INFLATION ALERT:

Thoughtful Article by Bill Dudley, former President of the Federal Reserve Bank of New York

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I've lately been arguing that financial markets could be in for a surprise in the form of higher-than-expected U.S. inflation. But let me be clear: This doesn't mean that it will spiral out of control or soon undermine the post-pandemic recovery.

Many forces are converging to push prices upward. The Biden administration and Congress are preparing a big fiscal stimulus package, and the Federal Reserve is aiming to provide enough monetary stimulus to push the inflation rate above its 2% long-term target. Meanwhile, the gradual easing of social distancing is set to release a lot of pent-up demand for everything from restaurants to travel and tourism, which recession-damaged businesses--many oriented toward a pre-pandemic economy--will initially struggle to satisfy.

So inflation is likely to head higher. But let's not overreact. There are also plenty of reasons to believe that things won't get out of hand, at least not quickly. First, the economy is still a long way from operating at capacity, the point at which inflation pressures are likely to become problematic. The U.S. is still about 10 million jobs short of full employment--a gap that will take time to close, as people who have stopped looking for work come off the sidelines and back into the labor force.

Second, inflation is a slow-moving process. The economy would have to run hot for a long time to push inflation significantly higher. Consider what it took to generate the double-digit inflation of the late 1970s: First the guns-and-butter spending of the Vietnam War and Lyndon Johnson's Great Society program, then the Nixon administration's wage and price controls, then two big oil-price shocks.

Third, when people are accustomed to low inflation, their expectations are well-anchored. In that situation, it takes a lot to change their expectations and behavior. Workers and businesses need to see inflation stay high for a while before they start expecting higher wages and charging higher prices, setting off a self-reinforcing upward spiral. In economics parlance, the short-run Phillips curve is very flat: Inflation doesn't initially accelerate much, even at very high levels of employment.

Fourth, the Fed has tools to keep inflation in check. Even if inflation moves a bit above 2% for a while, all the central bank needs to do is tighten monetary policy by raising short-term interest rates. True, it has pumped a lot of cash into the banking system by buying trillions of dollars in Treasury and other securities, but

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it can easily control how much gets lent by adjusting the interest rate it pays on bank reserves. This is why Fed officials are comfortable with their current, extraordinarily accommodative policy. Worries that rapid growth of bank reserves will result in higher inflation are misplaced.

The coming inflation cycle is likely to play out in three stages. In stage one, this year, the year-on-year inflation rate will rise as higher readings from early last year drop out of the comparison, and as increasing demand for services meets constrained supply. Fed officials have signaled that they will not react to this rise, because they view it as likely to be transitory.

Stage two will be the march back to full employment. This will happen much faster compared with the recovery from the 2008 financial crisis. Not only will the end of the pandemic lead to a snapback in activity, but also household finances, in the aggregate, are in much better shape compared to the prior business cycle. Although the lack of experience with post-pandemic recoveries makes predictions particularly fraught, this stage might take a year or two. During this time, the Fed will gradually taper asset purchases to zero, but keep short-term interest rates unchanged.

Stage three will arrive when the economy reaches full employment, and inflation has reached 2% and is expected to keep climbing. At this point, the Fed will start increasing short-term interest rates. The tightening process will probably have to happen quite briskly--perhaps at a rate of about 2 percentage points a year--given that there will be a long way to go from near zero to a level that would make monetary policy restrictive. If inflation were to surprise on the high side, the Fed might have to move even faster.

Ultimately, the process should leave U.S. interest rates higher than they've been in a long time. The bad news is that the transition will likely be painful for financial markets. The good news is that the Fed will have more firepower to fight the next recession.

Source: Bill Dudley, Bloomberg News

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