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Beyond Today's Inflation Storm

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Highlights:

- When the Fed determines how to contain inflation, the conditions matter.
- Before the pandemic, we had a period with "the wind at our back" when it came to containing inflation. A number of disinflationary factors affected the real economy and the Fed's success depended on us recognizing them, understanding their impact and adjusting.
- The pandemic has been quite a storm; bringing, it seems, one short-term inflationary gust after another. Initially, we thought inflation would be short-lived. Now, with inflation persisting and broadening, we have moved to start to normalize our monetary policy stance.
- What direction the winds will be blowing going forward remains an open question. There are reasons to think we may face more headwinds, requiring us to navigate in the context of more medium-term inflationary pressure. If that's the case, we may need to note the conditions and adjust.

This speech was delivered remotely.

Thanks for having me today. It's great to be back in front of this group. Today, I want to take a step back and look beyond today's headlines. I caution these views are mine alone and not necessarily those of any of my colleagues on the Federal Open Market Committee (FOMC) or in the Federal Reserve System.

The direction of the wind matters. Jim Croce once famously said you don't spit into the wind. The Irish blessing asks that the wind always be at your back. But maybe Virginia country singer and sausage entrepreneur Jimmy Dean said it best: We can't change the direction of the wind, but we can adjust our sails. If you're a sailor like my daughter or even a golfer like me, that notion is pretty familiar. You adjust your game based on the conditions you face.

I think this analogy extends to the question of how the Fed contains inflation. The conditions matter. We take note, and we adjust our course.

To give my Fed predecessors due credit, a lot of work has gone into anchoring inflation expectations over the last generation. As a result, our economy has seen healthy growth and an era of remarkably low and stable inflation.

During this period, a number of disinflationary factors affected the real economy. This "series of fortunate events" (if I can borrow from the children's books) could be described as putting "the wind at our back" when it came to containing inflation. But our success depended on us recognizing those factors and adjusting. The best known such story is probably in the late '90s, when the Fed deferred interest rate increases, recognizing that technology-enabled productivity would limit inflationary pressure in that period.

But there are several other examples of disinflationary forces:

Globalization, especially the rise of India and China, gave producers access to ever-greater proportions of lower-cost labor and consumers ever-increasing access to lower-cost products.

Technology enabled innovation. No one could have predicted the explosive growth of e-commerce, which lowered the barrier to price comparisons and cut costs for retailers. Or how fracking provided additional supplies of natural gas and then oil once thought to be depleting.

The "effective" labor force grew strongly, both in numbers (the baby-boom generation, high levels of immigration and offshore labor pools as mentioned earlier) and in participation (women in the workplace, higher educational attainment improving employability and better health enabling longer careers).

Professional purchasing organizations emerged and grew in retailers (e.g., Walmart) and manufacturers (e.g., automobiles), exerting continual year-over-year pressure on costs, and consequently prices.

And the federal government in the era between the early '90s and the Great Recession ran relatively low deficits, meaning lower inflationary fiscal impulses.

These forces particularly influenced pricing for goods. Goods inflation for the 20 years ending in 2019 were low at 0.4 percent per year, while services grew at 2.6 percent a year, leaving core inflation near target at 1.7 percent.

We recognized those disinflationary tailwinds and — as we learned their impact — adjusted policy. In the context of anchored inflation expectations, perhaps that is why we kept inflation near target for so long while running what was then conventionally viewed as accommodative policy. With wind at our back, a lighter touch on the rudder was all it took.

It's hard to remember today, but just 15 months ago, 12-month core PCE was only 1.5 percent. But it's quite clear, the wind conditions have shifted, at least for now. The pandemic has been quite a storm; bringing, it seems, one short-term inflationary shock after another.

We saw the pandemic shift demand to goods as it simultaneously suppressed supply of labor both here and abroad. We saw sizable fiscal stimulus escalate demand more broadly, while excess savings perhaps reduced labor supply. We saw new variants slow our labor market recovery further. We saw a long series of atypical events — a severe winter storm in Texas, a fire at a chip plant in Japan, a ship lodged in the Suez Canal, a backlog in Long Beach — stifle the supply chain. And, of course, most recently we've seen commodity price shocks coming out of the conflict in Ukraine and new lockdowns in China.

Where have these winds taken us?

Demand is strong and looks to remain robust, fueled by healthy business and personal balance sheets, the need to replenish low inventories and state governments that are flush with cash. We may see more variants, such as the one rising in Western Europe, but we are learning to live with COVID-19. Supply is tight. As demand for goods exploded in the midst of the pandemic, supply chains have struggled to keep up, and now to catch up.

