Dallas Fed

Speech by President Lorie K. Logan

Restoring price stability

Dallas Fed President Lorie Logan delivered this address on Feb. 14, 2023, at Prairie View A&M University.

Thank you for that kind introduction, Dean Quddus. It's a pleasure to be with you all this morning, and it's so good to be here at Prairie View A&M. I appreciate the many ways the Dallas Fed has been able to partner with Prairie View, including the Summer Banking Academy Program, the many students who have interned at our bank, and the graduates who are now part of our staff. Thank you so much for this invitation to join you all at The Hill.

While today's event was marketed as "A Conversation with Lorie Logan," I have to say I am extremely honored to be the one having a conversation with Dr. Ruth Simmons. Dr. Simmons' influence and achievements are almost impossible to overstate. As a scholar, teacher and administrator at universities across the country—from USC to Brown to Prairie View—she has changed the lives of countless students. You already know the many ways she has broken barriers. To put it simply, when the New York Times quotes Toni Morrison describing you as "a bit of a miracle" and "an unusual combination of real politics and integrity," you are providing a powerful example of leadership and service.

Dr. Simmons' passion for education and her extraordinary career are deeply inspiring to me and, I'm sure, to all of you.

So, Dr. Simmons, thanks for having me today. Thank you for your service as a member and, now, chair of the Houston Board of Directors at the Dallas Fed. And thanks most of all for the incredible work you have done throughout your career to create opportunities for everyone to grow, prosper and thrive.

The Federal Reserve

When I think about what we do at the Federal Reserve, it's all about advancing an economy where everyone has opportunities to thrive.

At the Dallas Fed, we describe our work as "Building a Strong Economy Together." The Dallas Fed is one of the 12 Reserve Banks that, along with the Board of Governors in Washington, D.C., make up the Federal Reserve System. We are the nation's central bank, and we perform five functions to support a strong economy for everyone in the United States:

- We supervise banks to ensure they are safe and sound.
- We promote the stability of the financial system as a whole.
- We operate parts of the payments system, which lets you get cash from your bank or send money electronically to pay a bill.
- We promote consumer protection and community development.
- And—this will be my main focus today—we carry out monetary policy to pursue two goals established by Congress: maximum employment and stable prices.

A theme of my remarks will be that in carrying out the Federal Reserve's mission, we make decisions for the long term. We try to do what is best and most sustainable for the economy over time, even when those choices are not the easiest to make in the moment.

That longer-term focus will be familiar to you as college students who have made real sacrifices to invest in your education and your future. And that focus is particularly important to me today because of the economic situation we are in.

There are many good things about the current economy. Unemployment, for example, is at the lowest level in more than half a century.

But today's economy also has flaws. Not everyone shares fully in the benefits of economic growth. And the high rate of inflation is undermining living standards.

In my view, the imbalances in the economy are not likely to be sustainable for the long term. So I would like to share with you some thoughts on what it will take to get to a more sustainable economy, and the Fed's role in that effort. As always, these views are mine and not necessarily those of my colleagues on the Federal Open Market Committee (FOMC).

Inflation

Inflation over the past two years has been much too high. The FOMC aims for 2 percent annual inflation as measured by the price index for personal consumption expenditures, or PCE, but prices have risen since January 2021 at an average annual rate of 5.5 percent.

This high rate of inflation challenges families and businesses in the short run, and it weakens our economy in the long run.

People's incomes fall short of the rising cost of rent and groceries, and increases in the cost of living have been particularly stressful for lower-income households. Businesses can't plan well when they don't know what they'll pay for materials or be able to charge their customers.

And the longer high inflation continues, the greater the risk that prices and wages rise just because people think inflation will remain high. Such a spiral makes the business cycle more volatile, undermining the long and stable expansions that particularly benefit the most vulnerable in society.

In sum, price stability is foundational for a healthy economy and labor market over time.

Now, there has been some progress on inflation in recent months. But the question for monetary policy is not whether there has been some progress, but rather whether the progress will continue. Will inflation return all the way to our 2 percent target, and will it sustainably remain there over time?

To answer those questions, I find it helpful to break down some of the components of inflation.

As it happens, for the last three months of 2022, headline PCE inflation slowed to an annualized rate of 2.1 percent. However, a good bit of that drop in inflation was due to falling prices of oil and other commodities. Energy prices, as measured by the PCE price index for energy goods and services, fell at a

16 percent annual rate over the last three months of 2022. But while it's a relief to see lower prices at the gas pump, energy prices can't keep falling at this rate forever.

