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# What Will DC Do? FAQs on Inflation Fighting

Headlines have been swirling about potential policies being pursued in the name of fighting inflation (i.e., tariff cuts, a windfall profits tax, a more aggressive Fed, etc.). We answer your frequently asked questions and conclude the Fed will remain the primary inflation fighter in Washington.

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# When it Comes to Fighting Inflation, Look to the Fed, Not Congress

President Biden continues to signal that blunting inflation is a top priority for his administration. Furthermore, Democrats' electoral prospects appear increasingly tied to the inflation trajectory. Hence, investors are increasingly focused on the likelihood of enacting various policy options that policy-makers have promoted as dealing with inflation. Our focus here is not on the efficacy of those policies if enacted, but rather their prospects for enactment. To that end, we evaluate some of the frequently asked questions that we receive below.

## 1) What legislative options are there? Little that's viable, in our view

Lawmakers have proposed a variety of solutions to tame rising prices, including a windfall profits tax on oil and gas companies, a gas tax holiday for consumers, or a 'use it or lose it' policy for drilling leases to shore up supply. However, these face an uphill battle in Congress as procedural constraints limit leadership's ability to move them through both chambers. Some details on those proposals are below:

- **Windfall profits tax:** Sen. Sheldon Whitehouse (D-R.I.) and Rep. Ro Khanna (D-CA) put forward a proposal that would put a 50% per barrel tax on the difference between crude oil prices and the average between 2015 and 2019, with revenues returned to consumers as a rebate. Similarly, Sen. Sanders (I-VT) introduced a bill that would place a 95% tax on excess profits of corporations with more than $500 million in yearly revenue.

- **Gas tax holiday:** Since March, lawmakers have been discussing the potential for a suspension of the federal gas tax until 2023, which is currently ~18c per gallon. However, moderates in the Democratic caucus have been hesitant to support the policy given that the gas tax flows into the Highway Trust Fund, which is used to support infrastructure projects across the country.

- **'Use it or lose it' for drilling permits:** Speaker Pelosi has expressed support for such a proposal, which could compel oil and gas companies sitting on non-producing acres to either begin producing from their land or pay a fee for each idled well.

**However, in our view, these proposals are limited in terms of both procedural hurdles to passage as well as potential impact on the macro environment:** As we note above, any proposal in Congress is subject to a number of procedural constraints, most notably the filibuster in the Senate, which requires legislation to garner consent from at least ten Republicans in that chamber (this reality likely blocks the 'use it or lose it' permit proposal). Although the reconciliation process presents an alternative vehicle for tax increases to pass without Republican support, any provision's inclusion would require support from all 50 Senate Democrats. House and Senate moderates have come out in opposition of a gas tax holiday and several centrists Senate Democrats have been reluctant to publicly support a windfall profits tax. Such opposition may be fueled by research questioning the impact of these policy options. For example, the Congressional Research Service notes that the last windfall profits tax (which was imposed in 1980 under President Carter) led to an 8% decline in domestic oil production and a 13% increase in imports. Similarly, recent analysis according to the Penn Wharton Budget Model shows that a suspension of the federal gas tax would have a minimal impact on consumers and reduce federal tax revenue by ~$20 billion.

**Yet, there's real prospects for a Build Back Better-like reconciliation bill that includes some deficit reduction:** Media reporting in recent weeks indicate a restart in negotiations between Senator Manchin – a key swing vote in the 50/50 Senate – and Majority Leader Schumer on a more targeted reconciliation package than the original 'Build Back Better' concerning deficit reduction as well as some other priorities. We outlined the potential impacts from that legislation in Public Policy Brief: The Read on Reconciliation (10 Jun 2022), but note that its ability to tame inflation will depend on the structure of the revenue raisers, which are still far from certain.

## 2) What might the White House do on its own? A 'get caught trying' strategy

Given the constraints described above, we also consider policy options that the executive branch can exercise unilaterally. The impact of some of these options on inflation may be limited or uncertain, but the motivation to exercise them is high as the administration likely wants actions to mirror its message that it is focused on reducing inflation. Some of the policies (some proposed, some already enacted) and their potential impact are described below:

- **Strategic Petroleum Reserve (SPR) release:** In a White House fact sheet the president outlined his plan to increase oil supply by releasing 1 million barrels of oil per day from the Strategic Petroleum Reserve for the next six months. The president suggested that the release could drive gas prices down from 10c to 35c per gallon. However, our oil strategists have noted that the releases have not worked to cool the market, as the International Energy Agency estimates that the releases are only replacing about a third of the supply that is lost per day due to the conflict in Ukraine (3 million barrels per day).

- **Leveraging foreign policy relationships to encourage allies and other players to boost production:** The president also noted in the fact sheet his plan to engage with allies to persuade them to release an additional 60 million barrels of oil from other countries' reserves. The US has also been working to improve relations with key South American countries to encourage production, and continuing to engage in the JCPOA negotiations to bring Iranian supply back to market. However, thus far efforts with non-allies have met some resistance: the administration received pushback from lawmakers of both parties amid media reports of potential rollback of sanctions on Venezuela in exchange for higher levels of production, and the negotiations to restore the Joint Comprehensive Plan of Action (the Iran Nuclear Agreement) and bring some Iranian supply back online have faltered. Lawmakers including Senate Foreign Relations Committee Chair Menendez recently signaled that those talks have come to a close.

