The Daily Dish

Inflation, Recession, and the Fed

DOUGLAS HOLTZ-EAKIN | APRIL 13, 2023

Prior to the release of yesterday's March report on the Consumer Price Index (CPI) and minutes of the March meeting of the Federal Open Market Committee (FOMC), the rough consensus was that the FOMC would hike another 25 basis points at its May meeting and then go on pause. Then came the news.

First, the topline CPI inflation was 4 percent (annual rate) in March, and 5 percent year over year. These are down from 6.9 percent and 6.0 percent, respectively. Core inflation came in at 5.8 percent (annual rate) in March and 5.6 percent year over year. Both were unchanged from the year before. The instant analysis (including mine) was that this was a promising report, but upon reflection the real story was that the energy component fell at an annualized rate of 10.5 percent. Outside of that, there is little promising news. Measured year over year, the core was unchanged, food rose 8.4 percent, and shelter rose 8.2 percent (and still has not peaked). My bottom line: no real evidence of inflation moving down.

Second, the minutes (as usual) contained a summary of the Fed staff's economic forecast that included two gems: (1) "Given their assessment of the potential economic effects of the recent banking-sector developments, the staff's projection at the time of the March meeting included a mild recession starting later this year, with a recovery over the subsequent two years." (2) "Reflecting the effects of less projected tightness in product and labor markets, core inflation was forecast to slow sharply next year." In short, kiss your soft landing goodbye, but we are winning the battle against inflation.

How should one think about this? The first observation is that the FOMC heard the staff's projected recession and lower inflation and hiked rates another 25 basis points anyway. This is entirely consistent with two things that Chairman Powell has emphasized in the past. First, the greater mistake that the Fed could make would be to ease prematurely or otherwise do too little to fight inflation. Second, the Fed would monitor actual inflation (not projected inflation) and adjust the stance of policy based on measured progress in reducing

inflation. As we saw at the outset, actual inflation remains stubbornly high.

Extrapolating forward, yesterday's developments seemingly lock in another rate hike in May. But more important, they leave in place the possibility of even more hikes to follow. Indeed, the Fed's bias toward doing too much instead of too little raises the probability that the staff will turn out to be right and the U.S. economy will see recession in the second half of 2023.