Which Way for the Inflation Winds?

In 2018, when I joined the Richmond Fed, few Americans had inflation on their radar. Why should they have? We'd had a generation of stable prices, supported by the growth of e-commerce, the rise of globalization, favorable workforce demographics, and innovations like the development of fracking.

My predecessors on the Federal Open Market Committee (FOMC) also deserve credit; their commitment to an explicit inflation target earned the confidence of businesses and consumers, helping to anchor inflation expectations. If anything, in the years before the pandemic, the concern had been whether inflation was too low. That sure seems like a long time ago.

You remember what happened next. COVID-19 and the associated shutdowns unleashed a series of material and labor supply shocks. Then, the successful vaccine rollout, federal stimulus, and excess savings combined to turbocharge demand. There weren't enough chips to put into cars, not enough workers to fill jobs, not enough houses to meet people's desire for more space. We also saw a slew of non-pandemic shocks complicate supply chains further, from winter storms to stuck ships to the Russian invasion of Ukraine. Prices soared.

The historical wisdom was that the Fed shouldn't overreact to short-term supply shocks; don't constrain the economy to address cost pressures that will resolve on their own. But high inflation didn't fade. In part, that was because it took much longer to get chips into cars, boats into ports, and workers into jobs than anyone anticipated. But it's also fair to say that the unprecedented scale of the fiscal and monetary policy response to the pandemic accommodated this price pressure.

Pretty soon, inflation started coming up in every conversation. The message was clear: 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 also exhausting. It takes effort to shop around for better prices or to handle complaints from unhappy customers.

THE INFLATION FIGHT

In March 2022, the FOMC began our rate hiking cycle, the steepest in recent history. Accordingly, inflation has been coming down. The Fed's preferred inflation measure — the 12-month personal consumption expenditures price index (PCE) — peaked at 7.2 percent in June 2022; "core" PCE — inflation without the more volatile numbers for food and energy — was at 5.3 percent. This February, those measures came in at 2.5 percent and 2.8 percent, respectively. We aren't yet back to our 2 percent target, but we've come a long way.

While I would love to give the FOMC full credit for the fight against inflation, and I do hope you think our efforts have been of value, we've had a lot of help.

First, the supply side has finally healed. Supply chain shortages have been largely resolved. The labor force has come back into balance. Second, productivity has been moving up as firms realize the benefits of the investments they've made in automation and more efficient processes. Additionally, we are getting help from consumers. They've been frustrated by high prices, but now they're taking action: trading down from beef to chicken, from sit-down restaurants to fast casual, from brand names to private labels. They're waiting for promotions or moving to lower-priced outlets. As the saying goes, "The cure for high prices is high prices." That's exactly what we're seeing. Price-setters are finding that their ability to raise prices is now limited by consumers' price sensitivity. (See "How the Pandemic Era Changed Price-Setting," *Econ Focus*, Fourth Quarter 2023.) It's elasticity in action.

Where does that leave us today? In general, the economy is in a good place. GDP grew 2.5 percent last year, a healthy level. Unemployment is low, near most estimates of its natural rate. Consumers have jobs and real wages are growing. In that context, consumers keep spending. Recession fears have dissipated. And as I noted, inflation is down.

While I see considerable progress being made with inflation, I know many Americans see it differently. The Fed is concerned with year-over-year price growth, but individuals care more about the price level. And the level of prices is still a frustration. That's particularly true because it has risen so fast recently. I remember my grandparents telling me that you used to be able to buy a Coke for a nickel. But they seemed ancient. If I could exaggerate a bit, it seems like we experienced in four years what they saw in a lifetime.

Now, it's true that wages have gone up at the same time. The overall price level is 18 percent higher than four years ago, while average wages have increased slightly more at 19 percent. But individuals aren't like firms, which can track their relative rise in revenues versus costs through their profit margins. Individuals don't have that kind of mental ledger. They see wages going up as the reward for their hard work and see higher prices as arbitrarily taking that away.

THE PATH FORWARD

In late 2024, we cut the federal funds rate by a full percentage point to 4.3 percent. Labor market conditions remain solid, while inflation remains somewhat elevated. It makes sense to stay modestly restrictive until we are more confident inflation is returning to our 2 percent target. I recognize the fight against inflation has been long, but it is critical that we remain steadfast. We learned in the '70s that if you back off inflation too soon, you can allow it to reemerge. No one wants to pay that price.

The challenge we have is uncertainty. There are many unknowns. Have price-setters come to accept that their pricing power has receded? How will geopolitical conflicts play out? What will be the impact of natural disasters? And — of course — how will all the policy changes in Washington affect the economy?

It's hard to know how policies will shake out. Will we see significant additional tariffs implemented, and with what response from affected countries, firms, and consumers? Which industries will see deregulation that changes their decision-making? What impact will immigration changes have on the workforce? How much energy production will be unleashed? What changes will be made to taxes and spending?

History gives us some guidance, but it's unclear how applicable it'll be to the present environment. I've seen economic analysis of the 2018 tariffs concluding that they increased inflation by about three-tenths of a percent. But the policies this time aren't exactly the same, and we don't know whether the recent experience of consumers and businesses with inflation will exacerbate or mitigate the effects. Will firms be more willing to pass costs along this time, or will consumer frustration with higher prices lead them to resist further price increases?

It is tempting to focus on gaming out these short-term factors, but it's hard to make significant monetary policy changes amid such uncertainty. So, I prefer to wait and see how this uncertainty plays out and how the economy responds.

I spend more time thinking about the longer term. As I mentioned earlier, for many years, we have had the wind at our back when it came to containing inflation. Today, the direction of the wind is less clear.

Over the last few years, we've seen tariffs, the pandemic, and geopolitical conflict expose the vulnerabilities associated with globalization. We may see more countries and firms rethink their trading relationships to prioritize resiliency, not just efficiency. At the same time, we may be seeing the labor force transition to being in shorter supply. Our population is aging, birth rates are declining, and it's unclear what will happen with net migration. Similarly, deficits have been running at historic levels, and entitlement and defense spending likely will grow further as our population ages and if geopolitical tensions rise. All these trends suggest we could see our tailwinds replaced by inflationary headwinds.

That shift in the winds is not guaranteed. You can never, for example, count out technology's potential to improve productivity and help rein in costs and prices. And, as you know, monetary policy has the power to respond and keep inflation under control. But all this uncertainty argues for caution as we look to wrap up the inflation fight. If headwinds persist, we may well need to use policy to lean against that wind.

But for now, I take comfort in the significant drop of inflation from its peak and look forward to further progress.

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A longer version of this essay was delivered as an address to the Rotary Club of Richmond on Feb. 25, 2025.