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OXFORD ECONOMICS

Research Briefing | US

Inflation will be higher for longer

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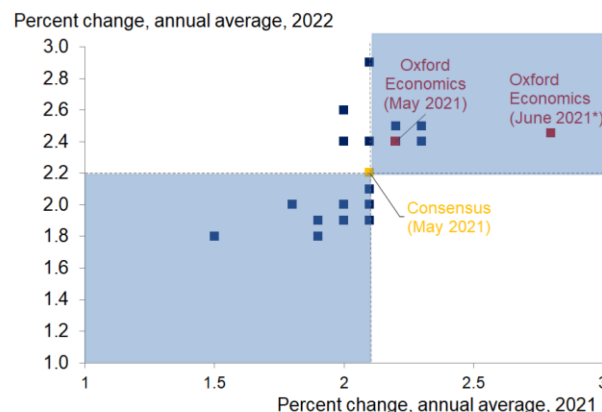
- **Major inflation surprises over the past few weeks have brought back fears of overheating. But, while the US economy is expected to feel a lot warmer over the coming months, we do not anticipate spiraling inflation.**
- **Incorporating the latest price developments and factoring a longer period of supply adjustments to rebounding demand, we think headline CPI inflation will peak at around 5% in May and core PCE inflation will surpass 3% for the first time since the early 1990s.**
- **Our forthcoming June baseline forecast will also feature increased inflation stickiness, with core PCE inflation averaging 2.5% in 2022 compared with 1.6% during 2010-2019. And while our baseline is already well-above consensus for 2021 and 2022, we think inflation risks are skewed to the upside.**
- **Forecast risks include the possibility of "good" inflation stemming from stronger demand, based on a greater release of excess savings, and "bad" inflation stemming from an insufficient capital and labor supply response.**
- **In this environment, we anticipate the Fed will tread carefully by signaling its attention to inflation risks while maintaining a dovish and careful approach to monetary policy tightening.**

Over the past year, we have consistently predicted higher inflation stemming from base effects, stronger activity in the wake of the economic reopening, higher commodities prices, and supply chain bottlenecks (**Figure 2**). But two uncertainties cloud the outlook: the level that inflation will peak at, and the persistence of inflation into 2022.

The surprisingly strong April CPI report shed more light on the likely inflation peak. With headline CPI rising 0.9% m/m and core CPI surging 0.5% – its largest gain since 1982, we now foresee headline inflation peaking in May at around 4.8% y/y/ and core at 3.5% y/y.

Figure 1: Inflation expected to be well above consensus



Our May 2021 baseline forecast was already above consensus for 2021 and 2022. Our forthcoming June baseline forecast will see inflation well above consensus in 2021, and still moderately higher in 2022.

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Inflation expected to be higher for longer

Accordingly, we expect headline PCE inflation to peak around 3.7% y/y. The core PCE inflation profile, meanwhile, may feature a double peak: around 3.1% y/y in the spring and around 3.2% y/y by year-end (owing to strong year-end base effects) (**Figure 3**).

Base case shows warmer inflation into 2022

Our bottom-up analysis of inflation dynamics envisages a gradual rotation of goods inflation toward services inflation, reflecting evolving spending patterns. But the rotation won't be smooth – given the ongoing supply bottlenecks, the summer is likely to bring an uncomfortable mix of elevated goods and services inflation.

Our forthcoming June baseline forecast will reflect these dynamics. We foresee headline CPI inflation ending 2021 around 3.9% y/y, roughly 0.8ppts higher than in our May baseline. Similarly, while core CPI inflation is expected to fall back moderately from its spring peak, it's still expected to hover around 3.4% y/y in Q4, about 0.6ppts higher than our May baseline (**Figure 4**).

Meanwhile, core PCE inflation – the Fed's main inflation gauge – is expected to hover above 3% y/y through most of the year, ending Q4 at 3.5% y/y. Not only would this represent the strongest inflation reading since 1992, it would also represent the longest stretch of inflation above 3% since the early 1990s (**Figure 5**).

