SMBC SMBC Group

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How Much Credit Does the Fed Deserve for Lower Inflation?

The short answer is not as much as you might think. If so, this has important implications for the economic and financial outlook. There are two reasons we make this case.

One, **longer run inflation expectations never became meaningfully unanchored**. The 10-year breakeven inflation rate peaked at just under 3% in April 2022, and this was after just one 25 basis point rate hike when the upper band of the funds target range was still only 0.5%.

Breakeven inflation collapsed thereafter, falling to 2.2% by September 2022 and implying sub-2% PCE deflator. The bond market was not worried about inflation.

The plunge in inflation expectations that began in April, one month after the Fed started raising rates, was not due to expectations of future policy tightness. We know that because the median dot on the histogram expected a 1.9% 2022 yearend rate. As an aside, other measure of inflation expectations showed the same pattern.

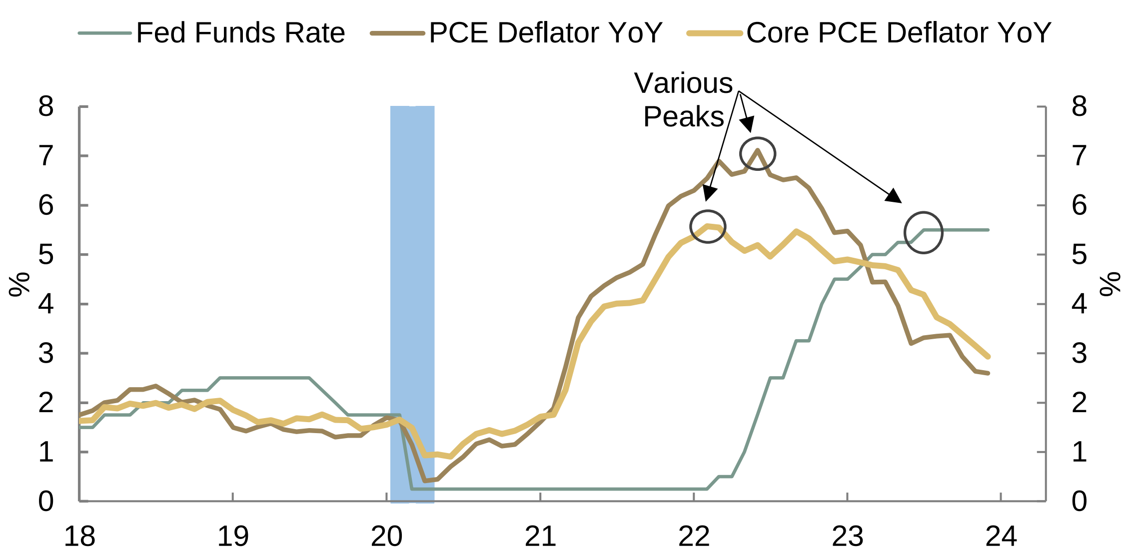
Rather, the bond market likely viewed the unexpected inflation surge, that began the previous year, as likely being temporary which leads to our next point.

Two, **inflation peaked well before the funds rate peaked**, which is highly unusual. In fact, the year-over-year rate on the PCE deflator topped out in June 2022 at 7.1% which was 13-months prior to the eventual peak in the funds rate.

More remarkably, the core PCE deflator peaked in February and March 2022 (5.6%), effectively before the Fed began raising interest rates. How can the Fed take the credit (or most of it), if a substantial portion of the disinflation we experienced was transitory in nature, as many economists (present company included) had argued at the time?

To be sure, no one can prove a counterfactual. So, there is no way of knowing exactly where headline and core inflation would be today if the Fed had stopped raising rates in early 2022 and kept policy loose. Our best guess is, and surely many if not nearly all others would agree, the inflation rate would be a lot higher.

But the point of the matter is that **the seeds of disinflation were planted early on**. Therefore, if less of the improvement in inflation was due to the Fed actions and more was due to a loosening in supply-side bottlenecks, the current stance of monetary policy is much too restrictive.



Source: Federal Reserve, BLS, Haver, SMBC Nikko

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