# Can the Fed bring inflation down alone?

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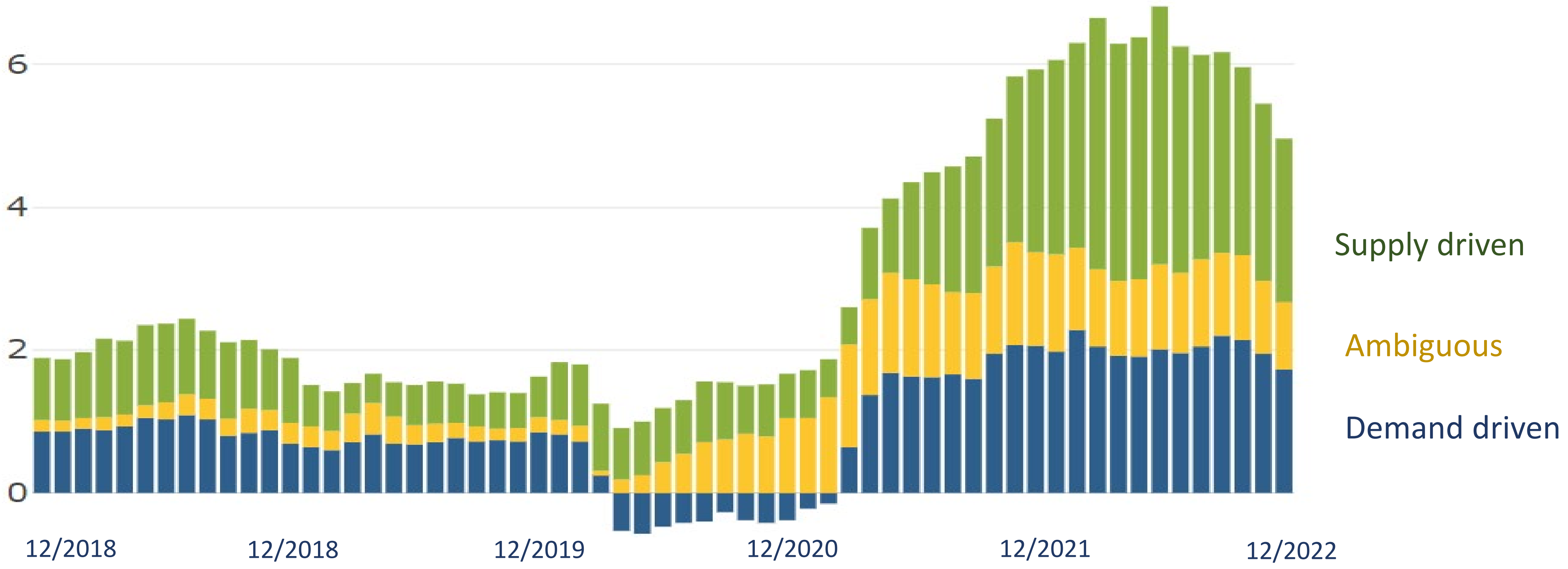
# Key Takeaways

- The Fed's interest rate tools are best suited for demand-driven inflation.
- Covid and the war in Ukraine caused supply-driven inflation
- Financial markets pass along the Fed's rate, but they don't always agree.
- Household finances are good, so interest rates are affecting demand less.
- It's best to solve labor shortages with more workers than fewer customers.
- Congress and the White House have tools to solve supply-driven inflation.

# Covid and Putin led to supply-driven inflation

12-month percent change in total U.S. Personal Consumption Expenditures.

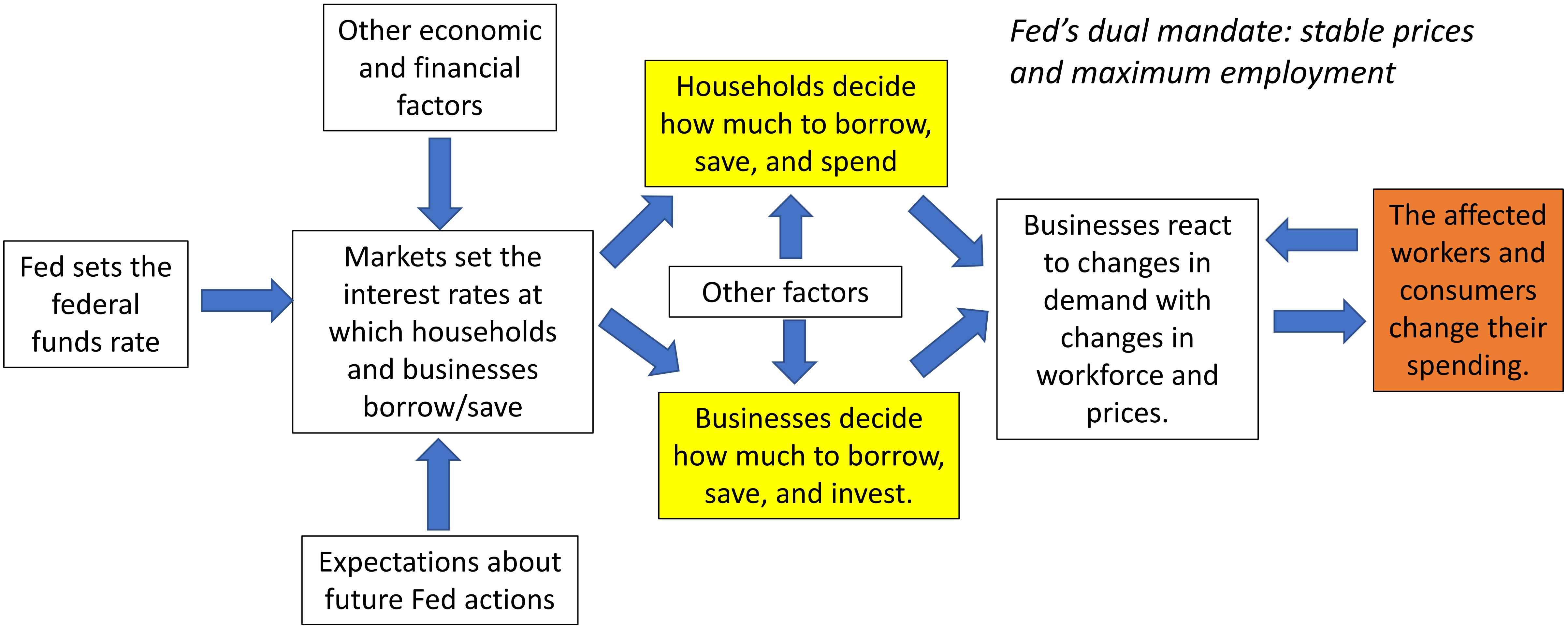



Source: Adam Shapiro, San Francisco Fed.

