Richmond Fed

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What's Keeping Inflation Elevated?

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Highlights:

- The question of when inflation gets back to normal is an important one for policy.
- We would all like inflation to fall quickly back to target. I am confident it will in time, but doubtful the process will be quick.
- I think it will take time to return to target, and, as a consequence, believe we still have work to do.

This speech was delivered remotely.

Thanks for that nice introduction and for having me here today.

One favorite Fed buzzword is "data-dependence," meaning we adjust our policy based on what we learn from incoming data. That sounds sensible but isn't easy. After all, the prints we see largely come in with a month's delay and can be revised multiple times. So, I spend a good part of my time outside our building trying to learn by gathering "real-time" information from businesses, community organizations and groups like the Stanford Institute for Economic Policy Research (SIEPR).

If you are following the economy closely, you know that recent data has been confusing, so I thought I might spend my time today talking about how I am seeing the economy, and the implications for inflation and for policy. I caution these are my thoughts only and not necessarily those of anyone else in the Federal Reserve System.

If you were looking at economic data a few weeks ago, the story seemed pretty clear and consistent. Demand was softening. The labor market was cooling. And inflation was settling. People were actually starting to imagine we were well on our way to the proverbial "soft landing."

But January data is telling a very different story. Consumer spending, job growth and inflation have all accelerated. Is January an aberration, or is the economy actually stronger than we had thought?

Let's start with demand. In January, real consumer spending saw the largest monthly increase since March 2021, up 1.1 percent. Real disposable income jumped 1.4 percent as January wage and Social Security

increases came on line. Real-time information from credit card companies confirms that consumers spent freely in January. So, I see the jump as real, but doubt that it is as large as portrayed, or is sustainable. The weather has been unseasonably warm (everywhere but California), and that likely has goosed spending. And it seems clear that the holiday season (with gift cards) has now stretched from two months to four months. Retail sales in October to January grew at only a 2.6 percent annual rate, making January partly a payback for a weak December. Finally, this data is seasonally adjusted, and I do wonder whether the last two year's January COVID-19 outbreaks didn't amplify the strength of this January.

Seasonal adjustments also matter in the labor market. We saw a huge jobs number in January — more than half a million added. But to give you a sense of how these adjustments work: Normally employment drops by about 2.9 million in January as holiday hiring is reversed. This year, employment dropped only 2.5 million. After adjustment, you see the half million growth number. Is it likely that, in today's labor market, employers were more reluctant to shed workers than in previous years? I think so.

But that said, the labor market is still quite tight. The unemployment rate is 3.4 percent, a 54-year low. Employers tell me they aren't as desperate as they were a year ago, but it is still difficult to find workers. I hear that particularly for skilled trades like nursing, construction and mechanics.

There have been a number of layoff announcements recently, particularly here, but I would note they have been disproportionately professionals rather than frontline workers. Repotting is never easy, but unemployment for those with a college degree is quite low: 2 percent. That suggests whatever labor market adjustments are required may come with less of a price than prior downturns. We aren't likely to repeat the Great Recession's painful Rust Belt construction and manufacturing challenges.

Finally, let's spend some time on inflation. After several months on a downward path, inflation accelerated in January, in both month-over-month and year-over-year terms. And the encouraging fourth quarter inflation numbers were revised upward. Is this just a blip on the path back to our 2 percent target? Or a signal that we still have a long way to go?

The question of when inflation gets back to normal is an important one for policy, so I want to spend some time on it. Some believe this will happen pretty quickly. Until a recent upward spurt, that's where markets were. And, ahead of the most recent inflation data, the average respondent in the Survey of Professional Forecasters projected inflation at 2.6 percent annualized by the fourth quarter of this year. Why may you expect a quick return to normal?

You might hang your hat on the transitory concept. Transitory has two different definitions: brief, and not permanent. Inflation certainly hasn't been brief, but maybe getting to the other side just takes time. After all, supply chain issues are easing. Most people are back to work. Transportation costs have come down. Broad commodity price inflation has returned to pre-pandemic levels. And fiscal stimulus is waning. If inflation was largely physical or fiscal-driven, then it could decline pretty quickly as we return to normal.

Or you might think the Fed's rate hikes and balance sheet reductions thus far are sufficient but will take effect with the usual delay. Our moves impact financial conditions fairly quickly but take time to work their way through the real economy. If we've hiked enough, as we make our way through that lag, inflation could quickly fall. After all, liquidity is leaving the system, the housing boom has subsided, demand is likely normalizing and wages are settling.

