Economic Shocks and Monetary Policy: Conventional Wisdom or New Reality?

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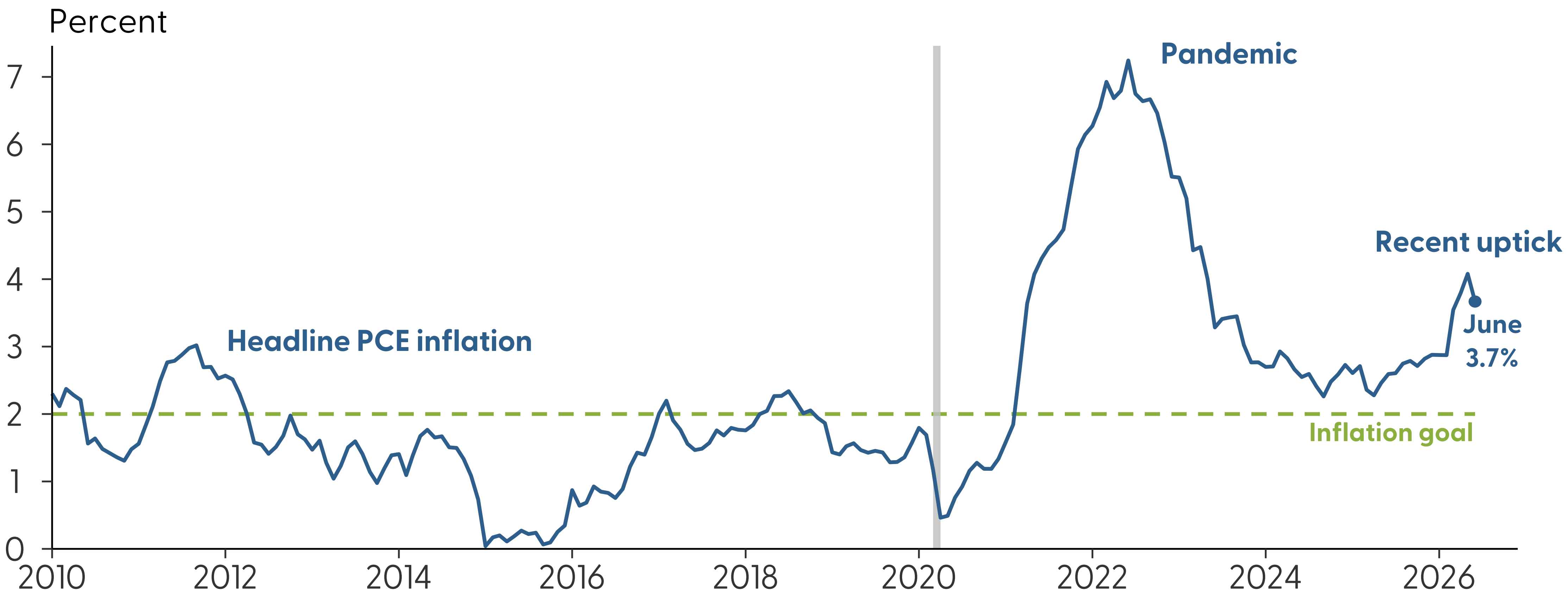
U.S. Inflation Picture

Headline PCE Price Index, 12-Month Change



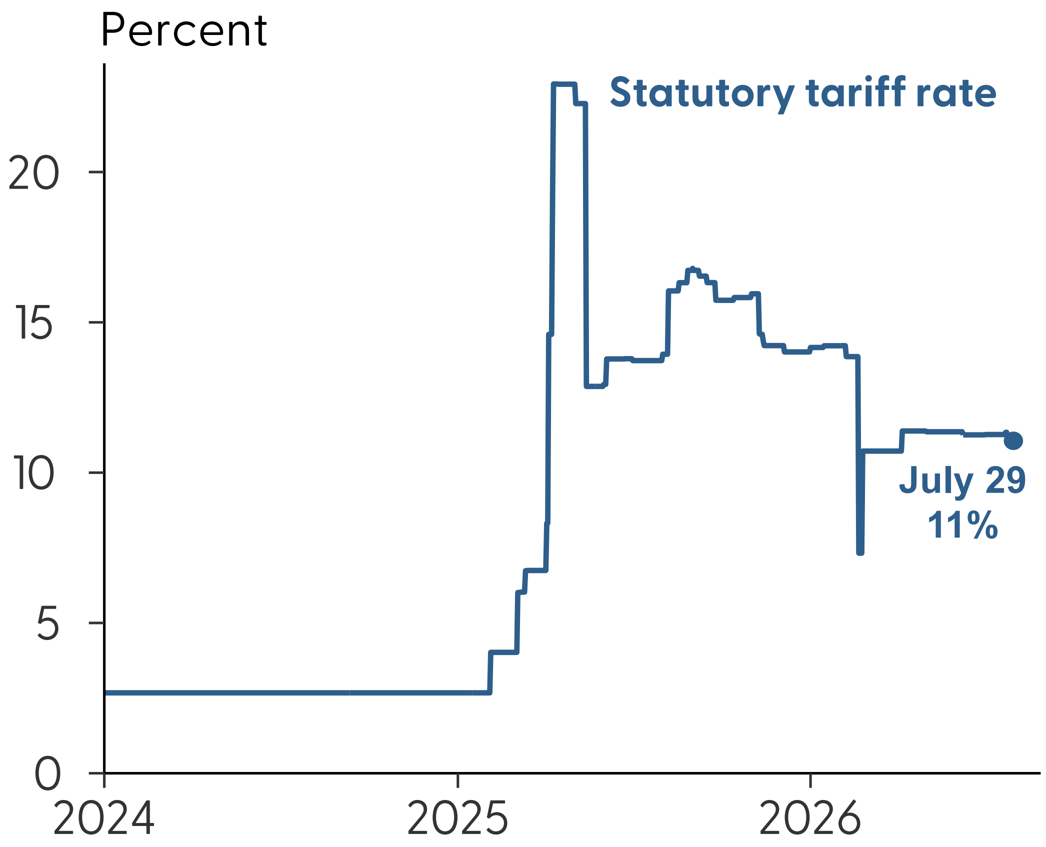
Source: Bureau of Economic Analysis.