Some "stickiness" into 2022

The second major uncertainty is the durability of inflation past its spring peak. Some commentators perceive the current rise in inflation as being entirely transitory, and assume that once base effects disappear, commodities prices stop rising, and the initial reopening of the economy is behind us, inflation will rapidly fall back.

Others, including Former Treasury Secretary Summers fear that inflation is the most important risk for the US economy, warning of spiraling inflation as expectations become unmoored, businesses retain pricing power, and workers gain stronger bargaining power. They argue these factors will lead to a strong inflation-wage push-push cycle.

Our view is that inflation will cool in the coming quarters, but will remain higher than it's been over the past decade. We see headline CPI inflation averaging 2.4% in 2022 compared with 1.8% during 2010-2019, while core PCE inflation will average 2.5% compared with 1.6% during 2010-2019 (**Figure 4**).

Figure 2: Strong base effects will gradually dissipate, but inflation will remain elevated

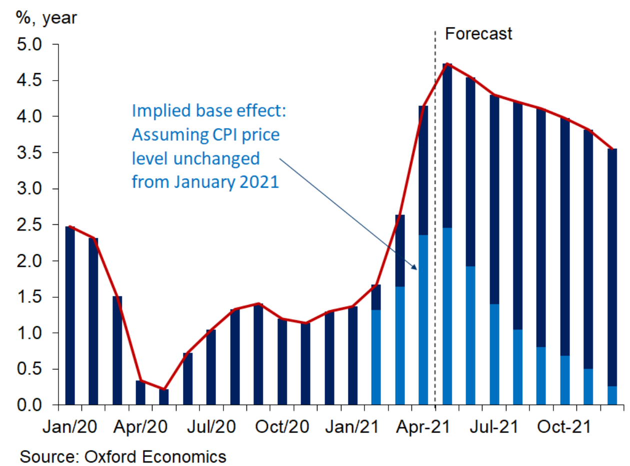


Figure 3: Inflation is expected to be extremely volatile in the coming months

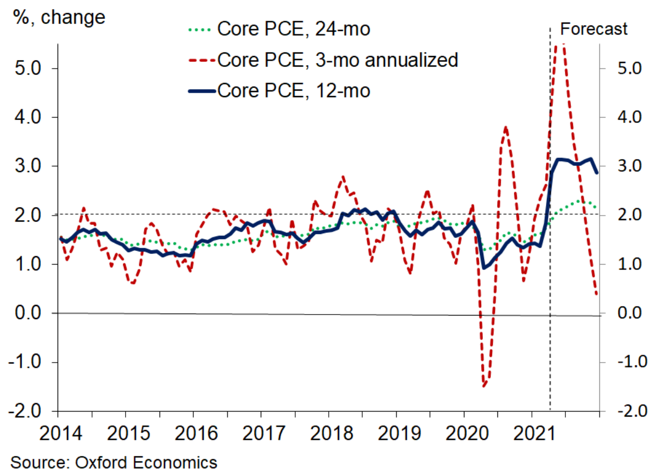
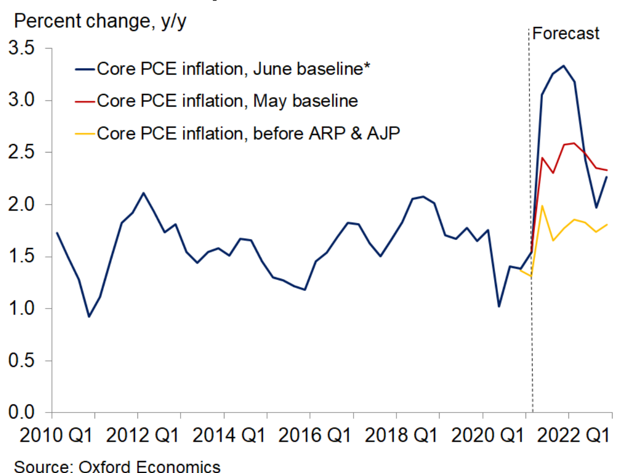


Figure 4: An upward revision to our inflation forecast



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Could we be wrong?

