How Long Will Higher Inflation Last?

For the first time in more than a generation, we are grappling with high, broad-based, and persistent inflation.

The pandemic and events like Russia's invasion of Ukraine unleashed shocks that affected supply chains and labor markets, pushing prices and wages up. In response to the pandemic, $6 trillion of fiscal stimulus was enacted, fueling demand and limiting labor supply. And some have argued the Fed's pandemic response was too expansionary for too long — that we were caught off guard after the prior decade of stubbornly low inflation.

Movements in any of these factors could have quieted inflation somewhat. But I'm not convinced any one of them is the whole story.

I've been spending a lot of my time on the ground with business and community leaders who help me understand how businesses and individuals experience the economy. Based on those experiences, what I'm seeing is the accumulation of many inflationary pressures at once. In football terms, we flooded the zone.

Over the past 40 years, inflation stayed so low and so stable that price and wage increases became an all-but-abandoned lever. Price-setters lost confidence that they could pass costs on to customers; they focused on reducing their own costs instead. Firms employed sophisticated purchasing professionals to fight suppliers hard on cost increases. Workers grew to expect annual increases in a low and narrow range. In that era of price and wage stability, consumers, quite rationally, were inattentive to inflation.

Now we have seen intense inflation pressures accumulate and persist. Massive industry-wide cost pressures pushed suppliers to take the risk of passing cost increases on to customers. Supply shortages gave them confidence they could do so. Purchasers, focused

on resiliency rather than efficiency, stopped objecting as much. Investors rewarded companies that passed price increases on and penalized those more reticent. Consumers, funded by stimulus, mostly accepted price increases. Workers gained confidence in this very tight labor market and negotiated for flexibility or wage increases. Employers desperately adjusted to do what it took to retain and recruit.

In short, businesses constrained by a generation of limited pricing power seized the opportunity that arose. Workers emboldened by unprecedented labor market tightness did the same. We all started paying attention.

The question is how long this can last. When I talk to business leaders these days, they still view their increased pricing power as temporary. They see it as an episode, not a regime change. To support that, with fiscal stimulus being drawn down, I hear more and more stories of consumers trading down or doing without. With recession talk widespread, I hear of labor pressures easing. Long-term market measures of inflation compensation remain in line with our 2 percent target despite short-term inflation and inflation expectations at multidecade highs.

The Fed is also moving expeditiously to bring down inflation. We have raised rates 4.25 percentage points this year, started shrinking our balance sheet aggressively, and signaled there are more rate increases to come. The transmission of these changes, especially in interest-sensitive sectors, has been rapid. Look at mortgage rates, which have more than doubled from a year prior.

So inflation should come down, but I don't expect its drop to be immediate or predictable. We've been through multiple shocks, and significant shocks simply take time to dampen. On the business side, I still hear firms facing wage pressure, especially for merit pay in the face of this year's cost-of-living pressures. And while margins remain healthy overall, I've heard from many businesses still working to recover costs not yet passed through. On the consumer side, while lower-income consumers are facing stress, higher-income ones are still spending.

The Fed's rate and balance sheet moves will take time to bring inflation down, but we will persist until they do. One of the key lessons from the 1970s was not to declare victory prematurely. Perhaps we will get help from supply chain and energy market normalization. But we have the tools to bring inflation down even if those disruptions continue.

A longer version of this essay was delivered as an address to the Prince William, Va., Chamber of Commerce on Sept. 30, 2022.