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# The Outlook for the Economy and Monetary Policy

Remarks by

Adriana D. Kugler

Member

Board of Governors of the Federal Reserve System

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I am very pleased to be speaking here at the Brookings Institution, one of the country's premier centers for policy discussion and analysis.[1] As you all know, the Federal Open Market Committee (FOMC) has been working to lower inflation in the context of achieving our dual mandate of maximum employment and price stability.

Today I will discuss recent economic developments in the U.S., talk about how I approach our dual mandate, and explain how I view the current stance of monetary policy.

By way of introducing myself, my career in both academia and public service has included a focus on both labor markets and inflation. In my academic work, I have explored various aspects of labor markets—including the effects of labor market policies and the role of educational attainment, among other topics—as well as detailed measurement of productivity and prices. As the chief economist at the U.S. Department of Labor, I engaged regularly with the Bureau of Labor Statistics, which produces data on both employment and inflation. I have approached these topics through both a rigorous focus on measurement considerations and a broader view of the real-world experiences of the people who underlie the headline data. I will continue to do that as a member of the FOMC. With that background, I will now turn to recent economic developments and the outlook for this year.

The pace of inflation continues to slow. Twelve-month inflation, as measured by the personal consumption expenditures (PCE) index, was 2.6 percent in December, down from its peak of 7.1 percent in June 2022. And the six-month rate for PCE inflation was even lower, at 2 percent. While the FOMC uses PCE inflation for our 2 percent target,

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

we also look to core PCE inflation, which excludes more volatile food and energy prices, as an indication of the underlying inflation trend. Core PCE inflation was 2.9 percent in December, also down from its high of 5.6 percent in February 2022, and six-month core PCE inflation was just 1.9 percent in December. We have made great progress. The slowing in total and core PCE inflation that we have seen over the past year or so is the most dramatic since the early 1980s—even though this progress has been uneven from month to month.

I like to look under the hood of the inflation numbers for clues about the inflation outlook. A lot of the disinflation we have seen has come from the goods sector, where many prices have actually fallen as demand has cooled and supply chains have mostly healed from pandemic disruptions. Price declines in the goods sector have been helpful, though the core goods category constitutes less than one-fourth of the total PCE index. We have seen less—though still meaningful—progress on services inflation, but there are reasons for optimism. Measures of housing services inflation are naturally persistent; tenant rents move slowly because of the prevalence of year-long lease agreements, and estimates of owner housing costs are imputed based in large part using those tenant rents. These measures react only gradually to data on newly signed rental agreements, and such data do suggest continued easing of housing services inflation—a category that accounts for about 15 percent of the total PCE index.

That leaves us with the category of core services excluding housing. This category saw a 12-month inflation of 3.3 percent in December, down considerably from its peak of 5.2 percent in December 2021. Continued overall disinflation will depend heavily on core services excluding housing, which accounts for roughly half of the total

PCE index. While this category's inflation rate is still elevated, there is reason to expect improvement, as I will discuss now.

I see three factors as likely to contribute to continued disinflation, especially in the category of core services excluding housing: continued moderation of wage growth, normalization of price-setting behavior by firms, and anchored inflation expectations.

First, the disinflationary process is being helped by wage growth moderation associated with the ongoing cooling of the labor market. The pace of payroll gains has slowed considerably over the past couple of years. The three-month average of payroll gains surged above 700,000 in mid-2021 and then trended down through 2022 and 2023. Of course, last week's payroll report was quite strong. And the three-month average gain jumped to nearly 300,000. But the broader trend has been one of moderating gains. This moderation in payroll growth largely reflects cooling demand. Actual hiring and hiring plans have eased, as is evident in the Job Openings and Labor Turnover Survey, or JOLTS, data and in other business surveys as well.[2] Job openings have also declined, such that the ratio of openings to unemployment has come down to 1.5 from a peak of 2.0 and is now closer to the pre-pandemic ratio of 1.2. I am pleased that this cooling of labor demand has been accomplished without a marked rise in layoffs, which would impose hardships and difficult transitions for individuals, families, and communities.