Labor markets are also quite tight. Unemployment has dropped to 3.6 percent. In addition, the pool of available labor has shrunk: 1.6 million fewer workers are in the workforce,[1] and immigration remains well below its pre-COVID-19 trend.

As a result, wages are up: Average hourly earnings have risen 5.6 percent. And price inflation is elevated, with core PCE at 5.4 percent — the highest since April 1983. Over the past year, goods inflation has been almost 10 percent, while services inflation has been 4.6 percent.

These shocks have required us, once again, to recognize changes and adjust our course. Initially, we thought inflation would be short-lived, as it seemed largely driven by temporary factors like chips in cars. But the fog of the pandemic made visibility difficult.

Now, with inflation persisting and broadening, we see clearly that it is time to normalize our monetary policy stance. At our last meeting, the Fed decided to raise interest rates 25 basis points, and the median Federal Open Market Committee member forecasted seven rate increases this year and three to four next year. These forecasts project inflation to be contained as pandemic pressures ease and rates move just past the median estimate of neutral.

How far we will need to raise rates in fact won't be clear until we get closer to our destination, but rest assured we will do what we must to address this recent bout of above-target inflation. And this commitment does not necessarily require a hard landing. In fact, it might help avoid one by convincing individuals and firms that the Fed is committed to our target, thereby cementing inflation expectations.

An interesting question for me is: Once these specific pandemic-era wind gusts fade, what direction will the winds be blowing going forward?

There are a few reasons to think we may face more headwinds when it comes to containing inflation going forward. That is, we may need to navigate in the context of more medium-term inflationary pressure than we have experienced during the Great Moderation.

Over the last few years, we've seen tariffs, the pandemic, and the Ukrainian conflict lay bare the vulnerabilities associated with offshoring and a globally complex supply chain. Moving forward, we are likely to see some deglobalization, as countries rethink their trading relationships and firms redesign their supply chains to prioritize resiliency, not just efficiency. These changes would suggest higher costs and less ability for intermediaries to drive year-over-year efficiencies.

We may also see labor transition from being long to short. Offshore labor may prove less available. At the same time, our population is aging. Birth rates are declining. We missed out on millions of immigrants during the pandemic. Reduced labor force growth can limit growth in the broader economy. And unless we can find a way to reduce labor demand (e.g., through automation) or increase participation (as Japan has done with older workers), a tighter labor market could also pressure wages, and in turn, prices.

Fiscal policy may also be shifting in a way that contributes to the headwinds. Government deficits are still running at historic levels, and entitlement spending will grow further as the population ages. Defense spending may grow as well. The coming investment in climate transition risks elevating energy costs in the interim.

Finally, the Great Moderation was marked by a relatively stable external environment. Who knows what the future holds.

If we find ourselves facing this "series of unfortunate events," we will recognize headwinds that become persistent and adjust how we navigate. Our goal — 2 percent target inflation — wouldn't change, nor would our longer-run ability to meet that goal, but the appropriate path to achieve it could.

Should the prevailing winds shift, we would be more likely to face periods with real forces imparting near-term inflationary pressure. These pressures could make "looking through" short-term shocks more difficult. As a consequence, our efforts to stabilize inflation expectations could require periods where we tighten monetary policy more than has been our recent pattern. You might think of this as leaning against the wind. Doing so would be consistent with our flexible average inflation targeting framework.

Communicating effectively could also prove more challenging. Inflationary pressure puts constantly on the table the potential for a trade-off between employment and inflation, our dual mandate goals. In contrast, the last 10 years have seen little conflict between our goals in making policy, and so the Fed's decisions have been relatively easier to explain. We will need to be crystal clear that a growing economy requires stable prices, and that we will remain committed to addressing inflationary gusts.

We don't need to make any of these judgments now. It is notoriously difficult to pinpoint shifts in the weather, and the old joke is that economic forecasting was invented to make weather forecasters look good. Innovations happen, and it's of course possible that technology will again create tailwinds we haven't anticipated. Without perfect foresight, the best short-term path for us is to move rapidly to the neutral range and then test whether pandemic-era inflation pressures are easing, and how persistent inflation has become. If necessary, we can move further.

Longer term, I am paying attention to the global forces I've described — whether they occur, in fact, and what impact they have on inflationary pressures. If we see headwinds persisting, we will do what we need to do to trim the sails.