Philip N Jefferson: Economic outlook and supply-side (dis)inflation dynamics

Speech by Mr Philip N Jefferson, Vice Chair of the Board of Governors of the Federal Reserve System, at the Brookings Institution, Washington DC, 6 February 2026.

* * *

Thank you, Wendy, for the kind introduction. It is an honor to speak at the Brookings Institution.[1]

Today, I will start by sharing my outlook for the economy. Then, I will discuss the possible implications of that outlook for the path of monetary policy. Next, I will turn to the subject matter of this conference and discuss supply-side inflation dynamics. After my remarks, I look forward to our discussion.

Economic Outlook

At the start of this year, I am cautiously optimistic about the economic outlook. I see signs suggesting that the labor market is stabilizing, that inflation can return to a path toward our 2 percent objective, and that sustainable economic growth will continue. To be sure, there are risks to both sides of the dual mandate, given to us by Congress, of maximum employment and stable prices. Incoming data bear careful watching.

Broadly speaking, economic activity appeared to be strong late last year. In the third quarter of 2025, gross domestic product (GDP) rose at an annual rate of 4.4 percent. That was a sharp acceleration from the first half of last year, mostly reflecting strong consumer spending and an upward swing in net exports, which were especially volatile over the first three quarters of 2025. In addition, GDP data for the fourth quarter of 2025 and first quarter of 2026 will be affected by last year's federal government shutdown and subsequent reopening. However, GDP data through the third quarter and the readings on spending we have received for the fourth quarter suggest that domestic demand held up well last year. It was supported by strong consumer spending and business investment, including investment in artificial intelligence (AI), which could support productivity growth. For 2026, I have revised up my growth forecast modestly in recent weeks, informed by signs of the economy's continued resilience. Now, I expect the economy to grow at a rate similar to last year's estimated rate of 2.2 percent.

In terms of labor market data, the unemployment rate was 4.4 percent in December 2025 and has changed little in recent months. Nonfarm payrolls declined at an average pace of 22,000 per month over the final three months of last year, but when excluding government employment, private payrolls rose at an average pace of 29,000 per month. Looking over the past few quarters, the evidence suggests that the pace of job creation has eased. At least part of the slowdown in the job market reflects a decline in the growth of the labor force due to lower immigration and labor force participation. However, labor demand has softened as well.

Other measures of labor market conditions point to stabilization. For example, new claims for unemployment benefits have remained low in recent months. While I look

forward to reviewing January's jobs report, I see the overall labor market as roughly in balance, with a low-hiring, low-firing environment prevailing. In this less dynamic labor market, the downside risks to employment remain, but my baseline is for the unemployment rate to hold approximately steady throughout this year.

I now turn to the price-stability side of our mandate. Progress on disinflation has stalled over the past year, and inflation remains elevated relative to our 2 percent target. Based on the most recent available data, it is estimated that the personal consumption expenditures (PCE) price index rose 2.9 percent for the 12 months ended in December 2025, and core prices, which exclude the volatile food and energy categories, rose 3 percent. Those readings are similar to levels recorded at the end of 2024.

The stall in the disinflationary process is mainly because of tariffs on some goods. Over the past year, we have seen a decline in services price inflation, mostly due to easing price pressures in housing services. But this decline has been offset by an increase in core goods price inflation. Certainly, some upside risks remain, but I expect the disinflationary process to resume this year once increased tariffs pass through more fully to prices. In addition, projected strong productivity growth may be a source of further help in bringing inflation down to our 2 percent target. I'll say more on this point later.

Monetary Policy

After assessing the current state of the economy, and reflecting my cautious optimism, I supported the FOMC's decision last week to maintain the federal funds rate at the current level. Over the last year and a half, the Committee lowered the target range for the policy rate by 175 basis points. That included three reductions late last year. These rate cuts were responses to downside risks to employment amid somewhat reduced upside risks to inflation. Collectively, these adjustments put our policy rate broadly in the range of estimates of the neutral rate while maintaining a balanced approach to promoting our dual-mandate objectives. Our policy stance should help stabilize the labor market while allowing inflation to resume its decline toward our 2 percent target.

We always follow a prudent, meeting-by-meeting approach. The current policy stance is well positioned to address the risks to both sides of our dual mandate. I believe that the extent and timing of additional adjustments to our policy rate should be based on the incoming data, the evolving outlook, and the balance of risks.

