Inflation Should Continue to Fall as Restrictive Policy Bites

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Key Points

- On June 29, 2023, Atlanta Fed president and CEO Raphael Bostic is speaking in Dublin to the Irish Association of Investment Managers on the fight to bring down inflation.
- Based on the latest Summary of Economic Projections, the median Federal Open Market Committee participant appears to believe the FOMC needs to do more in the short term to get inflation to the Committee's 2 percent target.
- Bostic does not fully share this view. He says we can expect continued progress on inflation without additional changes in the federal funds rate.
- If inflation continues to fall—as he believes is likely—the current policy stance may effectively become tighter, as real short-term interest rates increase. Bostic thinks of this dynamic as "passive tightening."
- Bostic believes we are just beginning to see signs that the cumulative effects of monetary policy adjustments are appearing in the real economy.

Thank you, Alison, for the kind introduction. I also want to warmly thank the Irish Association of Investment Managers, and in particular Chair Paul Price, Vice Chair Ann Prendergast, and CEO Michael D'Arcy for having me. I'm honored. Your domestic economy is dynamic and shares important ties with the United States, so I hope you find my comments helpful.

Be assured that since I'm speaking between you and dinner, I won't go on too long. But I am covering nuanced material, so I want to be clear and thorough.

As I'm sure most of you know, the Federal Open Market Committee, or FOMC, voted a couple of weeks ago to maintain the federal funds rate, the Fed's primary monetary policy tool, in the range of 5 to 5 1/4 percent. That meeting was one of four each year when all Committee participants submit projections for the current and subsequent

years for gross domestic product (GDP) growth, the inflation rate, the unemployment rate, and the end-of-year level of the federal funds rate.

The projections are collectively called the Summary of Economic Projections, or SEPs. They are not true forecasts in the statistical sense, nor are they commitments to follow a particular course of action. But they do offer a sense of how individual policymakers think conditions might evolve assuming appropriate monetary policy. Hence, they are scrutinized by Fed watchers and financial market participants. I'm guessing a number of you here in the room study them.

Relative to the projections published in March, this month's SEPs showed a notable increase in median projections for GDP growth and core inflation for 2023, and a decline in the median view of the unemployment rate in the fourth quarter. I will not presume to speak for any other FOMC participant—the thoughts I'll share today are mine alone. But it is reasonable to interpret these changes in the SEPs as reflecting a view that the US economy is stronger, and inflation is likely to be more persistent than the median Committee expectation indicated in March, soon after the Silicon Valley Bank and Signature Bank failures.

The upshot is that the median committee participant believes the FOMC needs to do more to get inflation back to our target. I have to confess: I do not fully share this view.

Let me be clear. I have consistently expected the US economy to be quite strong. I've also long expected inflation in the United States to be persistent and attenuate at a measured—some would say slow—pace.

But to be direct, I believe we are just now beginning to see signs that the cumulative effects of monetary policy adjustments that began last year are showing up in the real economy, including in labor markets. Furthermore, I believe that our latest readings on inflation indicate that we are making progress on reducing inflation toward the FOMC's goal of 2 percent, as measured by the Personal Consumption Expenditures price index.

In our time today I will explain why I've come to these conclusions based on the statistical data in hand, as well as on the information collected from the Atlanta Fed's surveys of businesses and conversations with contacts throughout the economy. I believe the economic effects and inflation progress I will describe are a consequence of monetary policy that only fairly recently moved into restrictive territory. And, although I don't want to take a specific position on the appropriate path of US monetary policy going forward, I do want to make a case that we can expect progress

on inflation to continue, even absent additional changes in the level of the federal funds rate.

Monetary policy just starting to affect the economy

I think it is wise to take a period to assess how monetary policy tightening is affecting the economy because, in my view, policy has been truly restrictive only for eight or nine months. The Committee began raising rates 15 months ago, yes, and bond rates began to rise even before that when we indicated the federal funds rate would likely rise.

Still, because the rate of inflation was very elevated, real interest rates remained accommodative even after the first few fed funds rate hikes. I like to organize my thinking on this by breaking up the moves: I view the first 325 to 350 basis points as removing accommodation, and then the subsequent 150 to 175 basis points as moving policy into restrictive territory.