- The Fed can push down demand with higher rates, but it can't push up supply.
- In fact, higher rates may depress supply, such as housing construction.

# The Fed’s tools are imprecise and depend on others

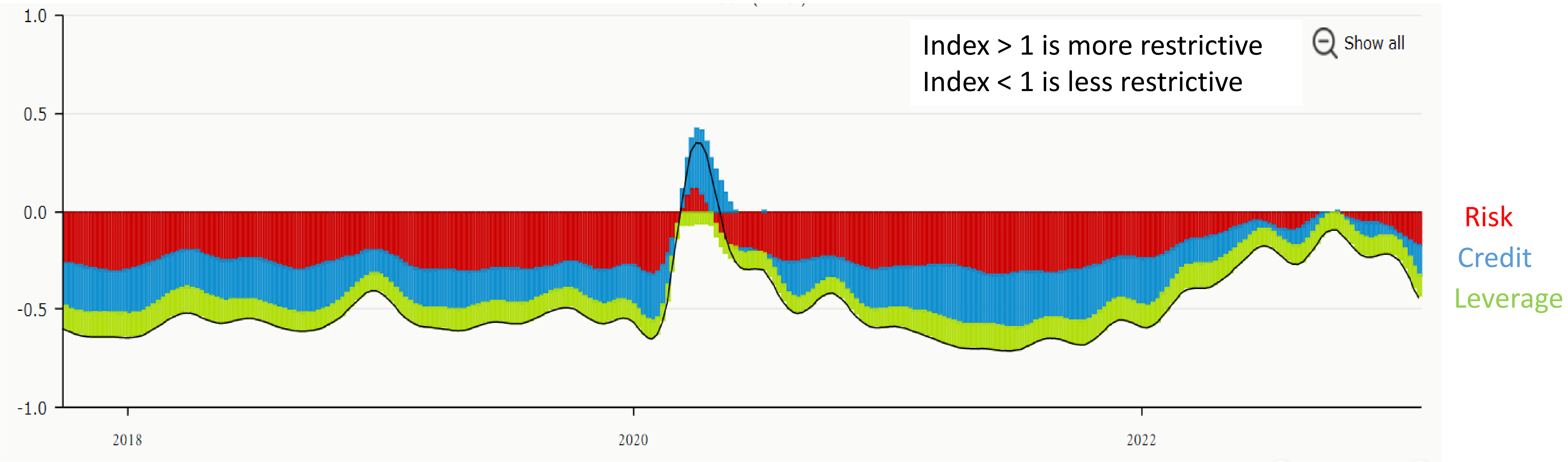
# Federal funds rate works through demand




- There are several steps. The Fed does not control to affect demand.
- The Fed's tools are blunt, take time to work, and are hard to calibrate.

