Powell's High Wire Act

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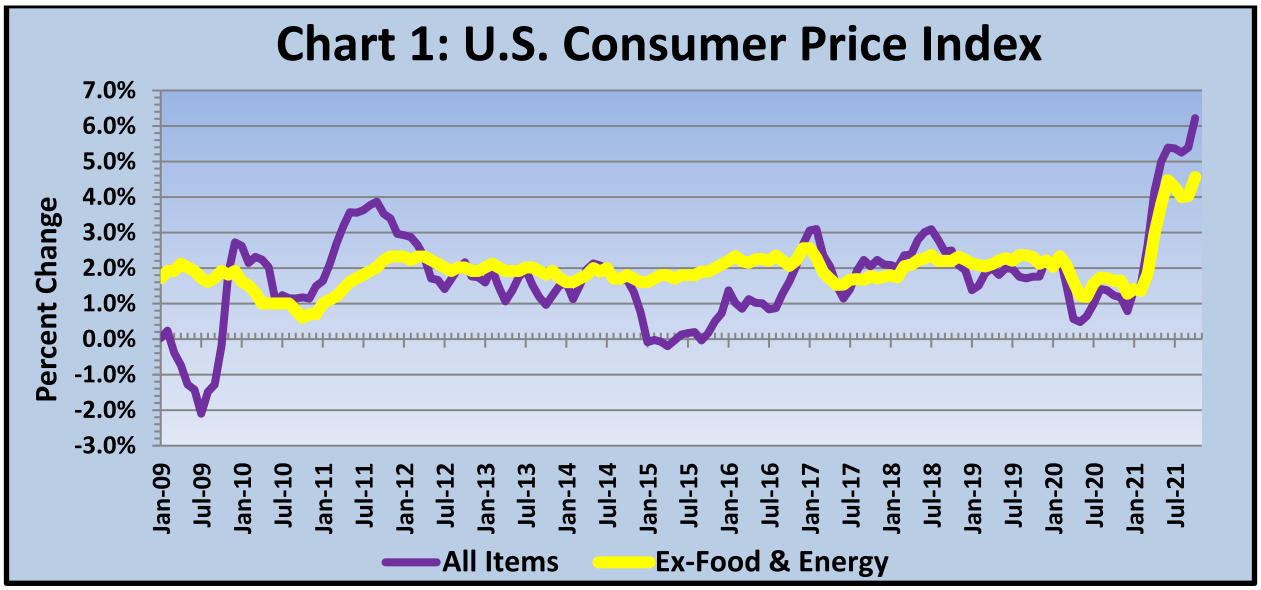
In April of this year, I published an *On Our Minds* commentary[1] suggesting that inflation was not an imminent threat – and indeed, the Consumer Price Index remained relatively muted through the summer and early fall. Although the "headline" numbers ticked up a bit, they were easily explained by the economy's rebound from depressed prices related to the year-earlier pandemic shutdown – a phenomenon most notable in energy prices.

Today, however, the data show a suddenly very different story. Chart 1 shows the recent spike in consumer prices, both with and without the more volatile food and energy components of the index. After decades of stability – dating back to the early 1990s, far off the left edge of the chart – inflation has jumped sharply higher, with the "all items" headline index now topping 6%.



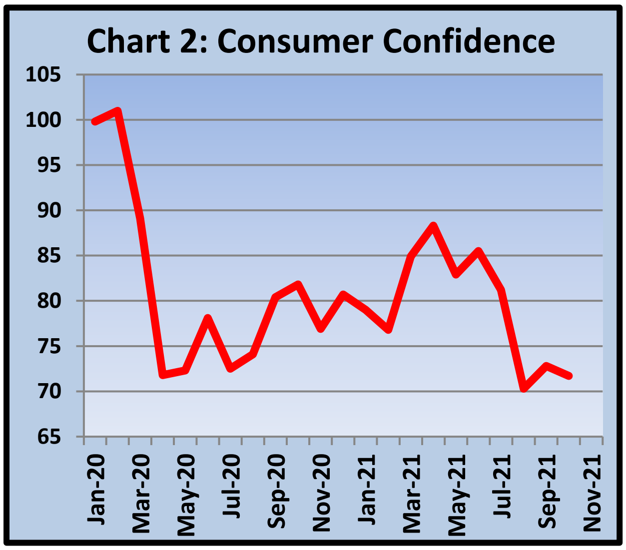
Source: FactSet

In that April commentary, I compared inflation to a fire, in that both require three elements: fuel, oxygen, and spark. At the time, it was evident that the U.S. economy had plenty of fuel to burn, in the form of a money supply that had jumped more than 25% since the pandemic had begun a year earlier. We were beginning to see evidence of oxygen – that is, consumer demand – as the unemployment rate fell and people began to resume their pre-pandemic lifestyles. But the spark – inability of supply to meet demand – wasn't yet evident.

