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United States economic outlook

Inflation trends post COVID-19

COVID-19
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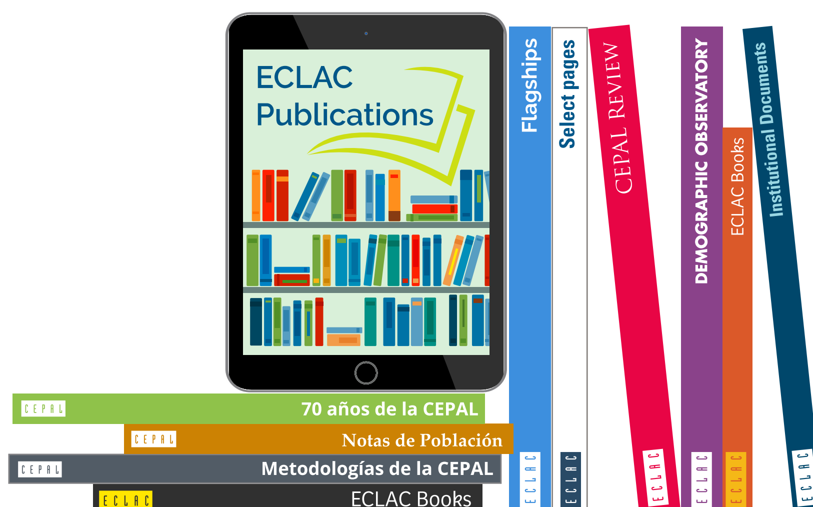

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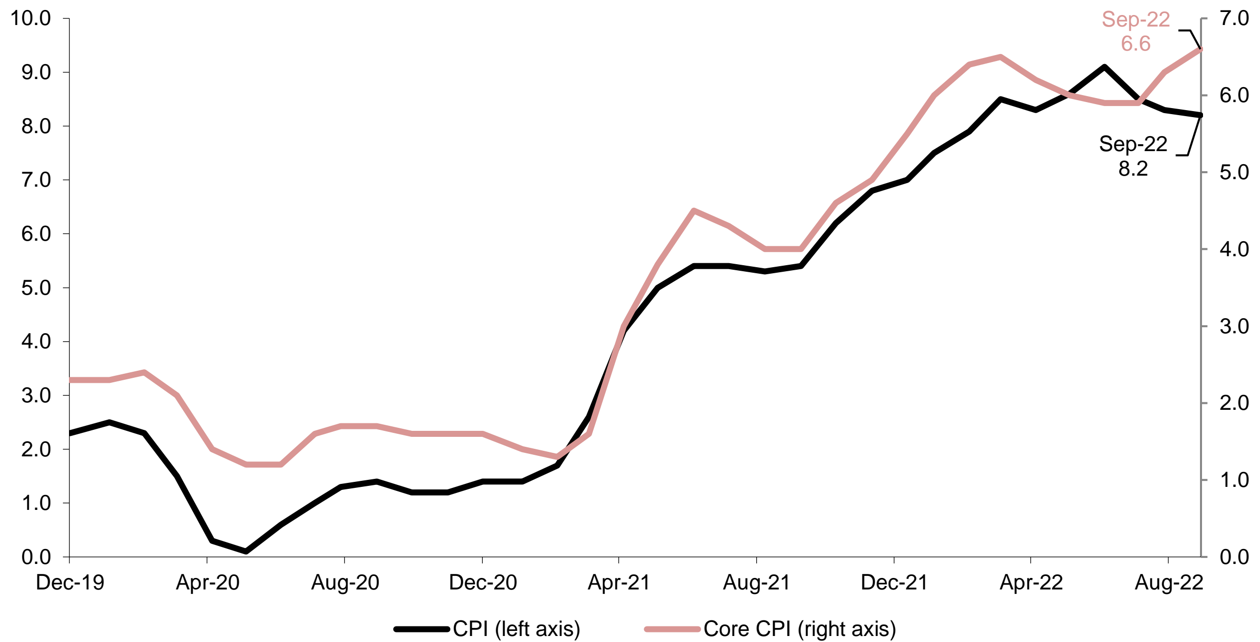
Overview

The United States has witnessed historic inflation since the economy began to reopen in 2021 following the COVID-19 lockdowns (figure 1). The factors behind this surge in prices, which have been difficult to disentangle, have been a topic of debate among policymakers and academics.

Figure 1
Monthly evolution of domestic prices, December 2019—September 2022
(CPI-U unadjusted 12 months percent change)

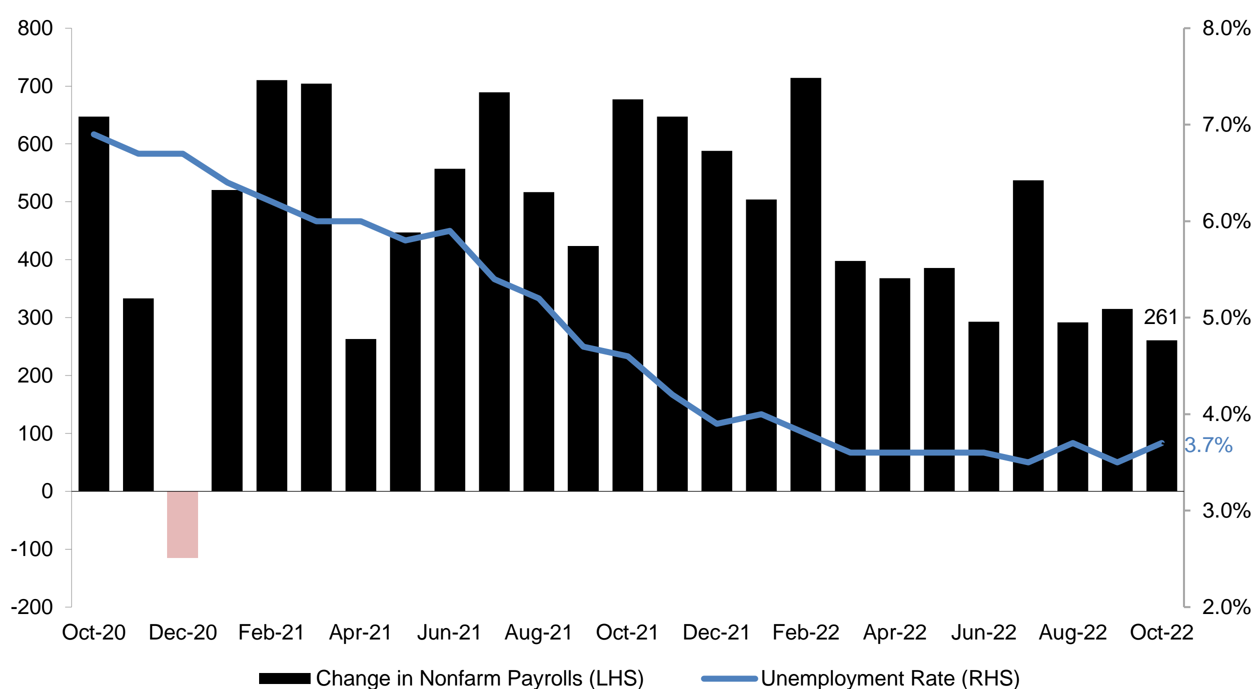


Source: ECLAC Washington Office, based on data from the United States Bureau of Labor Statistics.

Supply chain constraints and the shift in consumption patterns have affected economies worldwide. Some emphasize the pandemic-induced shift in consumer spending from services to goods, which occurred just as supply chains and labor markets were disrupted, as an important factor behind the increase in inflation. Russia's invasion of Ukraine and continued lockdowns in China have contributed to further delay the normalization of supply chains.

A uniqueness to the United States economy in the supply-side argument is the tightness of the labor market. Monthly job growth has averaged 407,000 thus far in 2022, compared with 562,000 per month in 2021. In October, employers added 261,000 jobs, the 22nd consecutive month of employment gains, while the unemployment rate edged up to 3.7%, slightly above September's 3.5% historic low, the United States Bureau of Labor Statistics reported (figure 2).

Figure 2
Monthly job creation and unemployment rate, September 2020-September 2022
(Average monthly job growth in thousands (left axis); Percentage (right axis))



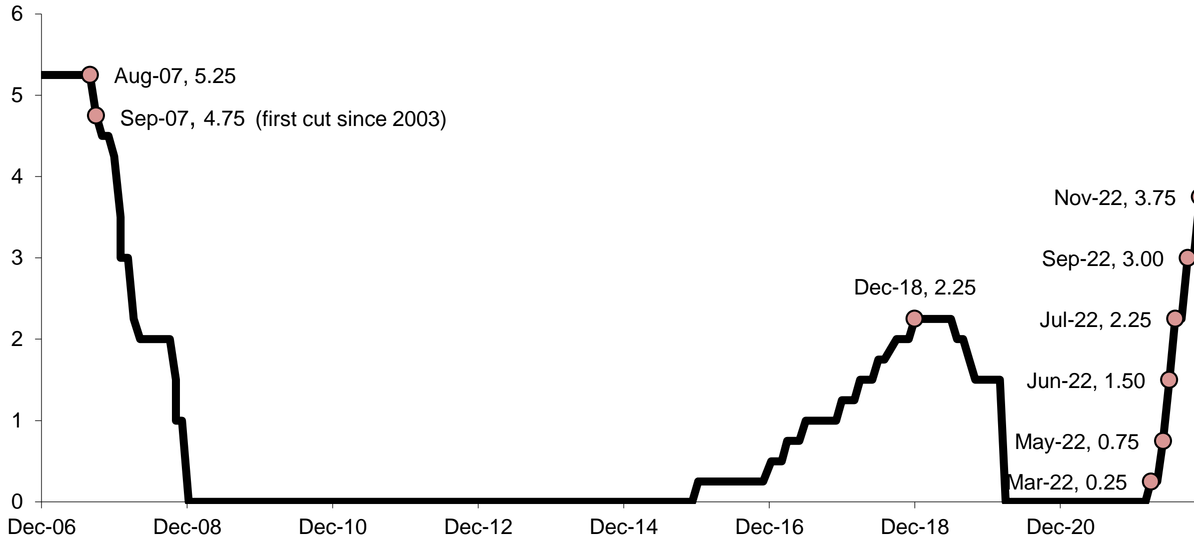
Source: ECLAC Washington Office, based on data from the United States Bureau of Labor Statistics.

Others place more emphasis on demand factors, faulting the largesse of pandemic stimulus measures such as the CARES Act passed in 2020 and the American Rescue Plan Act (ARPA) passed in early 2021 in particular,[1] as well as the historic level of monetary accommodation, for pushing demand beyond the economy's productive capacity.