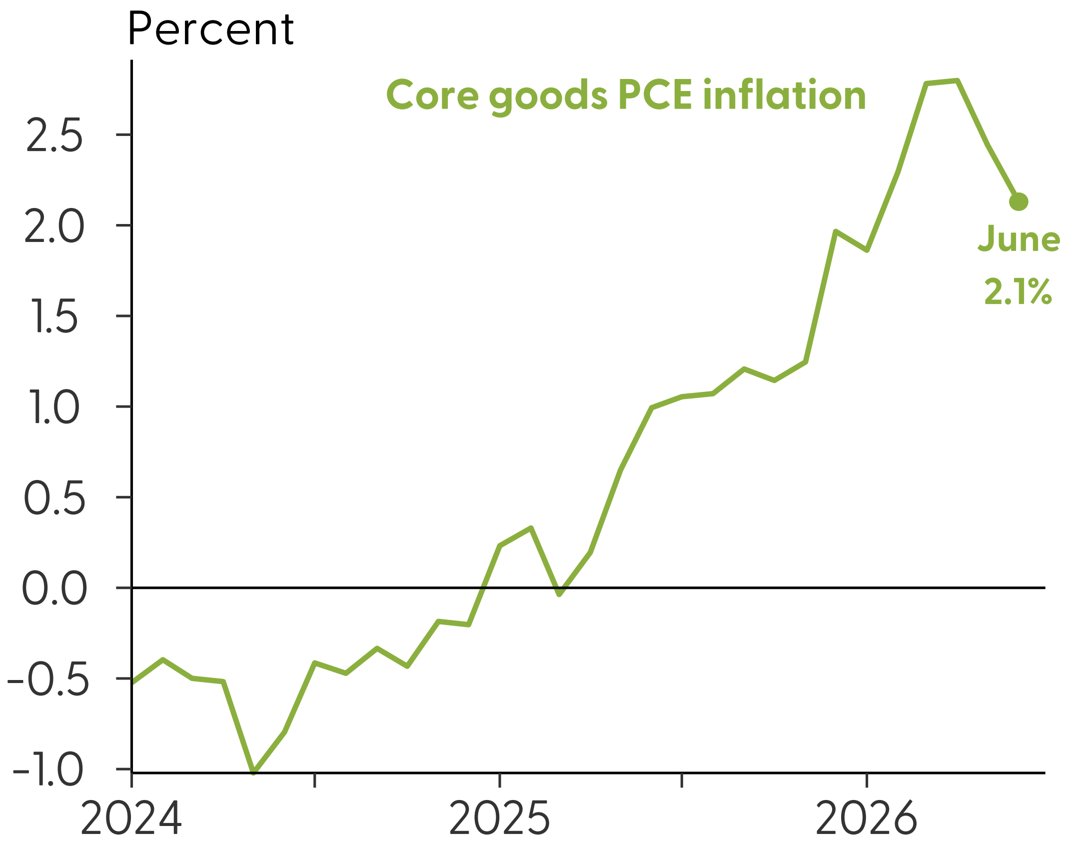
Uptick Reflects Three Shocks

- **Tariffs** (April 2025)
- **Energy** (March 2026)
- **AI** (Acceleration this year)

Tariff Shock

U.S. Effective Tariff Rates and Core Goods Inflation

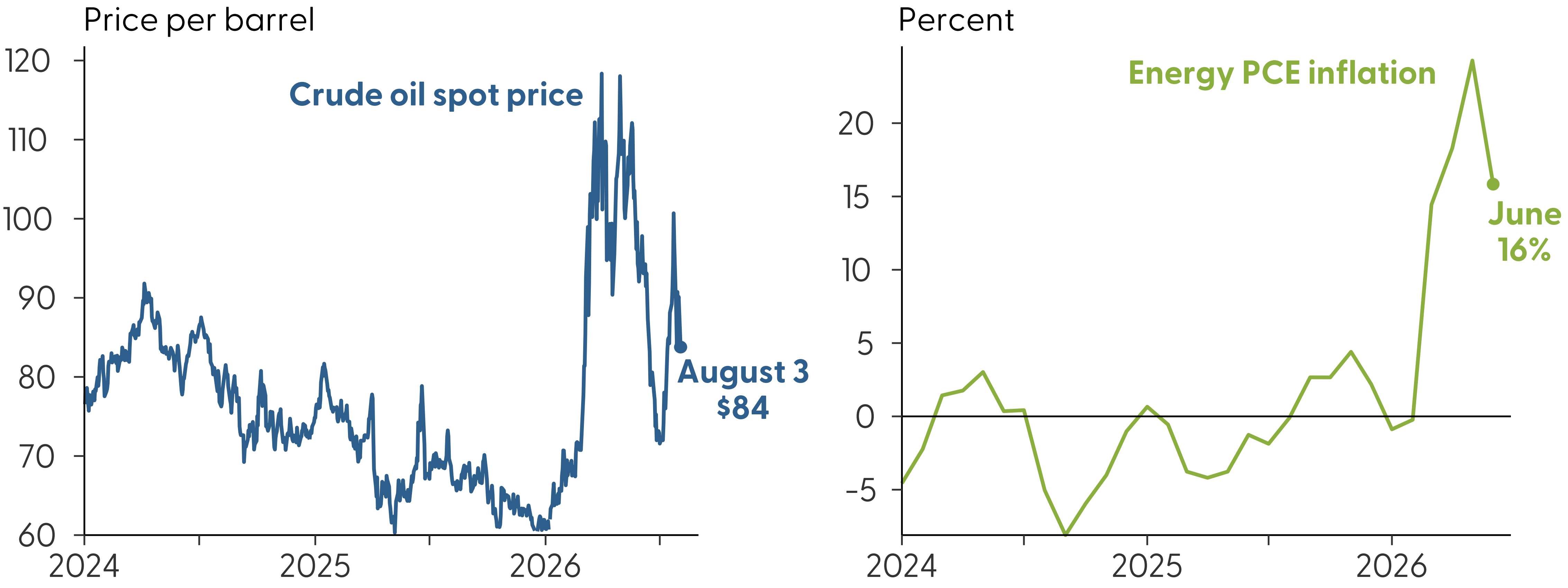




Note: Core goods PCE includes all goods categories excluding food and energy. PCE inflation expressed as 12-month percent change.
Source: The Budget Lab and Bureau of Economic Analysis.