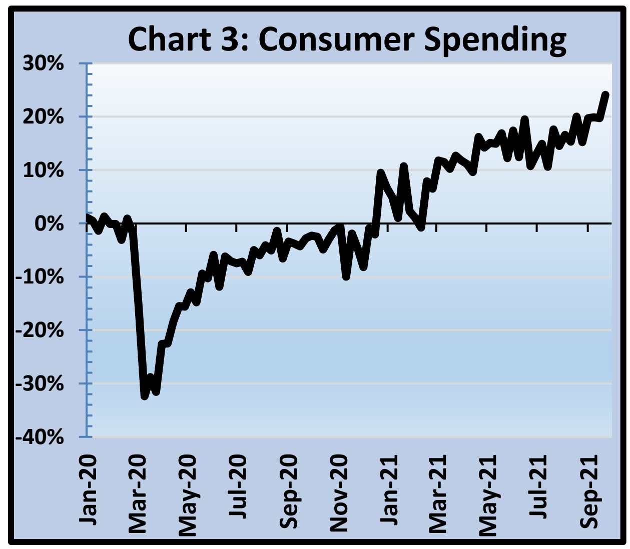
[1] "Inflation: Menace or Mirage?" April 1, 2021.

Today, we have all three elements solidly in place. The money supply continues to grow rapidly as the Federal Reserve ensures ample liquidity and continues to buy government debt; it's now about 35% above its February 2020 level. That's quite a lot of dried-out dead leaves on the forest floor, just waiting for a careless camper to drop a match.

The demand side – the oxygen – has likewise expanded rapidly, spurred by the hot winds of rapid changes in the labor market. The economy has added nearly six million new jobs this year, and the pace has accelerated since the Delta variant began to ebb in late summer. Consumers still report that they are worried (Chart 2), but their behavior has told a different story as actual spending has risen sharply in recent months (Chart 3, which compares spending to the January 2020 level). There's plenty of oxygen demand to go with the fuel of elevated money supply.



Source: University of Michigan



Source: www.tracktherecovery.org

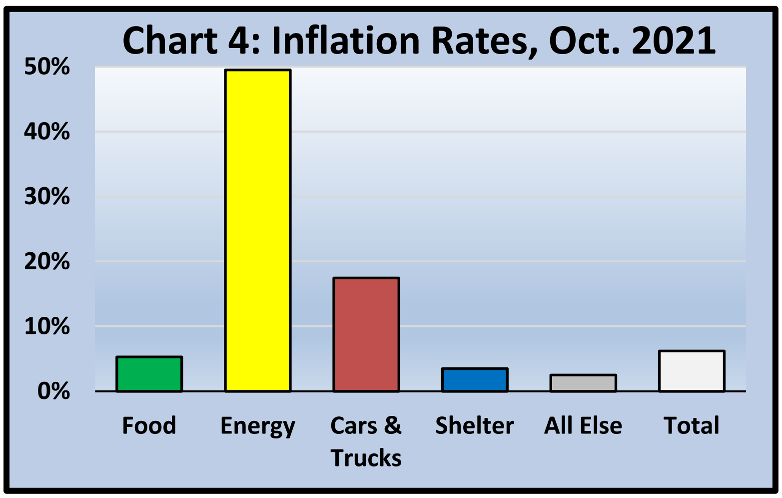
But what's really ignited inflation recently is the spark – the shortages of key products at all levels of the supply chain. Those shortages were initially in raw materials (e.g., lumber, rare earth metals) and they gradually filtered through to intermediate goods. Short supplies of semiconductor chips have choked off production of automobiles, home appliances, and a wide array of other consumer items.

Perhaps the most consequential shortage has turned out to be labor: For the fourth straight month, the U.S. has had more than ten million job openings that companies have been unable to fill.[2] This labor shortage is felt most acutely in transportation logistics: Cargo ships are unable to unload their wares because the ports have too few crane operators to offload containers; trucking companies can't move merchandise from dock to warehouse to retail store because they can't find drivers. Airlines can't schedule more flights because the aviators they laid off two years ago have either retired or taken better-paying jobs flying jets for Amazon.com and FedEx.