How do we know monetary policy has only begun to bite into economic activity? For one, that's what our contacts are telling us. While demand generally remains solid, it seems that surprises have been to the downside. For example, a contact from a large consumer-facing business expected demand to soften by 1 to 2 percent in April and May, but it fell 5 percent. Even in the red-hot travel industry, a contact pointed out that hotel room demand fell by just over 1 percent in April compared to the same month last year, the first year-over-year decline in that measure since February 2021.

Let me turn to the US labor market. Conditions appear to remain relatively hot based on headline employment growth. But a broader measure describes a more meaningful deceleration in activity this year. Though private nonfarm employment grew much faster than prepandemic rates, aggregate weekly hours worked on private payrolls, a more comprehensive gauge of labor conditions, rose more in line with pre-COVID conditions.

The difference in the two readings is that a disproportionate share of job growth over the past year was in part-time employment for noneconomic reasons, meaning workers chose to work part-time. That represents a rebalancing of employment after many workers who wanted to work part time were pressed into full-time duty amid the pandemic's labor shortages. The decline in hours worked indicates that the pace of labor growth has slowed far more than the headline job numbers suggest.

Input from our business contacts offers further evidence of easing in labor market conditions. Consistent with data from the Job Openings and Labor Turnover Survey, or

JOLTS, our contacts say it is easier to fill positions and that turnover is back to prepandemic levels. For the first time in a long time, we are hearing reports of workforce reductions through attrition and even the possibility of layoffs, especially for back-office employees.
In sum, contacts describe a labor market more like the one before the pandemic—still tight, but much less so than over the past few years. As one of our contacts said: “Twenty-two to 32-year-olds are no longer in control of the labor market.”

In that context, I believe it makes sense to give restrictive monetary policy time to work. In my view, it is less certain that we need to keep hiking the policy interest rate in the immediate term, lest we risk tightening too much and draining too much momentum from the economy.

Progress on inflation

When will restrictive monetary policy start restraining inflation more powerfully? Put simply, not as soon as I’d like. But I do believe underlying inflation is declining gradually, and in a way that may well be sustainable.

My staff and I find glimmers of hope in recent inflation reports. Notably, the distribution of price increases has narrowed considerably, a strong indicator that underlying inflation is in fact abating. Last month marked the first month since August 2021 when less than 40 percent of the expenditure-weighted share of prices in the Consumer Price Index (CPI) basket rose by 5 percent or more. For perspective, the share of prices jumping 5 percent or more peaked at 80 percent in early 2022. This narrowing of severe price increases deepens my conviction that we are on the path to reducing inflation.

Alongside the narrowing of price increases, I’ll sound a hopeful note on services prices. Even though it’s been widely noted that core non-housing-services prices have not pulled back substantially, my staff and I see nascent signs that could be changing. The rate of price increases in that category has edged successively lower in each of the past three monthly inflation readings. I recognize this does not necessarily herald definitive, long-term disinflation in services. Still, I see an emergent and promising trend, a green shoot of hope, in a category that accounts for more than half of the consumer market basket.

Surveys reveal promising signs on prices and wages

The data describe what’s happened. To deepen our understanding of events and help chart what may be ahead, we lean into the findings of our in-house survey shop and intelligence from business contacts.

Our latest surveys have produced promising results on prices and wages. Our Business Inflation Expectations (BIE) survey is a monthly canvass of 200 companies across industries and firm sizes. In the latest BIE, a dwindling number of firms say they plan to raise prices, and those that do plan to raise them say they'll do it by smaller amounts.

Almost three-quarters (72 percent) of firms in the BIE reported they increased prices of their core products or services in the 12 months through May 2023. The average increase was 7 percent. By contrast, for the year ahead the fraction telling us they intend to raise prices fell to 57 percent, and the average expected price increase was only 4 percent. Granted, that is a snapshot, but it shows a material reduction in planned price increases.

We are getting similar early results from a research collaboration with colleagues at the Cleveland and New York Feds on firms' price-setting practices amid high inflation. Surveys in this project reveal that firms expect their costs and prices to rise more slowly over the next year.