Oil Price Shock

Crude Oil Prices and Energy PCE Inflation



Note: PCE inflation expressed as 12-month percent change.
Source: Intercontinental Exchange and Bureau of Economic Analysis.

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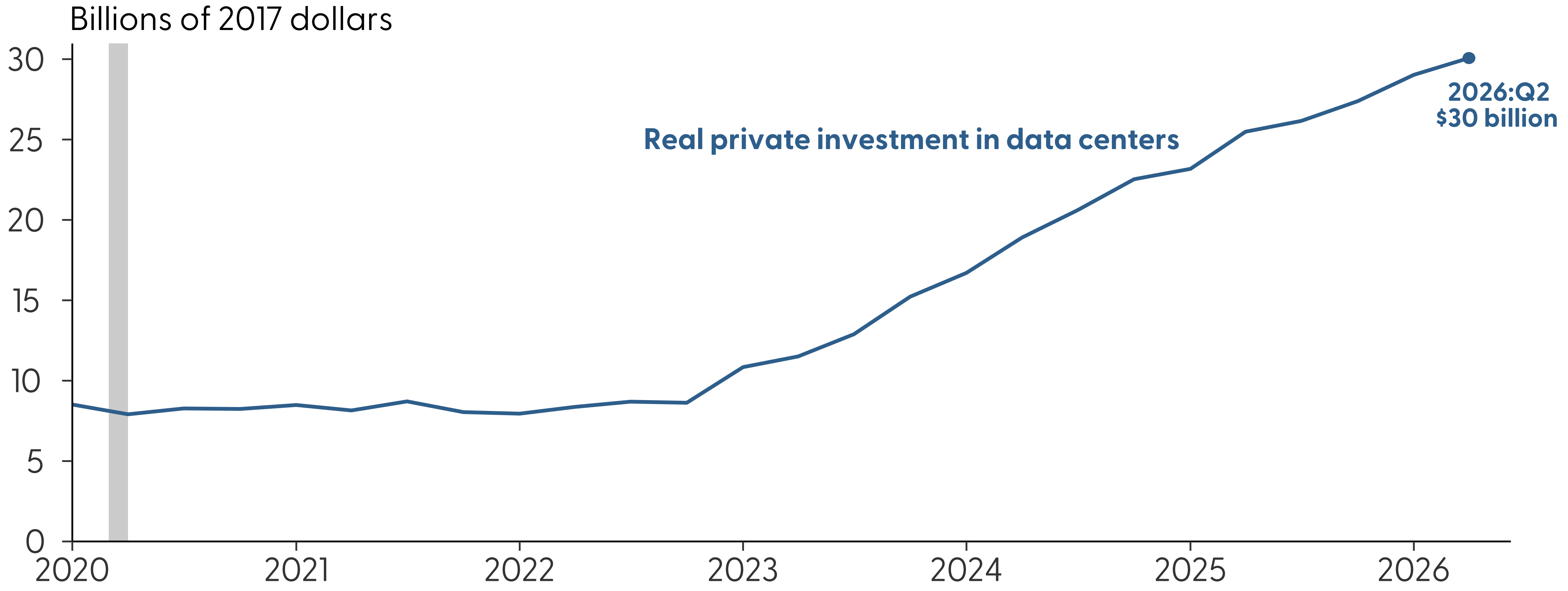
AI Investment Shock

U.S. Private-Sector Investment in Data Centers



Note: Adjusted for inflation.
Source: Bureau of Economic Analysis.

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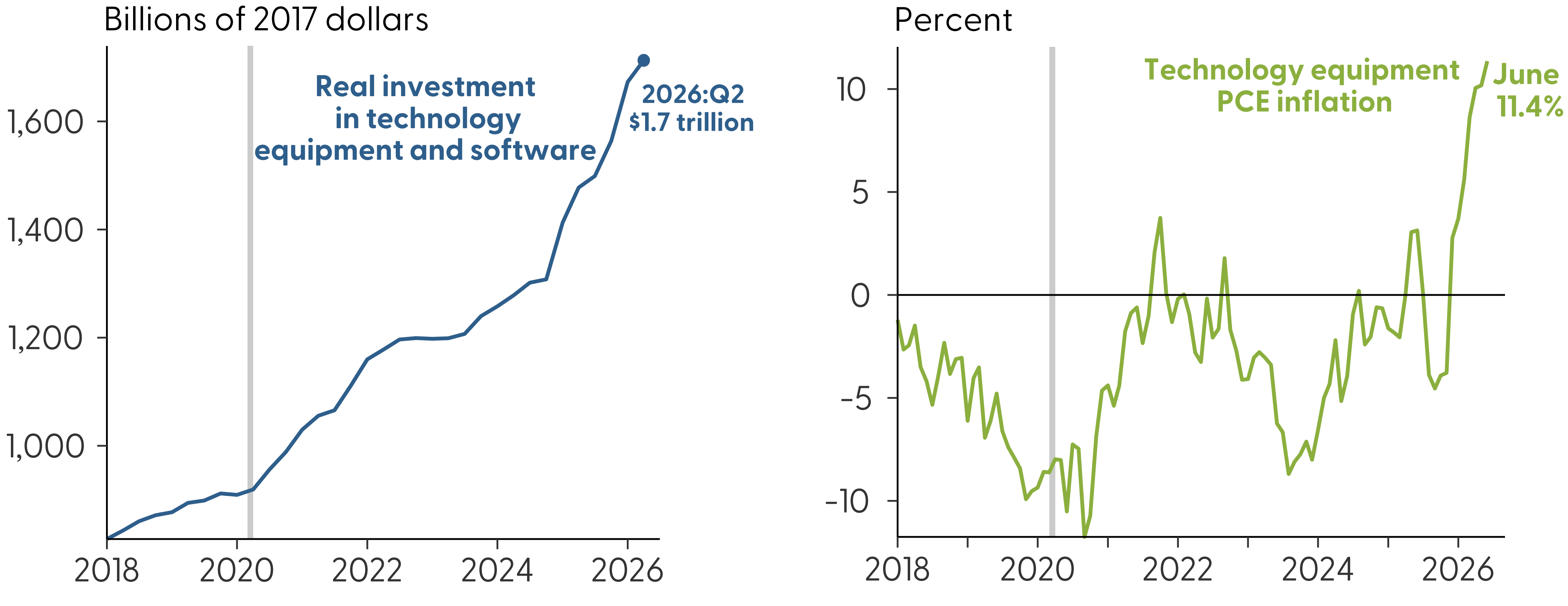
AI Investment Shock

Technology-Related Spending and Price Inflation



Note: Investment data adjusted for inflation. PCE inflation expressed as 12-month percent change and includes information processing equipment.
Source: Bureau of Economic Analysis.

