DOLLAR & SENSE: THE BROOKINGS TRADE PODCAST

"Inflation trends in the US and globally"

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Episode Summary:

Don Kohn, senior fellow in Economic Studies at Brookings, discusses inflation trends in the U.S. and abroad, the Federal Reserve's actions to address rising costs, and inflationary expectations among consumers and businesses.

DOLLAR: Hi, I'm David Dollar, host of the Brookings trade podcast Dollar and Sense. Today we are talking inflation with Don Kohn, senior fellow in Economic Studies at Brookings, and a 40 year veteran of the Federal Reserve, including as vice chairman. The Fed is meeting September 20, 21 in an environment of continued high inflation. So, this is a very topical discussion.

But before we begin, I want to tell you about a new podcast from Brookings called the Brookings Podcast on Economic Activity, featuring cutting edge economic policy research and the economists who create it. Here's more.

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DOLLAR: Welcome to the show, Don.

KOHN: Good to be on, David. Good to be on again with you.

DOLLAR: So, let's start with the big picture. What is the situation with inflation in the U.S. economy right now and what are the trends?

KOHN: So, it's not good, David. Inflation has remained high, remains stubbornly high and widespread. There were some signs we thought we saw maybe in July with some price increases easing off. We saw things like the price of gasoline that we buy every day, every few days at the pump coming down, some other commodity prices coming down. So, there have been some high hopes that the inflation picture was easing.

But the data we got earlier this week on the Consumer Price Index suggested that there wasn't any easing. So, on the headline, inflation did come off a little bit because it reflected the decline in gas prices, but the core inflation, the stuff that takes out the very highly volatile food and energy, if anything accelerated a bit and showed widespread increases. So, it still looks like a very, very serious issue that's not going away anytime soon.

DOLLAR: The Fed is in the process of raising its target interest rate. What will they be weighing as they decide how high it should go? You've been in these meetings in the past. Give us a little flavor of this kind of discussion. Chairman Powell has said that there will be some pain involved in lowering inflation. What will they be looking at to judge how high the unemployment rate needs to go? In particular, will they need to send the economy into recession?

KOHN: So, they've told us that they'll be looking very carefully at the incoming inflation numbers. They have a inflation target of 2%. The inflation now, depending on how you measure it, is 6, 7, 8%. It's way above where they need it to be. And so they they've said we're going to be raising interest rates until we see a clear path from the current level of inflation back towards our 2% target. So, they need to see a couple of months in a row of inflation coming in much lower. And then they need to be able to project ahead that that trend is going to continue.

So, I think one thing they'll be looking at very carefully is the labor market to judge about what the future trend is. We've said that some of the supply constraints we talked about in our last podcast that were contributing to inflation—the effects of COVID, supply chain stops, petroleum, oil and gasoline, energy prices—some of those effects are beginning to fade a little bit. But service prices, which are highly labor intensive, have been going up, if anything, a little bit faster. And that's because wages are going up faster. So, labor markets are very tight, wages are going up rapidly, prices are going up rapidly as well. And wages and prices are trying to keep up with each other there. They're interdependent in that regard. So, taking some pressure off the labor market is really important.

One of the things we've seen in this episode, the last couple of years, is that what we used to look at as indicating pressure on labor markets is just the unemployment rate. Now the unemployment rate is just a little over three-and-a-half percent. That's what it was at the end of 2019. In the beginning of 2020, when we went into this COVID crisis, the COVID, COVID effects on the economy, obviously, before the Russian aggression in Ukraine, et cetera, so the unemployment rate is about where it was, inflation wasn't too bad then. But what's different right now is that there are a huge number of vacancies that businesses are posting to hire people, so they're competing very hard to hire people. Many more vacancies than there were in 2019 when the unemployment rate was last around this level.

So, the thing that they'll be looking at is whether this level of vacancies is coming down, whether the competition for labor is easing some and therefore that the wage increases can ease off some because the wage increases have to ease off some in order to get the price increases to be easing off some. So, labor market is very much in there.

DOLLAR: So, Don, one of the things that comes out of the Fed meetings would be projections looking forward. And it strikes me up till now that they've been a little too rosy in a sense that they project inflation coming down, which we hope they succeed with that. But relatively minor increase in unemployment. It's certainly possible, but does this seem like a realistic scenario? Or are they reluctant to kind of indicate to people what's likely to happen with unemployment?

