# The Fed’s AI Dilemma: Long-Term Perspectives

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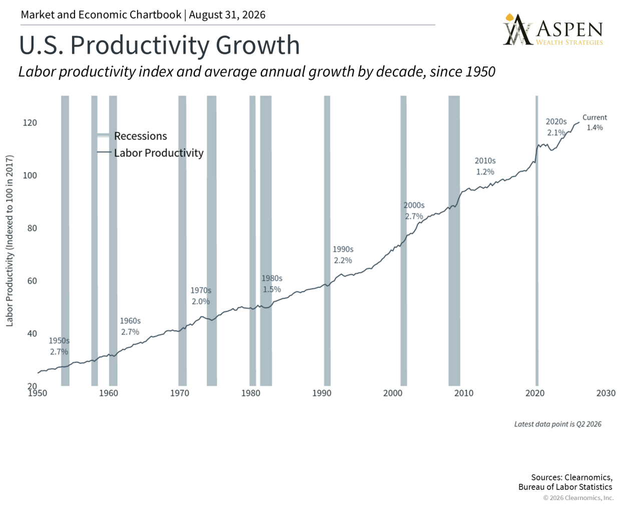
The Nobel Prize-winning economist Paul Romer once wrote that "economic growth springs from better recipes, not just from more cooking."[1] This key idea in economics is that raising our standard of living is not just about adding more workers or more equipment, but about enabling each worker to produce not only more goods and services, but higher quality ones as well.

This is often measured with the concept of "productivity," which is the main ingredient to the type of economic growth that improves wages and quality of life. It’s also one of the most important questions today as the adoption of artificial intelligence accelerates.

AI and Federal Reserve policy may seem unrelated on the surface, but they are connected. In the short run, this connection is through their effects on financial markets and interest rates, and in the long run through productivity and economic growth. In fact, Fed Chair Kevin Warsh recently addressed these topics at the Fed's annual symposium in Jackson Hole, Wyoming.[2] Given how much AI has already impacted markets in recent years, and the continued uncertainty surrounding the Fed's policy direction, what should investors consider from a long-term perspective?

**AI and long-run economic growth**




To understand why productivity matters, it helps to review how economists think about growth. Standard economic models are built around workers and “capital,” a term that includes equipment, machines, and tools. But just as important are education and technology, since they allow workers to produce more with the same amount of capital.

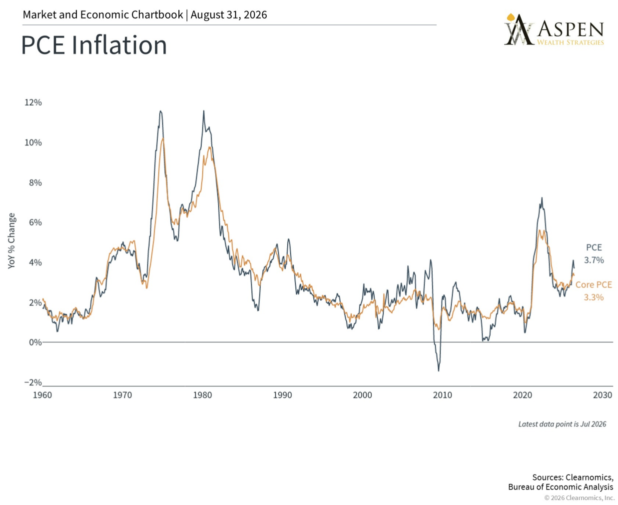
For example, a restaurant can create more meals if it has more cooks, better equipment, or better trained cooks that can make the best use of their tools and ingredients. A doctor that is more knowledgeable with access to more advanced facilities can produce better outcomes for patients. While economic models naturally oversimplify the world, the core idea is that generating more and better output per worker, no matter what the field may be, is what truly drives improvements in wages and living standards over time.

This is why productivity growth matters so much, even though it is difficult to measure precisely. What makes the effect of AI both interesting and hard to forecast is that it affects nearly all of these factors at once. Depending on the perspective, AI can be viewed as labor, capital, and a means to create even newer methods and technologies. Warsh, for instance, framed this question in his speech as whether AI would be "complementary or competitive to labor."