Or you could even believe the Fed is going to do more than we have signaled to date and is planning to clamp down in an even more aggressive manner, risking a deep recession, to snap inflation down quickly. Volcker proved we have this power should we want to use it. To be clear, I have not seen anyone suggest inflation has yet become the problem Volcker faced in the early 1980s.

By this point, you might have gathered that I don't think normalization will be this easy. Returning prices to the stability of the last 30 years will likely take a lot more time and effort. I think my view is in step with the actions of the Federal Open Market Committee (and with the most recent Summary of Economic Projections (SEP) that showed inflation not returning to 2 percent until 2025). Why do I see this fight lasting longer?

Partly because some of the dislocations we saw in the pandemic are enduring. Over a trillion in excess savings are still funding consumption, as are continuing fiscal outlays like the infrastructure bill. New auto inventories and houses for sale remain near historic lows, supporting prices in those sectors. Supply chain challenges remain, for example, in switchgears and cabinets. The labor market remains historically tight, as I said earlier. And China's reopening and events in Ukraine may well also pressure commodity prices.

Additional inflationary pressure comes from firms and workers trying to recapture lost ground. I hear from a number of sectors (like health care, utilities and food) whose margins have compressed and who feel the need to restore them through further price increases. They will presumably be motivated to move more aggressively than those sectors whose margins improved and who may eventually be pushed by their customers to give on price. Similarly, workers whose real wages fell are pressing to catch up. I've heard of many larger-than-normal increases in the end-of-year merit process.

And I'd also point to inflation expectations. While they remain well anchored on average, there's been enough movement under the surface to warrant caution. The University of Michigan Survey of Consumers has seen the one-year median expected inflation rate fall from its pandemic high of 5.4 percent to 4.1 percent in the most recent reading. But this masks an increase in the range of responses. By one measure, that spread is at levels last seen in 1982. And research on the '70s found that an increase in the standard deviation of inflation expectations preceded high and unanchored inflation expectations. It's worth remembering that even with Volcker's aggressive approach, it took years to corral expectations back to a narrow range. While his era was certainly different (unanchored expectations, no target, higher inflation), it took until 1983 to get inflation below 4 percent and 1986 to get to 2 percent.

Most fundamentally, two years of high inflation, and ubiquitous conversation about inflation, has surely had an impact on firm behavior. I think about it like this: For a generation, business leaders have learned not to count on pricing to drive profits. Large retailers (like Walmart or Home Depot) resisted every price increase with fervor and had options to redirect their business to lower-cost suppliers overseas. Consumers found that they had power as well through price-shopping enabled by e-commerce. The Fed had earned real credibility for its ability to deliver stable prices; you could say we played a role in every wage and every price negotiation.

Now, pricing is back in play. Its impact is considerable: Successful increases flow straight to the bottom line. Businesses have found inelasticity they hadn't had the courage to test for previously and are looking to find more. Supply chain challenges have worn down purchasing departments; they seem now more willing to accept increases, at a time when volatility has made supplier cost structures more opaque and availability more important. In most companies, there is a continual tug of war between a finance team that sees price as a path to profits and a sales team that fears loss of business and market share. Sales won for years, but finance is winning now and will continue to keep pressure on prices until customers and competitors reassert themselves.

Monetary policy plays an important role here. We have raised rates and reduced our balance sheet aggressively in the last year in an effort to bring demand and supply back into balance. Inflation is likely past peak. But I think it will take time to return to target, and, as a consequence, believe we still have work

to do. We have forecasted additional rate increases and the SEP has made clear that we don't anticipate rate cuts this year.

The Fed's objective isn't to hurt the economy, it's to reduce inflation. And if there is one thing we've relearned over the last two years, it is that everybody hates inflation. High inflation creates uncertainty. As prices rise unevenly, it becomes unclear when to spend, when to save or where to invest. Inflation is exhausting. It takes effort to shop around for better prices or to handle complaints from unhappy customers. And inflation feels unfair — the wage increase you earned feels arbitrarily taken away at the gas pump.

The Fed is the organization charged with fighting inflation, and we have made our resolve clear. The experience of the '70s is compelling. If you back off on inflation too soon, it comes back stronger, requiring the Fed to do even more, with even more damage. I'd like to avoid that.

But with real rates having risen dramatically in the last year, and sitting at positive levels across the curve, it makes sense to move more deliberately than we did last year. Here's where I come back to data dependence. If I'm right and inflation persists, we can react by raising rates further. And, of course, I'd be happy to be wrong.

We would all like inflation to fall quickly back to target. I am confident it will in time but doubtful the process will be quick. But I should close by reminding you that inflation doesn't come from statisticians but from the sum of individual actions. (So, if any of you in the audience have a price increase in the works, feel free to help us all out by backing off.)

With that, I am looking forward to your questions and input.