WHAT YOU NEED TO KNOW ABOUT

Inflation

PRO POINTS

- **Consumer prices were up 8.5% in July compared to** the year before, but they didn't rise, in aggregate, at all from June to July, thanks in particular to a steep drop in gas prices. Even so-called core inflation, which excludes volatile food and energy prices, suggested that price spikes might be cooling. This latest data has sparked hopes that inflation might have peaked.

- **Regardless of whether the U.S. is through the worst of** inflation, prices in key areas will continue to drive the cost of living higher for some time — especially rent, which has risen sharply in the wake of soaring home prices. The Federal Reserve is likely to keep raising interest rates through the end of the year in the hopes of ensuring that elevated inflation doesn't stick around past the next year or two.

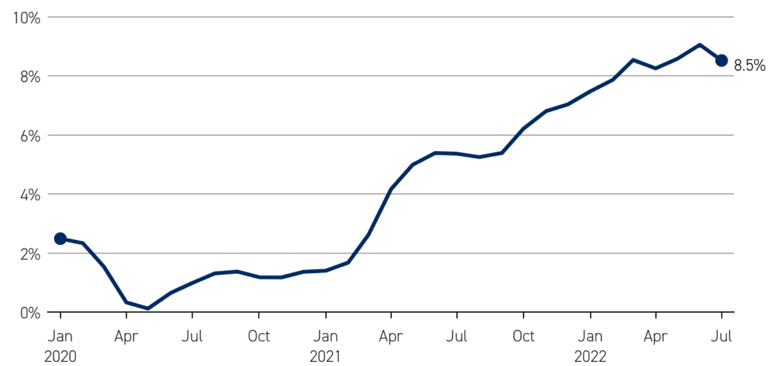
- **The Fed is under intense pressure to bring down** inflation without causing too much pain for the job market.

HOW WE GOT HERE

Inflation began to climb in April 2021, provoked by a semiconductor shortage that made it difficult to produce enough new cars to meet demand. Because price spikes that summer were powered largely by sector-specific factors, the Fed and the Biden administration, as well as many professional economists, judged that they would fade as production and shipping delays eased.

Inflation has risen over the course of the pandemic

Annual change in inflation, not seasonally adjusted



Source: Bureau of Labor Statistics
Taylor Miller Thomas / POLITICO

But as the year wore on, price spikes began to broaden beyond specific categories like automobiles. By the fall of 2021, the Fed began to shift its tone and sped up its timeline for ending its bond purchases, which were designed to hold down long-term interest rates. Still, the central bank didn' t take direct action to raise borrowing costs until March 2022, after its bond-buying program was phased out. That monthslong delay has generated criticism, and Chair Jerome Powell has said, in hindsight, the Fed would have preferred to have acted sooner.

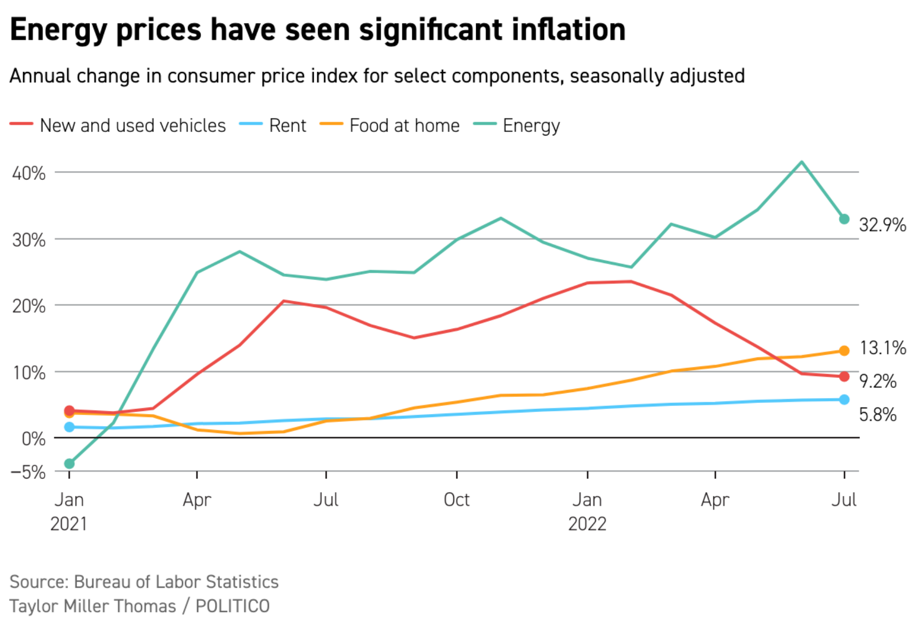
The central bank has now raised rates four times this year, including two increases of three-quarters of a percentage point — three times the standard hike — and its main borrowing rate sits between 2.25 percent and 2.5 percent.

