 Equitable Growth

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Inflation and macroeconomic outlook, 2023

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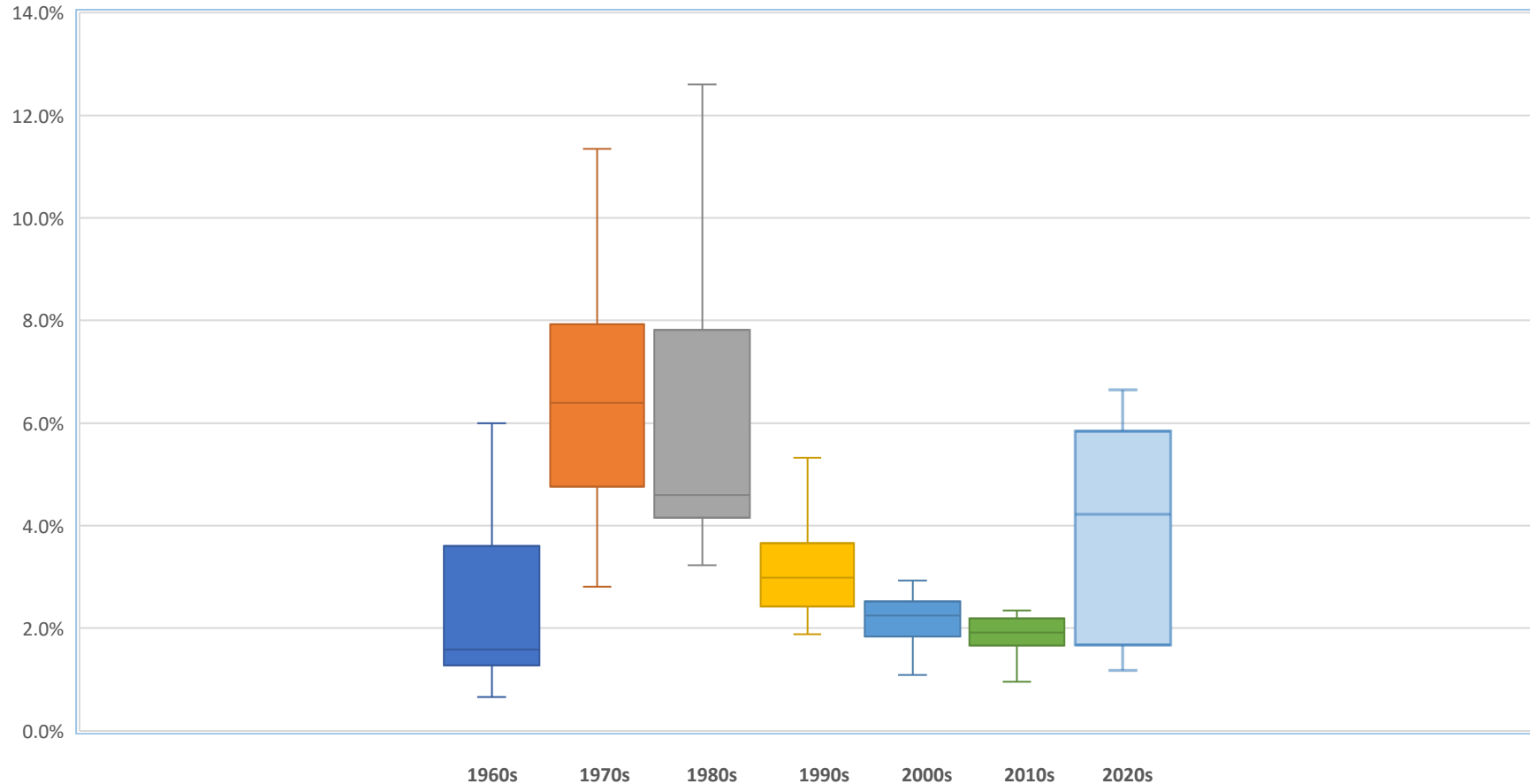
**Director of Macroeconomic Policy at the Washington
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What we will cover today

- 1) **Why do Human People care about inflation?**
- 2) **Why do Economists care about inflation?**
- 3) **What is inflation? why it does not happen in a vacuum**
- 4) **What do we expect this year, what does it mean for economic policy?**

Why we stopped caring about inflation & why it's back

Annual Inflation Range by Decade



Why do people care about inflation?