Too often baseline projections are taken at face value without considering the risks. Given the extreme uncertainty around the outlook, we believe it's important to understand where the risks of overheating could come from.

In our view, the sources of risk are three-fold. First, economic forecast risks, where demand and supply forecast errors lead to inflation forecast errors. Second, modeling errors, where pricing, wage setting, inflation expectations dynamics differ from historical norms. And finally, policy risks, where Fed credibility and independence are at play.

Here, we examine the first category of risks, and will analyze the two other dimensions in upcoming research examining whether we are on the verge of an inflation regime-shift.

Good inflation: Stronger demand

As part of our Global Scenario Service, we have modelled an upside scenario in which US consumers run down a large proportion of the $2.3tn in excess savings accumulated during the pandemic (**Figure 6**). We assume the funds are spent through end-2022, with a marginal propensity to consume 45%.

In such a scenario, real GDP would end 2022 about 2.5% above our current baseline. Stronger consumer spending would support greater business investment. But greater demand would also lead to CPI inflation being 0.6ppt higher at the end of 2022, prompting the Fed to tighten six months earlier than in the baseline (**Figure 7**).

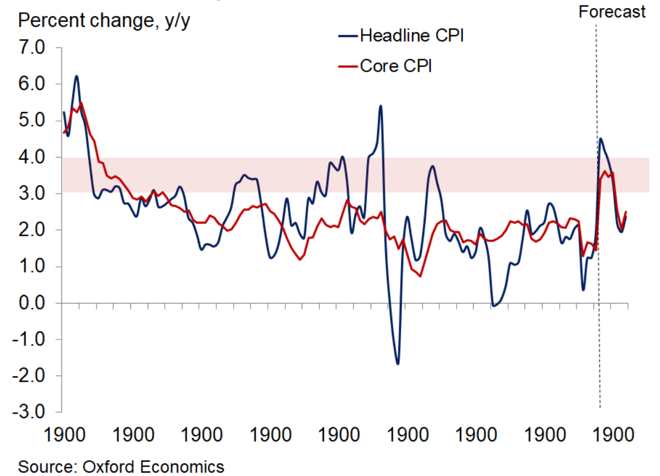
Bad inflation: Weak and slow supply response

Our alternative scenario features a marked deterioration in the inflation outlook, driven by a persistently slow and inadequate supply response to the post-pandemic demand resurgence.

In this scenario, supply is hit in three ways: global oil output fails to respond to rising demand; inflation expectations shift persistently higher; and labor supply recovers more slowly than in the baseline.

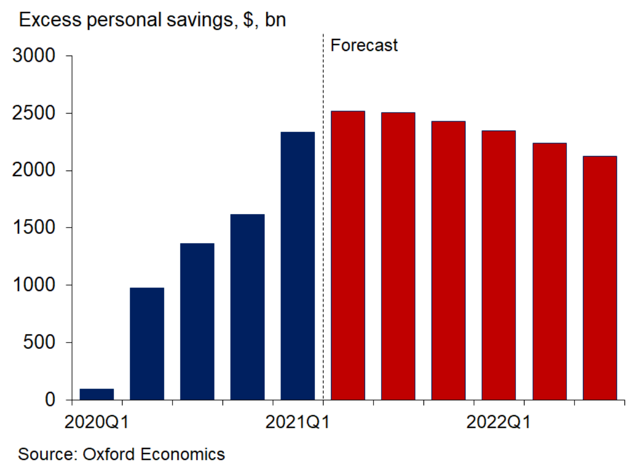
Consumer prices surge due to the weak supply response, with headline CPI hovering around 4%-5% and ending 2022 about 0.8ppts higher than in the baseline (**Figure 7**). In turn, this leads to a sharp bond market sell-off, amid heightened expectations of early policy tightening and a correction in equity markets. With consumers struggling to maintain real incomes in the face of higher prices, domestic demand is hit hard. US GDP falls 2% below the baseline in 2022.