The Federal Reserve has approved six interest rate increases this year, as well as a plan to shrink its US$ 9 trillion asset portfolio to combat inflation. On 2 November 2022, the Federal Reserve enacted its fourth consecutive 0.75 percentage point interest rate increase —its most aggressive monetary tightening campaign since the early 1980s— taking its benchmark rate (the federal funds rate) to a range of 3.75%-4.00% and bringing it further into "restrictive" territory (figure 3). This aggressive tightening aims to reduce excess demand in the economy and prevent the de-anchoring of inflation expectations.

[1] For detailed information on the United States fiscal response to the COVID-19 pandemic see R. Artecona and H. Velloso (2022), p. 16 and 17.

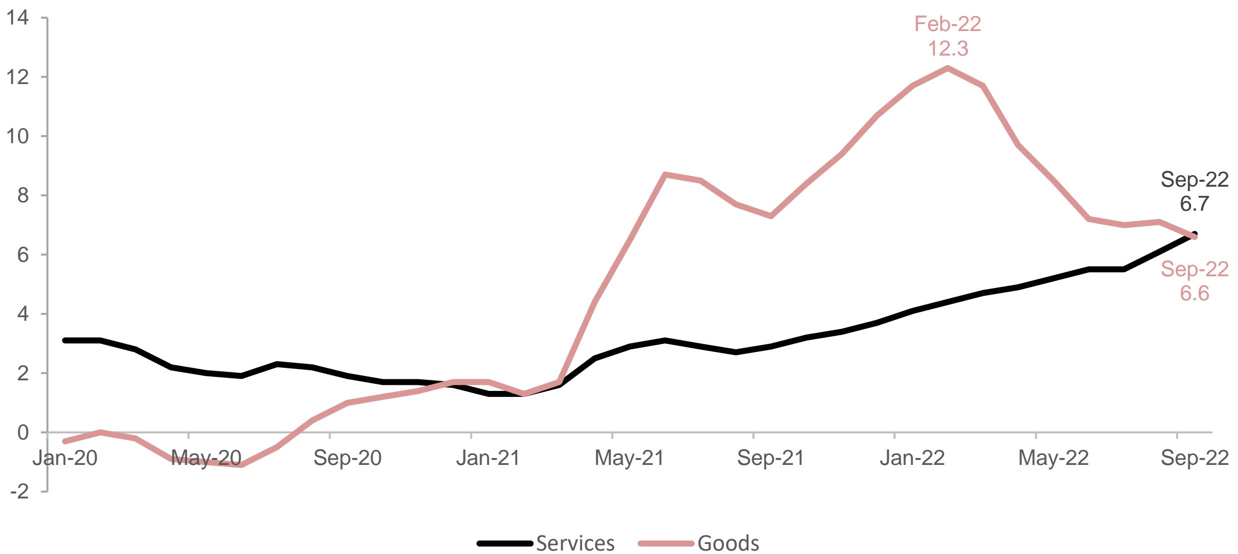
Figure 3
United States federal funds target rate, December 2006—November 2022
(Percentage)



Source: ECLAC Washington Office, based on data from the United States Federal Reserve. Rates in the chart are the bottom limit of the target range for the federal funds rate.

Inflation started in goods affected by supply chain issues. Supply chain pressures eased over the summer of 2022. However, while costs to transport goods declined and supply chain bottlenecks eased in September, prices of services rose. For the 12 months ended in September 2022, core service prices were up 6.7% according to data from the Bureau of Labor Statistics, the fastest pace since 1982. They are now rising faster than core goods prices, which rose 6.6% the same month, down from a peak of 12.3% in February (figure 4).

Figure 4
United States core consumer prices, January 2020 – September 2022
(12-month percentage change)



Source: ECLAC Washington Office, based on data from the United States Bureau of Labor Statistics. Goods: Commodities Less Food and Energy Commodities in U.S. City Average, Services: Services Less Energy Services in U.S. City Average. Not Seasonally Adjusted.

Behind this shift in price increases from goods to services is the tight labor market, as labor costs comprise more of the costs in services than goods. The concern is that the broadening of inflation to the service sector will make it more difficult for the Federal Reserve to bring inflation back to target in a timely manner, increasing spillovers to financial markets and the global economy, and to low-income and indebted countries in particular.

Despite the aggressive tightening, the United States consumer price index (CPI) rose 0.4% in September, following a 0.1% gain in August. On a year-ago basis, the headline and core CPI rose 8.2% and 6.6%, respectively, in September. These numbers keep the pressure on the Federal Reserve to keep raising interest rates and are a concern to financial markets and the broader economy. Markets are now pricing in a terminal federal funds rate of 5.00% to 5.25% sometime in the first half of 2023, then a decline by the end of next year.

In response to the rapid pace of policy tightening, the economy is expected to contract as employers cut expenses and jobs. According to the latest Wall Street Journal's Economic Forecasting Survey released in mid-October, on average economists put the probability of a United States recession in the next 12 months at 63%, up from 49% in July's survey. It is the first time the survey pegged the probability above 50% since July 2020 (Torry and DeBarros, 2022).

On an annual basis, average market projections point to growth of 1.4% in 2022, and of 0.6% in 2023, with projections made in September and October (table 1). Economic growth was downgraded in the latest projections released by the Federal Reserve on 21 September 2022. The Fed now projects a growth rate of only 0.2% in 2022 and 1.2% in 2023. With the United States economic outlook clouded by uncertainty and with the risk of a potential recession increasing, especially if the Federal Reserve raises interest rates faster and higher than expected to contain inflation, investors see monetary policy as a key risk to financial market stability.

This report focuses on the rise in inflation in the United States since 2021, the forces behind the surge in prices, and the trade-offs and risks for the policy response. Part I analyzes inflation trends and drivers, as well as labor market trends since the economy reopened following the COVID-19 pandemic. Part II discusses the economic policies implemented by U.S. officials in response to the pandemic and more recently to inflation, as well as their possible impact on financial conditions and economic growth. Part III focuses on the impact of the United States' inflation and tightening monetary policy on financial conditions in emerging markets and Latin America and the Caribbean in particular. The report concludes with some final thoughts on what lies ahead for the United States and the global economy.

Table 1
Annual forecasts for the United States economy, 2022 and 2023

	Real GDP (% change, y/y)		Inflation (% change, y/y)		Unemployment Rate (%)		FED Funds Rate (%)		
	2022	**2023**	**2022**	**2023**	**2022**	**2023**	**2022**	**2023**	**Date of Forecast**
A. What Government Agencies Say									
FED[1]	0.2%	1.2%	5.4%	2.8%	3.8%	4.4%	4.4%	4.6%	*Sep-22*
CBO	3.8%	2.8%	6.1%	3.1%	3.8%	3.5%	*na*	*na*	*May-22*
OMB[2]	1.4%	1.8%	6.6%	2.8%	3.7%	3.7%	*na*	*na*	*Jun-22*
B. What Markets Say									
Bank of America/Merrill Lynch	1.6%	-0.6%	8.0%	4.1%	3.6%	4.8%	4.4%	4.6%	*14-Oct-22*
Capital Economics	2.0%	0.2%	7.7%	2.4%	3.7%	4.7%	4.4%	4.1%	*5-Oct-22*
JPMorgan	1.9%	1.1%	8.1%	3.9%	3.7%	4.0%	4.5%	4.8%	*14-Oct-22*
Moody's Economy.com[4]	1.7%	0.7%	8.0%	3.9%	3.6%	3.9%	1.7%	4.6%	*10-Oct-22*
Mortgage Bankers Association	0.2%	0.9%	7.3%	2.3%	3.7%	4.2%	3.9%	4.1%	*19-Sep-22*
National Association of Realtors[4]	-0.2%	2.3%	7.7%	4.4%	3.7%	3.9%	2.3%	4.2%	*Oct-22*
National Bank of Canada	1.8%	0.2%	8.1%	3.4%	3.7%	4.5%	4.5%	3.3%	*Oct-22*
TD Bank Financial Group	1.6%	0.7%	8.1%	3.7%	3.7%	4.2%	4.5%	3.5%	*27-Sep-22*
The Economist Intelligence Unit[3]	1.5%	0.5%	7.9%	3.7%	3.8%	4.4%	3.9%	3.9%	*6-Sep-22*
Wells Fargo/Wachovia[4]	1.9%	0.0%	8.2%	4.4%	3.6%	4.2%	2.5%	4.9%	*14-Oct-22*
Market Average	***1.4%***	***0.6%***	***7.9%***	***3.6%***	***3.7%***	***4.3%***	***3.7%***	***4.2%***	
C. What International Organizations Say									
United Nations DESA (Baseline)	2.6%	1.8%	*na*	*na*	*na*	*na*	*na*	*na*	*May-22*
World Bank	2.5%	2.4%	*na*	*na*	*na*	*na*	*na*	*na*	*Jun-22*
OECD	1.5%	0.5%	6.2%	3.4%	3.7%	4.3%	*na*	*na*	*Oct-22*
IMF	1.6%	1.0%	8.1%	3.5%	3.7%	4.6%	*na*	*na*	*Oct-22*

Source: ECLAC Washington Office based on official and market sources.
Note: FED: Federal Reserve; CBO: Congressional Budget Office; OMB: Office of Management and Budget (U.S. Administration's forecasts).
[1]Projections of change in real GDP and inflation (the measure used is PCE inflation, the FED's preferred measure) are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. [2]Projections are for real, chained (2012) dollars GDP, fourth-quarter-over-fourth-quarter; CPI: fourth-quarter-over-fourth-quarter; unemployment rate: annual. [3]CPI: average; Fed Funds Rate: end-period. [4]Moody's, the National Association of Realtors, and Wells Fargo/Wachovia forecast the Fed funds rate as an annual average, not end-period.

I. High inflation and a tight labor market

When the Kansas City Federal Reserve hosted its annual Jackson Hole Economic Policy Symposium in August 2022, the theme of the program focused on "Reassessing Constraints on the Economy and Policy." According to Esther L. George, President and CEO of the Federal Reserve Bank of Kansas City, the economic conversation over the past quarter-century has been dominated by concerns over insufficient demand. Recent recessions up until the pandemic have largely been attributed to financial disruptions related to demand being supported by unsustainable asset allocations, different from the supply shocks and inflationary dynamics that had driven earlier post-war recessions. However, she says, the economic recovery following the pandemic shock has brought supply considerations back to center stage. "Bottlenecks and shortages related to the pandemic disruptions have limited supply and driven up prices. More generally, strong demand, supported by a historic level of fiscal and monetary accommodation, has pushed on the capacity limits of the economy. With demand no longer insufficient, supply constraints have become a key factor in the outlook for economic activity" (George, 2022).