An important question that is key to the path of inflation going forward is what caused it in the first place. The blame has been assigned to a hodgepodge of factors that all likely contributed to the highest price surges in four decades.

The supply chain crisis, driven by Covid-related factory shutdowns, clashed with a surge in demand for goods as people stayed home and bought things rather than going out and spending money on services like travel and entertainment. Many workers fell sick or suddenly had additional child care burdens as schools went remote, causing employers to have to pay more for labor, increasing costs. The government spent trillions of dollars and bolstered Americans' bank accounts to help them weather the crisis, though that also allowed many of them to afford higher prices. Rock-bottom interest rates fueled demand for debt- financed assets like houses. And some companies took the opportunity offered by rising prices to raise what they charge.

Meanwhile, Russia's invasion of Ukraine in early 2022 led to a further surge in the price of oil, key crops like wheat and other commodities that are used as inputs in manufacturing. That drove inflation to its recent 9.1 percent peak.

Now, the exact mix of these factors will determine how quickly inflation will cool and how aggressively the Fed still needs to keep raising rates.



WHAT'S NEXT

Since the July inflation data came out, stocks have risen steadily, while interest rates for U.S. government debt maturing in the next couple of years have fallen, on hopes that the Fed will not need to act as aggressively to help inflation cool.

Powell has said the central bank expects to raise its main borrowing rate into "restrictive" territory, meaning that Fed officials are trying to do more than just avoid contributing to inflation. They also think they need to get to a point where their policy is actively slowing economic growth. It's not clear what level of rates the Fed will need to reach to do that; by certain estimates, the central bank is already holding back the economy because credit is already much more expensive. But some economists argue that the Fed will need to bring inflation-adjusted rates out of negative territory, which could require the federal funds rate to rise by more than a percentage point.

It's also an open question whether the Fed will need to cause a recession (and by one technical definition — two consecutive quarters of negative GDP growth — the U.S. economy is already in one, though that data could later be revised). The job market is still holding up in the face of quick and large rate hikes, but Fed policy also takes time to work its way through the economy, and the unemployment rate — back to early 2020 levels at 3.5 percent — could begin to rise.

Growth in worker incomes has stayed remarkably strong, though it hasn't kept pace with inflation. That's contributed to fears both within the Fed and outside that wages and prices will keep pushing each other up, making inflation harder to tame. It might also mean that the Fed will have to bring the hammer down harder on the labor market to get price spikes to cool.

All of this heightens political risks for the Fed. Causing a full-blown recession and a surge in unemployment will not only cascade back on to the Biden administration but also lead to condemnation from Democrats like Elizabeth Warren, who says inflation is caused by supply-side problems that the Fed has no ability to solve. But if the central bank backs off from its rate hikes too early, that also runs the risk of further entrenching inflation into the mindsets of businesses and consumers, which could make it last much longer.

POWER PLAYERS

- **Lael Brainard:** The Fed vice chair is a Ph.D. economist who wields important influence at the central bank as No. 2 to Powell, a former private equity investor who was trained as a lawyer. She has particularly highlighted the ways in which inflation falls disproportionately on lower-income people.

- **Marc Goldwein:** The senior policy director for the Committee for a Responsible Federal Budget warned in early 2021 that nearly $2 trillion in additional spending could lead to an intense surge in prices, which has bolstered his sway on Capitol Hill on matters of inflation.

- **Lindsay Owens:** The executive director of progressive think tank Groundwork Collaborative, who is a former aide to Warren, was the driving force behind the Democratic argument that corporations have pricing power and their drive for profits is a key component of inflation. She and her team dug through hundreds of corporate earnings calls to make their case.

- **Larry Summers:** A D.C. fixture, the former Treasury secretary has the ear of the White House and has often been cited by Republicans because he pins considerable blame for inflation on government spending. He has also strongly criticized the Fed for not acting sooner to raise borrowing costs and suggested the unemployment rate needs to rise sharply to rein in inflation.