**: subsidence of omicron will likely expand demand faster than supply.
- **Shelter**: see Levy (2022).
- **Nominal Wage Growth**: workers seeking cost-of-living increases in a 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



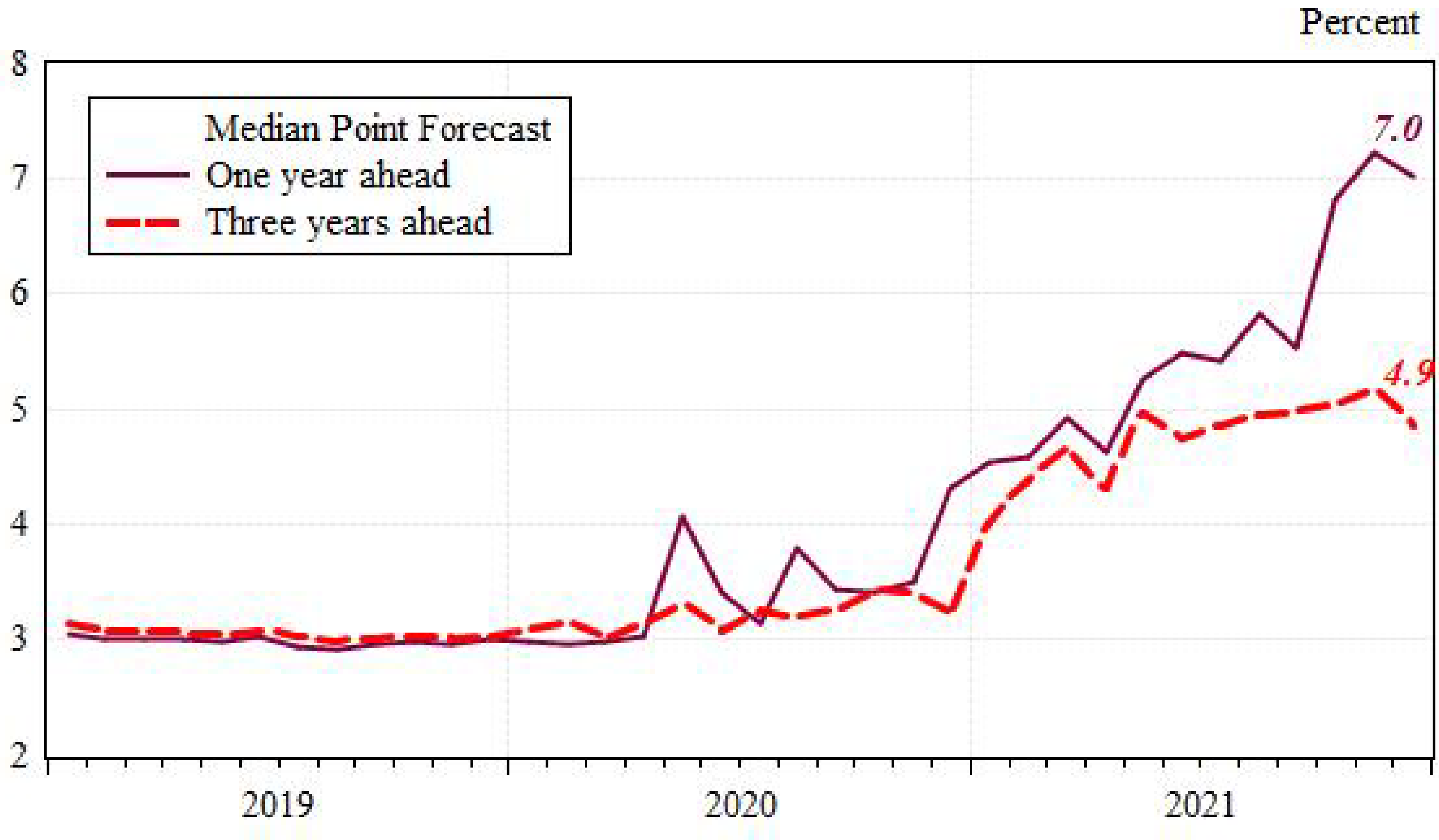
Source: Marine Exchange of Southern California, courtesy of American Shipper (posted at freightwaves.com on 12/5/2021).