The following sections will focus on the latest trends and the drivers behind the current inflation surge, including the tightness of the labor market and the significant impact of the COVID-19 pandemic on labor supply participation in the United States.

A. Inflation

As of September 2022, headline inflation (the price of all goods and services) and core inflation (excluding food and energy) were significantly above target. Inflation is expected to remain above target through the end of next year, but to slowdown in 2023. On an annual basis, average market projections point to an inflation rate of 7.9% in 2022 and 3.6% in 2023 (table 1, p. 9).

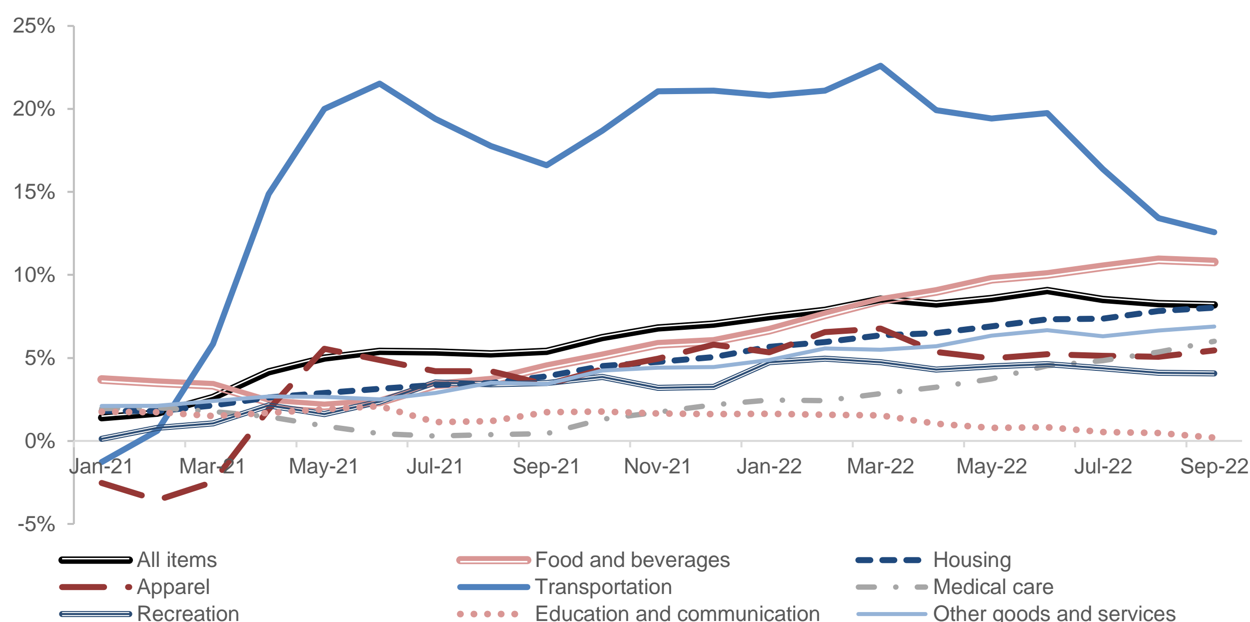
Two main forces, highlighted in JPMorgan (2022), are driving this expected moderation in the inflation rate. First, pandemic-related distortions that added inflationary pressures are starting to abate, some quite sharply. Second, the Federal Reserve's policy moves have led to tighter financial conditions, including significant U.S. dollar appreciation and higher mortgage rates. As the United States central bank continues to push policy further into restrictive territory into early next year, JPMorgan expects the now-tight labor market

to loosen as well (JPMorgan (2022), p.1). On average, market forecasts in table 1 point to the unemployment rate increasing from an expected 3.7% in 2022 to 4.3% in 2023.

1. Recent trends

Between January 2021 and September 2022, the United States Consumer Price Index (CPI) averaged 6.2% at an annualized rate. The CPI measures more than 200 categories of items arranged into eight major groups: food and beverages, housing, apparel, transportation, medical care, recreation, education and communication, and other goods and services. Transportation —which includes new and used motor vehicles, motor fuel (such as gasoline), as well as airline, train, and ship fares— had the highest inflation average between January 2021 to September 2022 (16.3%), reaching a peak of 23% in March and decelerating since then, as supply chain bottlenecks began to unwind and gas prices and shipping costs to fall. Food and beverages had the second highest average inflation in the period (6.2%) and the category has been on an uninterrupted upward trend since June 2021, with the war in Ukraine aggravating food supply chain disruptions. Housing —including shelter (rent and lodging away from home), fuels and utilities, and household furnishings and operations— came in third (4.8%) and has been on an upward trend since January 2021 (figure 5).

Figure 5
United States Consumer Price Index by major groups, January 2021—September 2022
(12-month percentage change)

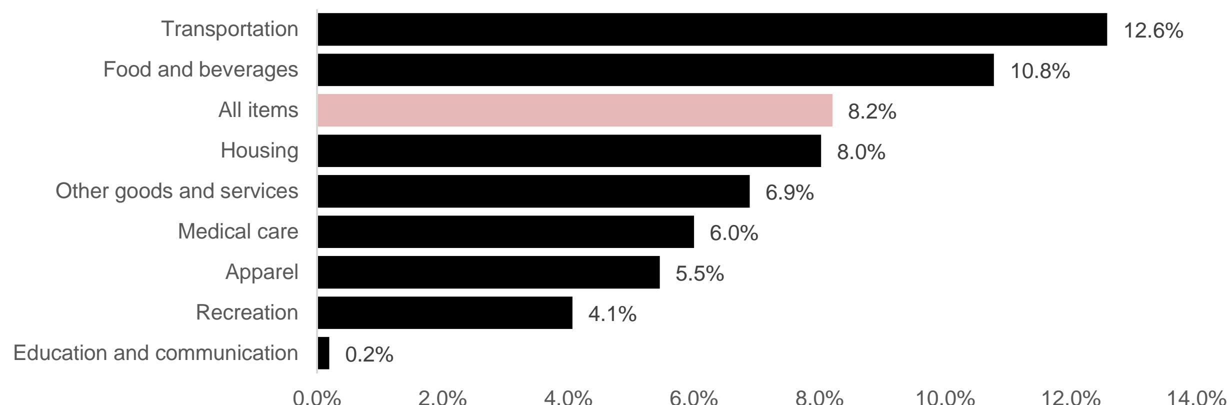


Source: ECLAC Washington Office, based on data from the United States Bureau of Labor Statistics.

The annual inflation rate for the United States was 8.2% for the 12 months ended September 2022. Following the recent trend, the steepest increase in prices was for transportation. Food and beverages came in second, and housing came in third (figure 6).

Food and energy increased at 11.2% and 19.8% annual rates in September, respectively, with gasoline prices surging 18.2% (figure 7). Core inflation (less food and energy) was 6.6%, with core goods inflation (represented by the BLS category "commodities less food and energy commodities") at 6.6% and core services inflation ("services less energy services") at 6.7%. Easing stress in U.S. supply chains —as shipping costs and commodity prices fall, inventories grow, and consumer spending shifts away from goods towards services— and the appreciation of the U.S. dollar, which makes goods exports more expensive, are weighing on growth in core goods prices.

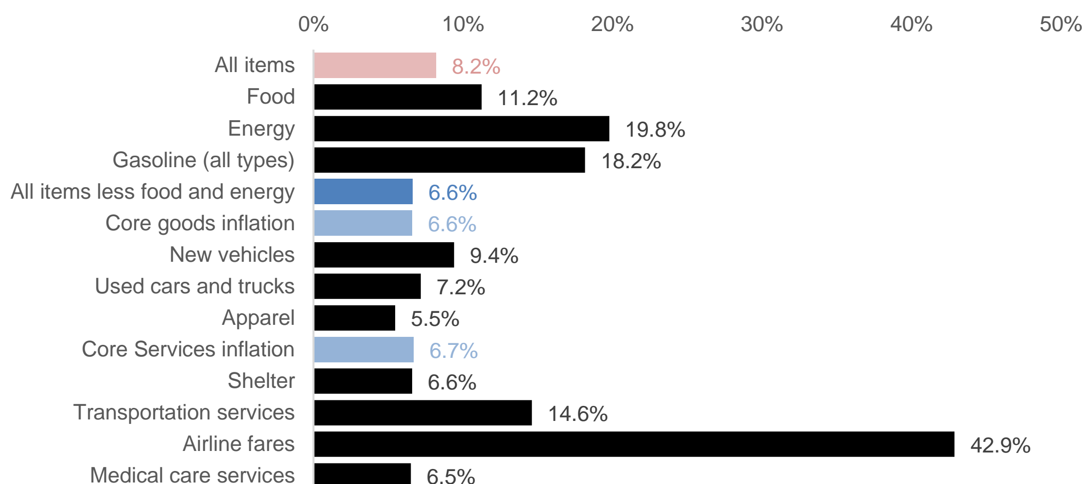
Figure 6
United States CPI by major groups, September 2021—September 2022
(12-month percentage change)



Source: ECLAC Washington Office, based on data from the United States Bureau of Labor Statistics.

Core goods inflation represented 21.3% of all items CPI in September, with prices of new vehicles and used cars and trucks up 9.4% and 7.2%, respectively, and apparel 5.5% for the 12 months ended September 2022. Core services inflation represented 56.8% of all items CPI in September, with prices for shelter increasing 6.6%, transportation services 14.6% (with airline fares, within this category, rising 42.9%), and medical care services 6.5% (figure 7). Shelter accounted for 32.5% of all items CPI in September. Within the shelter category, rents have remained near record highs.

Figure 7
United States CPI variation in select categories, September 2021—September 2022
(12-month percentage change)



Source: ECLAC Washington Office, based on data from the United States Bureau of Labor Statistics.

The COVID-19 pandemic and the lockdowns that ensued, supply-chain disruptions, the war in Ukraine, and other external shocks such as extreme weather might have disrupted many sectors in the U.S. economy. While the accelerating cost of shelter —the largest component of the CPI and one where trends tend to persist— is alarming, housing is also a sector that has been impacted by these disruptions. There was a shortage of housing brought on by pandemic-related migration, eviction moratoria and low mortgage rates, all of which have ended. In August, home prices posted their largest month-on-month decline in more than a decade as rising mortgage rates weighed on home-buying demand. In addition, effective asking rents grew 10.5% through August year-over-year according to data from RealPage Market Analytics. That marked a

continuation of a steady trend of decelerating rent growth after hitting a peak of 15.7% in February. Of the country's 150 largest markets, only 17 recorded a larger year-over-year rent increase in August than in July (Parsons, 2022).