Higher prices hurt

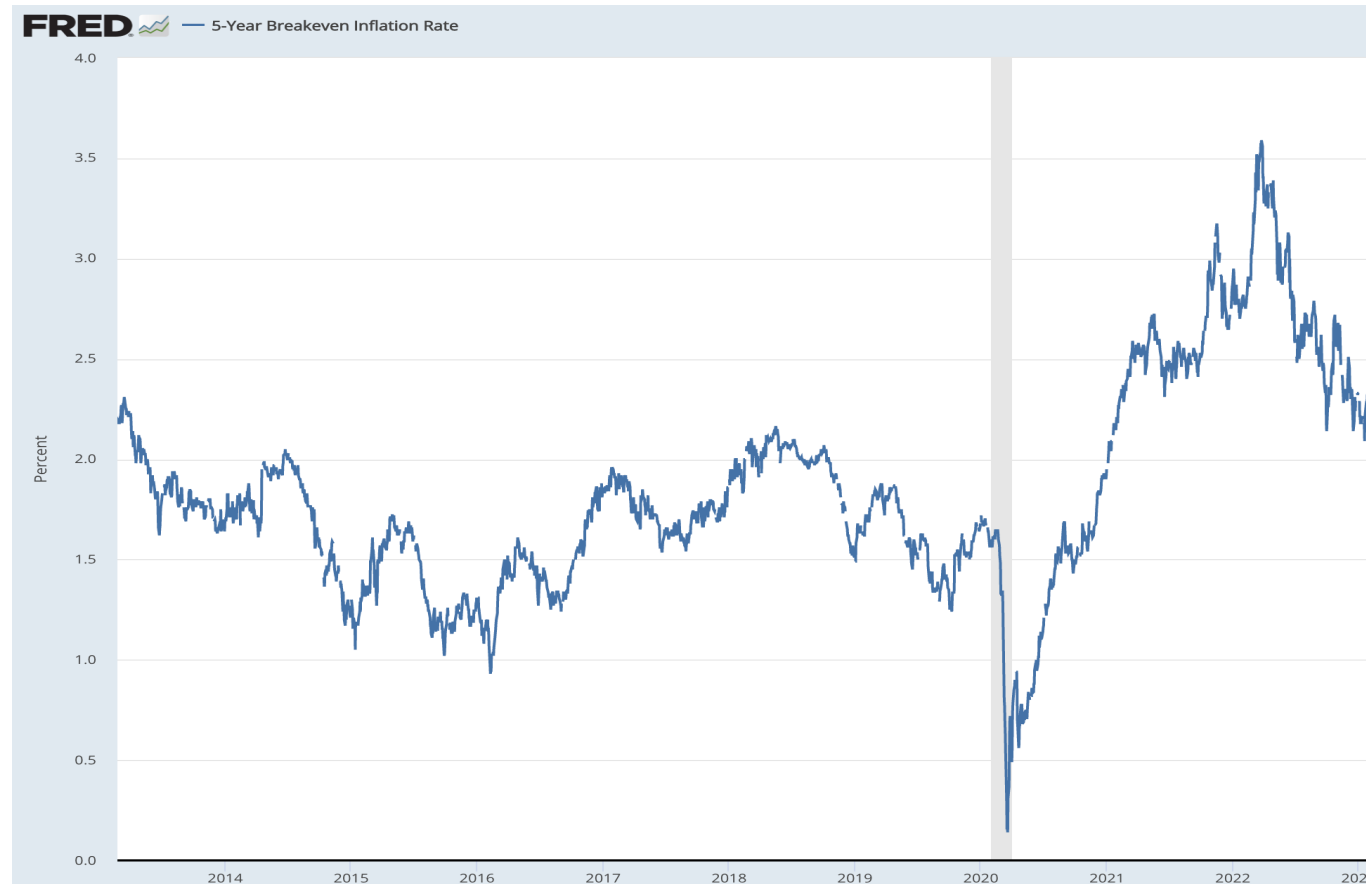
- 1) Higher prices are one of the **most visible** economic indicators.
- 2) Higher prices **impact everyone**, though impacts can be very unequal.
- 3). People **don't** see **higher prices** connected to **higher wages/incomes**

Why do economists care about inflation?