The science fiction version of the answer is that AI replaces workers entirely, particularly those whose tasks involve information, such as data analytics or computer programming. However, it is not yet clear that this is happening. The current evidence suggests that AI may instead be another tool that helps workers accomplish more, much as the information technology revolution did in prior decades. As early evidence of this, some companies are now rehiring after they previously reduced their workforces due to AI.[3]

The chart above shows that productivity growth has varied significantly across decades, but typically rises alongside adoption of new technologies. The expansion of the 1990s, for instance, was accompanied by an acceleration in output per worker, even though it took time to materialize.[4]

**Inflation remains the Fed's focus**



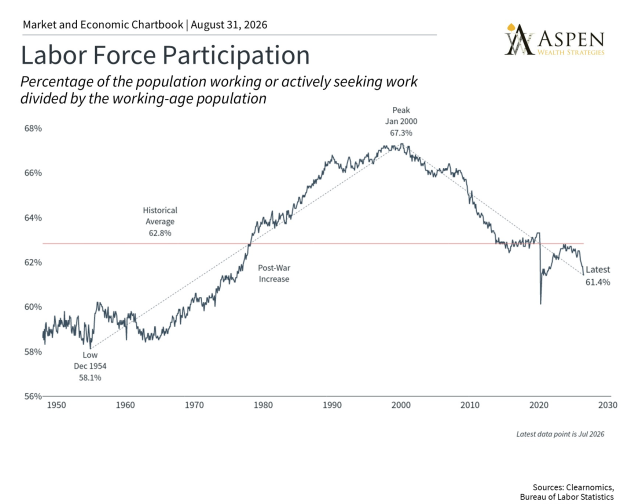

The Fed's more immediate focus is inflation. The Fed's preferred measure, the Personal Consumption Expenditures price index, shows that inflation rose 3.7% year-over-year, with core PCE at 3.3%.[5] Both measures remain well above the Fed's 2% target, and progress over the past two years has been limited due to higher oil and gasoline prices resulting from the war in the Middle East. In the short run, this puts the Fed in a difficult position as it tries to balance growth with price pressures.

Markets have tried to predict when the Fed might hike rates, which has resulted in recent market swings. At the moment, current expectations are for at least one rate hike by the end of this year, and possibly two by the end of the first quarter of next year. These expectations can change quickly as new data and Fed guidance come along, and have already shifted significantly over the past several months.

In the long run, however, the story could be different, depending on AI and other technology trends. This is because technology is naturally deflationary, since more output and higher quality goods can mean that prices fall over time. In fact, if AI were to lift productivity, the economy could then support faster growth and higher wages, with more moderate inflation over time.

This is particularly relevant because many areas of inflation are due to recent factors such as oil prices, data center construction, semiconductor shortages, and more. These inflation drivers have less to do with monetary policy and productivity, and could fade. However, that process takes time and there can be surprises along the way, so it’s important for investors to not focus too much on any individual inflation report.

**The labor market is a key consideration**




In the near term, the current state of the labor market shows that the economy is healthy. While layoffs have affected some sectors, many of these trends are due to cost cutting and the adoption of technology more broadly, not necessarily due to AI. Most importantly, the unemployment rate is still historically low at 4.1%, and has been stable for the past two years. Wage growth has decelerated, but at 3.1% on a year-over-year basis, earnings remain strong by historical standards.[6]

Why is unemployment so low even though job gains have been choppy? One reason is that the supply of labor has grown very slowly due to aging demographics and less immigration. The labor force participation rate fell to 61% in July, near its lowest level in decades, as more people exit the workforce, including many baby boomers.

Immigration restrictions have also slowed the growth of the available labor pool. When labor supply is barely growing, monthly job gains can naturally be low, even as workers hold onto their jobs and companies continue to hire when needed. This may help explain why initial jobless claims, which reflect workers seeking benefits after layoffs, are near historic lows.

Across technology, inflation, and the job market, it's important for investors to balance short-term factors against long-term trends. In the near term, markets remain uncertain since they depend on the conflict in Iran, the pace of data center buildouts, and more. Over the course of years and decades, productivity growth and broader economic trends are what will drive financial markets. Staying focused on long-term goals is what will increase the probability of financial success.

**The bottom line? The Fed faces a difficult balance between inflation and the job market, especially as AI trends continue to develop. For investors, it's best to maintain a long-term perspective aligned with financial goals.**

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