In sum, pandemic-related supply constraints have been a key driver pushing inflation higher. Recent trends show supply constraints moving in the right direction, however, with bottlenecks easing, some quite substantially.[2] In addition, some of the main contributors to headline inflation in September will likely ease as well, as the Federal Reserve continues with its aggressive tightening monetary policy to address excess demand. Absent some outside event to reignite a surge in price pressures, inflation is expected to fall in coming months, as the impact of rate increases trims demand, competition in the marketplace intensifies, and supply chain pressures continue to ease. Despite the expected decline, whether and for how long this high level of inflation will persist is uncertain. It will depend on the economic policy mix and whether external shocks continue to cloud the outlook with uncertainty.

2. Main drivers

There has been an active debate on why inflation is high, particularly in the United States, and on how long it may persist. Supply chain bottlenecks started with the pandemic (lockdowns, sick workers, halted transport and travel) and were made worse by the push arising from increased demand caused by expansionary fiscal and monetary policies; thus, supply and demand factors are at play in the surge in prices post COVID-19.

Summarizing the forces behind the surge in inflation, Agarwal and Kimball (2022) point to five key drivers: (1) supply chain bottlenecks, (2) a shift in demand towards goods and away from services, (3) aggregate stimulus and post-pandemic recovery, (4) a shock to labor supply as labor market disruptions from the pandemic continue even two years after it began, and (5) supply shocks to energy and food because of the Russian Invasion of Ukraine.

Seeing similar drivers, Blanchard (2022) points to four main forces behind inflation: (1) labor market tightness, whether the market is overheating or underheating (he sees the U.S. labor market as clearly overheating); (2) price shocks, from energy to commodity prices to supply chain disruptions, and their first-round effects on inflation (on that front he sees the United States in a good position, with commodity prices down and supply chains being repaired); (3) the so-called second-round effects, how the initial price shocks feed into other prices and nominal wages, as workers try to recover some of their lost purchasing power; (4) de-anchoring, i.e., how lasting inflation can weaken the credibility of monetary policy, potentially leading to a self-fulfilling increase in inflation (so far long-term inflation expectations have moved very little, he says).

Another driver that has been singled out is the role of corporate profits, which Reich (2022) says are close to levels not seen in over a half a century and driving inflation, as reported by Bloomberg (Pickert, 2022). As the cost of materials, components and labor increase, corporations have been able to raise their prices even higher, Reich argues, resulting in larger profits. He faults the lack of competition and industrial concentration for the increase in corporate power to raise prices beyond the level of inflation and highlights that wage increases have not kept up with inflation. In this regard, chapter 2 of the International Monetary Fund's World Economic Outlook released in October analyzes wage dynamics post–COVID-19 and wage-price spiral risks. It concludes that risks of a sustained wage-price spiral appear limited since underlying inflation shocks come from outside the labor market and monetary policy is tightening aggressively.

With supply and demand factors at play, di Giovanni (2022) of the Federal Reserve Bank of New York —using a model-based approach to quantify the cumulative effects of the pandemic on inflation from the fourth quarter 2019 to fourth quarter 2021 (before the energy-food shock on inflation brought by Russia's

[2] According to the Federal Reserve Bank of New York's Global Supply Chain Pressure Index (GSCPI), global supply chain pressures decreased in September 2022, marking a fifth consecutive month of easing. The September decline was quite broad-based, with HARPEX (a container ship charter rate index) contributing the most to downward pressure. The GSCPI's year-to-date movements suggest that global supply chain pressures are beginning to fall back in line with historical levels (Federal Reserve Bank of New York, 2022).

invasion of Ukraine)— decomposes the contribution of demand- and supply-side factors underlying the observed inflation and finds "60% of U.S. inflation over the 2019-21 period was due to the jump in demand for goods while 40% owed to supply-side issues that magnified the impact of this higher demand" (di Giovanni (2022), p.1).

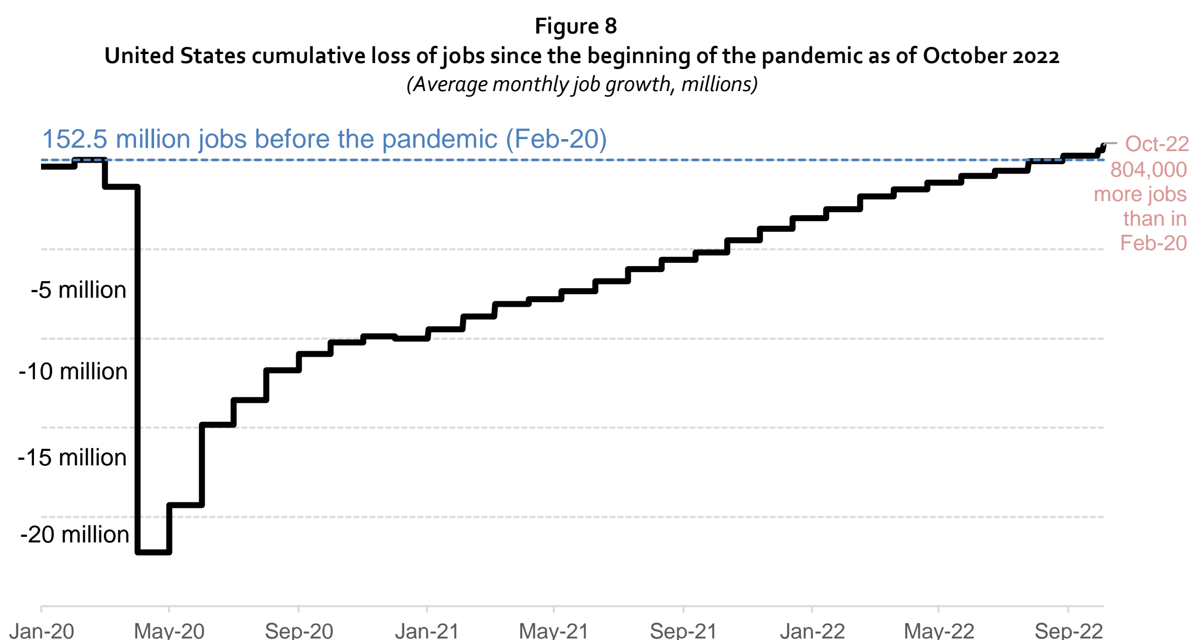
In an earlier paper in July, Shapiro (2022) of the Federal Reserve Bank of San Francisco arrived at a somewhat different conclusion. Separating the underlying data from the personal consumption expenditures price index (PCE) into supply- versus demand-driven categories, he concluded that supply factors were responsible for more than half of the elevated level of 12-month PCE inflation, arguing that this in part reflected supply constraints from continued labor shortages and global supply disruptions related to the pandemic and the war in Ukraine.

On the supply side, labor market disruptions from the COVID-19 pandemic have persisted. Labor supply participation, in particular, remains below pre-pandemic levels in the United States. According to Agarwal and Kimball, labor force participation is about 1.5% lower than before the pandemic in the United States, or about 4 million fewer workers (Agarwal and Kimball, 2022). They mention a recent paper by Domash and Summers which examines different labor market indicators and argues that "even under optimistic COVID-19 outcomes, the majority of the employment shortfall will likely persist moving forward and contribute significantly to inflationary pressure in the United States for some time to come" (Domash and Summers, 2022).

B. Labor market

The United States labor market remained strong in October. After adding 6.7 million non-farm payroll jobs in 2021 and averaging 562,000 new jobs per month, it added 4.1 million from January to October 2022, averaging 407,000 jobs per month. Employers added 261,000 jobs in October on a seasonally adjusted basis, down from 315,000 in September. October was the 22nd consecutive monthly gain, even as policymakers take significant steps to cool the economy and ease inflation. The gain leaves nonfarm employment 804,000 above its pre-pandemic level, which was finally reached in August 2022, 29 months after the start of the pandemic (figure 8). This number does not account for the jobs that would have been created if the pandemic didn't occur, which Moody's places in the vicinity of 5 million (Moody's, 2022).

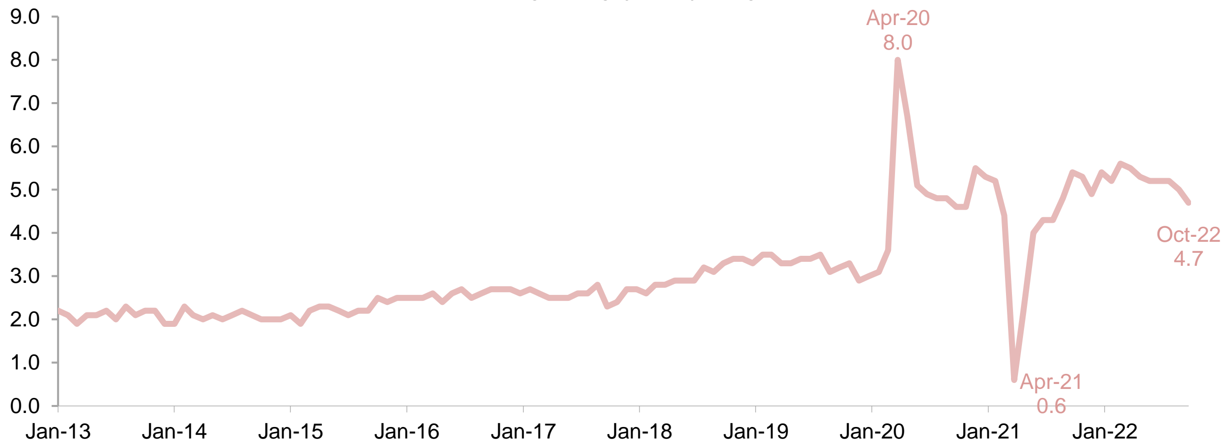
Figure 8
United States cumulative loss of jobs since the beginning of the pandemic as of October 2022
(Average monthly job growth, millions)



Source: ECLAC Washington Office, based on data from the U.S. Bureau of Labor Statistics.

