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Some Reasons for Optimism about Inflation

Remarks by

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Thank you for your introduction, Adam, and thank you for the invitation to speak here today. It is great to come to Peterson to discuss the economic outlook and monetary policy, which is my topic this afternoon.[1]

As I stand here today, inflation remains too high, but I am encouraged by the overall progress and trajectory. Recent data on the economy and inflation also give me cautious optimism that we are on track and making continued headway toward the Federal Open Market Committee's (FOMC) inflation goal of 2 percent. That progress may have paused in the first three months of the year, but information since then on economic activity, the labor market, and inflation points to renewed progress.

Over the last year through April, personal consumption expenditures (PCE) inflation was 2.7 percent, down from 7.1 percent at its peak in 2022. Core PCE inflation—which excludes the volatile food and energy categories—was 2.8 percent through April, down from its peak of 5.6 percent. Based on consumer and producer price inflation for May released last week, I estimate that 12-month PCE inflation in May was a bit lower than in April. I was encouraged by some of the details of the recent reports, particularly the continued improvement in market-based services inflation, which is based on observation of actual market prices rather than imputed values. That's important because market-based prices are likely to be a better indication of the overall trend for core services inflation than nonmarket prices.

Housing services inflation, meanwhile, continues to be persistent. Market rents for new tenant leases have already cooled significantly, but further progress in overall

[1] The views expressed here are my own and not necessarily those of my colleagues on the Federal Open Market Committee.

housing services inflation will rely on the ongoing pass-through of the previous market rents deceleration to the rents of existing tenants with expiring leases.

So inflation is still too high, and further progress is likely to be gradual. However, there are several reasons why I remain optimistic that improving supply and cooling demand will support continued disinflation.

The first reason I am optimistic about further progress on inflation has to do with declining price increases and even declining prices as consumers become more price sensitive. I think of this from several, related angles—I will mention a few.

As I have discussed in previous speeches, reduced frequency of price adjustments helps moderate prices. And the frequency with which firms adjust prices, which accelerated to less than every five months in early 2022, moved closer to every seven months as of the end of 2023.[2] Price adjustment frequency picked up some early this year, along with the temporary firming of inflation, but the general trend has been consistent with ongoing disinflation.

An additional basis for price-setting optimism is the fact that longer-run inflation expectations have remained well anchored. Research by the Richmond Fed has found that price-setting decisions by firms are related to their own expectations about the path of overall inflation, so anchored inflation expectations among firms are likely to result in price setting consistent with those lower price expectations.[3]

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[2] These facts are from Hugh Montag and Daniel Villar (2023), "Price-Setting during the Covid Era," FEDS Notes (Washington: Board of Governors of the Federal Reserve System, August 29), https://doi.org/10.17016/2380-7172.3298. I thank the authors for providing me with updated data through early 2024.

[3] For research on firms' price-setting and inflation expectations, see Felipe F. Schwartzman and Sonya Ravindranath Waddell (2024), "Inflation Expectations and Price Setting among Fifth District Firms," Economic Brief 24-03 (Richmond, Va.: Federal Reserve Bank of Richmond, January), https://www.richmondfed.org/publications/research/economic_brief/2024/eb_24-

In addition, there may still be room for markups of prices over labor costs to continue falling. While markups are famously difficult to measure, rough, simple estimates of markups of prices over labor costs have fallen back from high levels but still remain above their pre-pandemic trend, especially in the goods sector.[4] A return of markups to this trend could help ongoing progress toward 2 percent inflation.