Feedback from the field staff in what we call our Regional Economic Information Network confirms that pattern. Many contacts reported that pricing is normalizing, and it's harder to pass on increases in input costs. We were even told that big box retailers are pushing to "claw back" price increases imposed by their suppliers in 2021 and 2022, pointing to lower freight and commodity costs.

Now to wages. Economists are concerned about how much wage pressures are influencing inflation, especially in services prices. But debate continues to swirl about whether wages are a lagging or leading indicator of inflation. I don't want to devote more time to that subject, but we can discuss it in the Q&A if you'd like.

Right now, I will say we detect signs of current and future wage growth moderating in responses to the Survey of Business Uncertainty (SBU) our staff conducts with Stanford University and the University of Chicago. For the 12 months starting in May 2023, the SBU says employers aim to raise wages an average of 3.6 percent, down from last year's 5.2 percent. Here let me note that the SBU panelists accurately forecasted wage growth for the year through May 2023: firms projected 5 percent raises, and the number came in at 5.2 percent. This gives me confidence that we will see something close to the slowdown in wage growth that survey respondents suggest.

So, a bit of context concerning wages. Elevated inflation made real wage growth negative for much of the past two years, compared to positive growth just above 1 percent before COVID. So, I would expect nominal wage growth to exceed inflation for a time as real wage levels normalize, going back to the prepandemic growth trend. As long as firms continue to signal a slowing trajectory on price growth—that is, they are willing to absorb some margin contraction—then real wage growth probably won't put upward pressure on prices.

Gradual disinflation should continue

The data, survey results, and on-the-ground intelligence constitute a reasonable case that gradual disinflation will continue. I believe that will happen, even if the Committee does not increase the federal funds rate.

At this juncture, I'd like to make an important point. Pausing the policy rate increases, as we did this month, does not mean we are shrinking from the inflation fight. If inflation continues to fall in coming months—as I believe is likely—our current policy stance may effectively become tighter, as real short-term interest rates increase. I think of this dynamic as "passive tightening," which should help us continue on the path to our target if recent inflation trends persist.

Now, let me be clear what I mean by "pause." My view is that we have reached a level of the nominal federal funds rate that should be sufficient to move inflation toward the 2 percent target over an acceptable timeframe. I realize this suggests a definition of "pause" that brings with it an expectation of no further hikes unless things fail to go according to plan. That's my baseline case.

What would change that stance? Two things would tell me we should ratchet up rates soon: inflation moving away from our target, or inflation distorting long-term investment decisions by businesses and households. Today I see neither. Inflation is steadily, if slowly, declining, and long-term inflation expectations remain well-anchored, so inflation is not twisting Americans' economic planning.

Now, I do not absolutely rule out the necessity of further rate hikes in coming months. The last three years have taught us that we absolutely do not enjoy the luxury of certainty.

Let me be clear on another thing. While my base case does not anticipate further rate hikes, it also does not have the federal funds rate coming down in 2023 or 2024.

Rest assured, I do not want to see economic dislocation and suffering. And my baseline forecast remains that we can meet our inflation objective without a severe economic downturn.

But have no doubt that I will remain resolute in the battle to tame inflation, even in the face of some rise in unemployment. Why?

Start with history. The Great Inflation of the 1970s and ’80s taught us that indecisive monetary policy is a recipe for prolonged inflation and economic misery. Back then, it took 15 years and two bruising recessions to finally subdue inflation. That’s a history we do not want to repeat.

I’m also concerned that the “last mile” in pulling inflation all the way down to 2 percent could prove to be more difficult than the earlier progress we’ve made because of inertia in both the pricing behavior of firms and the wage demands of workers. So that’s why I think it is extra important that we stay resolute in the campaign to reduce inflation.

Policymakers face extraordinary challenges

In closing, it is worth reiterating that policymakers in the United States and abroad continue to face an extraordinary array of challenges.

Pandemic-related effects on the economy have not fully unwound. US and global economic growth appear to be slowing. There is concern about financial stability in light of recent liquidity and credit issues in the banking system.

We are not living in a standard business cycle. We lack proven formulas to navigate the economic chaos of a global pandemic and its aftermath. Events have foreclosed any sense of certainty in forecasting economic conditions.

But I say this with certainty: the Federal Open Market Committee will not waver in the fight to bring down inflation.

Thank you.