They don't! They care about **Expected inflation**

- **1) Inflation: If the price of everything goes up by 5%...**
- **2) Expected inflation: Affects **future inflation**.**
- **3). Inflation still creates winners and losers, but—**thanks to policy changes**—much fewer than in the past**

Inflation from 2020-2022: inflation expectations stayed much lower than actual inflation, deviations from target were similar to previous recovery:



Inflation from 2020-2022: both supply and demand shocks drove inflation up over this period, studies differ on exact apportionment, but this should not be surprising. For example:

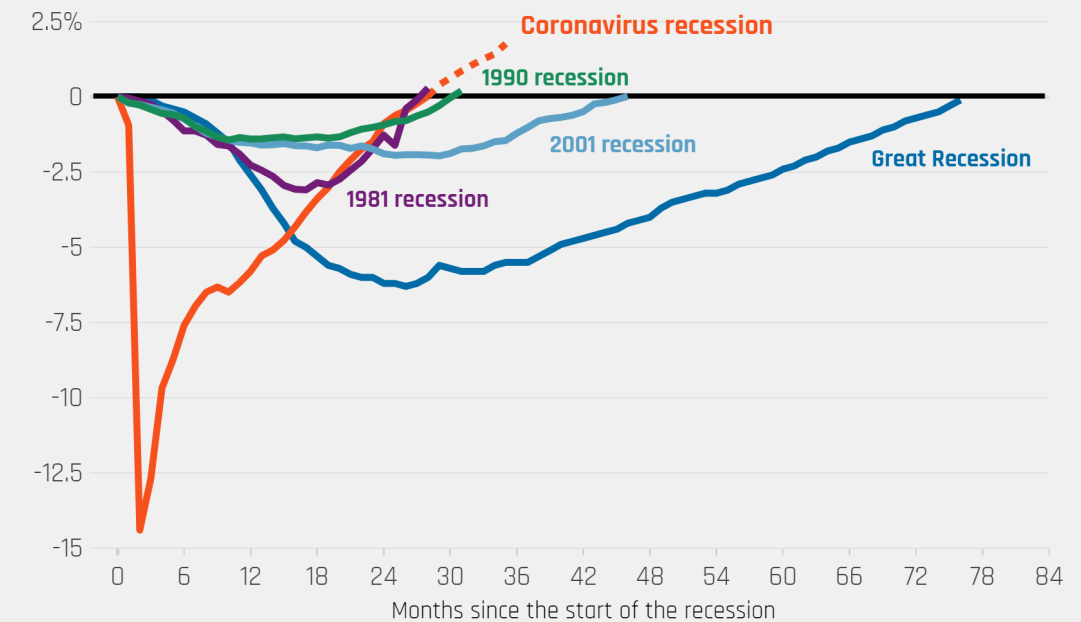
- **Supply & demand factors nearly balanced** ([San Francisco Fed](#))
- **Global supply pressures contribute significantly to US PPI & CPI** ([NY Fed, January 2022](#))
- **Roughly 2/3 demand shock, 1/3 supply shock in 2022** ([NY Fed, August 2022](#)).
- **Overkill was the plan:**
“the risks of overdoing it seem, for now, to be smaller” ([Jay Powell, October 2020](#))

Understanding inflation requires **Earth 2 comparisons**, We would all like **this recovery** without inflation, but:

- **This is the strongest economic recovery in at least a generation, A weaker recovery would have lowered inflation**
- **Low inflation in the last recovery was not a positive, a grinding recovery destabilized lots of things**
- **CBO scores this recovery & inflation as better for the economy**

Employment recovered much more quickly after the coronavirus recession than after previous recessions

