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Powell Is Looking Well Past the Next Inflation Report

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If you believe market bulls, the next US inflation report on Tuesday could be the one that gives the Federal Reserve the opportunity to turn less hawkish. Their thesis is that a second-straight slowdown in the monthly pace of inflation -- especially in the core measure that excludes volatile food and energy — might allow the central bank to raise interest rates in smaller increments going forward. Fed Chair Jerome Powell just gave a couple of key reasons for why banking on such a scenario would be foolish.

First, the Fed is clearly concerned about the strength in the labor market, which has wages growing above trend. Headline and core inflation were always bound to come off their boil after supply-chain snarls started to untangle and energy prices tumbled. And next week's consumer price index report is forecast to show a 0.1% decline in August after no change in July. But the Fed is as concerned with potential inflationary pressures next year and in 2024 as it is with this year's, even if many may indeed prove "transitory." That wouldn't mean inflation has been vanquished, though.

The dynamics of future inflation will probably be different and more influenced by the labor market, which is part of why it could be relatively easy to get the personal consumption expenditures price index back down to the 3.5% to 4% range, but significantly harder to get it to the Fed's 2% target next year. Speaking at a Cato Institute event Thursday, Powell took note of "very, very strong" labor market conditions:

We think by our policy interventions what we hope to achieve is a period of growth below trend which will take – which will cause the labor market to get back into better balance, and then that will bring wages back down to levels that are more consistent with 2% inflation over time. That's what we're trying to achieve.

How will Powell know if wage pressures are abating? Average hourly earnings might offer some indication, but they're still growing at around 5.2% year-over-year. Of course, earnings growth can exceed inflation to the extent that it's offset by productivity growth, but productivity is actually declining in the US. And 5.2% would still be too high, even if productivity returned to a more typical 1% to 1.5% range.

Next, Powell is clearly intent on being cautious and bracing for any future problems that aren't obvious now. Powell was humbled by the experience of the past 18 months, including the temporary slowing of inflation that tricked the Fed around the summer of 2021, when price increases seemed to moderate, but then suddenly re-accelerated. Speaking Thursday, he noted that there's much that the rate setting Federal Open Market Committee cannot know about the current state of the economy, somewhat echoing a candid remark made in June that "we now understand better how little we understand about inflation." The supply shocks that initially

drove up the price of used cars and other durable goods in 2021 may be abating, but Powell is looking toward the next disruption. As he put it Thursday:

The question really is, is this going to be a temporary thing that's really related to the pandemic in some way, or is there actually something more structural and persistent happening? For example, if we're moving to a world where we're going to see more frequent, larger and more persistent supply shocks for whatever reason, that will have critical and difficult implications for the conduct of economic policy and monetary policy in particular. So this is not possible to know right now.

Powell made clear that he's looking at more than just one inflation report -- and investors should too. Even if CPI shows further improvement, two good reports hardly make for convincing evidence that the problem has been solved. Perhaps that's why federal funds futures now imply an 85% probability that the central bank will raise the upper bound of its target rate by 0.75 percentage point this month to 3.25%. The central bank is intent on fighting the inflationary pressures that are forthcoming, not just the ones that may be behind it. Like it or not, that suggests that the bank is likely to stay aggressive in the year ahead.