Wages have increased as demand for workers has exceeded the number of unemployed people looking for work for the past year. However, the strength of inflation is erasing gains in workers' pay. Average hourly earnings have fallen from an annual pace of 5.2% in August to 4.7% in October (figure 9), well below the inflation rate. However, they rose 0.4% in October on a monthly basis, more than expected and an acceleration from September's increase. Wage growth is failing to keep up with inflation but has remained fast enough that Federal Reserve officials see it as a sign they have to keep tightening monetary policy. They see continued strong wage increases as likely putting further upward pressure on services price inflation. According to the minutes of the Federal Reserve meeting in September, officials believed a wage-price spiral "had not yet developed but cited its possible emergency as a risk" (FOMC, 2022).

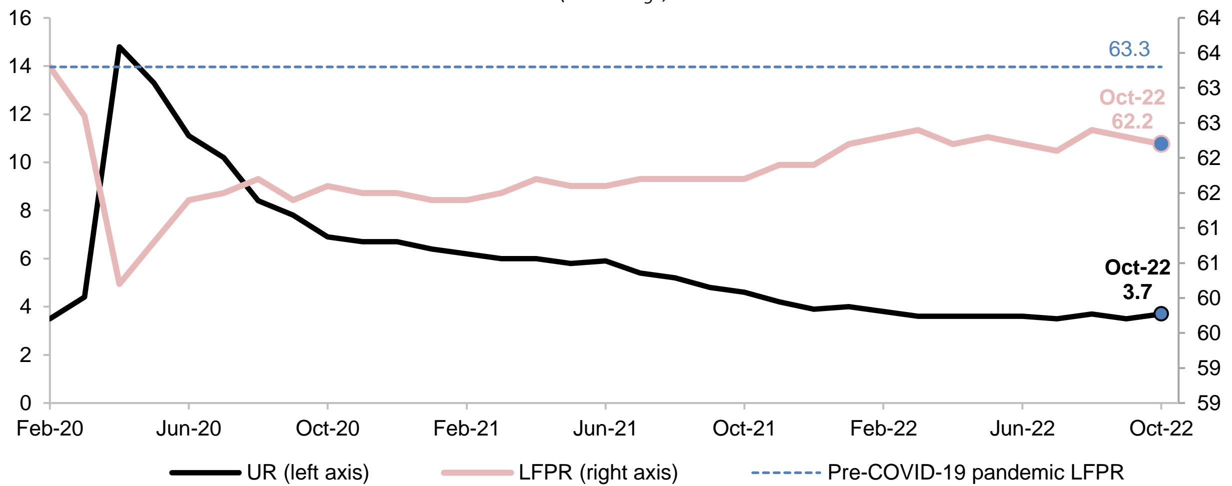
Figure 9
United States average hourly earnings and unemployment rate, January 2013—October 2022
(Percentage change from a year ago)



Source: ECLAC Washington Office, based on data from the U.S. Bureau of Labor Statistics.

The unemployment rate increased to 3.7% in October from 3.5% in September, a historic low, what markets welcomed as a sign that the Federal Reserve's efforts to cool the economy may be having some effect even as hiring remains robust. The labor force participation rate decreased slightly to 62.2% in October from 62.3% in September, still below its pre-pandemic level. In February 2020, the month before the COVID-19 pandemic began to seriously weigh on the labor market, participation stood at 63.3% (figure 10).

Figure 10
United States labor force participation share, February 2020—October 2022
(Percentage)

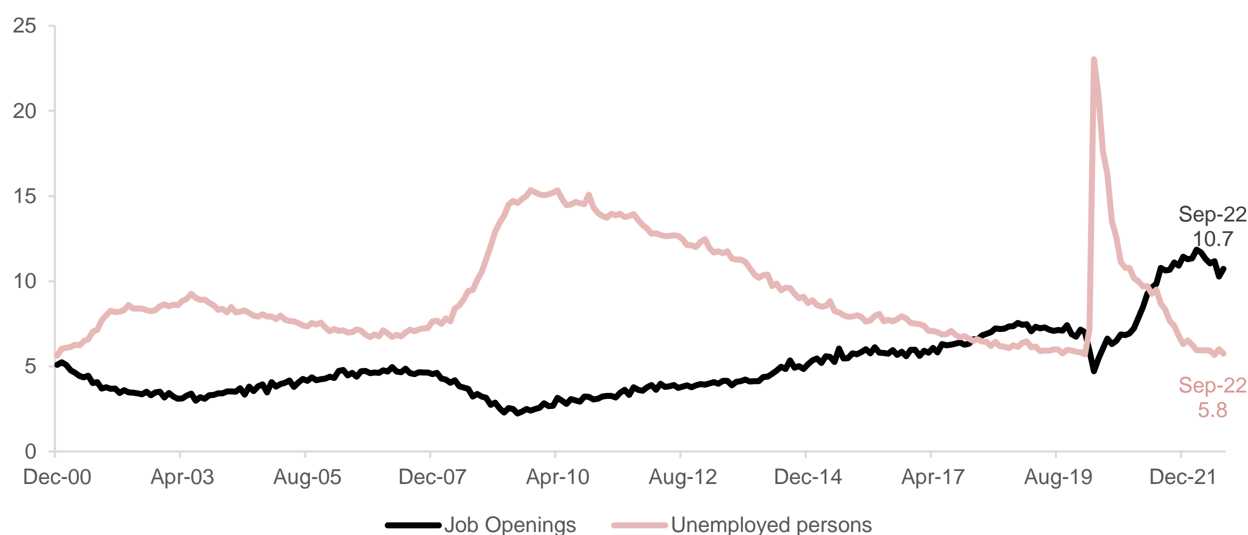


Source: ECLAC Washington Office, based on data from the U.S. Bureau of Labor Statistics. UR: unemployment rate; LFPR: labor force participation rate.

Disruptions associated with the COVID-19 pandemic —such as lockdowns and sick workers— led to labor shortages that were amplified by other factors, including early retirements, less immigration, and lack of childcare, which reduced the economy's productive capacity. The hope was that once schools and day care centers started to reopen workers who were on the job market's sidelines would return. That has happened only slowly, and progress in pushing participation higher appears to have stalled in recent months.

The current labor market situation has been perhaps the most worker-friendly climate in decades, as workers have the ability to sort through near-record levels of job openings, given the labor shortages. Employers cut 0.9 million job vacancies in August according to the Job Openings and Labor Turnover Survey (JOLT), however, what many took as a sign that the Federal Reserve's aggressive efforts to cool the economy were starting to have an impact on the labor market. Job openings fell 8% in August 2022 to a seasonally adjusted 10.3 million from 11.2 million the month before, their lowest level in a year, but rebounded in September to 10.7 million, the latest sign of how strong the job market remains despite the Federal Reserve's attempts to weaken it. The number of unemployed persons in September was 5.8 million. Achieving a soft landing would require a lower number of job openings without a significantly higher number of unemployed people (figure 11).

Figure 11
United States job openings vs number of unemployed persons, December 2020—September 2022
(Millions of openings and persons)



Source: ECLAC Washington Office, based on data from FRED Graph Observations, Federal Reserve Bank of St. Louis, Job Openings: Total Nonfarm, Level in Thousands, Monthly, Seasonally Adjusted and Unemployment Level, Thousands of Persons, Monthly, Seasonally Adjusted.

Historically, job openings have not gone down without a sharp increase in unemployment, as figure 11 shows. Federal Reserve Governor Christopher Waller in a speech in May argued that hires per vacancies are currently at historically low levels, thus reducing vacancies from an extremely high level to a lower (but still strong) level would have limited effect on hiring and on unemployment, which would make soft landing a possibility (Waller, 2022).

Despite the labor market strength, which has made it easier for workers to find jobs and to earn raises, the relative positions of employees and employers so far have not changed. According to the Department of Commerce data, wages and benefits accounted for 62.5% of national income in the second quarter of 2022, the same share in the fourth quarter of 2019. The labor share increased in the first half of 2020, during the pandemic-induced economic recession, but it dropped back in the second half of the year as the economic recovery took hold.

Why the workers' share of the economic pie is not growing in this favorable labor market is a question mark. Wage increases may have largely gone to people switching jobs, who represent a relatively small share of the workforce in any given month. According to the Federal Reserve Bank of Atlanta, the median wage increase for those switching jobs was 7.1% in September, compared to 5.2% for those who stayed at their jobs. A second reason could be that strong consumer demand has given firms the power to raise prices and collect higher revenues. In any case, some economists point to the labor share to argue that the risk that higher wages will feed into higher inflation in a wage-price spiral is low, given that the labor share is not increasing substantially.

In sum, the surge in prices since the United States started to reopen its economy following the lockdowns during the COVID-19 pandemic has had drivers from both the demand- and supply-sides. From the supply-side, supply-chain stress has eased and is moving in the right direction, with prices falling. Further progress is expected, but that will depend on whether external shocks, such as the war in Ukraine and COVID-19 cases leading to lockdowns in China, will continue to cloud the outlook with uncertainty.

From the demand-side, the Federal Reserve's aggressive monetary policy tightening has already had an impact on sectors that are more sensitive to interest rates, but while workers try to recover some lost purchasing power, prices of services may stay high for longer before start falling. The costs of transport, food and childcare have risen faster than salaries, making the return to work at the office more costly and aggravating the labor shortage.

Business and consumer confidence remain historically low, as tight labor supply and high inflation have clouded the economy's future course. Also, the risk of a policy mistake is rising. Whether the Federal Reserve will be able to achieve a soft landing is uncertain, and the probability of a United States economic recession next year has risen considerably.

II. Economic policy and inflation: trade-offs and risks

The scope of the COVID-19 pandemic was unprecedented in the modern era. So was the United States government's policy response. The United States borrowed, lent, and spent trillions of dollars to keep the economy from plunging further than it did and to accelerate recovery. These actions were at the center of the unusual nature of both the pandemic recession and the recovery. At the same time, the Federal Reserve pursued a very accommodative monetary policy, including interest rates near zero and trillions of dollars in asset purchases that eased credit. These policies have come under scrutiny after prices started to surge in 2021. The American Rescue Plan Act, in particular, has become the center of a debate over whether its largesse has contributed to inflation, and how much, while the Federal Reserve has been criticized for being slow to respond to the surge in inflation.

The economic policies implemented in response to the COVID-19 pandemic, as well as the Federal Reserve's change in direction when inflation began to take off, are the focus of this section. So are the possible trade-offs and risks for policymakers in the United States. The section starts with a review of the fiscal support in response to the pandemic and what critics see as leading to an overheating of the economy. It then describes the monetary policy then and now, with an emphasis on the change in direction towards an aggressive tightening campaign and its impact on financial conditions.