Core inflation, which excludes volatile food and energy prices, has historically been a better guide to where overall inflation will go in the future. And core PCE inflation was nearly 3 percent annualized for the last three months of 2022, which is significantly higher than the inflation rate the public is counting on us to deliver.

To better understand the challenge in returning inflation sustainably to 2 percent, we can break down core inflation into a few more pieces: core goods, which includes items like cars and clothing; housing services, such as rent; and core services excluding housing. This last category makes up about half of personal consumption and includes everything from health care to transportation to entertainment.

Core goods prices fell at a 3 percent annual rate in the last three months of 2022, partially offsetting rapid increases in services prices. Goods prices dropped in part because supply chains were recovering from the disruptions of the pandemic. Supply chains can't recover twice, so I don't see 3 percent deflation in core goods as sustainable. It seems more likely that core goods inflation will move up to the prepandemic trend of zero or a bit below, which means we'll need lower services inflation to sustain 2 percent inflation overall.

Turning to housing inflation, during the pandemic, the demand for housing rose, pushing up rents and house prices. More recently, the housing market has cooled as interest rates have risen. Because rents adjust infrequently as leases turn over, it takes time for a cooler housing market to translate into lower measures of housing inflation. Housing inflation was still around 9 percent annualized for the last three months of 2022. But our research at the Dallas Fed suggests that housing inflation should peak later this year.

The larger concern is with services other than housing. Core services inflation excluding housing has been running in a range of 4 to 5 percent for close to two years, with little sign of improvement. You could say this is the core of the inflation problem.

If core services inflation excluding housing remained in its current range, while other categories returned to their prepandemic pace, total inflation going forward would settle much closer to 3 percent than to our 2 percent goal. And depending on how the U.S. and world economies evolve, inflation could be even higher. For example, the Dallas Fed's business contacts tell us that China's rapid transition out of zero-COVID policies could drive up commodity prices this year by more than what most people currently expect.

Broad-based and persistent services inflation is not the result of special circumstances like supply-chain disruptions that will eventually go away. Rather, I see it as a symptom of an overheated economy, particularly a tight labor market, which will have to be brought into better balance for the overall inflation rate to return sustainably to 2 percent.

Employment

The labor market is important in its own right for monetary policy, given the FOMC's mandate to achieve both price stability and maximum employment. But in addition, because services prices depend

substantially on labor costs, the outlook for sustainably returning inflation to 2 percent hinges in large part on what happens in the labor market.

The job market today is incredibly strong. Last month, the U.S. economy added 517,000 jobs. By most estimates, that's more than five times what's needed to keep pace with the growth of the labor force. We shouldn't put too much weight on a single report, which can be driven by one-off factors. But on average over the past half-year, the economy has added 350,000 jobs a month, which is still very high.

Another sign of strength in the labor market is that as of December, there were 1.9 job openings for every unemployed person in the United States. That is down only slightly from the all-time high of two openings per unemployed person last March. And it is well above the ratio of 1.2 openings per unemployed person in 2019—which was thought at the time to be a very strong labor market.

The strong labor market has been driving up wages, which have been growing at an annual rate of about 4.5 to 5 percent by a variety of measures.

Now, your first thought may be that rising wages are a good thing. If workers are earning 5 percent more, aren't they better off? But rising wages make workers better off only if workers can buy more goods and services with those wages. Most workers' wages have not risen as fast as prices. So even though workers are taking home more dollars, their budgets are stretched thinner and thinner.

Over time, to be able to buy more goods and services with their wages, workers taken together must produce more goods and services. In other words, labor productivity must rise.

There is a formula for this. In the long run, if companies' profit margins—or, more precisely, capital's share of income—are stable, the growth rate of prices will equal the growth rate of wages minus the growth rate of labor productivity.

Falling profit margins could also conceivably contribute to lower inflation in the short run.

But for 5 percent wage growth to be consistent with 2 percent inflation on a sustained basis, productivity would have to rise at a 3 percent annual rate. Yet output per hour worked grew at an annual rate of only 1 and a quarter percent from 2012 through 2019, and there is little indication it has accelerated meaningfully since then.

Absent a dramatic rise in productivity, it seems likely that sustainably returning inflation to 2 percent will require substantially lower wage growth. That may take time. Respondents to the Dallas Fed's Texas Business Outlook Surveys expect more than 5 percent wage growth in 2023, which is down significantly from what they saw in 2022 but still quite elevated. Wage pressures have moderated somewhat in the latest national reports on average hourly earnings and employment costs. I'd need to see a lot more data, though, to be convinced the labor market is no longer overheated.

To achieve better balance, labor supply will have to increase, or labor demand will have to decrease.

