Understanding U.S. Inflation During the COVID Era

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This paper analyzes the dramatic rise in U.S. inflation since 2020, which we decompose into a rise in core inflation as measured by the weighted median inflation rate and deviations of headline inflation from core. We explain the rise in core with two factors, the tightening of the labor market as captured by the ratio of job vacancies to unemployment, and the pass-through into core from past shocks to headline inflation. The headline shocks themselves are explained largely by increases in energy prices and by supply chain problems as captured by backlogs of orders for goods and services. Looking forward, we simulate the future path of inflation for alternative paths of the unemployment rate, focusing on the projections of Federal Reserve policymakers in which unemployment rises only modestly to 4.4 percent. We find that this unemployment path returns inflation to near the Fed’s target only under optimistic assumptions about both inflation expectations and the Beveridge curve relating the unemployment and vacancy rates. Under less benign assumptions about these factors, the inflation rate remains well above target unless unemployment rises by more than the Fed projects.

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