# Financial markets can disagree with the Fed

National Financial Conditions Index

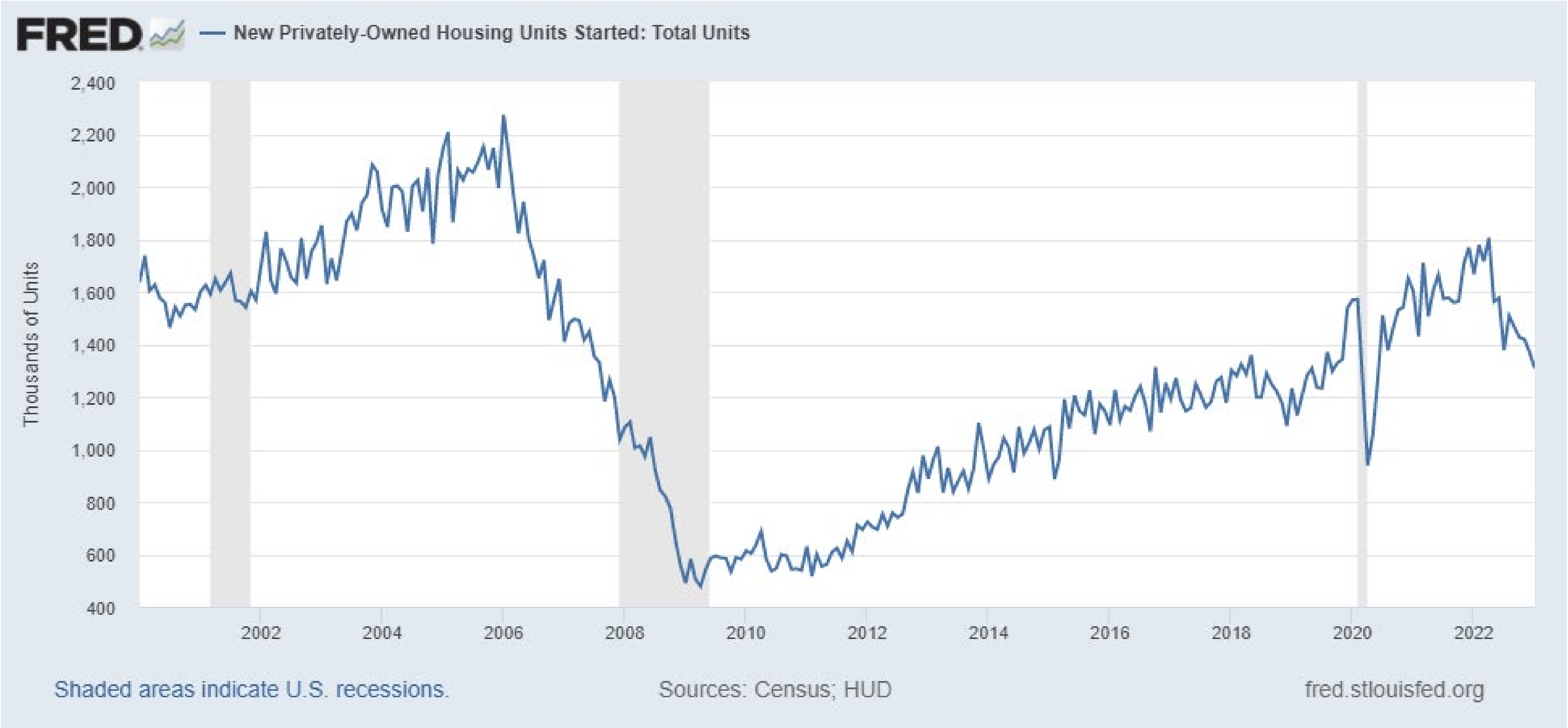



Source: Federal Reserve Bank of Chicago.

- Financial conditions tightened after Fed rate hikes began but then eased after October, even as Fed raised rates more. Reversing some now.
- The Fed does not *control* our interest rates. It does not control demand.

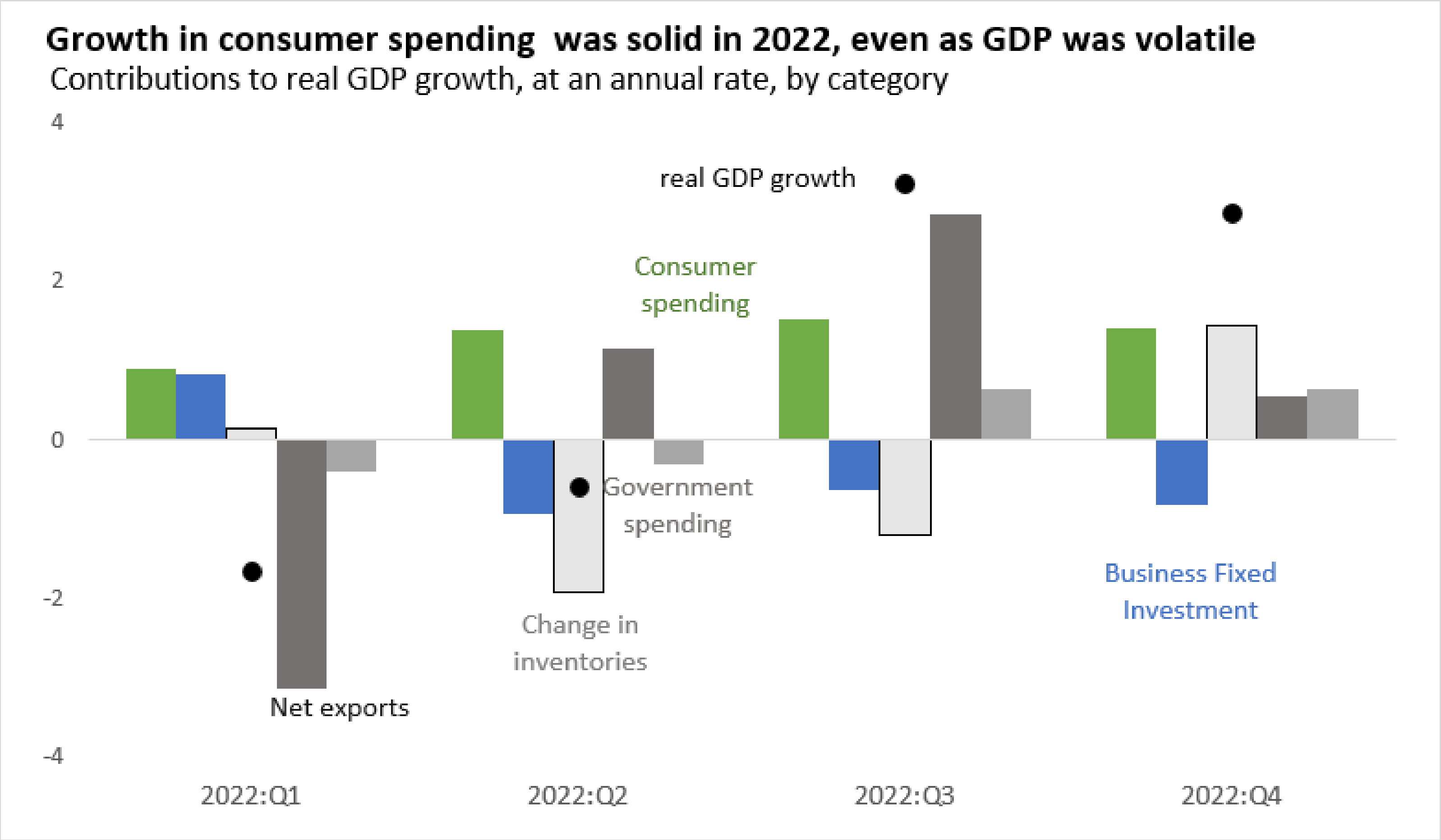
# How’s it going for the Fed?

# Interest rate sensitive sectors are contracting




- Business investment has contracted since 2022:Q2 and housing starts have plummeted 20%. Even so, construction jobs not declining.