Figure 5: Core inflation at the highest since the early 1990s



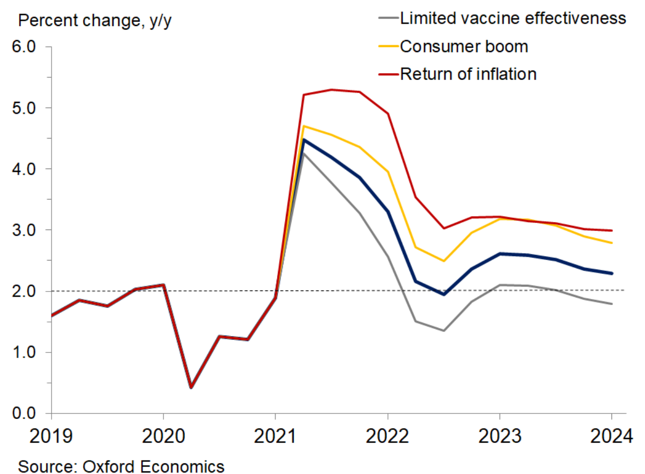
Source: Oxford Economics

Figure 6: Excess savings could fuel a stronger post-pandemic rebound and higher inflation



Source: Oxford Economics

Figure 7: Inflation risks are skewed to the upside



Source: Oxford Economics

Lower inflation shouldn't be discounted

While we think inflation risks are skewed to the upside, we shouldn't discount downside risks to inflation. As part of our Global Scenario Service, we also explored a scenario in which new virus variants result in renewed restrictions. With vaccines failing to limit the spread of the virus, stricter restrictions are implemented for longer.

As a result of the renewed virus fears and social distancing measures, consumption and investment weaken while investor sentiment deteriorates with equity prices falling and risk premia on corporate debt spiking. US GDP falls 6% below the baseline in 2022, and inflation falls below 2.0% in early 2022, ending the year 0.6ppt below the baseline (**Figure 7**).

Fed is in no rush to remove policy accommodation

As it contemplates these risks to inflation, the Fed will proceed cautiously in removing policy accommodation. The Fed is now openly "talking about talking about" QE tapering, with the FOMC minutes, Vice Chair Clarida, and other policymakers alluding to being one degree removed from considering tapering.

We believe that discussion around asset purchase tapering will start in earnest later this month – provided economic data point to a resilient recovery – with an announcement possible at the Fed's Jackson Hole Symposium in August. With tapering starting in early 2022, we believe the Fed will consider raising rates in early 2023 (**Figure 8**).

Still, we shouldn't anticipate the Fed departing from its new flexible average inflation targeting framework (FAIT), which identifies three conditions for rate liftoff: inflation at 2%; and inflation on track to moderately surpass 2% for some time; and maximum employment.

While the Fed's new reaction function remains unclear, our latest baseline forecast would only fulfil the price stability criteria by the end of 2022 if the Fed uses a 2-year look-back window. If instead, the Fed prefers to make up for inflation misses over a longer horizon, then it would have to tolerate inflation being above the 2% for some time beyond the end of 2022 (**Figure 9**).

Figure 8: A dovish Fed

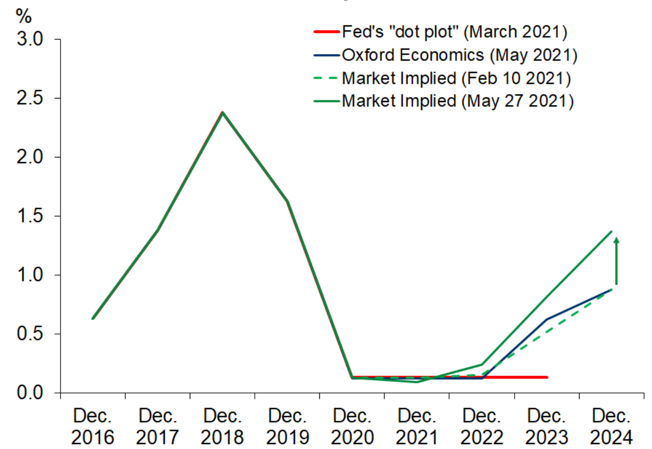


Figure 9: Headline and core prices are expected to remain under the five-year 2% trend