INFLATION & MONETARY POLICY

by

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Inflation has been an important topic for the past year since the Federal Reserve cut the rate which lowers the interest rate to near zero as a response to the coronavirus pandemic. This is a tactic to support the economic recovery of the United States. Since then, the Consumer Price Index has increased due to this recovery. The Consumer Price Index in the United States rose 7.9% as of February 2022. There are a lot of factors that have contributed to this rise in the CPI. After the pandemic started, the government introduced multiple stimulus responses to support the unemployment rates and help with economic recovery. Furthermore, there were disruptions in the supply chain due to an increase demand of products and limited supply of critical materials such as semiconductors which led to an increase in prices. There is also a current geopolitical risk due to the start of the Russian and Ukrainian war which has limited trade and introduction of harsh sanctions between countries. These factors precipitated the rise in inflation. Therefore, high inflation will persist due to the fiscal stimulus in response to Covid-19, supply chain bottlenecks of microchips, and geopolitical tensions from war. This will result in the Federal Reserve to aggressively raise interest rates to keep it in check.

There were three different fiscal stimulus responses to the coronavirus pandemic. In April 2020, the U.S. Congress passed the CARES Act which was a $2.2 trillion economic stimulus bill. Later, the Coronavirus Response and Relief Supplement Appropriations Act was signed off as the second stimulus package which was $900 billion. Finally, the $1.9 trillion American Rescue Plan signed into law as the third round of fiscal stimulus. With the three stimulus packages signed off by the U.S. government, it would overheat the economy. Substantial overheating will lead to higher inflation due to the adjustments in expectations of inflation to actual inflation. In a written piece, “In defense of concerns over the $1.9 trillion relief plan” by Oliver Blanchard, he states, “The history of the Phillips curve is one of shifts, largely due to the adjustment of expectations of inflation to actual inflation … But, with such overheating, expectations might well de-anchor. If they do the increase in inflation could be much stronger.” [1] In other words, as a result from the overheating that we are seeing currently due to the Covid-19 pandemic, it would lead to a much stronger inflation rate. Even though the inflation expectations have been almost constant for many years, it has not always been the case. Historically in 1969, the inflation expectations started adjusting and it increased inflation to 6 percent. This led to a recession from 1969 to 1970. Therefore, high inflation will persist due to the fiscal stimulus in response to the coronavirus pandemic which will result in the Federal Reserve to aggressively raise interest rates to keep it in check.

Additionally, the Covid-19 pandemic has caused supply chain disruptions resulting in higher inflation in the economy. The coronavirus pandemic increased the demand for semiconductors due to pandemic-driven demand for electronics. Semiconductors are a key component for production of many goods. The scarcity of semiconductors could potentially halt the production of the good. Based on data from the Federal Reserve, the U.S. domestic production of autos have decreased due to the rise in scarcity of semiconductors which resulted in a higher U.S. producer price index for vehicle sales. In the economic synopses done by Fernando Leibovici, a Senior Economist from the Federal Reserve Bank of St. Louis states, “We focus on the case of semiconductors, for which demand increased along with the pandemic-driven demand for electronics … Semiconductor shortages have held up auto production and driven up prices … Semiconductor shortages might be exacerbating supply chain bottlenecks

[1] Blanchard, Olivier. (2021, February 28). In defense of concerns over the $1.9 trillion relief plan. Peterson Institute for International Economics. Retrieved February 27, 2022, from, https://www.piie.com/blogs/realtime-economic-issues-watch/defense-concerns-over-19-trillion-relief-plan

further fueling inflation." [2] This is saying that Covid-19 increased the demand for electronics while semiconductor dependent industries such as automobile manufacturers or other electronics would have to slow production which decreases supply. This would drive prices of semiconductors and other manufactured goods up because of higher demand for the products further "fueling inflation." With the disruption in the supply chain with semiconductors as the bottleneck, inflation will persist resulting in the Federal Reserve aggressively raising interest rates.

Finally, the recent geopolitical tensions from war will lead to higher inflation. Russia is a prominent provider as an energy supplier. With the conflict between Russia and Ukraine, NATO announced sanctions to pressure the Russian economy. Exports and imports from the country have been halted which constrains the global energy supply. The Monetary Policy Report for February states, "Demand for oil rose as the global economy recovered further, and oil supply was constrained by U.S. oil production disruptions due to Hurricane Ida and by only modest production increases by OPEC (Organization of the Petroleum Exporting Countries) and its partners. Geopolitical tensions with Russia have also contributed to higher energy prices, including oil and natural gas." [3] In other words, the recovery from the pandemic has led to an increase in demand for oil. The geopolitical tensions between Russia and Ukraine reduced supply which increased the prices of energy. Additionally, the sanctions imposed by NATO countries could impact the import and export prices. With the recent geopolitical upheaval, it caused

[2] Leibovici, F., & Amp; Dunn, J. (2021, December 16). Supply Chain Bottlenecks and Inflation: The Role of Semiconductors. ECONOMIC Synopses. Retrieved March 11, 2022, from https://files.stlouisfed.org/files/htdocs/publications/economic-synopses/2021/12/16/supply-chain-bottlenecks-and-inflation-the-role-of-semiconductors.pdf

[3] Board of Governors of the Federal Reserve System. (2022, February 25). Monetary Policy Report - federalreserve.gov. Retrieved March 12, 2022, from https://www.federalreserve.gov/monetarypolicy/files/20220225_mprfullreport.pdf

economic tensions which would put more pressure on inflation resulting in the Federal Reserve to aggressively raise interest rates to keep it in check.

In conclusion, there are many elements that caused the rise in the Consumer Price Index. The most prominent factors include the fiscal stimulus in response to Covid-19, supply chain bottlenecks of microchips, and geopolitical tensions from war. The stimulus responses from the US government overheated the economy which ensued higher inflation. Due to the increase demand for electronics and other products with a limited supply of microchips, it resulted in higher prices stemming inflation. Further, the recent geopolitical tension between Russia and Ukraine arose many restrictions to global imports and exports of energy which increased prices for oil and gas. With the increase in inflation derived from these factors, this will result in the Federal Reserve to aggressively raise interest rates to keep it in check.