KOHN: I think this is one of the important controversies that is among economists these days. So, some economists say, well, why can't we go back to 2019 when the unemployment rate was roughly where it is today? Maybe a little, it would have to be a little bit higher. The vacancies, the competition for labor would come down with very little increase in unemployment. And that's basically where the Fed is. When they last told us their projections, they said, well, the unemployment rate is going to have to rise from then, about three-and-a-half percent to about four, a little over 4%. That'll be enough to bring inflation down. And I think they truly believe that. I don't think they're making this up.

But there is another school of thought here which says, no, these vacancies aren't going to come down. The competition in the labor market is so fierce that you're going to have to have a much larger increase in unemployment in order to take the pressure off the labor market, get these wages down.

Last Friday at Brookings, there was a meeting of the Brookings panels on papers on economic activity, BPEA. And Jason Furman at that meeting said his estimate was that the unemployment rate would have to rise to about six-and-a-half percent for a couple of years in order to get inflation down towards the Fed's 2% target. So, a 2 percentage point or more greater increase than the Fed had been estimating.

I would say no one knows how this thing is going to play out and the Fed's just going to have to raise interest rates, slow the economy, reduce the demand for labor, and see how that plays out in the labor market. This is a situation we haven't really been in before with these very sharp differences about what history tells us about how high the unemployment rate is going to have to go.

DOLLAR: Don, you mentioned that we got some pretty sobering recent news about actual core inflation, but we also got some positive news about inflation expectations, as I understand it. So, can you say a little bit about why inflationary expectations are important and what seems to be happening there?

KOHN: So, they're important, David, because the theory, is the observation is, that to some extent, as businesses set prices and as workers evaluate their prospects and decide how much of a wage increase, a salary increase, they want, they look at where inflation is going to be and think about where inflation is going to be to try and keep themselves whole. So, a worker thinking inflation would be 5% over the next few years would demand a higher wage increase than one thinking inflation would be 2%. Likewise, it's a business thinking that as costs were going to go up not only in wages, but the raw materials that she buys to make her product were going up at 5%, she would raise her prices by enough to make up for that. If she thought it was 2% she would raise by less.

So, inflation expectations are thought to influence wage and price setting. The Federal Reserve has emphasized very strongly the importance of keeping those expectations anchored at 2%, which is its target for inflation.

One of the characteristics of the period, this high inflation period we've come through, is that longer term expectations have remained pretty well anchored at 2%. That is, households responding to surveys, people operating in financial markets seem to expect the Fed to accomplish its objective over time to get that inflation back to 2%. But not surprisingly, with the prices, particularly of food and energy that people buy every day rising rapidly until very recently, their expectations about inflation in the short run over the next couple of years have been rising.

Now the good news you referenced was that the Federal Reserve Bank of New York does an inflation expectations survey asking people about the next couple of years. And those expectations have come down in the most recent survey, and I'm sure that reflects what they're seeing at the pump. That's a characteristic of household responses to inflation surveys. It's the stuff they buy every day has a very important influence about their perceptions.

So, inflation expectations near term, medium term have come down a little. Long term remain anchored. But I think as long as those shorter and intermediate term expectations are high, there's a risk that they get built into longer term expectations as well.

DOLLAR: Yeah. So, if the New York Fed calls you as one of its survey people, do those recent numbers strike you as about right for expectations for two-year and five-year?

KOHN: I don't actually remember exactly what they were, but they weren't unreasonable. They were, I think, a bit higher on the couple of years out than the financial markets have and I think higher than the Fed thinks it's going to have. But that's also characteristic of a lot of household surveys. So, the University of Michigan does a survey, and the inflation expectations they get out of that survey is always higher than actual inflation, even when expectations are. So, I would expect inflation to be somewhat lower than in that New York Fed response. But I think the fact that it's moving down is important and it does need to move that, still elevated by any by any measure.

DOLLAR: So, in addition to the interest rate decisions when the Fed board meets, there's also the opportunity to adjust the balance sheet. And I think this is something that's probably not that well understood by ordinary people because it's a little bit technical, but increasing the balance sheet we referred to as quantitative easing and then reducing the balance sheet is quantitative tightening. So, as I understand it, we're now in a phase of quantitative tightening. So, can you explain that a little bit? What's the objective? And are there particular risks here?

KOHN: That's correct, David. So, quantitative easing—expanding the balance sheet, buying securities, mainly Treasury securities but also some mortgage backed securities—was intended to reduce the interest rates that people pay to buy a house, to borrow to buy a house, or to borrow to buy a car, or a corporation borrows in the corporate debt market to make a capital investment. And by reducing those interest rates it was trying to encourage demand when the economy was weak.