A final factor for optimism about positive price-setting developments is the range of anecdotes from firms themselves. The most recent edition of the Fed's Beige Book suggests firms are increasingly attentive to consumers pushing back against additional price increases and that these businesses expect to increase prices only moderately in the near term. Beyond the Beige Book, I have gleaned from recent earnings reports by publicly traded companies that lower-income consumers are pulling back from their purchasing and that firms are responding by moderating price increases or, in some cases, actually cutting prices. What I have heard in my own conversations with business contacts is that consumers are "trading down" to lower-cost products and that firms are responding with more discounting. And some large retailers have publicly spoken about cutting prices in the face of resistant consumers. These various indicators—markups, price adjustment frequency, inflation expectations, and anecdotes from a range of

03#:~:text=Evidence%20from%20a%20Federal%20Reserve,most%20firms%20set%20their%20prices. With regard to overall measures of inflation expectations, anchored longer-run inflation expectations are apparent in the University of Michigan Surveys of Consumers, where 5-to-10-year-ahead expectations remain close to values seen a decade ago; in the Survey of Professional Forecasters, where 10-year inflation expectations are close to pre-pandemic norms; and in other sources.

[4] For example, the ratio of the producer price index (PPI) for final demand goods to the employment cost index for private goods industries rose roughly 20 percent from the end of 2020 to the middle of 2022. In services, this ratio rose roughly 5 percent. The ratios for both sectors have come down from their peak levels but were still above their end-2020 levels as of the first quarter of this year—and they had been on downward trends before the pandemic. Similar analysis using PCE prices instead of PPI yields a qualitatively similar result for goods industries, though, in services, the PCE price-to-wage ratio has been roughly flat.

sources—suggest that, on balance, price-setting behavior is likely to continue to move closer to consistency with the FOMC's inflation target.

A second reason for my optimism about continued disinflation is slower growth in the costs faced by businesses. Among those, nominal wages are a big part of total costs in the services sector. Nominal wage growth has continued to trend down, consistent with a labor market where supply and demand are coming into better balance. Of course, as a general matter, I want to see Americans experiencing strong wage growth, but for that wage growth to be sustainable, it must be consistent with our inflation target. Notably, as inflation has come down, real wages have been rising and now exceed pre-pandemic levels, which means that the purchasing power of workers has also been increasing. But at the same time, we have seen slowing growth in nominal labor costs. For example, the 12-month increase in average hourly earnings has been running just above 4 percent over the past couple of months after peaking at around 6 percent in 2022 and falling more or less steadily since then. The latest readings compare with an average of around 3 percent a year before the pandemic, when inflation was running below our 2 percent goal. Wage moderation is especially evident in some service sectors for which labor is a large share of costs. If this moderation in wage growth continues, it will soon be at levels consistent with price stability. And I note that the market-based services inflation measure I mentioned earlier tends to move closely with wage growth.

Other developments in labor markets also point toward continued resilience, but there are signs of gradual cooling and continued wage moderation. Gains in payrolls averaged 218,000 over the past two months, which is a solid pace. But most other

indicators point to a slow but steady easing of the labor market, supported by cooling demand for hiring as well as strong supply.

In terms of demand, both the job openings rate and the hiring rate have come down from their highs of late 2021 and early 2022. The job opening rate is not far above its pre-pandemic range, and the hiring rate is below pre-pandemic. Surveys of business hiring intentions likewise suggest cooler demand for workers. On the supply side, we have seen notable growth in labor supply over the past year. Labor force participation among prime-age women, in particular, reached another all-time record in May. And the strong inflows of immigrants I have discussed in previous speeches have continued this year, which points to continued labor supply growth as recent immigrants gradually make their way into the labor market.

With cooling demand and solid supply, measures of labor market tightness have continued to ease. The unemployment rate has been gradually rising and reached 4 percent in May, still very low in historical terms and the 30th straight month at 4 percent or lower. Another indicator of labor market tightness, the ratio of job vacancies to the number of people counted as looking for work, crossed an important threshold in April. After rising as high as 2 vacancies for each person seeking a job during the pandemic, that ratio fell to 1.2, which was the level before the pandemic. Another indicator of labor market tightness, the rate of people voluntarily quitting their jobs, is actually below the pre-pandemic level. The average duration for job vacancies is down, and it is becoming easier for employers to fill jobs. We policymakers like to make our judgments based on a preponderance of the data, and a preponderance of the labor market data indicates that labor market supply and demand are coming into better balance.