[2] In the *On Our Minds* commentary "Too Many Jobs? Or Too Few?" (August 26, 2021), I examined some of the reasons behind this labor shortage. Among them are Boomer retirements, skills gaps, child care and elder care responsibilities, and government policy.

And so it has come to pass that consumer demand and supply have disconnected: Consumers are returning to their workplaces and going out to the mall again, but they aren't taking mass transit to get there; yet they can't find cars to purchase on dealer lots. Similarly, we may be ready to fly again, but the aircraft remain parked because the airlines can't schedule flights without pilots.

This dynamic is evident in a breakdown of the recent inflation statistics, released last week. Chart 4 shows the annual change in prices of a few key items alongside the overall consumer price index. The combined effects of supply chain disruptions, labor shortages, and changing consumer behavior are evident in the 17.5% increase in the prices of passenger cars and light trucks from a year ago. Unwilling to ride the bus and unable to afford new cars, millions of consumers have flocked to the used car lots. While new vehicle prices have risen 9.8% over the past year, the average price of used cars has skyrocketed 26.4%.



Source: Bureau of Labor Statistics

The first three columns in Chart 4 all share one thing in common: They are functions of short-term fluctuations in supply and demand. Food prices are up 5.3% in part because of difficulties getting farm output to market; energy prices plunged last year when demand evaporated and then recovered sharply this year as producers held output steady;[3] and vehicle prices leapt in response to a pandemic-induced change in consumer demand.

The columns on the right side of Chart 4 tell a different story, however. Prices for shelter have remained relatively stable, up only 3.5% over the past year. That may seem hard to square with reports of double-digit gains in home prices, but the long moratorium on evictions served to hold rental prices down. (So did large-scale moves to the suburbs and exurbs from some major urban centers, though this trend may now be reversing itself.) More impressive, the "all else" category showed, in aggregate, only a 2.5% increase in consumer prices. The *median* inflation rate among all 337 distinct consumer goods and services categories tracked by the Bureau of Labor Statistics was only 4.1% in October – well below the 6.2% *mean* trumpeted in the press.

In short, the inflation we're seeing is largely confined to a few highly visible – and short-term in nature – categories. To the degree that companies can unkink their supply lines and lure more workers back into the labor force, these product-specific inflationary spikes would likely abate. If that happens, then Fed Chair Jerome Powell will be proved correct in his assessment that this inflationary episode will have been transitory and not persistent.

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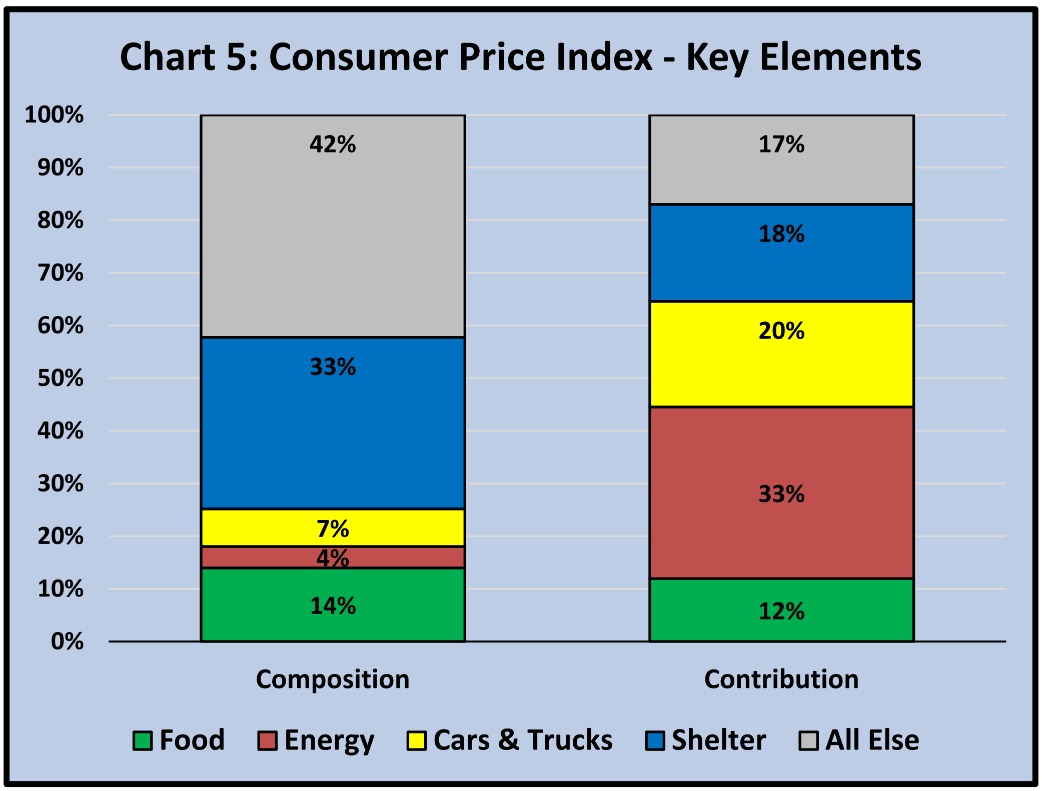
[3] In fact, despite the 49% spike from a year ago shown in the chart, the current $82 cost of a barrel of oil is still more than $25 below its 2014 peak. A gallon of gasoline is likewise still no more expensive than it was seven years ago.