A. Fiscal policy[3]

The American Rescue Plan Act of 2021 (ARPA) is an economic stimulus bill passed by the 117th United States Congress and signed into law by President Joe Biden on 11 March 2021. It provided a total of US$ 1.9 trillion in mandatory funding, program changes and tax policies aimed at mitigating the continuing effects of the pandemic. The ARPA built upon previously enacted aid measures.

Before the ARPA's enactment, COVID relief came from four pieces of legislation implemented in 2020 —the Families First Coronavirus Response Act (FFCRA) signed into law on 18 March 2020, the Coronavirus Aid, Relief, and Economic Security (CARES) Act signed into law on 27 March 2020, the Paycheck Protection Program and Health Care Enhancement (PPPHCE) Act signed into law on 24 April 2020, and the end of year stimulus relief (Response and Relief Act) that was part of the Consolidated Appropriations Act, 2021, signed into law on 27 December 2020. Of the US$ 3.4 trillion in relief from those four bills, US$ 1.9 trillion results from

[3] This section relies heavily on R. Artecona and H. Velloso (2022).

the CARES Act, US$ 915 billion from the Response and Relief Act, and the remaining US$ 580 billion comes from the other two bills (table 2).

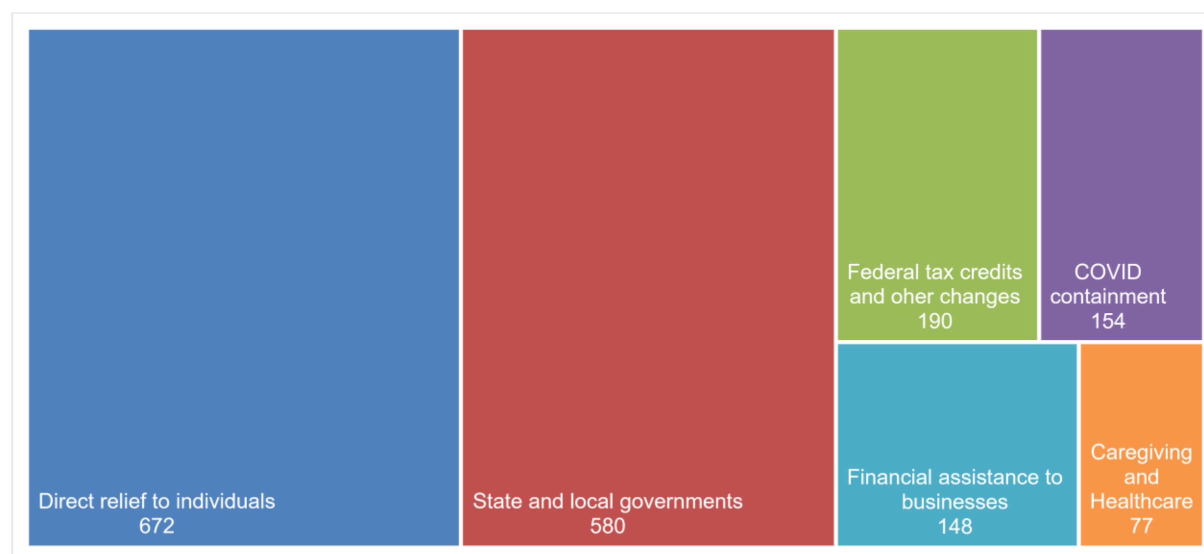
Table 2
Estimated deficit impact of major COVID relief United States legislation (2020)
(Billions of dollars)

	FFCRA	CARES	PPPHCE	Response & Relief	Total
Small business support[a]	-	375	255	300	**935**
Unemployment benefits	5	460	-	120	**590**
Recovery rebates	-	290	-	165	**460**
Health care spending	90	160	100	70	**420**
State and local aid[b]	85	190	-	85	**360**
Tax relief	25	265	-	40	**330**
Other Spending	20	170	-	135	**325**
Total COVID Relief (Net Cost)	225	1,915	355	915	**3,415**

Source: Committee for a Responsible Federal Budget (2021a).
Note: rounded to nearest US$ 5 billion. Totals may not sum due to this rounding.
[a]The Committee assumes the Paycheck Protection Program (PPP) from the CARES Act cost based on its initial score and allocate all returned or unused funds to the PPPHCE.
[b]Includes Coronavirus Relief Fund money and funding for public schools, transit, and existing Medicaid costs

The ARPA's goal, following these four previous bills, was to speed up the United States' recovery from the economic and health effects of the COVID-19 pandemic. The expenditures in the bill can be roughly divided into three equal parts (Yaros, 2021): direct relief to individuals; state and local government aid; and a mixture of personal tax cuts, business assistance, and public health spending, among others (figure 12).

Figure 12
Breakdown of the American Rescue Plan Act
(Estimated cost (2021-2031) in billions of dollars)



Source: R. Artecona and H. Velloso (2022), p.18.

While the ARPA's direct relief and aid spurred the fastest recovery of any country in the Group of Seven, critics say that the indiscriminate nature of that spending helped ignite the largest increase in consumer prices in fourty years. Although experts disagree about the extent of the rescue plan's contribution to inflation, it seems clear that it has had a role.

Individuals were the biggest beneficiaries of the ARPA, receiving US$ 672 billion in direct relief. The largest source of household income support in the Act was a third round of stimulus checks of as much as US$ 1,400 per person, costing US$ 410 billion. The stimulus payments phased out for single filers with incomes between US$ 75,000 and US$ 80,000 and for joint filers with incomes between US$ 150,000 and US$ 160,000.

Close to 80% of these stimulus checks were distributed in the second half of March 2021, adding an annualized US$ 3.8 trillion to nominal personal income that month. According to the Committee for a Responsible Federal Budget (CRFB) based on data from the United States Bureau of Economic Analysis, nominal disposable income grew 10.6%, or US$ 1.8 trillion, from the twelve months before April 2020 to the twelve months through April 2021. By comparison, income grew by an average of 5% per year over the prior three years —despite those years having much stronger overall economic growth.[4]

At the same time as the stimulus checks started to be distributed, prices for items such as used cars and airline and sports tickets began to rise. Even without ARPA the United States would have experienced significant inflation because of the unprecedented dislocation brought by the COVID-19 pandemic. As the economies around the world eased their pandemic restrictions, a surge of consumer spending collided with supply chain disruptions to increase prices almost everywhere. However, there have been studies that have concluded that the ARPA contributed to make U.S. inflation worse.

In March 2022, economists from the Federal Reserve Bank of San Francisco (Jordà et al, 2022), after comparing the U.S. experience to that of other advanced economies, concluded that the combined income transfers of all fiscal measures in 2020 and 2021 may have contributed to an increase in inflation of about 3 percentage points by the fourth quarter of 2021. Ball et al (2022) arrived at a similar figure for the contribution of the ARPA alone to core inflation (2.8 percentage points for July 2022, and the effect on 12-month inflation at 1.0 percentage point and rising), in a paper presented at a Brookings Institution conference in early September. In October 2021, Barnichon et al (2021), relying on a labor market measure of economic slack, found a smaller impact for the ARPA, however. They concluded that ARPA is projected to cause a transitory increase in the vacancy-to-unemployment ratio, which translates into a core inflation rate that is about 0.3 percentage point higher per year through 2022.

The United States administration argues that the legislation's benefits outweighed its costs, since it came at a time when the recovery was still uncertain, and before the unexpected COVID-19 Delta and Omicron variants, the continued Chinese lockdowns, and the Russia's invasion of Ukraine that roiled global energy markets. In an interview, Gene Sperling, the White House American Rescue Plan Coordinator and Senior Advisor to the President, argued that each of these shocks or together "could have derailed this recovery long ago without the cushion provided by more sustained recovery funding" (Lynch, 2022).

However, the fiscal stimulus measures from the bill have already expired. In fact, the United States government posted a record decline in federal deficits in fiscal 2022 according to the Treasury Department, as surging tax revenue —thanks to a strong economy that drew more people into the labor market, increasing the amount collected in individual and corporate taxes— and waning pandemic spending, helped cut the budget gap in half. The annual budget shortfall totaled US$ 1.37 trillion, compared to US$ 2.77 trillion in the previous fiscal year. Moreover, growth in the money supply —a proxy for nominal demand— has slowed sharply as fiscal stimulus measures taken in response to the COVID-19 pandemic began to expire (figure 13), suggesting that fiscal policy has ceased to be expansionary.

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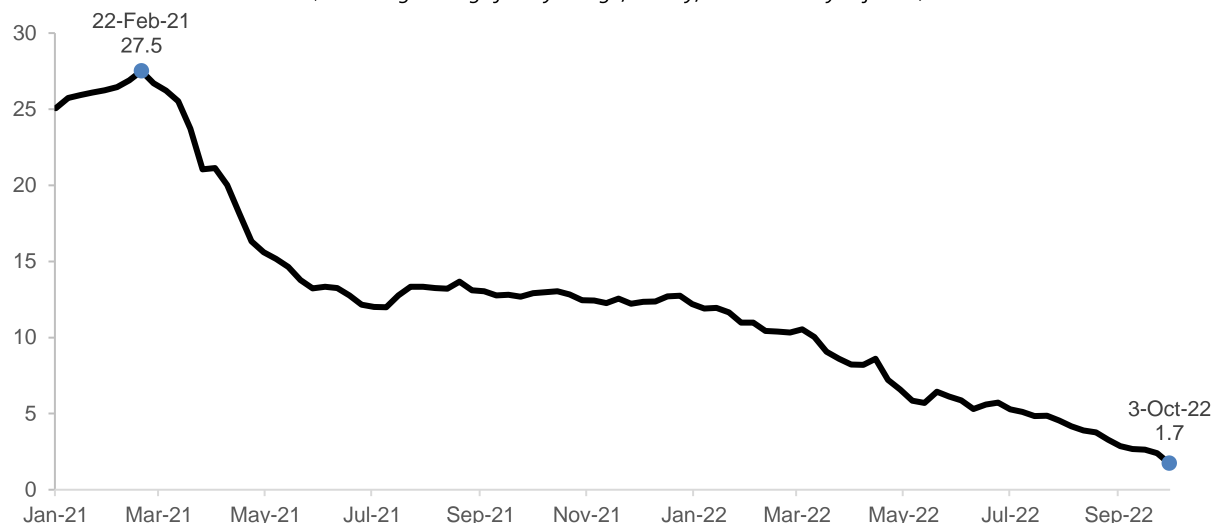
[4] On a month-to-month basis, COVID relief contributed to temporarily boost income to new records, amidst a pandemic. Disposable income in March 2021 was 30% higher than in February of 2020. Total March income of US$ 1.8 trillion (US$ 21.9 trillion annualized) included US$ 335 billion in recovery rebates, US$ 40 billion from expanded unemployment benefits, US$ 12 billion in personal income from the Paycheck Protection Program, and US$ 5 billion from other COVID-relief measures. Another US$ 5 billion in base unemployment benefits was enough to bring base income (excluding direct COVID relief but not its economic impact) to roughly pre-pandemic levels (and 4% above the average over the prior year). See Committee for a Responsible Federal Budget (2021b).