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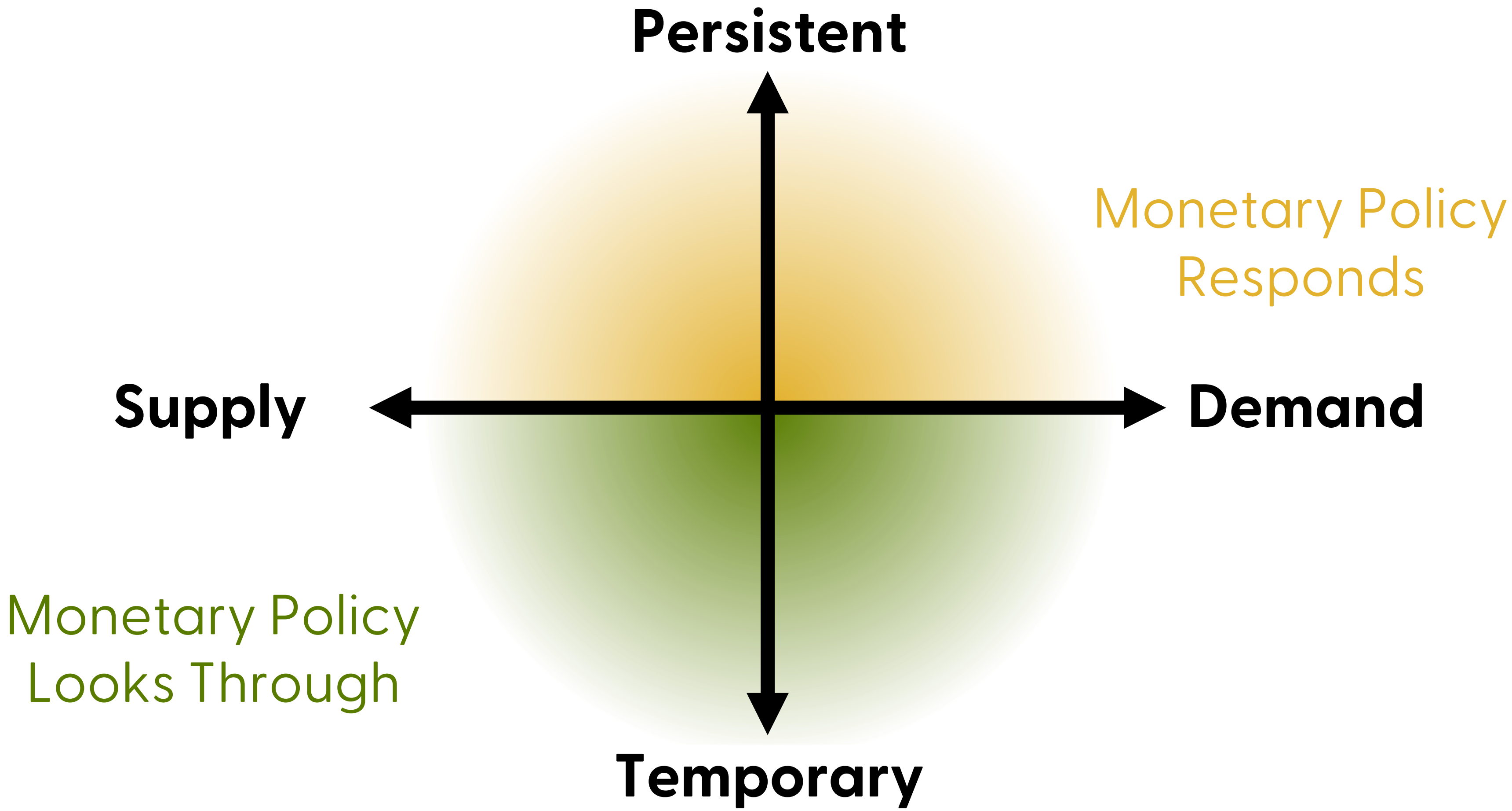
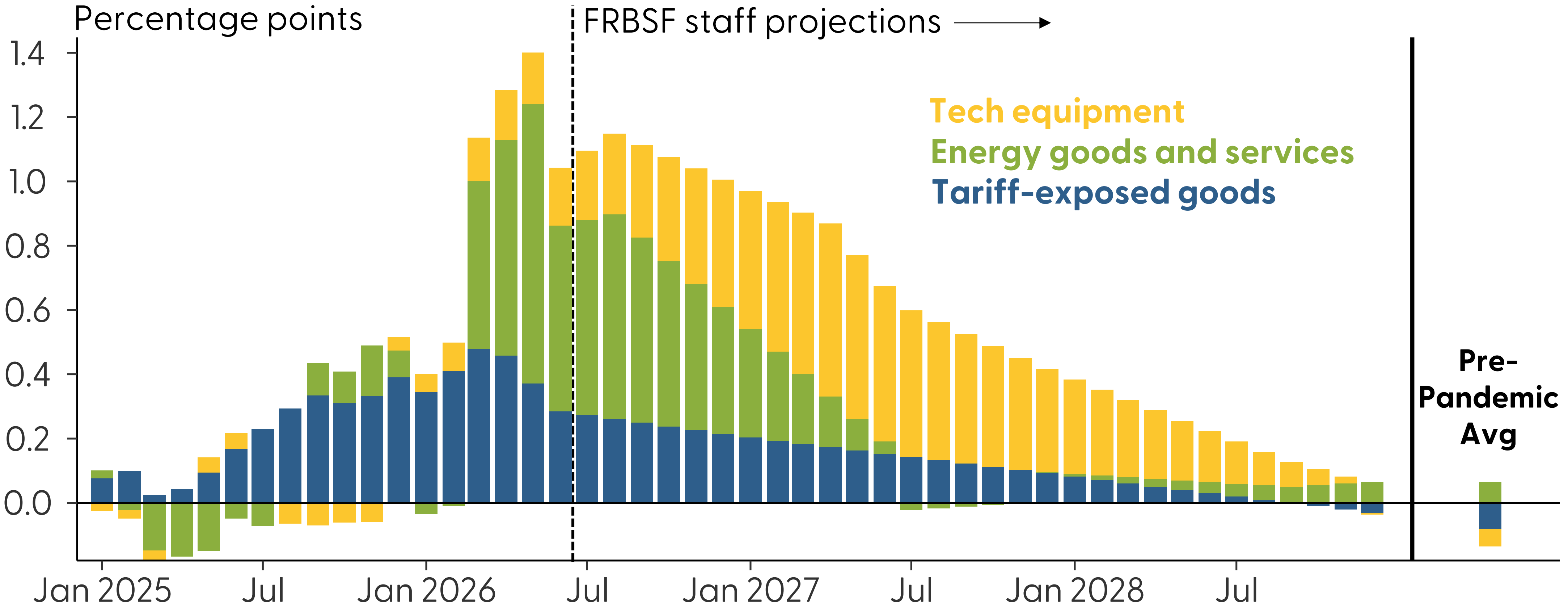
Conventional Wisdom