A third reason for my optimism about achieving 2 percent inflation is that I am also cautiously optimistic about productivity growth, which is a source of supply expansion that is likely to put downward pressure on inflation without slower economic growth. One factor is the remarkable rise in the rate of new business creation, which started early in the pandemic and has continued, more or less, even through last month.[5] Economic research finds that while many new and young firms struggle to survive, a small subset of new firms are highly productive and grow rapidly, eventually making significant contributions to aggregate productivity.[6] And the pandemic-era business creation surge has been particularly strong in high-tech sectors, such as computer systems design and research and development services.[7] Some recent history favors a payoff to productivity growth from this surge in entrepreneurship. Before the jump in productivity growth in the late 1990s through the early 2000s, there was a similar wave of strong business entries in high-tech industries.[8] I suspect that most of the productivity benefits of the recent entry surge are still ahead of us.

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[5] See Ryan Decker and John Haltiwanger (2023), "Surging Business Formation in the Pandemic: Causes and Consequences?" *Brookings Papers on Economic Activity,* BPEA Conference Draft, September 28–29, pp. 1–87, https://www.brookings.edu/wp-content/uploads/2023/09/4_Decker-Haltiwanger_unembargoed.pdf?mod=djemRTE_h. Data from the Census Bureau's Business Formation Statistics suggest business creation has remained above pre-pandemic norms through May 2024.

[6] See Titan Alon, David Berger, Robert Dent, and Benjamin Pugsley (2018), "Older and Slower: The Startup Deficit's Lasting Effects on Aggregate Productivity Growth," *Journal of Monetary Economics,* vol. 93 (January), pp. 1102–47; and Ryan Decker, John Haltiwanger, Ron Jarmin, and Javier Miranda (2014), "The Role of Entrepreneurship in US Job Creation and Economic Dynamism," *Journal of Economic Perspectives,* vol. 28 (Summer), pp. 3–24.

[7] See Ryan Decker and John Haltiwanger (2024), "High Tech Business Entry in the Pandemic Era," FEDS Notes (Washington: Board of Governors of the Federal Reserve System, April 19), https://doi.org/10.17016/2380-7172.3499.

[8] See Lucia Foster, Cheryl Grim, John C. Haltiwanger, and Zoltan Wolf (2021), "Innovation, Productivity Dispersion, and Productivity Growth" in Carol Corrado, Jonathan Haskel, Javier Miranda, and Daniel Sichel, eds., *Measuring and Accounting for Innovation in the Twenty-First Century,* vol. 78: *Studies in Income and Wealth* (Chicago: University of Chicago Press), pp. 103–136.

Another basis for productivity optimism is the prospect for widespread implementation of artificial intelligence (AI) in its various forms. To be sure, there is tremendous uncertainty around the future path of AI and its effects on the economy, and we must all think carefully about how it may affect workers and the kinds of tasks they perform. But AI technology has the potential to make workers and firms more productive—effectively boosting aggregate supply. Of course, many technologies can take a long time to show through to aggregate productivity. The spread of electrification more than a century ago required complementary assets like power lines and appliances to be created and installed. But I suspect that AI may diffuse more quickly, in part because many of the complementary assets needed for the initial spread of AI—such as computers, networks, and the like—are already in place, even while there is still an enormous amount of additional hardware buildout still ahead of us. And survey data from the Census Bureau suggest that firms in many sectors are already employing AI.[9] Only time will tell, of course, but the prospect of higher productivity growth raises the possibility that inflation can fall without a significant slowdown in economic activity and employment.

My fourth and final reason for optimism on inflation is that I believe the current stance of monetary policy is sufficiently restrictive to help cool the economy and bring inflation back toward 2 percent without a sharp contraction in economic activity or a significant deterioration of the labor market. Interest rates remain elevated relative to a year ago, and certainly relative to two or three years ago, and are restricting economic

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[9] Data are from the Census Bureau's Business Trends and Outlook Survey. In data released May 23, 2024, the share of firms reporting current AI usage was 18 percent in the information sector and 12 percent in the professional services sector. Several other sectors had shares at 5 percent or above.

activity. Of course, some aspects of financial conditions, such as house prices and, especially, stock prices, remain robust; and credit is still generally available, though high interest rates make borrowing expensive. These factors likely have some distributional implications: Higher-income people with large stock portfolios may not feel that conditions are so restrictive, while lower earners who need to borrow to buy a house or a car do not need to be told that finances are tight.

