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Ratings

Lasting Effects of Temporary Inflation: Higher Prices, Lower Purchasing Power

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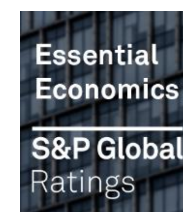

We continue to believe that US inflation pressures are largely transitory, meaning that under the Fed's currently announced policy settings inflation will come back to the target rate of an average of 2%. However, inflation will be stronger and last longer than initially forecast. This presents a "rates versus levels" dilemma. While the rate of inflation will come back to the policy target next year, the level of consumer prices will be permanently higher on the order of almost 4%. To the extent that this higher price level is not offset by higher wages, purchasing power will be permanently lower and consumer confidence will likely decline. This will slow demand growth and help to bring inflation back to target.

The Upside Surprise

US inflation continues to surprise to the upside, sparking a discussion of the monetary policy stance and some not always pleasant reminiscing about the hyperinflation of the 1970s. The current upside surprise has several dimensions. The initial inflation shock corresponding to the recovery from the economic effects of COVID-19-related lockdowns was stronger than anticipated. While inflation above the Fed's 2% average target was expected, the initial jump in early 2021 was sharper than anticipated and pushed the year-on-year CPI inflation rate to over 5%. Moreover, this spike in prices has been more persistent than envisaged, keeping the inflation rate above 5% since mid-year.

This has sparked a debate over whether inflation is temporarily higher, or whether the Federal Reserve is behind the curve and needs to start withdrawing accommodation earlier than planned. We acknowledge that inflation risks are higher, but that the dynamics remain as expected, although operating at a slower pace.

This can be seen by looking beyond the year-on-year inflation rates and focusing on momentum – see chart 1. The seasonally adjusted and annualized rate of CPI inflation over the previous three months (3m/3m saar) intentionally exaggerates recent inflation moves and serves as a common measure of inflation momentum. This measure rose to almost 10% in June – easily the highest rate in the past decade – as prices for goods such as lumber, chips and used cars surged.

Importantly, inflation momentum fell by half in the third quarter and now stands below 5%. The alternative six-month measure shows a similar pattern. Barring another upside inflation shock, developments are clearly trending in the right direction. It will take some time to get back to around 2% year-on-year inflation, as the very strong monthly prints for April through June 2021 will keep rates elevated until they drop out of the data.

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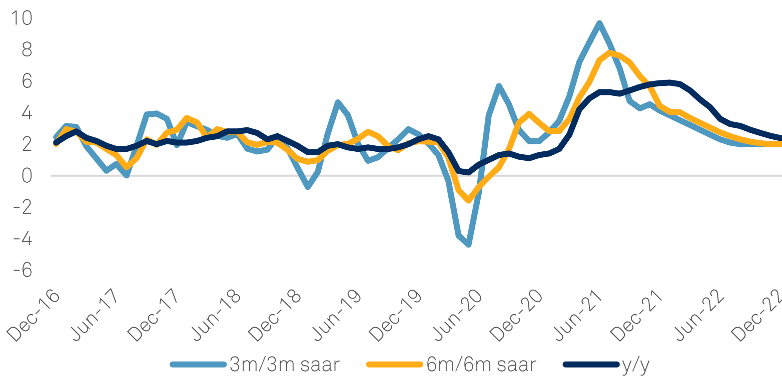
Chart 1

U.S. CPI Inflation Measures (%)



Source: US Bureau of Labor Services, S&P Global Economics.

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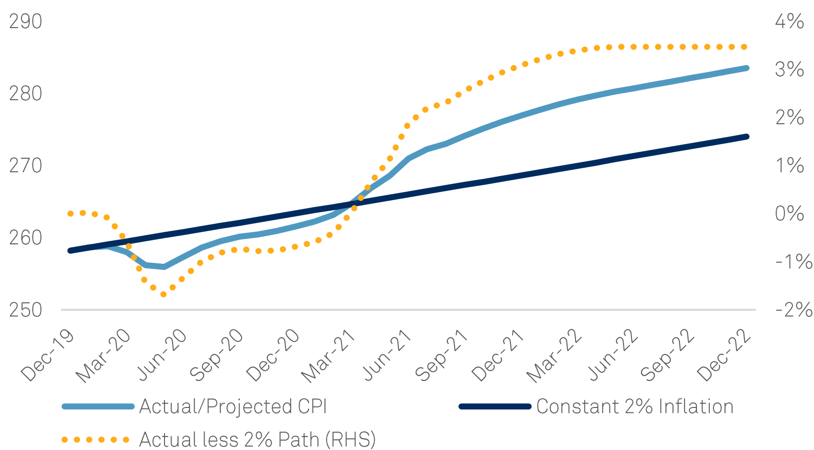
Higher Prices Will Persist

Ultimate success on the inflation front does not mean the story is over. While the headline inflation rate is forecast to fall back to around 2% next year, a higher level of prices will be a lasting outcome. To see this, image the path of prices if the Fed had met its 2% inflation target over the COVID period (beginning in January 2020); this corresponds to the orange line in Chart 2. Compare this with the actual (and projected) path of prices denoted by the blue line, and the difference noted by the dotted line.

Chart 2

U.S. CPI Levels



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Prices were lower than projected in the throughout much of 2020 for reasons that are now well known. The pandemic forced the lockdown of sectors where person-to-person contact was prevalent and led to unprecedent declines in GDP. Not surprising in this environment, demand was weak and prices fell, although an aggressive government response helped to cushion the blow. Real wages (after adjusting for inflation) where therefore higher than expected, at least in aggregate and for those still holding jobs. Those “gains” peaked at 1.7% in May 2020.

However, this has turned about sharply in 2021. Following the surge in inflation in the second quarter of 2021 and persistent inflation thereafter, prices are currently 2.6% higher in the COVID period relative to the constant 2% inflation path. Our forecasts suggest that this gap could climb toward 4% by the middle of 2022. Unless offset by wage gains – which are happening in some sectors affected hardest by the lockdowns last year – this higher-than-expected price level represents an unexpected loss in purchasing power, despite inflation returning to target. Consumer confidence and spending are likely to slow, which will push overall GDP growth and inflation pressures lower.

Two Takeaways: Price Levels and Purchasing Power

The takeaways are twofold. First, price levels matter for households as well as inflation rates. While we continue to forecast that inflation will return to the 2% target, the period of stronger and longer inflation has dented household purchasing power. Second, price levels are distributing purchasing power across groups in the economy. Upstream producers and those on the “opposite side” of the transaction may see purchasing power increases with lasting higher price levels. This points to the need to look at distributional effects in additional to level and rate effects.

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