Taxonomy of Inflation Shocks



Overlapping Impacts

Contributions to 12-month Headline PCE Inflation



Note: Tech equipment represent the Information Processing Equipment category. Tariff-exposed goods represent all other core goods categories.
Source: Bureau of Economic Analysis and FRBSF staff.

Two Scenarios for Inflation

Scenario 1: Short-lived inflation

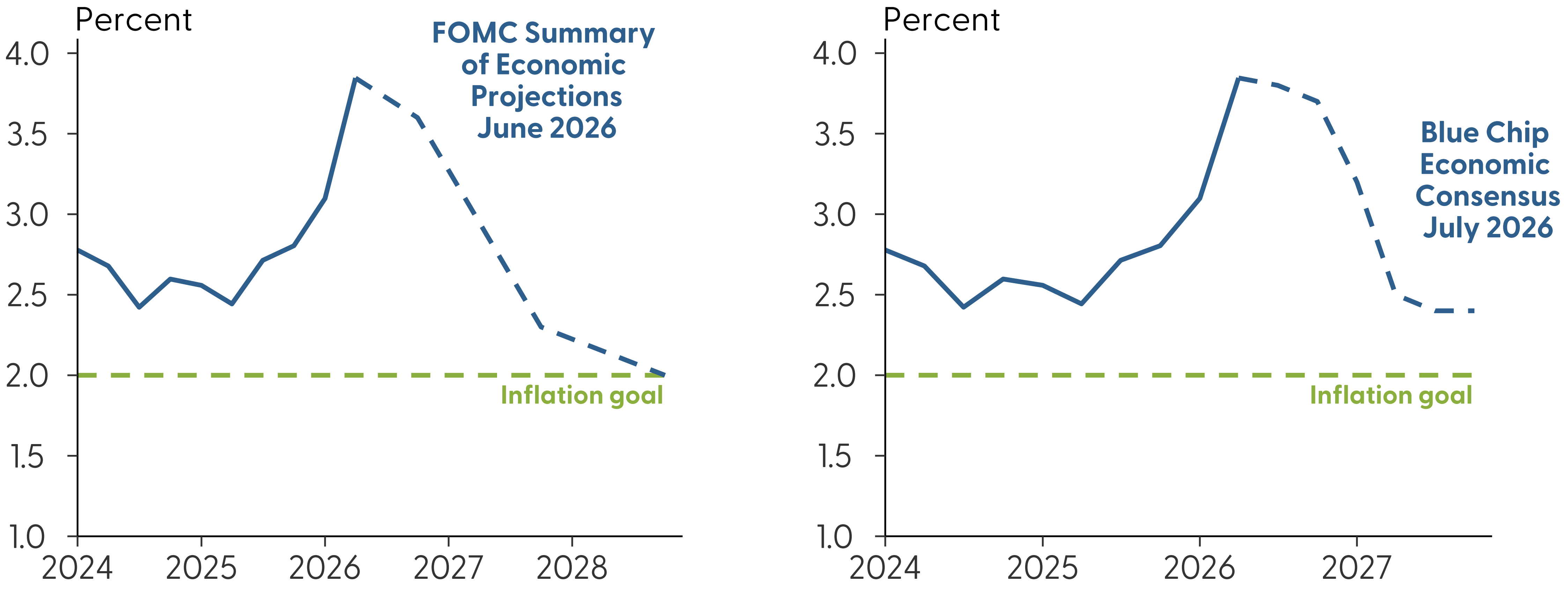
- Shocks follow conventional dynamics
- Inflation temporarily rises and then falls as shocks dissipate
- Current mildly restrictive policy gradually returns inflation to 2% goal

Scenario 2: Lasting inflation

- Overlapping shocks compound, amplifying the effects
- Inflation broadens and becomes more persistent
- Policy must be recalibrated to bring inflation down