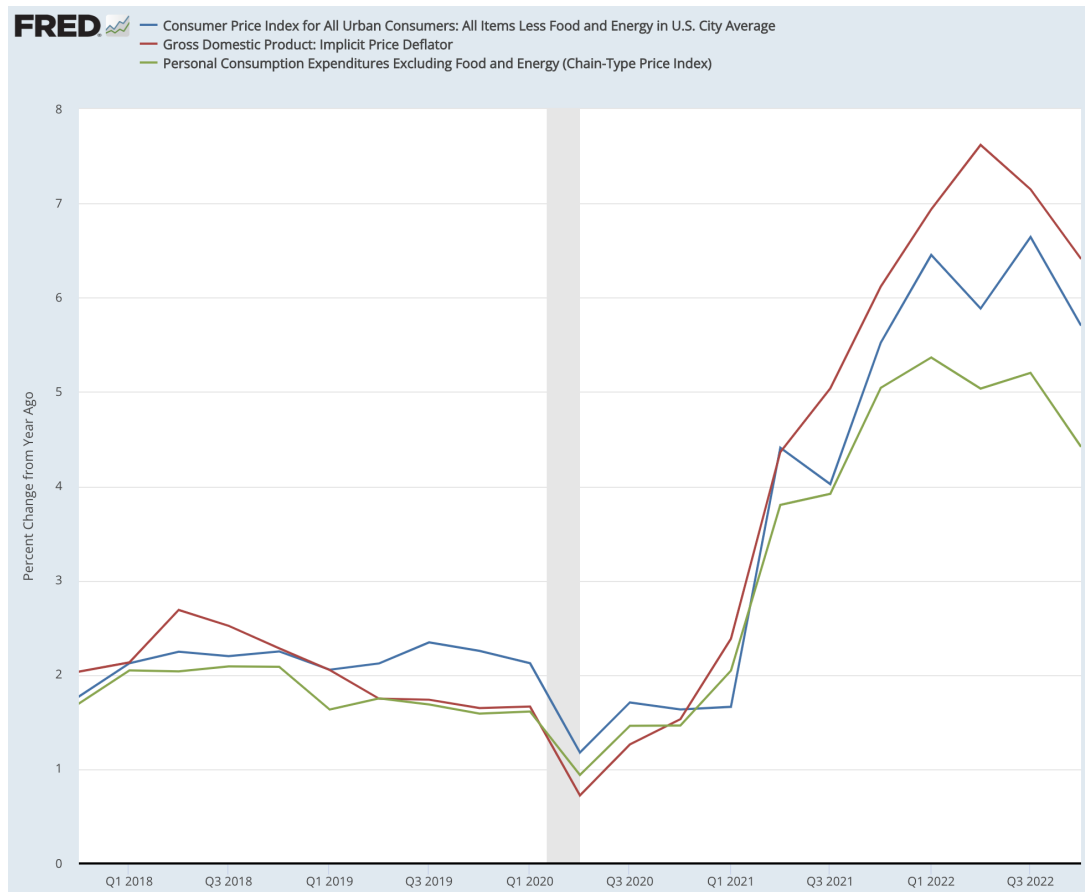
Percent loss in employment since the start of the recession



Source: U.S. Bureau of Labor Statistics, retrieved from Federal Reserve Bank of Saint Louis, "All Employees, Total Nonfarm," [n.d.] available at <https://fred.stlouisfed.org/series/PAYEMS>.

What is Inflation?

Which one are we talking about?



