Navigating Supply Shocks

Over the last several years, the U.S. economy has faced wave after wave of supply shocks. Every time one wave recedes, we're hit with another: the COVID-19 pandemic, the Russian invasion of Ukraine, the collapse of Silicon Valley Bank, the tariff tumult, and most recently, the conflict in the Middle East. These shocks affect the available supply of goods and services. After the pandemic, we even saw supply challenges with labor. Typically, these shocks result in higher prices for a time and, in turn, a pullback in demand.

Conventional central bank wisdom says the Fed should look past supply shocks. After all, they typically cause only temporary increases in prices, not sustained elevated inflation. Waves may rock the boat momentarily, but they rarely cause lasting damage.

Raising rates to weaken demand doesn't address the root cause behind supply shock-driven inflation. It doesn't free up trade routes, reopen factories, or melt ice. You wouldn't want to address a bird flu-driven egg shortage by slowing demand across the economy.

This approach of looking through supply shocks has worked well for a generation thanks to what economists call "anchored long-term inflation expectations." Where businesses and consumers expect inflation to be in the future helps shape actual inflation. It informs how individuals negotiate wages and how businesses set prices.

When these expectations are "anchored," consumers understand that temporarily elevated inflation does not mean sustained inflation in the long term. They won't negotiate for an outsized increase in wages because they don't expect outsized increases in rent, groceries, and other expenses to persist. They won't feed inflation by preparing for perceived inflation to come.

Put differently, when an anchor is secure, waves don't push a boat into

the rocks. The same is true here.

That said, I've been asking myself whether we've entered an era where supply shocks will become more frequent. Prior to the pandemic, the U.S. economy had enjoyed decades of relatively smooth sailing: The Berlin Wall fell, the world globalized, demographics boosted labor supply, and geopolitical conflicts faded into the background. But looking forward, it's easy to imagine more challenging conditions: heightened geopolitical tensions, trade fragmentation, more frequent severe weather events, rising government debt, cyber risk, slowing workforce growth, and more. Supply chains could face increased risk.

If that occurs, does the Fed have the luxury of riding out all the waves that come our way? For me, it comes down to how much businesses, consumers, and inflation expectations can take. Allow me to torture the analogy a little further.

First, will businesses get queasy? They have spent the last few years finding efficiencies. They've improved processes. They've invested in technology and automation. They've reaped the benefits of low turnover. But they've largely gotten more productive through attrition, not layoffs. At what point will they more broadly gain conviction that it is time to reduce headcount more actively?

Second, will consumers abandon ship? Thus far, they've continued to spend. They've traded down to lower price products and retailers. They've made trade-offs between spending categories. They've been creative in how they finance their purchases. They're certainly not happy — consumer sentiment remains historically low as measured by the University of Michigan Surveys of Consumers — but they've persisted. As real wage growth slows, tax refunds fade, and trade-down options run their course, will consumers finally reduce their appetite for spending?

And finally: How secure is the inflation expectations anchor? I'm hearing a renewed determination by businesses to pass highly visible, conflict-driven cost increases on to their customers. But, so far, measures of forward inflation compensation beyond the next year and survey-based measures of long-term inflation expectations remain well anchored. With inflation above our 2 percent target for over five years now, it's worth asking whether the cumulative impact of so many waves risks loosening the anchor.

The answers to those questions will determine whether the Fed still has the luxury to look through supply shocks.

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