# Consumer spending is holding up despite rate hikes



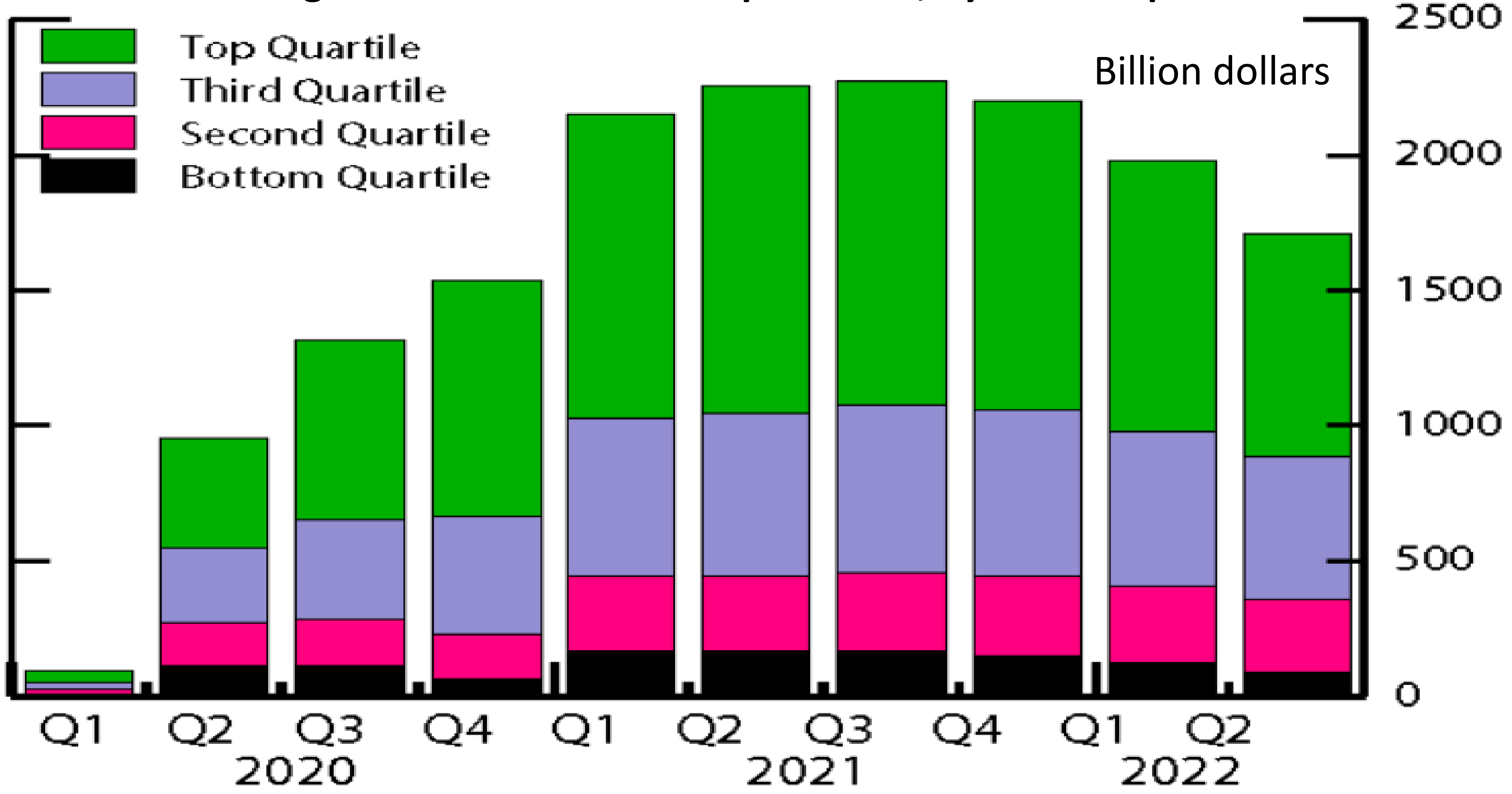

Source: Bureau of Economic Analysis.

- Consumer spending is almost 70% of the economy.
- Resiliency of consumers makes it harder for the Fed to cool demand.