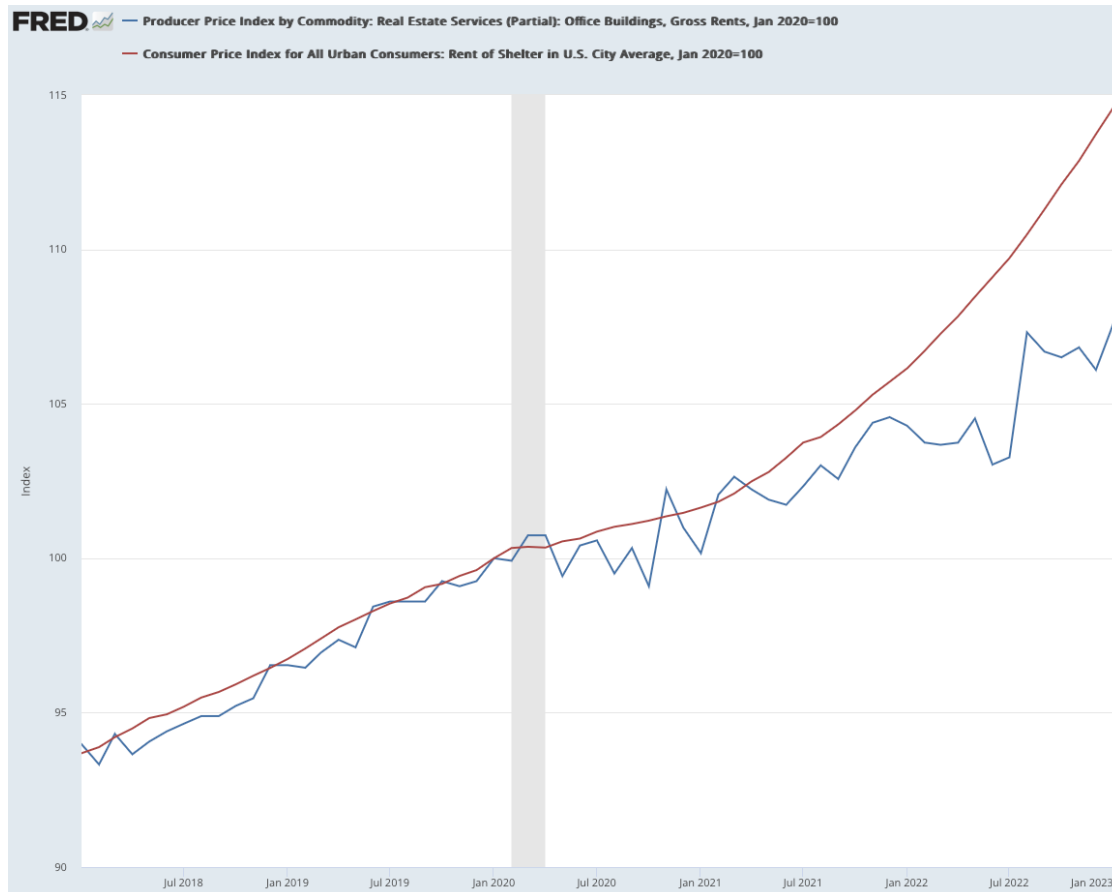
Policy debates focus on **consumer prices** (Roughly 60% of economy)

- **Consumer prices matter for**
 - **expectations**
 - **wage demands (historically)**
- **Bespoke measures**
 - **For clarification**
 - **For narrative purposes**

Inflation measurement is very precise, Inflation concepts can be messy

- **Housing** [40% of core CPI]
 - Rent (lags)
 - Owner Housing (lags, is fake)
- **Persistent** sectors likely to drive **future** inflation
 - Median inflation
 - Trimmed mean CPI
 - Sticky price inflation
 - Historically Healthcare, Housing
- **Central** prices likely to drive **wider** inflation
 - Energy
 - Wages

Inflation with shifts in[to] consumer prices



Substitution between household goods **lowers long-term inflation**

- **Office rents are not consumer prices**
- **Home office rents are consumer prices**