Figure 13
United States money supply (M2), January 2021—October 2022
(Percentage change from year ago, weekly, not seasonally adjusted)



Source: FRED Graph Observations, Federal Reserve Bank of St. Louis, WM2NS_PC1: M2, Percent Change from Year Ago, Weekly, Not Seasonally Adjusted [online] https://fred.stlouisfed.org/series/WM2NS#0.

B. Monetary policy

The Federal Reserve increased its short-term benchmark interest rate six times this year (figure 3, p.7), 0.25% in March, 0.50% in May and 0.75% (the largest increase since 1994) in June, July, September and November, bringing the federal-funds rate to a range of 3.75% and 4.00% as of November 2022. This has been the most aggressive monetary tightening campaign since the early 1980s and has driven the U.S. dollar up and mortgage rates to a 20-year-record high. Before that, the interest rates were kept at the lower bound range from April 2020 to February 2022, as the United States economy battled the impact of the COVID-19 pandemic.

The Federal Reserve has been criticized by some for being slow to react in face of rising prices and an expansionary fiscal policy. These critics say that while the central bank made a reasonable assumption that inflation would be "transitory" and would return to lower levels once supply chain disruptions were repaired, they failed to pivot fast enough when the assumption proved wrong.

Rate hikes have become more painful than a year ago. The United States economy contracted in the first half of the year but according to the Bureau of Economic Analysis preliminary estimate released on 27 October, grew at a 2.6% annual rate in the third quarter despite consumers slowing their spending. The report showed consumer spending slowed to a 1.4% rate from the prior quarter's 2.0% pace, and the GDP deflator —an indication of price pressures— eased to 4.1% from the prior quarter's 9.0%.

So far, key elements of the economy remain resilient. The job market has cooled a little but has remained strong with robust payroll gains and low unemployment. Consumers, the economy's main engine, have continued to spend. However, the slowdown in consumer spending in the third quarter suggests that higher interest rates may be starting to affect consumers, and despite showing resilience, the pace of job creation has slowed. Many economists are thus worried about the possibility of a recession in the coming twelve months.

Even so, the latest interest rate increase in November came against a backdrop of mounting evidence that inflation is not abating yet, despite signs that consumer demand is starting to cool, and the housing market has slowed significantly under the weight of mortgage rates that have risen above 7%. In the statement released following the November Federal Open Market Committee (FOMC) meeting, officials said

the "ongoing increases in the target range will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2% over time" (FOMC, 2022a).

However, since changes to monetary policy take time to filter through the economy, Fed officials hinted that the Committee could slow the pace of future increases as its recent aggressive rate hikes work their way through the economy. The statement said that "in determining the future increases in the target range" the FOMC "will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments" (FOMC, 2022a). With rates now well into restrictive territory, the central bank might be able to afford to slow the pace of increases, partly to assess what impact the 375 basis points of cumulative tightening that has already taken place this year so far is having.

In September, the economic projections released by the FOMC revealed that just over half of officials were in favor of an additional 125 basis points of tightening over the rest of the year, implying another 75 basis points increase in November and a 50 basis points increase in December, what would bring the policy rate to a 4.25%-4.5% range by the end of 2022. However, Federal Reserve Chairman Jerome Powell in his press conference following the FOMC meeting on 2 November 2022, explained that even if rate increases slow, "we may ultimately move to higher levels than we thought at the September meeting." What the endpoint interest rate may be remains uncertain, and market fears that the Federal Reserve may go too far are rising.

Regarding monetary policy risks and trade-offs, the IMF October World Economic Outlook (International Monetary Fund, 2022a) argues that although there are risks of both under- and over-tightening, these policy mistakes are not symmetric. Under-tightening would prove much more detrimental to future macroeconomic stability. While over-tightening risks pushing the global economy into an unnecessarily severe recession and financial markets to struggle, under-tightening could undermine the hard-won credibility of central banks, lowering business and consumer confidence. Federal Reserve officials also have signaled they are more concerned about doing too little to rein in inflation than doing too much, according to the minutes of their September meeting (FOMC, 2022b).

Charles Evans, President of the Federal Reserve Bank of Chicago, makes a case for caution in the battle against inflation, however. In recent remarks to the press, he said that he worried that interest rates moving too high could have "a nonlinear kind of impact ... with businesses becoming very pessimistic and changing their strategies in a sort of notable way," once rates reach a certain point (Schneider, 2022).

Nonetheless, the persistence of inflation in recent months has been a concern to policymakers. Inflation in the United States remains high despite many disinflationary trends. The New York Federal Reserve Bank's Global Supply Chain Pressure Index has fallen back to where it was on the eve of the pandemic, the strong U.S. dollar is reducing import costs, semiconductor prices are easing, used car prices have fallen in the past few months, and crude oil is down by one-third since June. Yet, the Federal Reserve's preferred measure of core inflation, the Personal Consumption Expenditures Price Index (PCE) stood at 5.1% in September, up from 4.9% in August and 4.7% in July, and more than twice as high as the target. There is a risk that the longer the Federal Reserve takes to bring inflation down, the higher the human cost of its tightening policy may be.

C. Financial conditions

The rapid increase in interest rates is following a period of ultra-low rates brought about by the need to provide emergency support to the economy at the height of the COVID-19 pandemic. One consequence of the accommodative monetary policy for such a long period according to Capital Economics, was to bid up asset prices across the board. With interest rates now rising sharply from very low levels, there is a corresponding risk of large and simultaneous fall in asset prices (Shearing, 2022). Raising interest rates usually leads to lower stock prices, higher bond yields and a stronger U.S. dollar.

The Federal Reserve's more rapid exit from crisis-era policies could place the US$ 24 trillion U.S. government bond market under extra strain, heightening concerns about the stability of the financial system. In September, the central bank accelerated the pace of winding down the nearly US$ 9 trillion balance sheet it built up for more than a decade in an effort to cushion the economy from shocks. The aim was to shrink the total by US$ 95 billion a month —double the August pace. The concern is that liquidity stress increases as a result.

There has been mounting volatility in government bond markets this year, which has carried the yield on the 10-year U.S. Treasury note —a benchmark for borrowing costs on everything from mortgages to corporate loans— above 4% for the first time in more than a decade (figure 14). Stocks have also fallen, particularly shares of more speculative companies. The S&P 500 is down 20% from January to October 2022, the Dow Jones Industrial Average down about 12% and the NASDAQ down 31%.

Signs of stress in financial markets are showing as interest rates go up. The recent turmoil in British bond and currency markets is one. It exposed potential risks lurking in pensions and government bond markets, which have been seen as havens in past financial turbulence. The risk of the Federal Reserve and other central banks raising interest rates at a fast pace, in addition to losses in wealth and household savings, is that the interest rate hikes can cause disruptions in lending, which swelled when rates were low. In addition, the historically low interest rates implemented in response to the COVID-19 pandemic have encouraged risk-taking and leverage.

Figure 14
10-year United States Treasury security yield, September 2012—October 2022
(Constant maturity; daily yields)

Source: ECLAC Washington Office, based on data from the Federal Reserve of St. Louis (FRED).

Abrupt adjustments can lead to a slowdown more severe than what the Federal Reserve and other central banks want. Threats to financial stability sometimes spread from unexpected sources. Financial instability is often at the heart of economic downturns, and there are signs of strain in markets for corporate and emerging market debt, for example.

Non-financial corporate debt has grown significantly as a share of the United States economy in the past decade, from 40% in the first quarter of 2012 to 50% in the first quarter of 2022 according to data from the Federal Reserve. Mark Zandi of Moody's points out that leverage lending has grown at a double-digit per annum pace over the past quarter century, swelling to a US$ 1.3 trillion market. About two-thirds of these loans back securities known as collateralized loan obligations, or CLOS, and are thus mostly rated and required to disclose substantial amounts of financial information. However, the remainder of the loans, he says, are sold to a mixture of lightly regulated non-bank financial institutions in the so-called shadow financial system. Very little about these loans is disclosed. As the economy and the sales and cash flow of these borrowers weaken, there will

invariably be defaults, and the risk is that given the lack of transparency and information, these defaults could lead to a panic and to a sudden stop in the flow of credit, causing a severe financial event (Zandi, 2022).

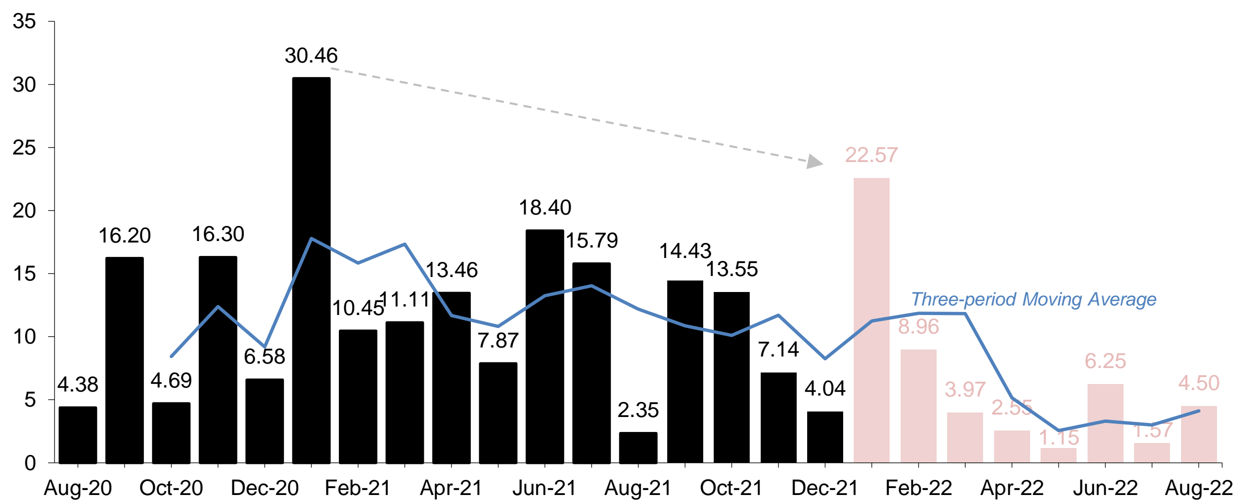
Interest-rates are still much higher in the U.S. than in much of the developed world. That, along with anxieties about a global recession, are weakening a broad range of currencies relative to the U.S. dollar. That in turn is feeding inflation in those economies, putting extra pressure on their governments and central banks to raise interest rates or otherwise take action to strengthen their currencies. The strong U.S. dollar has thus spillover effects elsewhere. Despite the United States only accounting for 10% of world trade, around 40% is invoiced in dollars, and this figure is much higher in many emerging markets. As imports become more expensive, they will weigh on demand for traded goods and hence global growth. Higher import prices will make inflation outside the United States higher than it might otherwise have been.