# Why is the consumer doing well, despite high inflation?

# Households have additional savings as a buffer

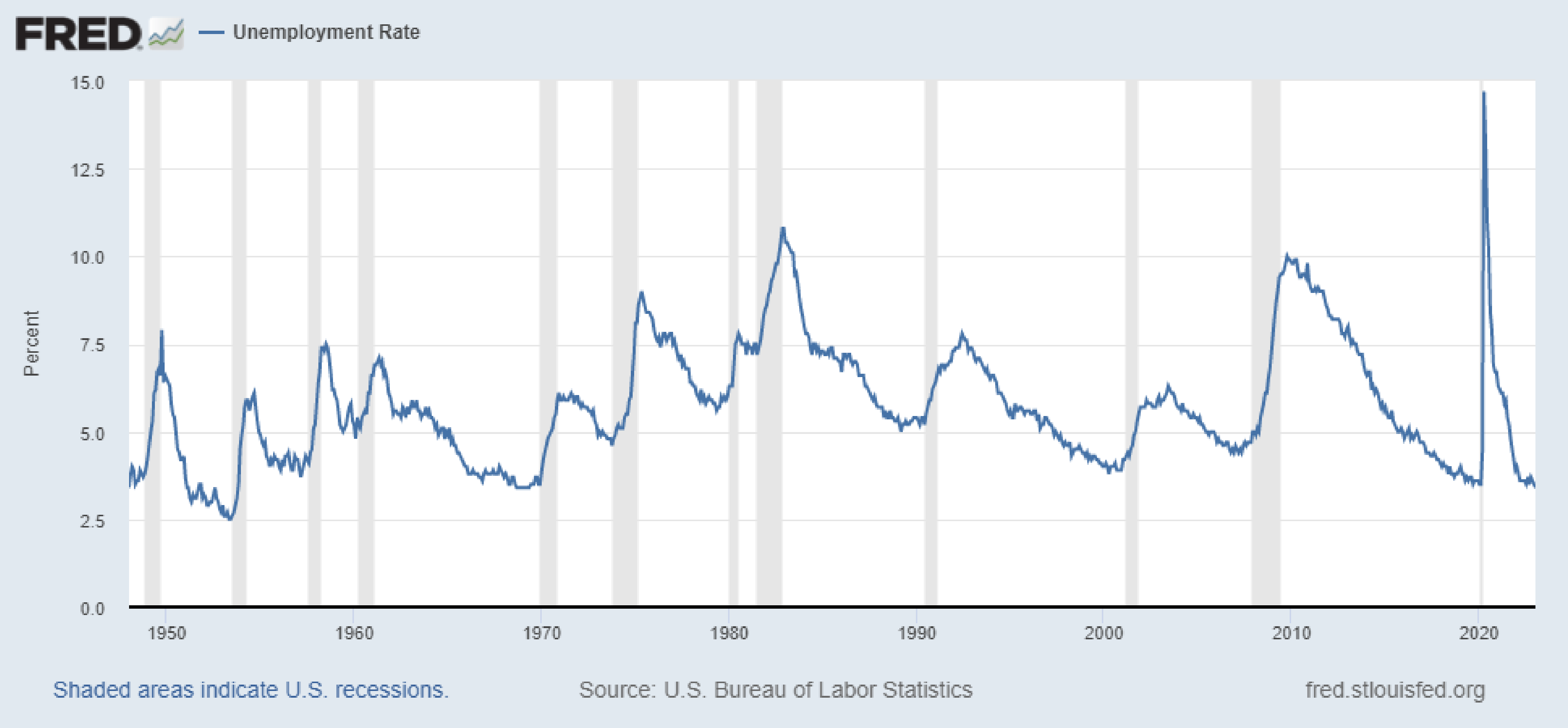
Additional savings relative to before the pandemic, by income quintile




Source: Aditya Aladangady, David Cho, Laura Feiveson, and Eugenio Pinto (2022).

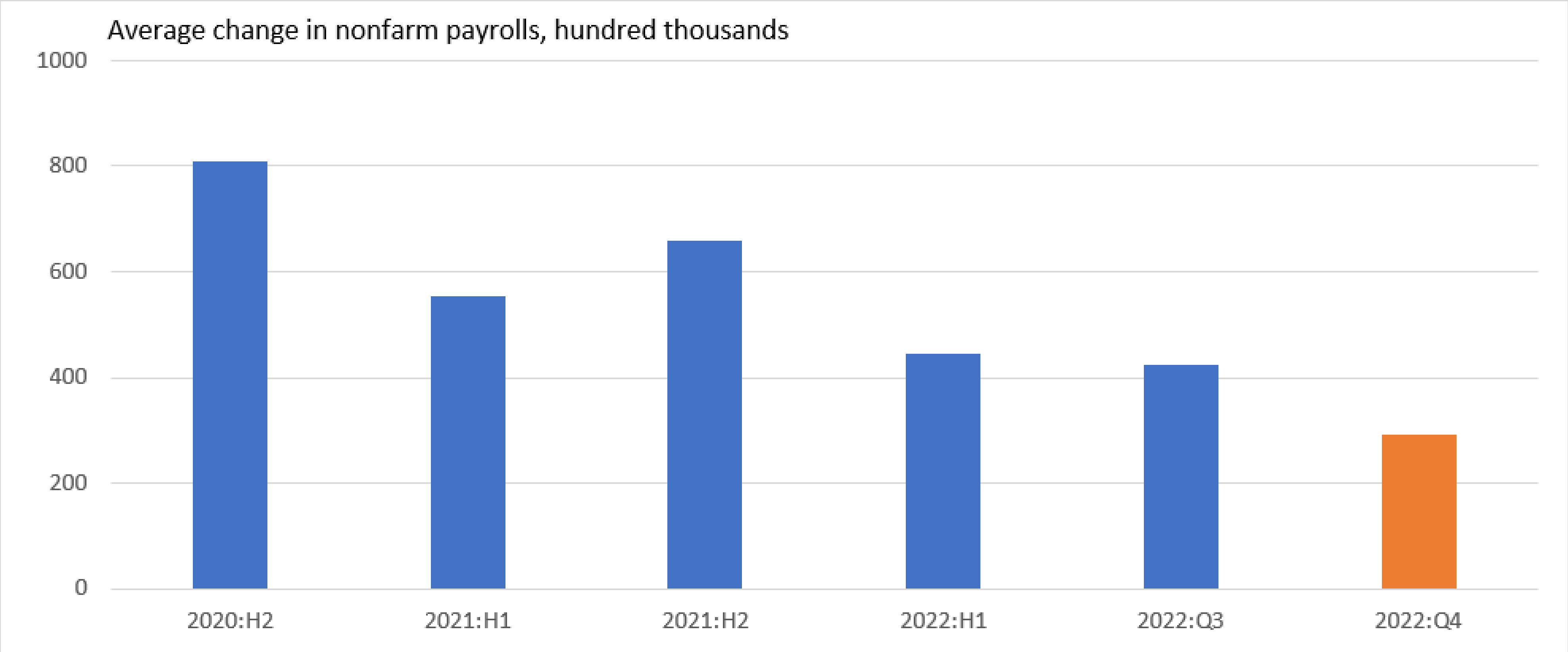
- Resiliency is good. Among top 25%, Covid-related reduction in spending is the main contributor to the additional savings; for the rest, it is fiscal stimulus.

# The labor market is strong, and wage growth solid!!!




- The unemployment rate of 3.4% is at its lowest since 1969.
- Wages grew 4% in Q4, growth's been strongest among low-wage workers.