Assessments of Consumers' Expected Inflation Rates



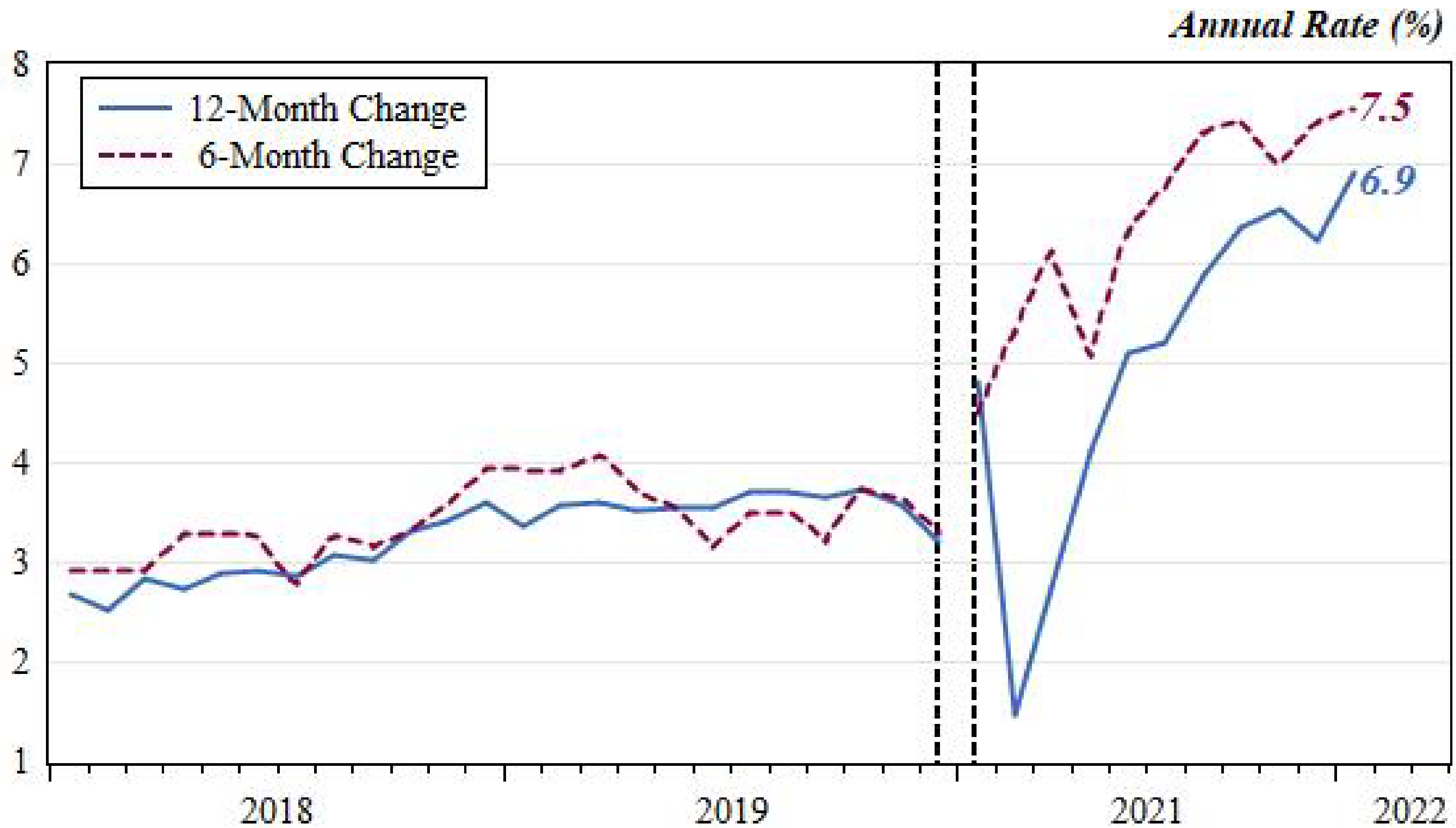
Source: Federal Reserve Bank of New York

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.**