Inflation and macroeconomic outlook, 2023

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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

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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

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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.

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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

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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 \([2, 5, 10\text{ year}]\)

- **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)

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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 🪶

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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?

- 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]

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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**