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Uncertainty about monetary policy increases due to rising energy prices

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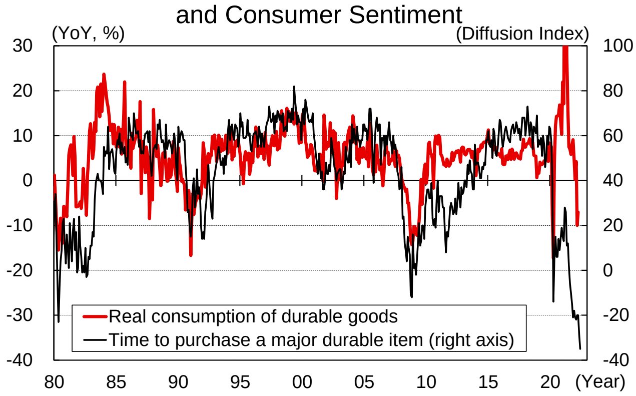
At the Federation Open Market Committee (FOMC) meeting in June, the target range for the federal funds rate was raised by 0.75% points for the first time since 1994. In its Meeting Statement, the FOMC said: "the Committee is strongly committed to returning inflation to its 2 percent objective". At the press conference following the meeting, Chair Powell said the Committee plans to lower the inflation rate by moderating the strong demand in goods and labour markets with rate hikes.

The tightening of financial conditions – as seen by the rise in long-term interest rates since the start of the year – and concerns about recession are already having an impact on household and business sentiment. In the University of Michigan's Surveys of Consumers, the "time to purchase a major durable item" was at its all-time lowest for the second month in a row, and consumption of durable goods based on personal income statistics has also turned to a decline (Chart 1). Furthermore, according to Small Business Economic Trends by the National Federation of Independent Business (NFIB), the diffusion index of businesses that "expect real sales higher" was negative at the start of the year and the ratio of businesses that plan to increase their compensation is falling (Chart 2). If strong demand in goods and labour markets is supressed, there is a possibility it will contribute to the deceleration of the core inflation rate.

That being said, the upward pressure on inflation from energy and food was seen as temporary in the beginning, but it has become prolonged (Chart 3). It is unclear if the Fed can achieve its inflation target of 2% with a deceleration in the core inflation rate given that Chair Powell said the Fed cannot impact food and energy prices. For example, soaring gasoline prices are not just due to a rise in oil prices, but are also caused by structural factors such as the decrease in distillation capacity resulting from decarbonisation and a decline in new investment (Chart 4). Although the Biden administration has asked the oil industry to increase the supply of gasoline, the oil industry is demanding an easing of restrictions related to decarbonisation and the situation is highly unpredictable. In addition, it is reported that large refineries are currently undergoing maintenance, and there is a risk that gasoline prices will rise higher in the near term.

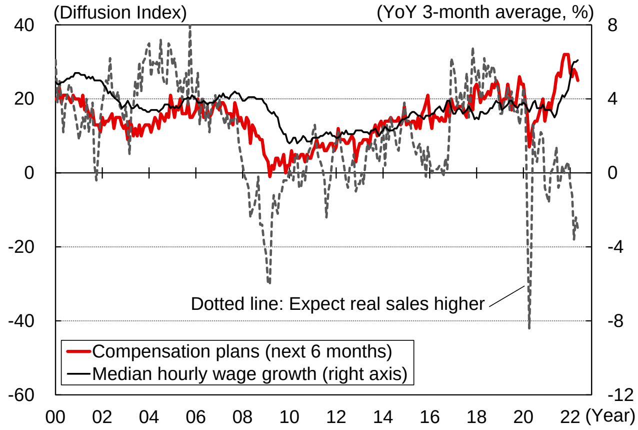
During this current period of high inflation, the impact of factors that the Fed cannot control, such as war and decarbonisation, is huge, even compared with the 1980s. It is important to bear in mind the risk that demand will have been curbed more than anticipated by the time the FOMC is certain that the inflation rate will fall to 2% (i.e. the risk of economic recession).

Chart 1: Consumption of Durable Goods and Consumer Sentiment



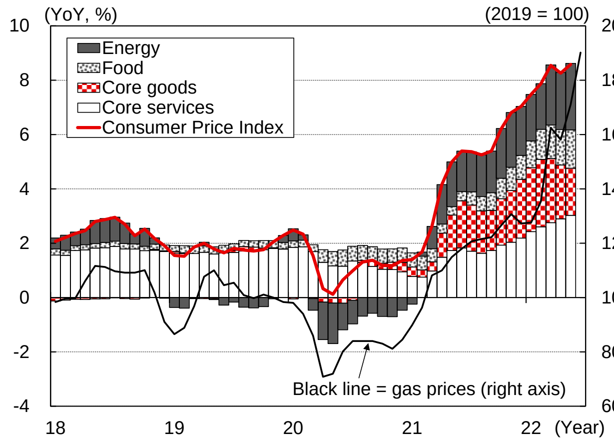
Note: Figures for "time to purchase a major durable item" is the difference between respondants who answered "good time" and "bad time"
Source: Department of Commerce, University of Michigan, MUFG Bank Economic Research Office

Chart 2: Small Business Sentiment and Hourly Wages



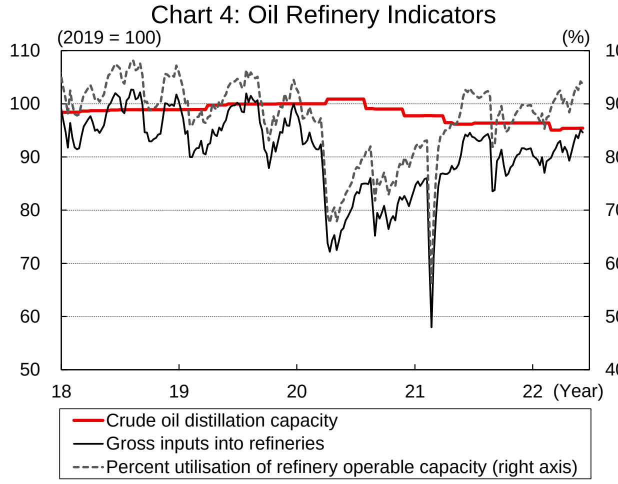
Source: National Federation of Indepenent Business, Federal Reserve Bank of Atlanta, MUFG Bank Economic Research Office

Chart 3: Consumer Prices and Gas Prices



Source: US Bureau of Labor Statistics, Department of Energy, MUFG Bank Economic Research Office

Chart 4: Oil Refinery Indicators



Source: Department of Energy, MUFG Bank Economic Research Office

Translation by Elizabeth Foster

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