As the economy grapples with these challenges, however, we can find some worrisome data lurking within the Consumer Price Index. Chart 5 compares the *composition* of the CPI to the *contribution* of the same elements highlighted in Chart 4. The left-hand column shows the weighting of each element in the total index; think of this column as the wallet of a hypothetical household: Food represents 14% of this household's monthly budget, while energy (including gasoline, heating oil, electricity, and all other energy sources) represents only 4%, and so on.

The right-hand column shows each category's cumulative contribution to the total 6.2% inflation rate, calculated by multiplying each item's weighting in the basket by its own specific change in prices. In this chart, energy's 4% wallet share is multiplied by its 49% inflation rate, contributing 2.1 percentage points to the overall inflation rate; that 2.1 percentage points is 33% of the overall 6.2% rate. Likewise, the 3.5% increase in housing prices, multiplied by its 33% share of typical household spending, adds up to 1.15 percentage points, or 18% of the total 6.2% inflation rate.



Source: Bureau of Labor Statistics, Eastern Bank Wealth Management

Why does this matter? Energy and cars represent only 11% of household spending but are responsible for more than half of the reported inflation rate. Shelter, on the other hand, is three times as important to the hypothetical household budget but today contributes only half as much to inflation. If the end of eviction moratoriums means that housing costs start to climb at a faster rate, the impact on overall inflation could be substantial. Unfortunately, that's exactly what may be happening: The October inflation report was noteworthy because housing prices ticked up 0.44% compared with September, a 5.2% annualized rate after months of stability.

It's not implausible to think that housing costs could accelerate further. If so, housing is such a big component of the market basket that we could see overall CPI numbers going higher even if energy and vehicle prices suddenly stabilize. Worse, housing price changes tend to be sticky, while energy and used car prices are more volatile. Thus, a sharp increase in housing cost inflation could transform the overall narrative from *transitory* to *persistent* inflation.

This leaves the Federal Reserve in a difficult position. Its two primary mandates are now in direct conflict with each other: To curb incipient inflation, the Fed would normally raise interest rates and hasten its exit from bond purchases. But to encourage maximum employment, the central bank must keep rates low enough to encourage businesses to expand their borrowing and hiring decisions. As Leon Russell noted during a previous inflationary era fifty years ago,

> *I'm up on the tight wire*
> *One side's ice and one is fire*

Fed Chair Jerome Powell has been walking that tightrope in his recent press conferences and testimony before Congress. He can do so safely only if he can persuasively argue that inflation is in fact transitory; that would give him latitude to keep interest rates low, focusing on jobs while letting inflation run hot for a while. But if the fire of inflation begins to look persistent, failure to raise rates now could allow prices to run amok as they did in the 1970s. Were Powell to raise rates sooner in a bid to head off higher inflation, he would risk thwarting jobs growth and possibly even throwing the U.S. into a recession. That's quite a tightrope indeed.

Powell is also aware, as Russell was before him, that he is in a precarious position himself:

> *And the wire seems to be*
> *The only place for me*
> *I'm up in the spotlight*
> *Oh, does it feel right?*

Powell's term as Fed Chair expires in February, and he is under intense scrutiny as President Biden considers whether to renominate him. Progressives would rather replace him with current regional Fed bank president Lael Brainard – whose views are considered much more dovish – while centrist Democrats and most Republicans favor reappointment. Whether we like it or not, the Fed's future inflation policy may be affected by politics as much as by sober assessment of conflicting economic pressures.