# Job gains continue to be strong but slowing some.

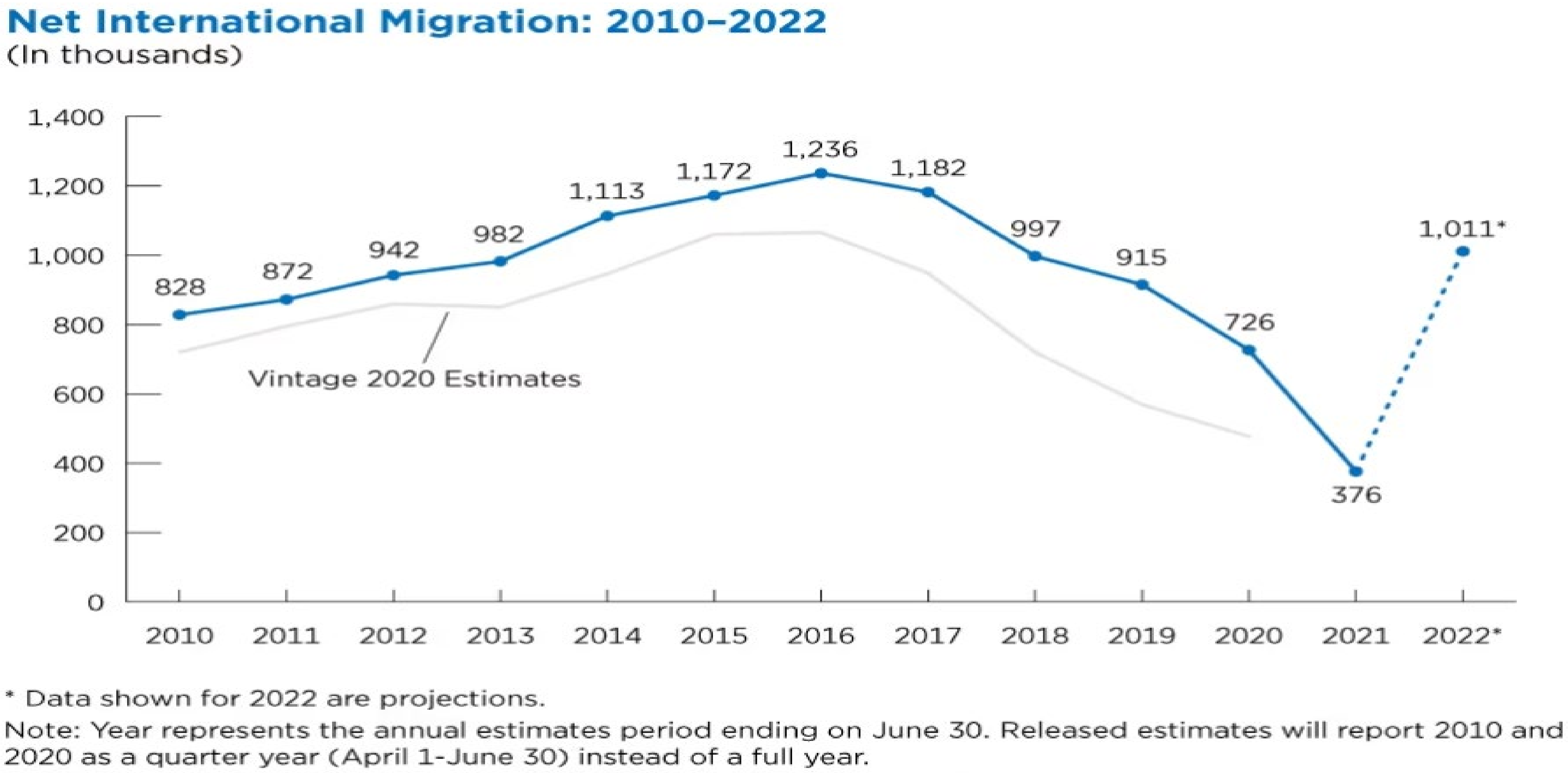



Source: Bureau of Labor Statistics

- This recovery is the first "job-full" recovery in decades.
- Workers have power: job switching, raises, and better working conditions.

Fiscal policy can address supply-driven inflation.

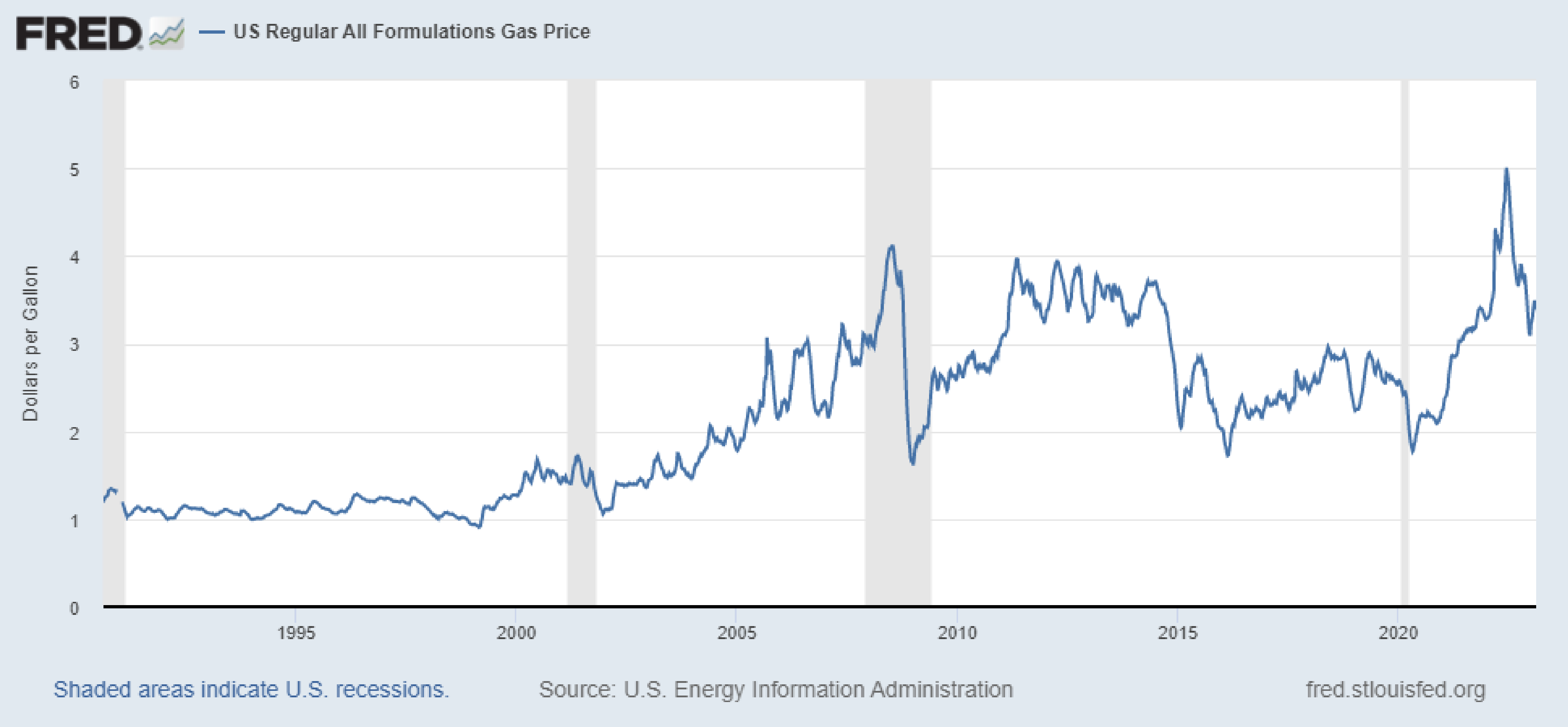
# Immigration helps to ease labor shortages