Well, the economy hasn't been weak. So, they said we're tightening monetary policy. We're worried that demand is too strong, putting pressure on wages and prices. So, we've got to reverse that. So, they're raising interest rates, but they're also letting that portfolio run off. So, they don't want to hold be holding a lot of securities that are helping interest rates stay low. The whole point is to raise interest rates.

So, the thought here is that by allowing that portfolio to run off, they're putting more securities, longer term securities, into the market, forcing the market to absorb them. That tends to put downward pressure on the prices of bonds, upward pressure on the interest rate.

So, that will add at least a little bit around the margin to the increases in interest rates that we see as the Fed is raising its target for the very short term interest rate.

The risk that people see around that is not that interest rates will rise too much. I mean, that's really under the control of the interest rate target. I think the risk people see is that liquidity in the markets might be disrupted. So, the markets have to absorb a lot more securities now that the Fed is not taking them out of the market but putting them back in. Markets are not always so liquid, particularly in a period of great uncertainty the way we are right now about the way forward in the economy. So, you could get some very choppy, volatile trading, volatile prices in these markets and disruptions to market liquidity.

And the Fed is very aware of that. And one of the things they tried to do is be very clear about their plans and intentions. So, they don't want to surprise the market. So the market understands, market participants understand what they're going to do and can plan for it. So, I would say the risks are more on the market side than on the economic side.

DOLLAR: But on the market side, the Fed could adjust pretty quickly, right, if there's volatility in that market?

KOHN: Yes. An example of that is the fall of 2019 and September of 2019, quantitative tightening was underway. The level of reserves in the banking system got uncomfortably low. There was volatility in some of these markets that were affected by the level of reserves. And the Fed just stopped, stopped selling and actually went in and added some reserves first to calm the market down.

Since then, it's actually put in a what they call a standing repo facility, a facility that would be activated and be waiting there. If volatility picked up, it would be a way for people to bring their Treasury securities to the Fed and borrow against those securities in order to damp down the volatility. So, they're very much aware of this, and they've tried to take steps to prevent it.

DOLLAR: So far we've been talking about inflation in the U.S. But this inflation seems to be a worldwide phenomenon. And right now it's particularly acute in in Europe and the United Kingdom—not part of the euro zone, but part of Europe still. So, can you talk a little bit about Europe's inflation challenges and what it's doing with its monetary policy and whether that could create spillovers to the U.S. that makes our inflation management more difficult?

KOHN: So, Europe is facing very severe challenges, I think much more severe than the U.S. because, of course, they're exposed to the cut off of gas and possibly petroleum coming from Russia as a side effect, as a consequence, of the Russian aggression in Ukraine. So, they're facing quite elevated prices for natural gas that they use to heat their homes and run their factories. The households and businesses will be hit very, very hard by these prices. That means that as those prices rise, they have less money left over to spend for other things. So, I would say both the inflation and recession risks are considerably higher in Europe than they are in the U.S. because of their exposure, exposure to Russian-Ukraine issues.

Now, the European governments, many of them have taken steps or are talking about taking steps to cushion the effects of the rise in energy prices on households to cap the rise in energy prices, which would put downward pressure on or avoid having inflation be quite so high, or send money to the households so they can afford to heat their homes.

I think it is important for those energy prices to rise in order to discourage the use of energy. So, I'm not sure that capping these price increases the best public policy. It'd be better, I think, to let the prices rise and then subsidize the households and the businesses to make sure the economy can keep running. But so they're facing some very serious issues.

I think there could be spillovers to the United States. The U.S. and Europe are very closely integrated economically. Weakness, recession in Europe, is going to reduce demand for exports from the United States. So, it will spill over here. We have not only problems in Europe, but as you know better than almost anybody, David, problems in China. So, the Chinese economy is slowing or has been quite slow and slower than slower growth than people anticipated. So, you've got recession and slow growth threats all around the world, including obviously in the U.S. and the U.S. growth has to slow in order to contain inflation, but the slowing in demand from the rest of the world will contribute to slowing in the U.S. And this is a complication that the Federal Reserve, I know, is looking very closely at.