Inflation Going Forward: choppy, slowing

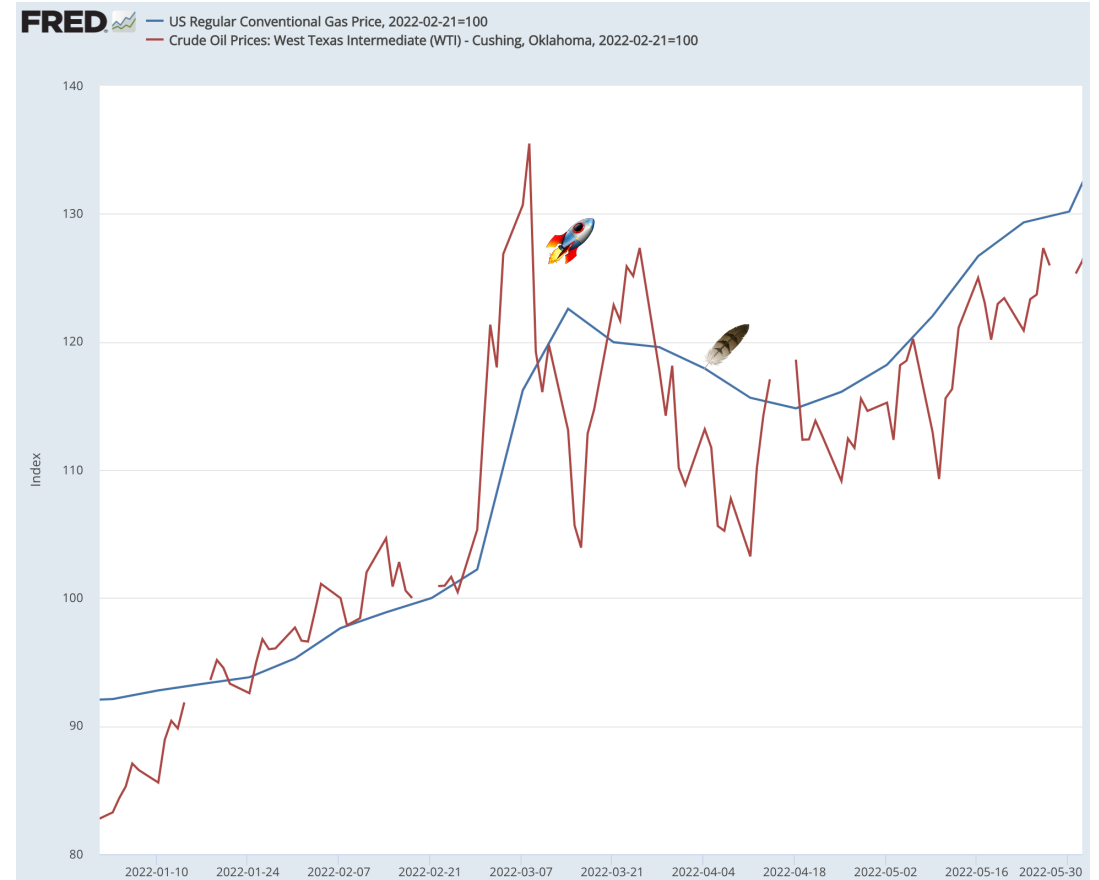
- **Market expectations: large decline in expected inflation** (2, 5, 10 year)
- **Fed** remains very hawkish in tone
- **Inflation tailwinds**
 - **housing** (as measured CPI)
 - **Diesel prices**
 - **Gasoline matters for consumer expectations**
- **Headwinds**
 - **Services inflation**
 - **Possibly wage growth** (absent faster productivity)

Better understanding of individual prices than aggregate inflation

Oil market prices vs Consumer Gasoline prices following War in Ukraine

 **Everyone loses at first** 

 **Profits rise as prices fall** 



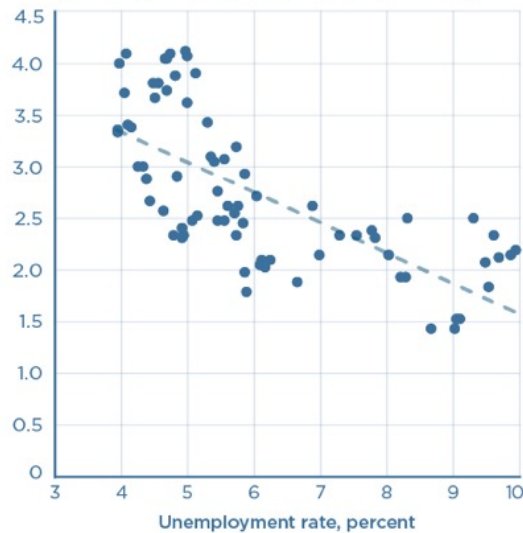
Where does **inflation land** & what's next?

- **Most forecasts say inflation falls to 3.x% by end of 2023**
- **Fed wants inflation at 2.0%, but has said little about patience so far**
- **Fed credibility is important, speed of slowing is the next debate**
- **Important to connect inflation to broader economy**
 - **Wage growth, especially for lower incomes ([Richsession](#))**
 - **Social Security COLAs (>15% over last 2 years)**
 - **Record low Unemployment**

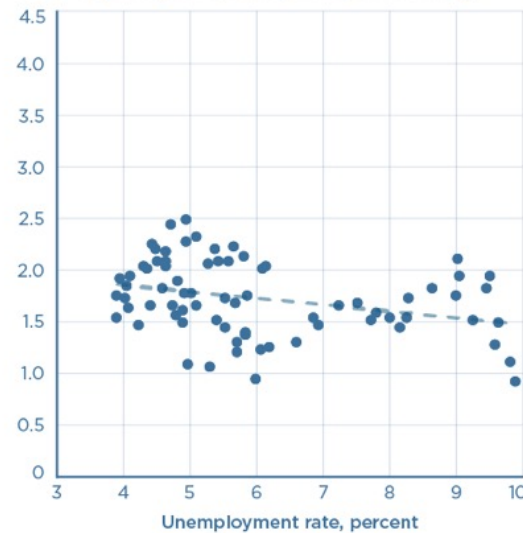
How much does inflation today tell us about future inflation ?