But the overall restrictiveness of financial conditions is apparent in interest rate–sensitive sectors. For example, the level of residential investment in the first quarter—though showing some modest improvement relative to last year's pace—was still roughly 15 percent below its peak in 2021. Business investment in equipment contracted a bit in 2023 and showed only tepid growth in the first quarter of this year. And while consumption growth has been resilient over the past couple of years, fueled in part by excess savings accumulated during the pandemic and solid real wages that now exceed pre-pandemic levels, it slowed noticeably in the first quarter, especially for spending on goods. Indeed, high interest rates have left a mark on consumer assessments of buying conditions for motor vehicles and other large durable goods, which often have to be financed.[10]

The effects of restrictive financial conditions are also evident in labor markets. As I discussed earlier, the labor market has cooled gradually, and, looking ahead, I expect some cooling of economic activity to continue. But I am watching closely for any signs

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[10] In the Michigan Surveys of Consumers, the net shares of respondents reporting that now is a bad time to buy, versus a good time to buy, motor vehicles or large household durables, specifically because of high interest rates, remain well above pre-pandemic levels, though there has been some gradual improvement since mid-2022.

of labor market deterioration that may take hold, as the FOMC also pays attention to the other side of our mandate.

Notwithstanding my optimism about the economic outlook, I am mindful of a number of risks to both sides of the dual mandate. On the inflation side, the resurgence of import prices at the beginning of the year is concerning, even if import prices came down some last month, and could anticipate greater pressure on goods prices in the coming months. Goods prices have been a key source of disinflation over the past year or so, as supply chains have healed. While supply chains appear to have been fairly resilient to a series of shocks since the end of last year—including attacks on shipping in the Red Sea and low water levels in the Panama Canal—geopolitical developments in Ukraine and the Middle East still could lead to a sharp rise in global energy and food prices and disrupt global supply chains. Another risk I am focused on is that a further cooling of the U.S. economy could lead to a sharp deterioration in labor market conditions. Output growth appears to have slowed in the first half of this year, and while consumer spending still grew in the first quarter, the May retail sales report we received this morning may be another signal that the long-expected deceleration in consumer spending may finally be upon us. After a considerable decline in job vacancies, firms facing decreasing demand might increasingly resort to laying off workers. Lastly, I also see risks to the global economy that could spill back to the U.S. economy. While growth in some countries—notably in Europe—appears to be picking up from a soft patch last year, that pickup remains tentative. And the latest data from China suggest that economic momentum there has slowed considerably amid a continuing real estate crisis.

Let me now turn to the implications of my economic outlook for monetary policy. While I remain cautiously optimistic that inflation is coming down, it is still too high, and it is moving down only slowly. I believe that policy has more work to do, which is why I supported the FOMC's decision last week to keep the federal funds rate in a range of 5¼ to 5½ percent. We need to see more progress toward 2 percent inflation before I will have confidence that inflation is moving sustainably toward that objective. For the reasons I have outlined today, I believe economic conditions are moving in the right direction. If the economy evolves as I am expecting, it will likely become appropriate to begin easing policy sometime later this year. But, as always, my judgment will be guided by the data.

Let me conclude by acknowledging that the surge in inflation over the past few years means that prices are now significantly higher than they were just a few years ago, even as the rate of price increases has slowed dramatically since mid-2022. While I am heartened by data showing that nominal wages are now growing at a faster rate than prices, I know many Americans are still struggling with high costs. I also know that many Americans are facing high borrowing costs. That's why I will be watching the data carefully in the months ahead to ensure that we are on track to achieve both sides of our dual mandate.