What do they need to do with monetary policy? I would say one phenomenon here is the dollar has been extremely strong in foreign exchange markets. That's actually helpful to the Federal Reserve because it damps inflation. Imports are less expensive. When the dollar is strong, exports are more expensive to people overseas if they have to pay in these strengthening dollars. So, that helps to reduce the pressure on U.S. businesses to produce exports. And it holds down prices.

But of course, it exacerbates the inflation recession issues, let's say, in Europe, where the euro has dropped quite a bit, raising the price of imports and an increase in demand for exports. So there's the dollar strength is an important help to the Fed, but I don't think it'll be helping the ECB. The euro weakness will not be helping the ECB as it tries to control inflation.

DOLLAR: Yeah, I'm really glad you brought up the issue of the dollar, Don. I really think you're right that that is an important part of the whole playbook and the high level of the dollar, and we have an increasing trade deficit. And I'm a little bit surprised there haven't been more political voices complaining about this in the U.S. It would be a little bit irrational given that we have excess demand and imports are a way to meet that without inflation. But are you surprised there hasn't been more politicization of this whole dollar issue?

KOHN: Yes. I think the contrast with the previous administration is very marked. President Trump was very focused on a weak dollar. He wanted the dollar weak because he was focused on increasing our exports and reducing our imports. I think, as you noted, that would be completely inappropriate right now and that would just make the problems of the Federal Reserve even harder.

One reason the dollar is stronger than these other currencies is the Fed has been moving more quickly in some cases, certainly more quickly than the ECB has been raising rates much more rapidly than other central banks. So, the rate that investors can earn on their dollar investments are going up relative to the rate they can earn on their investments in Europe or Japan or the United Kingdom. And that means that they are taking money and putting it in the U.S., putting it in the U.S. and that adds to the strength of the dollar, as we both noted, that that's very helpful to the Federal Reserve. So, right now it's a good thing. And it means that U.S. households have access to less expensive imports.

DOLLAR: Last question for you, Don. When you and I talked about six months ago, one issue we talked about was developing countries are concerned about the Fed tightening, what would happen with the dollar and interest rates. And a lot of developing countries have debts in U.S. dollars and they become more expensive, more difficult to service. This kind of Fed tightening has precipitated financial crises in the past in some developing countries. So, how do you see that that playing out now that we're several months into the tightening?

KOHN: Well, I think a surprising thing, David, is how little this seems to have affected many emerging markets. So, the threat you mentioned is certainly there. To the extent that emerging market economies, their governments and their corporations, have borrowed in dollars where the interest rates are rising and the dollar is getting stronger, but their cash flow is in domestic currencies, it's going to be very, very hard to service those debts.

So far, I don't think there's been a lot of anticipation, as you and I have been talking, that there will be problems, but not a lot of problems actually developing. And I think there's some good news there. And the good news is that more of these emerging market economies have better policy frameworks. They have, the central banks are more credible having to do with their inflation targets, and they've taken actions to enforce those inflation targets. And Brazil is a good example of that, where interest rates have risen even before they started rising in the U.S.

So, I would say it's maybe a knock on wood kind of situation here where it looks like there are dangers out there. But so far, they really haven't come through. I mean, there are some countries that have had problems, and Turkey is the obvious example. But they're they have a very perverse monetary policy where the leader of the country thinks that lowering interest rates is going to lower inflation. And I think he's proving that that's not true. And it's really weakened the currency. People worry about Egypt and some other countries. So, I think this is the certainly on the worry list for the IMF and the World Bank, but so far, so good.

DOLLAR: Yeah, Don, in my years with the World Bank, I sometimes ran into this argument that lowering interest rates would help you deal with inflation because it would encourage supply. You know, if inflation is too much demand chasing too little supply, let's ratchet up supply. The problem, though, is in many cases, you would need implausible increases in supply to really deal with the issue. But I agree with your basic point that the macro management in emerging markets has really improved. I would add flexibility of exchange rates to the list of things you put in there. And that's cautious good news.

KOHN: Right. So, I guess we'll have to stay tuned here, David.

DOLLAR: I'm David Dollar and I've been talking to my colleague Don Kohn. Really, thanks, Don, to give us a lot of insight in the kind of discussions going on at the Fed, but also in the larger economics community. It's a really difficult global environment right now, and you really helped us understand it. So, thank you very much.

KOHN: Good to be with you, David.

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DOLLAR: Thank you all for listening. We release new episodes of Dollar and Sense every other week. So, if you haven't already, follow us wherever you get your podcasts and stay tuned.

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Until next time, I’m David Dollar and this has been Dollar and Sense.