Many Expect Scenario One

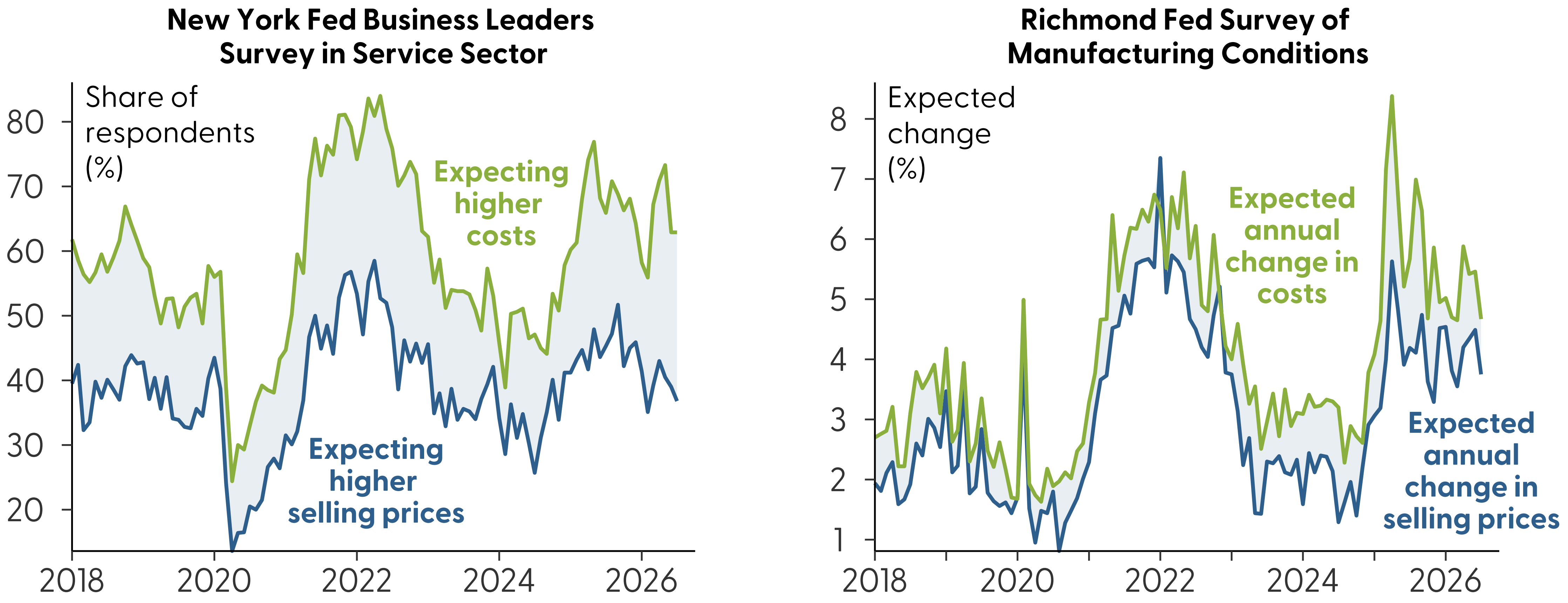
Headline PCE Inflation Projections



Note: Inflation shown as four-quarter percent change. SEP projections are for year-end only.
Source: Bureau of Economic Analysis, Federal Reserve Board of Governors, and CCH Incorporated.

Business Pricing Power Limited

Business Expectations of Costs and Selling Prices



Note: Surveys cover the geographic area of each District. Expectations are 6 months ahead for New York Fed and 12 months ahead for Richmond Fed. Expected price changes are expressed as annualized percent change.

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Households Focused on Energy

U.S. Gas Prices and Near-Term Inflation Expectations

Note: Expectations measure is for one year-ahead inflation rate. Gas prices represent the monthly national average across all retail gas grades.
New York Federal Reserve Bank and Energy Information Administration.

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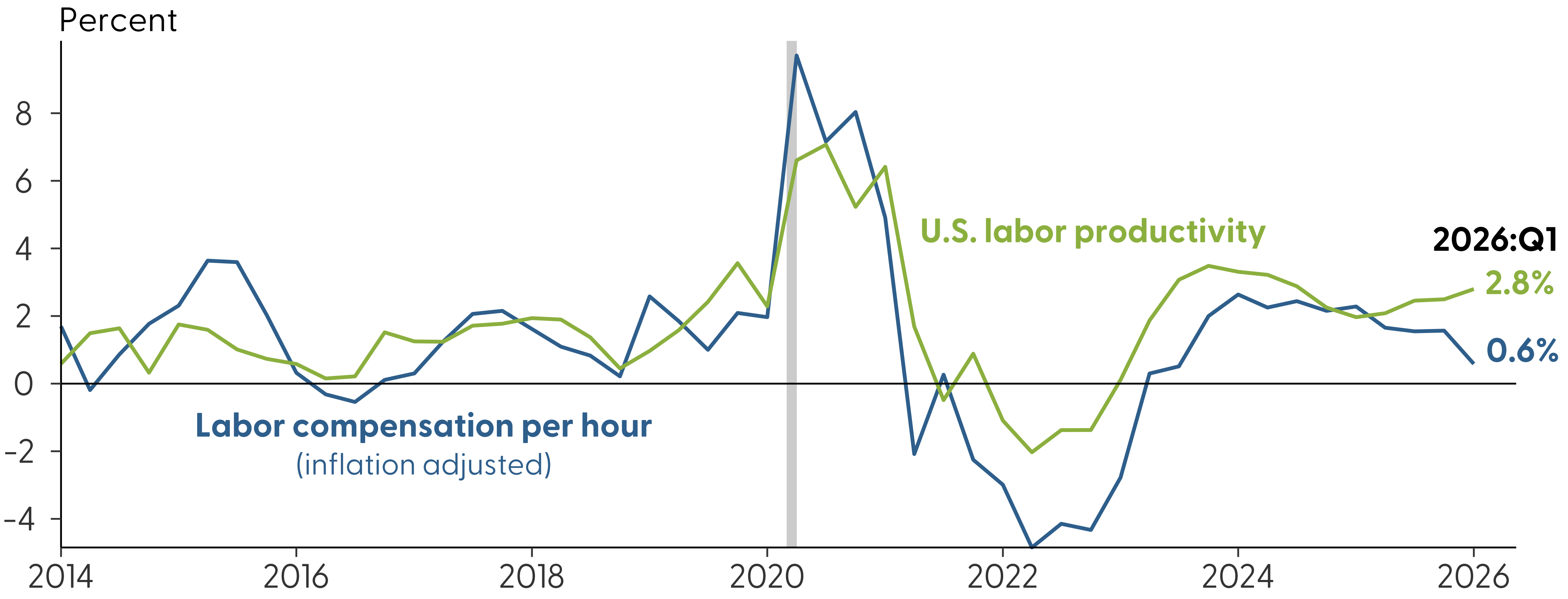
Little Pressure from Wages

Labor Pay and Productivity, 4-quarter Change



Note: Nonfarm business sector. Series adjusted for inflation.
Source: Bureau of Labor Statistics.