At the same time, labor supply has improved significantly, returning to pre-pandemic levels. Labor force participation has risen sharply for prime-age workers since early in the pandemic, particularly among women, who last year reached the highest participation rate on record. And we have seen an increase in immigration—a source of

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[2] Hiring plans in the National Federation of Independent Business survey have cooled significantly from their peak in mid-2021. Cooling of hiring plans is also evident in the January Beige Book.

workers that is particularly important for certain sectors. For example, in the construction sector, about one-fourth of all workers are non-natives, and in leisure and hospitality, the share is about one-fifth.[3]

With easing labor demand and robust labor supply, we have seen a slowing trend for wage growth. Of course, as a general matter, I prefer to see robust growth of workers' wages, but for wage growth to be sustainable, it must be consistent with 2 percent inflation. Further wage growth slowing is likely to be important for ongoing disinflation, particularly in the labor-intensive services industries. For private services overall, 12-month growth of average hourly earnings was 4.4 percent in January, down from its peak pace of 6.1 percent in March 2022. More specifically, in the leisure and hospitality sector, earnings growth was 4.4 percent in January, down from a peak rate of 13.9 percent in late 2021. In education and health, earnings rose 3.7 percent in January, versus a peak pace of 6.9 percent in late 2021. Some of these sectors did see a pickup in wage growth in January, but the broader cooling trend is clear.

I mention these sectors because they exemplify just how labor intensive the services sector can be. For example, labor costs are roughly 60 percent of value-added in leisure and hospitality and more than 80 percent of value-added in education and health services.[4] An easing of labor-cost growth in these and other labor-intensive services industries is likely to be passed on to consumers as lower prices and to help reduce inflationary pressures.

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[3] These shares refer to the share of workers who are foreign born, averaged over 2015-2023. Data from Bureau of Labor Statistics Current Population Survey.
[4] See Bureau of Economic Analysis (2022), "Composition of Gross Output by Industry" tables, https://apps.bea.gov/iTable/?reqid=150&step=2&isuri=1&categories=gdpxind.

The second factor that is likely to contribute to continued disinflation has to do with how frequently individual prices are adjusted by firms. Research by Federal Reserve Board staff and others has found that the rise in inflation during 2021 and 2022 mostly reflected firms changing prices more frequently, rather than firms making larger adjustments when they did change prices. In particular, before the pandemic, the median price lasted more than 10 months, but by early 2022, the median price was lasting less than 5 months. Encouragingly, the frequency of price adjustment has declined since then, with median price duration moving up to nearly 7 months in the third quarter of last year.[5] I am looking for a return to pre-pandemic price adjustment patterns in the services industries as cost pressures ease and as the FOMC's actions to support a return to price stability continue to affect consumer and firm behavior. There are some signs that businesses may be more wary of the response by consumers to higher prices and may already be responding by raising prices less frequently. For example, mentions of consumer "price sensitivity" have become more common in the Fed's recent Beige Book, which reports economic conditions across our 12 Districts from various market participants.

The third factor favoring continued disinflation—one that is related to the other two factors I have just mentioned—is the stability of inflation expectations. Inflation expectations can feed into wage demands and negotiations as well as into price-setting decisions. To understand why this matters going forward, I will first look back: Over the

[5] Updated data 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://www.federalreserve.gov/econres/notes/feds-notes/price-setting-during-the-covid-era-20230829.html. The authors also find that the likelihood of upward (versus downward) price adjustments was higher in the pandemic episode than in previous years, another important component of the inflation story.

past couple of years, some workers have demanded large pay increases to catch up with higher-than-normal growth in the cost of living resulting from various pandemic-related shocks. Some of these wage gains, in turn, likely passed through to higher prices as part of firms' frequent price adjustments.

If expectations for future inflation had become unanchored or persistently higher, then workers might have continued to demand higher-than-normal wage increases going forward, and firms might have continued to pass on these costs to consumers.[6] But inflation expectations have stayed reasonably well anchored. As inflation expectations stay anchored and in tune with inflation slowing further in the future, employees—many of whose wages have recently been rising faster than price inflation—are less likely to continue demanding very large wage and salary increases.[7] Similarly, as businesses expect the prices of labor and other inputs to rise more slowly (or, for some inputs, even to fall), they will be less likely to plan to significantly increase their own prices throughout the year, which in turn helps reduce inflation. Survey data from the Richmond Fed show a close relationship between firms' expectations for overall price inflation and those firms' own price-setting plans. In particular, as inflation comes down, firms become less reactive, and inflation expectations play less of a role in firms' price adjustments.[8]

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[6] For a helpful discussion of this potential "wage–price spiral," see Guido Lorenzoni and Ivan Werning (2023), "Wage–Price Spirals," paper presented at the Brookings Papers on Economic Activity Conference, held at the Brookings Institution, Washington, September 28–29, https://bpb-us-w2.wpmucdn.com/voices.uchicago.edu/dist/c/3483/files/2023/10/5_Lorenzoni-Werning_unembargoed.pdf.
[7] Real wages—that is, wages adjusted for price inflation—declined earlier in the recent inflationary episode. But real wages have been recovering more recently.
[8] 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_24-03.