Wage growth appears more responsive to changes in the unemployment rate than price growth since 2000

Average hourly earnings growth for production and nonsupervisory workers, four-quarter percent change



Core PCE price growth, four-quarter percent change



Note: Dotted line is linear trend.

Sources: Bureau of Labor Statistics; Bureau of Economic Analysis; Haver Analytics; author's calculations.

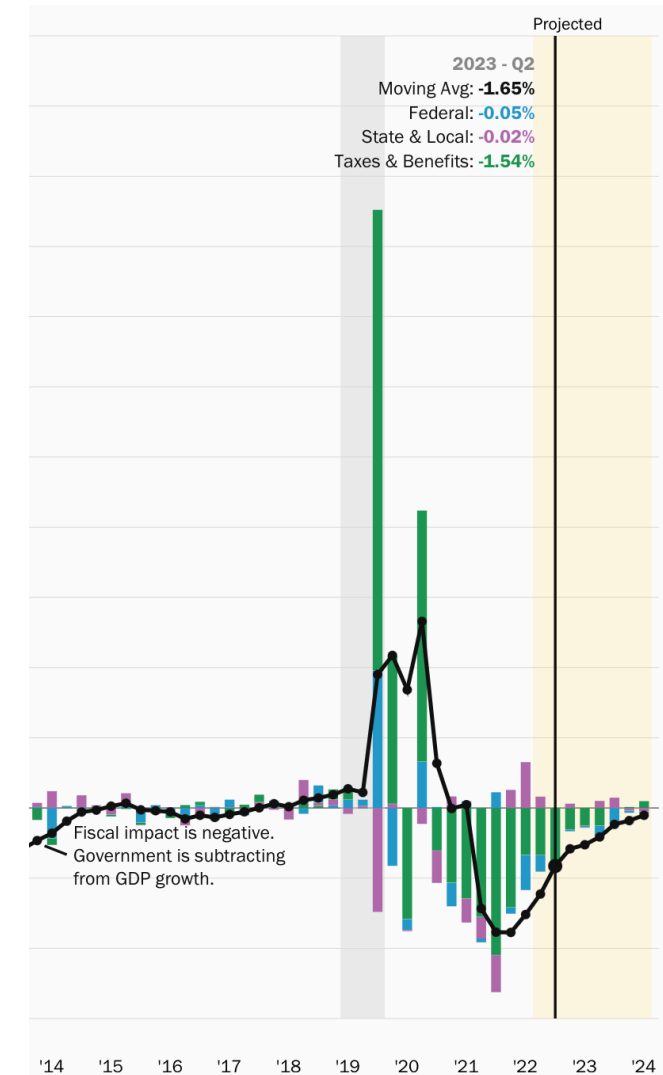
- Broad consensus **price anchoring** broke this relationship pre-pandemic
- New Debate: was this
 - Luck?
 - Modern Central Banking?
 - Other

Source: [Furman, 2019](#)

What does all this mean for public policy?

First, take the wins!

- **Legislation fixed major inflation costs for families and the economy,**
 - **Social Security Benefits are up ~15% over last 2 years**
 - **Indexed tax brackets are lowering taxes on middle class earnings**
- **Legislation is lowering Inflation in 2023, shrinking spending is lowering GDP > 1% over 2023 [[Brookings](#)]**



What does all this mean for public policy?

Austerity is not the answer to inflation, but there are good ideas!

- **Fix IRS treatment of TIPS bonds to provide better market forecasts of Expected inflation**
- **Invest in lowering costs for the future**
 - **short-term [inflation] pain for long-term gain**
- **Clean energy investments can reduce inflation volatility**