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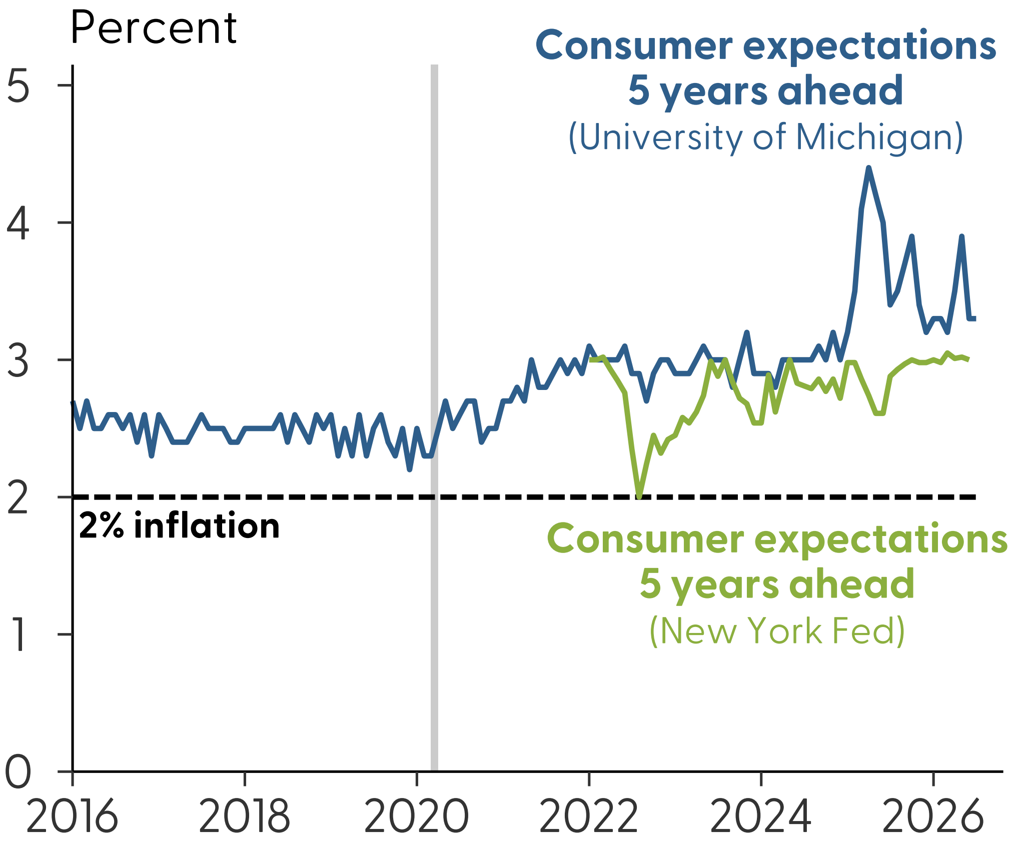
Inflation Expectations Stable

Measures of Long-Run Inflation Expectations



Source: Philadelphia Federal Reserve Bank, Federal Reserve Board of Governors, New York Federal Reserve Bank, and University of Michigan.

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But Scenario Two Is Possible

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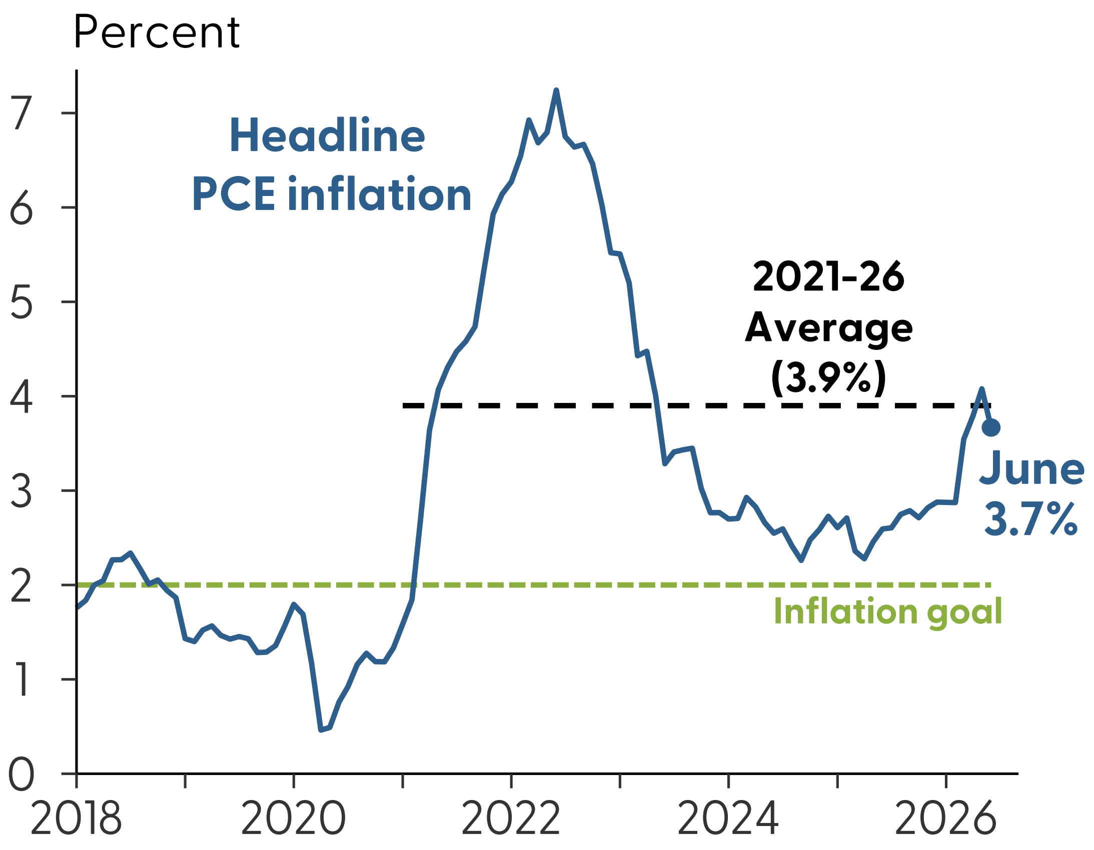