Several data sources support the idea that expectations are indeed well anchored. One closely watched source is the Michigan survey, in which expectations for inflation during the next 5 to 10 years have remained fairly flat recently, near levels seen for much of the past decade. And expectations for inflation in the year ahead have come down a fair bit after peaking in 2022. Expected inflation in the New York Fed's Survey of Consumer Expectations shows a similar pattern, with both one-year and three-year expectations close to their pre-pandemic norms. Expectations also appear well anchored in surveys of forecasters and in market-based measures of future inflation. This information suggests that firms, workers, and investors understand that price- and wage-setting behaviors are likely to return to pre-pandemic norms, which will help us return to the price stability we enjoyed before the pandemic.

I have noted three reasons I expect continued progress toward the FOMC's 2 percent target for inflation, and I believe monetary policy has played a key role in driving these factors. An open question looking ahead, though, is how spending momentum will evolve this year, which may either help or hinder this disinflationary process. I expect consumer spending to grow more slowly this year than last—which should help with disinflation. Large balances of excess savings accumulated early in the pandemic have supported household spending during the past few years. By now, these excess savings are likely exhausted, at least for households in the bottom half of the income distribution. And we have begun to see signs that some households have come under increased stress, such as rising delinquency rates on credit cards.[9] Just two days ago, the Federal Reserve released the January survey of senior loan officers (or SLOOS).

[9] Rising credit card delinquency rates can be seen, for example, in quarterly "call reports" data from the Federal Reserve, which currently extend through the third quarter of 2023.

That survey showed continued tightening of credit card lending standards, the latest in a string of such surveys documenting tighter conditions for a variety of consumer lending. These signs of tight financial conditions point to slower consumer spending. Business spending growth is also likely to be a bit slower this year, since the widely discussed boom in factory construction may level off, albeit at a high level. Eventually, equipment investment should rise to fill those newly built factories with machines, but that process will likely be gradual.

And I closely watch developments in broader financial markets as well. Some measures of financial conditions have become a bit less restrictive in recent months but remain relatively tight. Indeed, the FCI-G, a measure of financial conditions published by the Board, and other indicators suggest that overall financial conditions are consistent with continued progress on our inflation mandate.

So I am pleased with the disinflationary progress thus far and expect it to continue. I must emphasize, however, that the Committee's job is not done yet. Consumer spending was surprisingly strong last year. Gross domestic product (GDP) grew at a nearly 5 percent rate in the third quarter, led by consumption. And even though spending and output growth moderated some in the fourth quarter, consumption contributed nearly 2 percentage points to fourth-quarter GDP growth. So consumers could surprise us again this year, and that could slow progress on inflation. Last week's employment report was also surprisingly strong amidst the broader cooling trend. It is important that supply and demand in both product and labor markets broadly continue moving into better balance.

I am also paying close attention to the upside risks to inflation posed by geopolitical developments. Russia's ongoing war on Ukraine and the widening of the conflict in the Middle East could contribute to higher commodity prices and disrupt global trade, in turn pushing up goods inflation in the U.S. When I worked at the World Bank, I followed these issues on international supply chains and commodity prices closely, and I certainly continue to do so now.

I will remain focused on the inflation side of our dual mandate until I am confident that inflation is returning durably to our 2 percent target. I am keenly aware that high inflation vastly complicates business decision making and importantly creates serious hardships for our most vulnerable households and individuals. Having lived in Colombia during periods of high and volatile inflation, I know firsthand how destructive it can be. It is critical that inflation returns to 2 percent, as that is indeed the pace the Committee has deemed to be consistent with price stability.

Of course, I am mindful of our employment mandate, and I am closely tracking labor market developments. While historically we have sometimes seen a tradeoff between inflation and employment, the recent experience of disinflation has been sustained without a significant increase in unemployment. I do expect job growth to continue; however, history has shown that labor market conditions can change quickly, sometimes before we see strong signals in spending data. Thus, I am watching closely the totality of the data, with risks on both sides of the mandate in mind.

I am also cognizant of international risks to our employment mandate. For example, a broader slowdown in Europe or China—two of the engines of global growth—could become a drag on the U.S. economy.

For now, I see the risks to our dual mandate as roughly balanced; our policy stance is restrictive, but the target range for the federal funds rate has been steady for some time now, and the most recent Summary of Economic Projections by FOMC participants suggests that the rate is at its peak level, if the economy evolves as expected. At some point, the continued cooling of inflation and labor markets may make it appropriate to reduce the target range for the federal funds rate. On the other hand, if progress on disinflation stalls, it may be appropriate to hold the target range steady at its current level for longer to ensure continued progress on our dual mandate.

In summary, I am pleased by the progress on inflation, and optimistic it will continue, but I will be watching the economic data closely to verify the continuation of this progress. This approach is the surest path to achieving and maintaining both of the FOMC's economic objectives and promoting an economy that benefits everyone in America.