In addition, dollar strength will also weigh on emerging markets with large external vulnerabilities, such as high dollar debt, large current account deficits, and low foreign exchange reserves, threatening higher interest costs to emerging market governments that borrowed heavily in recent years from foreign investors seeking higher returns. The foreign debt of low- and middle-income countries rose 6.9% last year to a record US$ 9.3 trillion, according to World Bank estimates. Emerging market governments have also to repay roughly US$ 86 billion in U.S. dollar bonds by the end of 2023, according to data from Dealogic. Dollar strength tends to move in tandem with lower capital inflows to emerging markets.

III. Impact on financial conditions: Latin America and the Caribbean

Investor appetite for emerging markets assets has diminished because of rapid monetary policy tightening to tackle persistent inflation, increased geopolitical risk and lower economic growth. Latin American and Caribbean (LAC) bond issuance in international markets has slowed considerably in the first eight months of 2022 as a result, with issuers from the region often turning to local markets for funding. LAC issuers placed a total of US$ 51.5 billion of bonds in international markets from January to August 2022, down 53% from the US$ 109.9 billion placed from January to August 2021 (ECLAC, 2022). Global inflation concerns, the United States Federal Reserve's tightening monetary policy stance and the strength of the dollar, as well as the war in Ukraine, contributed to push funding costs higher (figure 15).

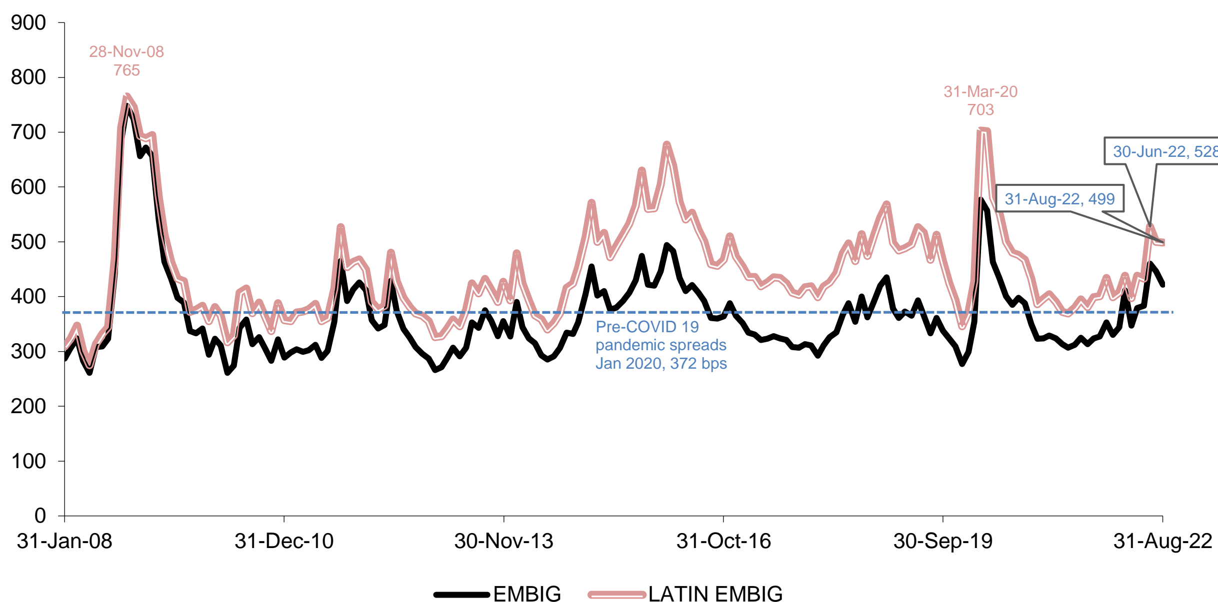
Figure 15
Monthly LAC international bond issuance, August 2020—August 2022
(Billions of dollars)



Source: ECLAC (2022) p.7, based on data from Dealogic, LatinFinance and Bloomberg

Borrowing costs for LAC issuers increased by 100 basis points in the first eight months of 2022, amid rising financing costs and weaker risk sentiment, and reached a peak in June 2022 (528 basis points). At 499 basis points at the end of August, LAC bond spreads, as measured by the JPMorgan Emerging Market Bond Index Global (EMBIG) Latin component, were 127 basis points higher than pre-pandemic levels (372 basis points at the end of January 2020) (figure 16).

Figure 16
EMBIG and Latin American daily spreads, January 2008—August 2022
(Basis points)



Source: ECLAC (2022) p.10, based on data from JPMorgan, "Emerging Markets Bond Index Monitor".

With inflation remaining elevated at the global level, leading to synchronized tightening of monetary and fiscal policies, tight funding conditions are expected to endure. As LAC countries continue to grapple with the effects of two previous shocks, the pandemic and Russia's invasion of Ukraine, the IMF October 2022 Western Hemisphere Regional Economic Outlook called the tightening of global financing conditions a third shock the region is now facing (International Monetary Fund, 2022b).

For many governments in the region, domestic funding costs are at the highest levels in recent years. Facing rising inflation, Brazil's central bank began lifting its benchmark lending rate in March of 2021 from a record low 2% to a five-year high of 13.75% in August. Central bankers in Mexico, Peru, Chile, and Colombia soon followed. Chile and Colombia have increased interest rates to 11.75% and 10% respectively in September, and the tightening process is expected to soon come to an end. Peru and Mexico have increased interest rates to 7% in October and 9.25% in September, respectively.

Brazil is now making gains in the war on inflation, which has declined from a peak of 12.1% in April to 7.7% in September, and the other countries are gaining on inflation as well. High real interest rates have also kept Latin America's currencies strong. While the pound, euro and yen are wilting against the strong dollar, three Latin American currencies have appreciated against the U.S. dollar this year: the Brazilian real, the Mexican peso and the Peruvian sol. Although raising interest rates can boost their currencies, it can also put the brakes on economic recovery.

As sovereign issuances serve as benchmark for issuers in other asset classes, rising sovereign funding costs point to an overall tightening of financial conditions. Higher global and domestic financing costs can accelerate capital outflows and represent a challenge for the region. In this scenario, the countries that may

be most affected would be those rated below Ba by credit rating agencies and that lack deeper domestic credit markets. High levels of debt in the corporate sector are another source of concern.

Focusing on the increasing vulnerabilities of developing countries, the United Nations Conference on Trade and Development (UNCTAD) said in its annual report on the global economic outlook that the Federal Reserve risks causing significant harm to them if it persists with rapid interest rate rises. The agency estimated that a percentage point rise in the Fed's key interest rate lowers economic output in other rich countries by 0.5%, and economic output in poor countries by 0.8% over the subsequent three years. UNCTAD estimated that the Federal Reserve's rate increases so far this year would reduce poor countries' economic output by US$ 360 billion over three years, and further policy tightening would do additional harm (UNCTAD, 2022).

IV. Looking ahead

Inflation in the United Sates remained high in September, with prices increasing at an annual rate of 8.2%. The Federal Reserve's commitment to bring inflation down has been emphasized by its officials in recent speeches and interviews. The pace of monetary tightening this year is expected to make a dent on inflation by squeezing demand. It has helped to strength the dollar and ease import-led inflation. However, it is also expected to have an adverse effect on growth, and most forecasts point to an economic contraction in 2023.

On the supply side, supply-chain disruptions related to the pandemic and subsequently to China's zero-COVID policy, the effect of the Russia-Ukraine war on food and fuel prices, and rising labor costs are all factors also contributing to the rise in prices in the United States and around the world. Supply chain disruptions are on the mend, as the Federal Reserve Bank of New York's Global Supply Chain Pressure Index indicates. Global supply chain pressures as measured by the index decreased in September 2022, marking a fifth consecutive month of easing.

The United States economy is uniquely positioned to overcome the current bout of inflation, according to Moyo (2022), "owing to its relative energy and food independence, abundance of immigrant labor, strong production capacity, and access to the capital needed to maintain and increase domestic manufacturing." As a net energy exporter, the U.S. should be less affected by soaring energy prices. Also, the United States economy continues to attract and rely on immigrant labor flows, which tend to have a dampening effect on wage inflation, and it is the second larger manufacturer after China. Due to supply constraints, corporations will most likely continue to favor resilience over cost-cutting and diversification, meaning a pivot of manufacturing back to the United States. Reshoring could lead to a one-off increase in labor costs, Moyo argues, as employers bring jobs back to the higher-wage U.S. economy, but over time reshoring manufacturing will lead to less price volatility and ultimately, lower inflation.

There are already signs that inflation is starting to cool, but inflation will not return to the target of 2% anytime soon. Gagnon (2022) argues that to keep unemployment low, central banks should plan to raise the inflation target to at least 3% or as much as 4%. His research suggests that the major advanced economies had excessively high unemployment almost continuously from the mid-1990s to 2020, because central banks overestimated the level of unemployment needed to stabilize inflation by using linear models only, when he

argues there is abundant evidence that the effect of unemployment on inflation is highly nonlinear. The lessons of his research, he says, are that central banks should embrace a wider range of economic models, including those with nonlinearities in inflation (the behavior of U.S. inflation during the pandemic supports a nonlinear model, he says).

In sum, high inflation has persisted in the United States despite the pace of monetary tightening thus far, and given the uncertain external backdrop, it remains a major concern for policymakers. Alarmingly, core inflation accelerated in October and spread from industries affected by pandemic-related supply chain disruptions and the war in Ukraine to services, suggesting that the economy may need to slow down further to take some of the demand-side pressure off. The combination of strong inflation and weakening growth prospects present U.S. and global policymakers with a complex scenario for the coming months, and risks of policy trade-offs and miscalibration are growing.

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