Source: US Census Bureau (2022).

- Best to solve labor shortages with more workers, not fewer customers.
- Fed can only get us fewer customers by reducing demand.

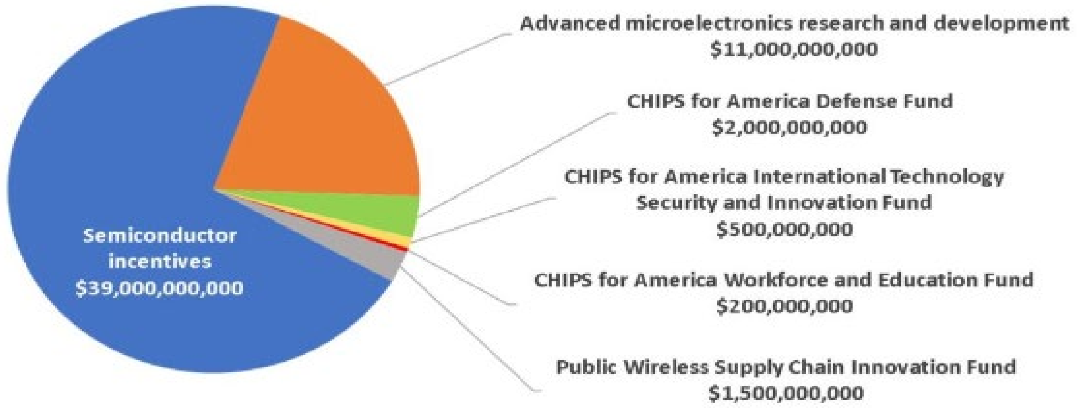
# Gasoline is an example of fiscal fighting inflation



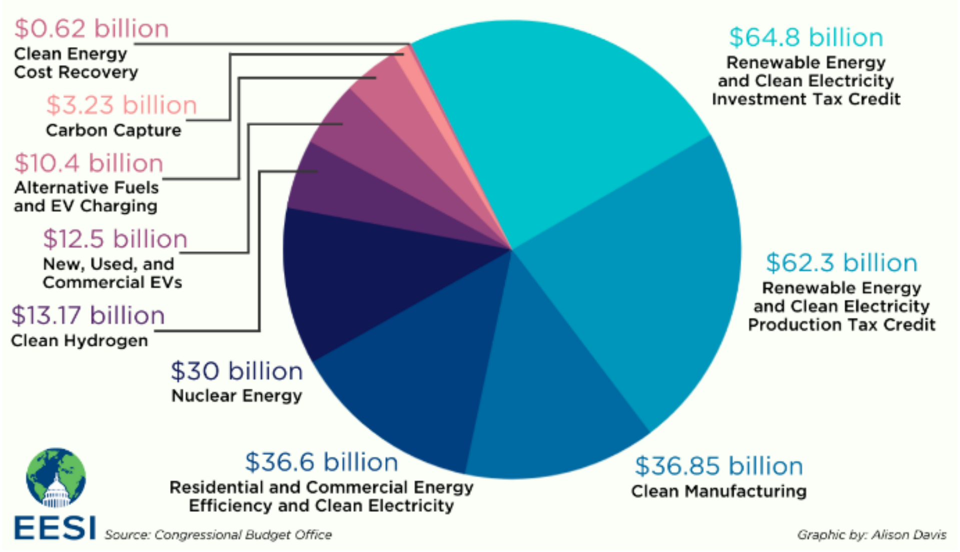

- Biden administration released180 million barrels from the Strategic Petroleum Reserve and guaranteed producers a minimum price to refill it.

