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OPINION | COMMENTARY

Four Reasons to Keep Worrying About Inflation

Labor markets are tight, demand remains elevated, and the effects of Covid are highly uncertain.

By Jason Furman

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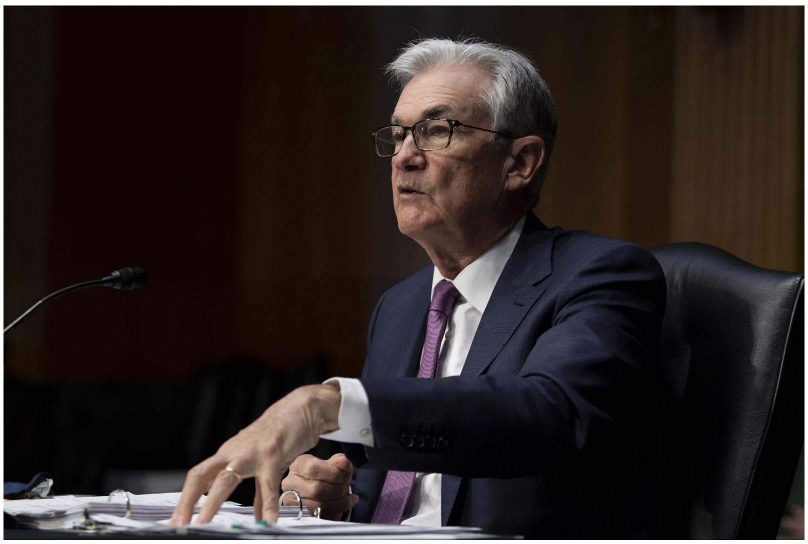

Federal Reserve Chairman Jerome Powell speaks during a Senate committee confirmation hearing in Washington, Jan. 11.

PHOTO: BRENDAN SMIALOWSKI/BLOOMBERG NEWS

Federal Reserve Chairman Jerome Powell may have retired the term, but conventional wisdom still holds that most of the excess inflation in 2021 was transitory. Many economists and market watchers expect most of it to disappear in 2022. I am much less sure and expect the economy to experience elevated inflation this year, possibly even higher than in 2021.

The core personal-consumption-expenditure price index (which is, de facto, what the Fed targets) rose around 4.5% in 2021. The median Federal Open Market Committee member expects it to slow to 2.7% while the Fed staff predict an even lower rate. Inflation-indexed bonds suggest the market expects about 2.5% inflation this year on a comparable measure.

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Those who imagine that inflation will be lower argue that the huge burst of fiscal policy is behind us, supply chains will unsnarl, consumers will shift from buying goods to services, workers will return, and prices for commodities like oil will continue to fall. Some of their arguments are overstated, while others are likely wrong. And if we focus only on reasons that inflation should be lower in 2022, we risk ignoring four countervailing forces that will push toward higher inflation this year.

First, the economy is beginning 2022 with much tighter labor markets than a year ago. Over the two decades before the pandemic, the best predictor of year-ahead inflation was the quits rate—the number of people who quit their jobs as a percentage of total employment. It is now far and away the highest it has ever been. A year ago the unemployment rate suggested substantial slack. Now it is nearly 3 percentage points lower. Nominal wage growth is running about 5 points above productivity growth.

Second, demand should remain above pre-pandemic trends, while supply will likely continue to lag behind. Many analysts were counting on dramatic reduction in fiscal support to restrain inflation. That dramatic reduction is now more than eight months behind us with no sign that consumer spending is cooling off. Fiscal support will remain relatively high with more than $500 billion of the American Rescue Plan being spent this fiscal year. Tax cuts and spending increases by states and localities, flush with huge surpluses, are adding to fiscal support. Add the lagged effects of extremely accommodative monetary policy, the excess savings households have from two years of high incomes and low spending, and rapidly rising employment and wages, and you have a recipe for continued high spending. At the same time, supply chains should improve but are unlikely to be fully recovered for much of 2022.

Third, consumers, businesses, forecasters and financial markets all expect near-term inflation to be about 1 to 3 percentage points higher than a year ago. This will add more upward inflation that the economy didn't have to contend with last year.

Fourth, the trajectory of Covid and its effect on inflation are highly uncertain. If the pandemic becomes manageably endemic in 2022, that could boost inflation in the same way that the rapid reopening of the economy did in the first half of 2021. If China tries to maintain a zero rate of Covid with its population effectively unvaccinated against Omicron, we could get the worst of all worlds as strong U.S. demand pushes against fraying global supply chains.

The most credible argument for lower inflation is the shift in demand from goods to services. But this may do less to restrain inflation than many are counting on. Almost all excess inflation in 2021 was due to rapidly rising goods prices. That inflation should moderate and could even turn negative for such major categories as used cars. But it only takes a 1 percentage point increase in service-price inflation to offset a decline of 5 percentage points in goods inflation. Prices for such services as rent, air travel and hotels have already been rising in recent months and are poised to keep going up.

Forecasters' biggest error in 2021 was overconfidence in their underprediction. The economy is always hard to predict, and the current unique circumstances make it even harder. I expect inflation in the range of 3% to 4% this year, but I wouldn't be surprised by a recession leading to 1% inflation or major geopolitical instability driving the inflation rate above 6%.

Mr. Powell was right to pivot toward concern about inflation in December. He proved that the Fed's actions will depend on the data, and the Fed is now on course to start raising rates in March. If inflation remains as high as I fear it will, expect him to continue to follow the data by pivoting further. Given the uncertainty, however, he should stay the course—for now.

Mr. Furman, a professor of the practice of economic policy at Harvard University, was chairman of the White House Council of Economic Advisers, 2013–17.

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