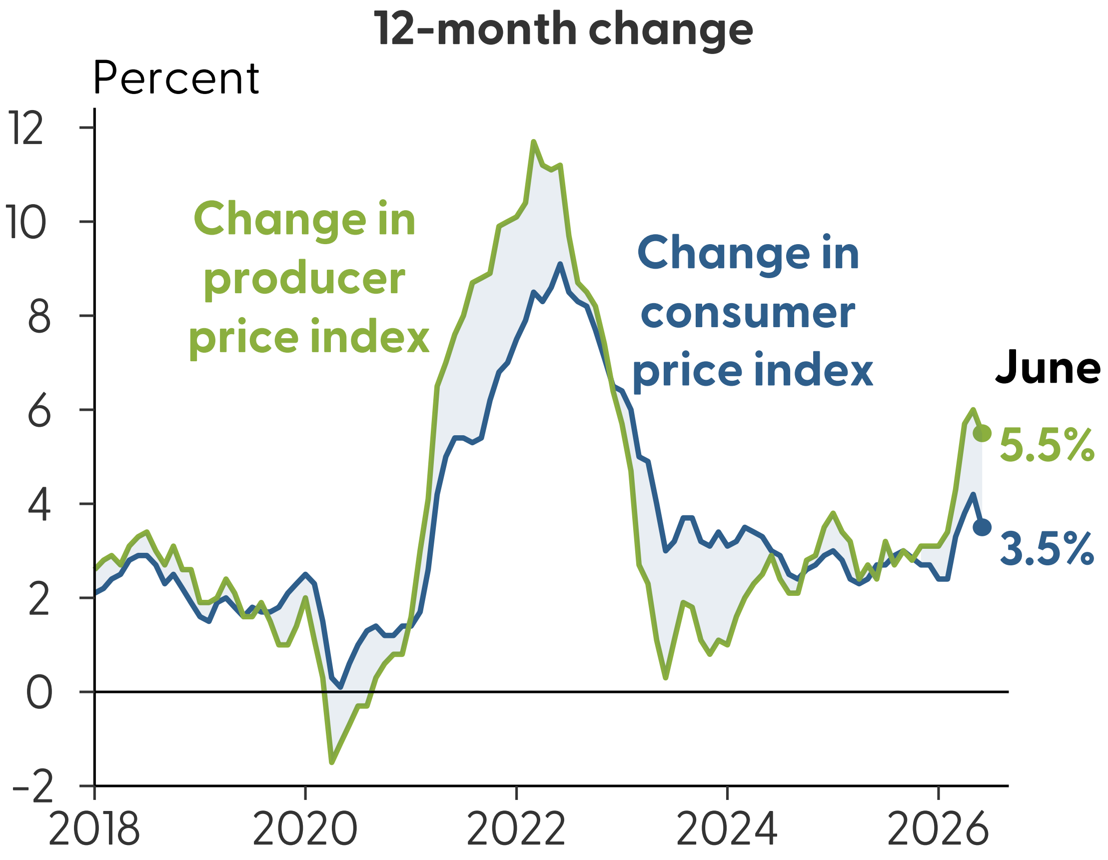
Forthcoming AER paper:

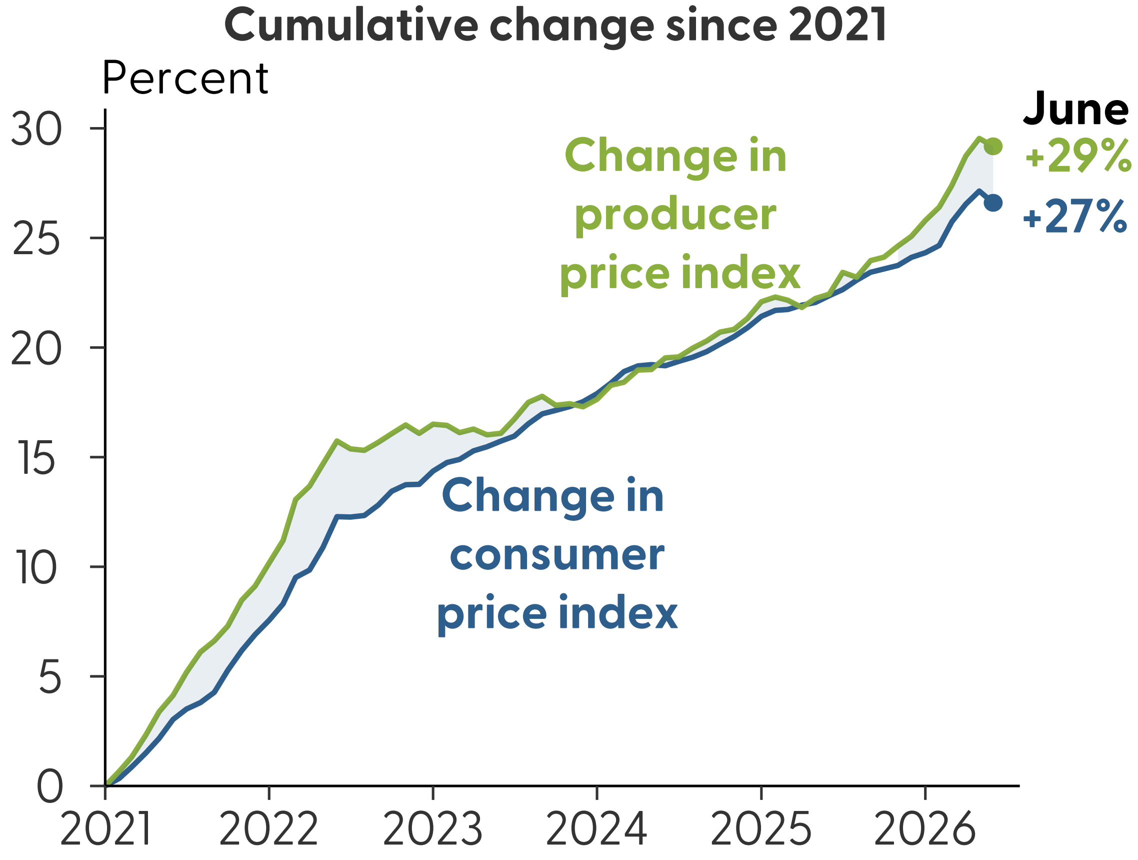
- Consumers' attention to inflation impacts inflation itself
- Crossing a threshold moves people to a high-attention regime (threshold ~4% annualized change in consumer prices)

Source: Bureau of Economic Analysis and Pfäuti, Oliver (forthcoming). "*The Inflation Attention Threshold and Inflation Surges*," American Economic Review.

Costs Outpacing Price Growth

Producer and Consumer Prices





Note: Producer Price Index and Consumer Price Index shown. Cumulative change relative to January 2021 levels.
Source: Bureau of Labor Statistics.

Policy Risk Management

- FOMC faces bimodal risk and considerable uncertainty
  - Scenario 1—inflation is short lived and current policy is well-positioned to achieve price stability
  - Scenario 2—inflation is gaining momentum and aggressive policy recalibration is likely required
- We must remain vigilant to each scenario and be prepared to act