# Fiscal policy to strengthen supply and guard against inflation

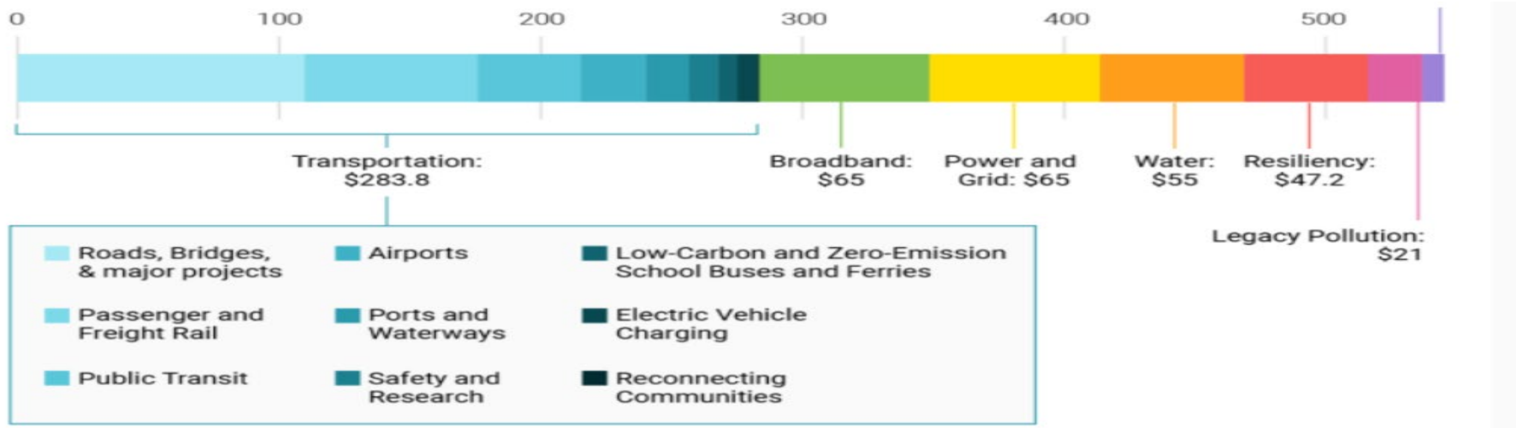
CHIPS Act




Inflation Reduction Act



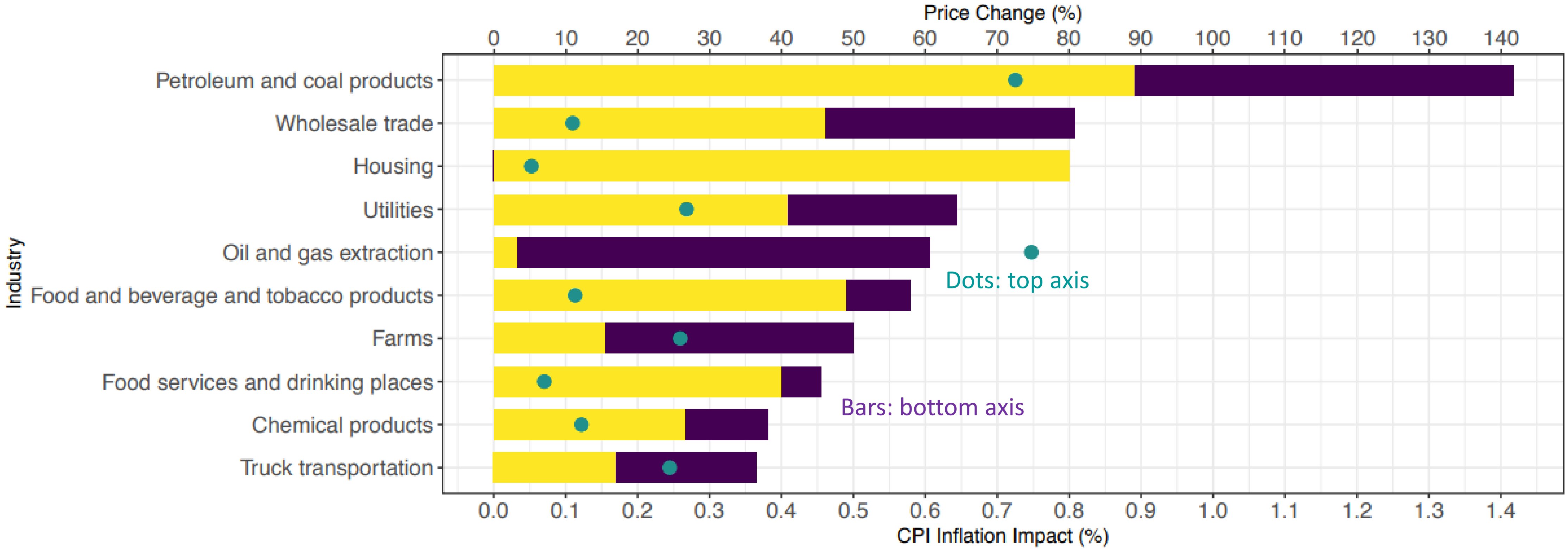

Infrastructure Act




- Fiscal policy is more targeted than monetary policy. The new legislation aims to make supply chains more resilient and provide energy security.

# Targeting systemically important industries is smart

**Effect an inflation shock on the price change from 2021:Q2 to 2022:Q2, by industry**




Source: Isabella M. Weber, Jesus Lara Jauregui, Lucas Teixeira, and Luiza Nassif Pires ([2022]). Note: The results of price-shock simulations for the top 10 inflation impact individual industries using the Leontief price model. The combined length of the purple and yellow bars represents the total inflation impact on a synthetic CPI generated by a price shock to each industry. The green dots are the magnitudes of the price shocks to each industry.

- Isabella Weber and colleagues identify industries that are crucial to containing inflation. These need to be resilient to adverse events. Fiscal can do that.

# In closing.

# Fiscal and monetary policy best to fight inflation

- The Fed absolutely has a role to play in fighting inflation.
- Monetary policy is not an efficient way to contain supply-driven inflation.
- Fiscal is harder to coordinate, and it must be done.

DO IT WELL!

# More resources

- "We need to restore balance: a recession is not the path to balance."
- "The best way to solve a labor shortage is with labor."
- "Ban the Phillips Curve."
- "Fed, you're so vain; you probably think this economy is about you."
- "Olivier [Blanchard] throws it down: the Fed does not decide what is inflation is, we do."

*Many more pieces and links to other analysis on my Substack.*