- **Utilizing the FTC to go after companies' "price gouging":** The president has called on the FTC to investigate behavior from energy companies for 'anti-consumer' behavior, on account of the difference between the price of unfinished gasoline and the average price at the pump, which has now surpassed $5 nationally. The FTC can conduct investigations into price gouging and anti-consumer behavior, but relies on Congress for expanded resources and authorities. The House recently passed the Consumer Fuel Price Gouging Prevention Act, which expands the FTC's authority to investigate potential instances of price gouging and delivers state authorities enhanced enforcement power through civil court action; however, for the reasons we mention above, passage in the Senate comes with its own set of challenges.

## 3) What about reducing tariffs on China? We see scope for limited action only, and a hawkish posture should continue

**Media reports recently have indicated that the administration is considering relieving some tariffs on certain Chinese imports to blunt the impact of inflation:** This is something the executive branch could accomplish without congressional approval, through the office of the US Trade Representative. However, our economists' view is that the impact from tariff relief on select goods would be minimal in terms of taming inflation. In recent research they refer back to a study from the Peterson Institute for International Economics earlier this year stating that the direct effect of tariff removal would "put only a small, short-lived dent in overall inflation" of 0.26pp (for CPI, or 0.5pp on PCE).

**Hence, we do not expect broad-based tariff rollback given the trade-off between limited GDP impact and the political risk in an election year of not appearing hawkish with respect to China:** A unilateral rollback of tariffs absent concession from China would be, in the USTR's words, equivalent to the sacrifice of leverage in negotiations. For that reason, reports are indicating that the administration is considering targeting certain items (consumer goods, for example) for relief. In our view, if this limited or temporary tariff removal is announced, it will likely be paired with some incremental hawkish actions. These actions could include: potential new export restrictions on other items, a Section 301 announcement, explicit support for outbound investment restrictions, or others that we detail in Public Policy Brief: What If? US/China Catalysts (12 Apr 2022). Given the limited scope, we expect that this event is neither a panacea for inflation concerns in the US nor a meaningful new incentive for capital to flow to China.

## 4) Is the Fed, then, the main inflation fighter in DC? Yes

**The main tool to fight inflation is through monetary policy:** The Fed's two mandates – promote maximum employment and keep prices stable – can be achieved via its primary tool of interest rates. Through raising interest rates, interest rate-sensitive sectors of the economy, namely housing, consumption, and business investment, will pull back demand. Even if supply constraints do not ease, the softening in demand should help to alleviate inflationary pressures.

**At the June FOMC meeting, the Fed delivered a 75bp rate hike and reiterated that it is "strongly committed" to reducing inflation:** With inflation prints set to remain elevated through the summer, we expect more aggressive tightening to come. We see the Fed delivering another 75bp hike at its July meeting and our modeling suggests that it will take a steady diet of 50bp increases per meeting through November to push GDP growth below potential. A final 25bp hike at the December meeting brings the mid-point of the federal funds target range to 3.625% at end-2022.

**By pushing growth below potential, the Fed is creating slack in the economy and labor market, which should in turn ease inflation:** Sensitivity in aggregate demand directly exposed to higher interest rates (consumption and housing primarily) pushes GDP growth below its potential to 1.4% 4Q/4Q in 2022 and 1.6% in 2023 (4Q/4Q). Our quarterly path has real GDP growth running between 1.5-1.8% Q/Q annualized growth throughout 2023. Consumption will come down on a stronger pullback in durable goods expenditures from higher interest rates, as well as moderation in housing services and home-related spending. On housing, higher rates will slow residential construction meaningfully, reducing supply further, while ongoing affordability issues and higher mortgages rates will greatly reduce demand for housing. We see residential investment declining by 5.9% 4Q/4Q in 2022 and 1.1% in 2023. This slower growth should alleviate labor tightness, and we now expect the unemployment rate to tick up 20bp in 2H23 to 3.8%.

As the Fed works to slow economic activity, measures of inflation should follow. We expect headline PCE inflation to come down to 5.3%Y by 4Q22 and 1.9%Y by 4Q23. Core PCE inflation is forecast to moderate to 4.1%Y by 4Q22 and 2.6%Y by 4Q23.

**Investors need to be watching the data and thinking like the Fed:** What data will it have in hand before each FOMC meeting that would push it to change its policy guidance or not? By the September meeting, the Fed will have CPI inflation for July in August in hand, which should continue to show elevated prints on a Y/Y basis, but M/M there is a notable deceleration. We forecast core CPI to moderate from 0.6%M in May to 0.4%M in June and 0.3%M in July and August, as core goods inflation declines M/M starting in July (data available in August), and core services inflation cools.

A further re-acceleration in inflation that is broad-based (similar to the May print) would push the Fed to act more aggressively in the back half of the year, lifting policy rates well above "neutral" (2.5%) in order to drive down economic activity. However, it is important to note that policy works with a lag, and while we see some immediate effects in the housing market and in financial conditions, we believe that the front-loading of policy in 2022 will most significantly impact activity in 2023.

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