Money Talks by David Helscher

May 2021

Dominating the financial news recently has been whether inflation is headed higher and action needs to be taken now to curtail the trend or whether the recent inflation numbers are transitory because of the re-opening of the economy and inflation rates will retreat after a few months. The answer will likely be in the rear-view mirror but there is a case to be made for each position.

Will the economy get too hot to handle? Economists expect inflation numbers to rise in the near term, but there are three major views on the potential long-term effects. The view held by many, including Fed Reserve Chair Powell and Treasury Secretary Yellen, is that the impact will be short-lived and due primarily to the base effect with little or no long-term consequences. The base effect refers to comparison to inflation rates a year ago (the base) when the economy all but shut down due to the pandemic. Inflation has been abnormally low since the Great Recession, consistently lagging the Fed's 2% target. In August 2020, the Federal Open Market Committee (FOMC) announced that it would allow inflation to run moderately above 2% for some time in order to create a 2% average over the longer term. Given this policy, the FOMC is unlikely to raise interest rates unless core PCE (personal consumption expenditure index) inflation runs well above 2% for an extended time. The FOMC mid-March projections sees core PCE inflation at just 2.2% at year end and fed funds rate remaining at 0.0% to 0.25% through the end of 2023. The latest print of the consumer price index (CPI) showed a year-over-increase of 4.2% for April, with core CPI (excluding food and energy) coming in at 3.0%. This view holds that annual inflation comparisons will decline as the comparison to last year's figures start to reflect the rebound in the summer of 2020.

A second view believes inflation may last longer, with potentially wider consequences, but that any effects will be temporary and reversible. A third perspective thinks that inflation could become a more extended problem and difficult to control. Both camps project that the base effects will be amplified by demand exceeding supply and pushing prices upward. The third view believes this might lead to a "cost-push" effect and inflationary feedback loop where businesses, faced with less competition and higher costs, would raise prices preemptively, and workers would demand higher wages in response. This view believes that some of the increase can not be explained away by the base effect. Core retail CPI rose 1.3% in February, 1.6% in March, and 3.0% in April. Core PCE, the Fed's favorite inflation measure, rose 1.4% in February year-over-year, 1.8% in March, and is estimated to be 2.5 – 3.0% in April. Wages grew at an annualized 8.4% accordingly to April labor report. Commodity prices have been on a bit of a tear over the past year. Businesses will be tempted to pass through their higher costs to consumers and these increases may be more sustainable than many believe.

Over the next few months, we may have an answer. Inflation is calculated monthly but it is usually cited in terms of the index value's change from a year before. This measure is going to spike in coming months, as the initial months of the pandemic enter the calculation. These months saw substantial volatility in prices of key products and this complicates the process of collecting them. High inflation numbers and higher prices in specific sectors over the next few months should be taken in stride as the economy returns to some level of normalcy.