Labor supply has been weak coming out of the pandemic. Early retirements, deaths and lingering illness from the pandemic have reduced the supply of workers. So have structural challenges like the lack of child care for working parents. And immigration fell to nearly zero during the pandemic, though it has since

bounced back sharply. Beyond that, employers tell me that when workers are available, they often lack the necessary training or skills.

Addressing the structural challenges is critical for the Texas and U.S. economies in the long run. Developing a larger, higher-skilled workforce will help support productivity growth and ensure we have a strong economy for everyone.

At the Dallas Fed, we're committed to partnering with communities in our region and conducting research that can inform solutions. For example, our digital inclusion initiative is helping community leaders in South Dallas, Ector County, El Paso County and southern New Mexico find ways to expand affordable broadband internet access and digital skills training to bridge the digital divide. That will allow more students to complete online school assignments, more parents to access online job postings and more people to participate fully in the economy. Through our Advance Together initiative, we are also supporting public, nonprofit and business leaders who are transforming their local education and workforce systems.

But efforts like these take time. So when it comes to the current elevated inflation, the FOMC has to respond by tightening monetary policy to reduce demand.

Interest rates

What do I mean by tightening monetary policy? The FOMC's primary tool is the target range for the federal funds rate, an overnight interest rate. Since the start of 2022, we have raised this target by 4.5 percentage points, the largest one-year increase in four decades. In addition, since last June, we have been reducing our holdings of Treasury and agency mortgage-backed securities.

Both of these tools push up interest rates for consumers and companies throughout the economy. Financial conditions have, therefore, tightened significantly. The 10-year nominal Treasury yield has risen about 2 percentage points, and mortgage rates have risen nearly 3 percentage points, since the start of 2022. Importantly, in recent months, real medium-term interest rates as measured by the yields on Treasury Inflation Protected Securities have averaged above 1.5 percent. That is a significantly restrictive level given that most estimates suggest the neutral real interest rate is below 1 percent.

In moving forward with monetary policy, we need to manage two risks.

The most important risk I see is that if we tighten too little, the economy will remain overheated and we will fail to keep inflation in check. That could trigger a self-fulfilling spiral of unanchored inflation expectations that would be very costly to stop.

Just last week, the Dallas Fed's Research Department hosted some of the world's leading scholars on the history of inflation. These experts had studied experiences with high inflation in the United States, Europe and Latin America from the 1920s through the present. They offered a wide range of views on macroeconomics and monetary policy, and it was a stimulating debate. A key lesson I took away was that when central banks aren't sufficiently proactive in addressing high inflation, the road back to price stability is longer, the labor market is weaker, and the scars on the economy can last long after inflation is finally reduced. We must stay focused on bringing inflation back to target in a sustainable and timely way.

At the same time, if we tighten too much or too fast, we risk seeing the labor market weaken much more than is necessary to control inflation. Those job losses would be very costly, too, particularly for lower-income households.

My own view is that, given the risks, we shouldn't lock in on a peak interest rate or a precise path of rates. After raising rates at a historically rapid pace during 2022, the FOMC decided at our most recent meeting to increase rates by a more historically typical increment of a quarter percentage point. I anticipate we will need to continue gradually raising the fed funds rate until we see convincing evidence that inflation is on track to return to our 2 percent target in a sustainable and timely way.

The evidence I'm looking for to gain confidence in the inflation outlook includes some further and sustained improvement in the inflation statistics, as well as a clear change in the underlying factors—like the imbalance of aggregate supply and demand and resulting very tight labor market—that have been producing high inflation. And I think we need to see the economy evolving more or less as forecasts predict. When inflation repeatedly comes in higher than the forecasts, as it did last year, or when the jobs report comes in with hundreds of thousands more jobs than anyone expected, as happened a couple weeks ago, it is hard to have confidence in any outlook.

I will also remain attentive to financial conditions. Ultimately, conditions need to be sufficiently restrictive to restore price stability. We must remain prepared to continue rate increases for a longer period than previously anticipated, if such a path is necessary to respond to changes in the economic outlook or to offset any undesired easing in conditions. And even after we have enough evidence that we don't need to raise rates at some future meeting, we'll need to remain flexible and tighten further if changes in the economic outlook or financial conditions call for it.

Conclusion

The FOMC is committed to delivering a healthier economy, with maximum employment and stable prices. And our policy strategy must be one that will sustain those outcomes over the long run. That requires paying attention not only to the latest wiggles in inflation and employment, but also to whether the economy is rebalancing in a way that can last.

Thank you.

About the Author

Lorie K. Logan is president and CEO of the Federal Reserve Bank of Dallas.

The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.