Supply-Side (Dis)Inflation Dynamics

Now that I have shared my near-term outlook for the economy and monetary policy, I will turn to the topic of supply-side influences on inflation-the subject of this conference. To do that, I will first look back briefly at lessons learned about this topic from the economic experience of the pandemic period. Then, I will discuss current factors driving what could be a persistent increase in productivity growth. Finally, I'll consider some potential implications of a persistent increase in productivity growth for inflation.

The unprecedented events surrounding the COVID-19 pandemic highlighted the critical role played by supply dynamics in shaping inflationary pressures. The pandemic created global disruptions in labor markets, international trade, and supply chains,

making it more costly to produce and transport goods. Geopolitical events, such as the war in Ukraine, boosted input prices through restrictions on commodity production and additional supply chain disruptions, further exacerbating inflationary pressures. These constraints on supply were accompanied by shifts in the composition and level of demand, partly driven by supportive fiscal and monetary policy responses to the pandemic. The resulting supply–demand imbalances pushed the 12-month change in total PCE prices up to a high of 7.2 percent in June 2022.[2]

The labor market tightened considerably around this time, with the unemployment rate reaching a nearly 60-year low of 3.4 percent in April 2023. Models of inflation dynamics built on standard Phillips curve relationships, however, were unable to explain fully the magnitude of the surge in inflation.[3] This was true even for models that tried to adjust the natural rate of unemployment in real time to the unusual economic circumstances. Richer models developed since then, including those presented at this conference, emphasize the importance of features such as nonlinearities and alternative measures of economic slack as well as the role of input-output linkages in propagating supply chain disruptions throughout the economy.[4]

The disruptions caused by the pandemic have receded, and inflation has come down sharply since earlier in the decade. Nevertheless, it remains above our target, as I noted earlier. Moreover, the economy has continued to evolve rapidly over the past few years, particularly in response to technological advances and changes in the policy landscape. These changes have affected the economy's supply side, and likely will continue to do so, with implications for the behavior of prices and wages. Research that untangles the complex and dynamic effects of changing supply conditions on prices and sheds light on appropriate policy responses therefore remains crucial and of great value to policymakers.

One important development in recent years is that structural productivity growth in the United States, which is a key component of aggregate supply in the economy, appears to be notably above the growth rates observed in the decade before the pandemic. Productivity growth in the business sector is reported to have increased at an average annual rate of 2.2 percent from the start of 2020 to the third quarter of last year, notably faster than the 1.5 percent pace over the previous business cycle.[5] If this more rapid pace of productivity growth persists, it will have important economic implications. Strong productivity growth has the potential to support a robust expansion in economic output and strong real wage gains without adding to inflationary pressures.

Some of the recent strength in productivity growth may reflect one-time factors. For example, many firms expanded the use of labor-saving technologies early in the pandemic in the face of significant labor shortages in some sectors. However, other factors may be more persistent. New business formation has remained strong since early in the pandemic, which has likely supported strong productivity growth because new firms tend to adopt more efficient production processes. Also, this new business formation has been disproportionately concentrated in high-tech industries, which tend to drive productivity gains.[6]

More recently, integration of AI into production and the workplace may already be having some early effects on productivity, although most economists expect that the

bulk of any productivity gains due to AI are yet to come.[7] Other factors may also have some effect on productivity going forward, including higher tariffs, which academic research suggests will be a drag on productivity growth, and deregulation, which should provide a boost. That said, it is too soon to say if productivity effects from these policies have begun to materialize and what their net effect will be.[8]

Should we expect the pickup in productivity to affect inflation? As in the pandemic experience, the answer likely depends on how the balance between supply and demand is affected over time. For example, though businesses and individuals are increasingly adopting AI, the most transformative structural changes from this new technology may still be ahead of us. Excitement about the potential of AI, however, appears to be affecting economic activity today, contributing to a boom in data center construction and AI-related investment. Even if AI ultimately succeeds in greatly enhancing the productive capacity of the economy, a more immediate increase in demand associated with AI-related activity could raise inflation temporarily, absent offsetting monetary policy actions.

Of course, productivity is not the only change in supply conditions that may influence inflation. Reductions in immigration, for example, typically lead to a reduction in the supply of labor, though the effect on inflation may be mild if aggregate demand is simultaneously reduced through lower consumption from this group. Still, even if demand declines in line with supply, wage and price inflation could still be boosted if the reduction in immigration results in labor shortages in sectors that depend heavily on immigrant labor.

While changes to aggregate supply are usually driven by broader economic forces, monetary policy plays a pivotal role in regulating the level of aggregate demand. Consequently, prudent policy that maintains balance in supply and demand conditions can influence whether improvements in productivity translate into inflationary or disinflationary pressures. Whether monetary policy is stimulating or restraining aggregate demand depends on the position of short-term real interest rates vis-a-vis the neutral rate, which reflects the underlying balance of saving and investment in the economy. All other things being equal, persistent increases in productivity growth are likely to result in an increase in the neutral rate, at least temporarily. With faster productivity gains, consumers may anticipate higher future income growth and choose to spend more now, reducing their saving rate. At the same time, increased productivity gains also imply a rise in the marginal productivity of capital and thus higher investment demand.

In addition to influencing aggregate demand directly, monetary policy also has a role to play in maintaining anchored inflation expectations. During the pandemic, well-anchored longer-term inflation expectations likely helped to prevent the surge in inflation from becoming entrenched and subsequently facilitated progress toward the FOMC's 2 percent inflation objective without a large increase in unemployment. Anchored inflation expectations also provide greater policy flexibility to support both objectives in the dual mandate. For example, although I see higher tariffs as having boosted inflation somewhat in 2025, I continue to see it as a reasonable base case that the effect on inflation will not be long-lasting and will amount to a one-time shift in the price level, in part because anchored inflation expectations should limit second-round effects of tariffs on prices and wages.

With the FOMC strongly committed to returning inflation to its target, the risk of such a one-time shift leading to sustained inflation is likely to be low. This implies that there is more leeway for the supply side of the economy to evolve without the need for precautionary monetary policy restraint.

Conclusion

Our understanding of supply-side developments and their effect on inflation has grown rapidly in recent years and seems likely to continue evolving in the foreseeable future. I am studying these trends carefully because they matter to setting appropriate monetary policy to achieve both parts of our dual mandate. As I stated, I have supported the FOMC's decisions to lower the target range for the policy rate by 175 basis points since the middle of 2024. In my view, those actions have brought the federal funds rate broadly in the range of estimates of the neutral rate while maintaining a balanced approach to promoting our dual-mandate objectives. I view the current policy stance as well positioned to respond to economic developments, putting the economy in a good position as we move forward.

Thank you once again to the Brookings Institution for inviting me to be here today. I look forward to our discussion.

---

[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.

[2] The drivers of the post-pandemic U.S. inflation surge, including the impact of supply and demand imbalances, the role of expectations, and the policy response, are reviewed in Ina Hajdini, Adam Shapiro, A. Lee Smith, and Daniel Villar (2025), "Inflation since the Pandemic: Lessons and Challenges," Finance and Economics Discussion Series 2025-070 (Washington: Board of Governors of the Federal Reserve System, August).

[3] This was particularly the case for linear Phillips curves, which assume that inflation responds to economic slack at a constant rate. Also, many Phillips curve models with modest nonlinear effects (a steepening that occurs when the economy becomes very tight) underpredicted the magnitude of inflation.

[4] Peneva, Rudd, and Villar (2025) give a retrospective of the Federal Reserve Board staff inflation forecast during the pandemic, including a description of the pre-pandemic Phillips curve model along with subsequent additions and improvements. These improvements hold out the promise that a revised specification of the Phillips curve will capture the supply-side factors that I consider below. See Ekaterina Peneva, Jeremy Rudd, and Daniel Villar (2025), "Retrospective on the Federal Reserve Board Staff's Inflation Forecast Errors since 2019," Finance and Economics Discussion Series 2025-069 (Washington: Board of Governors of the Federal Reserve System, August).

[5] These figures are based on labor productivity (real output per hour) data for all workers in the business sector from the Bureau of Labor Statistics via Haver Analytics.

[6] Decker and Haltiwanger (2024) document the surge in business formation for a variety of metrics. Further, they show that elevated business formation has been disproportionately concentrated among high-tech firms, which may have had important productivity consequences because high-tech firms have historically been important drivers of productivity. See Ryan A. Decker and John Haltiwanger (2024), "Surging Business Formation in the Pandemic: A Brief Update," working paper, September.

[7] For example, the case is made that AI may substantially boost the level of productivity over a decade in Martin Neil Baily, Erik Brynjolfsson, and Anton Korinek (2023), "Machines of Mind: The Case for an AI-Powered Productivity Boom," Brookings Institution, May 10.

[8] For a fuller discussion of possible factors supporting productivity growth since 2020, see the box "Labor Productivity since the Start of the Pandemic" in Board of Governors of the Federal Reserve System (2025), *Monetary Policy Report* (PDF) (Washington: Board of Governors, February), pp. 18–20.