Views on the Economy and Monetary Policy

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Introduction

I thank John Carroll University for inviting me to participate in the Mellen Executive Speaker series. I always enjoy being on college campuses and feeling the vibe from all the learning going on. I had the pleasure of meeting with some John Carroll students earlier today, so I now feel better prepped for the upcoming question and answer session that will be moderated by Professor Frank Navratil.

But before we get to that, since I have just returned from last week's meeting of the Federal Open Market Committee (FOMC), the body that sets monetary policy in the U.S., I thought it would be helpful to briefly review the FOMC's decisions and put them into context. As a reminder, the views I present today will be my own and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee.

Last Week's Monetary Policy Decisions

In making its monetary policy decisions, the FOMC is always guided by its strong commitment to achieving its congressionally mandated goals of price stability and maximum employment. In pursuit of these goals, at its meeting last week, the FOMC took actions to begin removing some of the extraordinary monetary policy accommodation that was necessary earlier in the pandemic. Back in March 2020, at the start of the pandemic, the FOMC had reduced the target range of its policy rate, the federal funds rate, to 0 to 1/4 percent and held it there to support the economy in the wake of the unprecedented COVID shock. Last week, the FOMC raised the target range by one quarter of a percentage point, to 1/4 to 1/2 percent, and indicated that it anticipates that ongoing increases in the target range will be appropriate.

Throughout the pandemic, the FOMC has also used its balance sheet as a policy tool, buying large quantities of Treasury securities and agency mortgage-backed securities. These asset purchases were an important policy response to the severe strains in financial markets seen early in the pandemic and have helped to support the economy throughout the pandemic. The Fed ended its asset purchases in early

March, and last week, the FOMC indicated that it expects to begin reducing the size of its balance sheet at a coming meeting. As Chair Jay Powell indicated in his post-meeting press conference, that reduction could start as early as our next meeting in May.

I strongly supported the FOMC's actions last week to begin the process of removing monetary policy accommodation. I based my support on my assessment of economic conditions, the economic outlook, and the risks around the outlook. In my view, inflation, which is at a 40-year high, is the number one challenge for the U.S. economy at this time.

Russia's invasion of Ukraine is a tragedy for the Ukrainian people, who are suffering tremendously; so they need to be first and foremost in our thoughts. In terms of the implications for the U.S. economy, the situation has already led to strong increases in the prices of energy and other commodities, and it has the potential to further disrupt global trade. Events are unfolding, and uncertainty about the economic outlook over the medium run has risen. Despite the uncertainty, I believe it is appropriate that the FOMC take action to get inflation under control and put it on a downward trajectory toward our longer-run goal of 2 percent while sustaining the economic expansion and healthy labor markets.

Economic Conditions and the Outlook

Despite the challenges posed by the pandemic, U.S. economic growth was very strong last year, with real GDP growing at a 5-1/2 percent rate, the highest annual pace since 1984. This is well above the trend growth rate, which I estimate to be about 2 percent. Economic activity moderated somewhat early this year in the midst of the surge in virus cases from the Omicron variant but picked back up again as cases subsided. The pandemic is still with us, but over time, firms and households have become more resilient to the economic impacts of new variants of the virus. The strength in household and business demand has been supported by extraordinary fiscal policy and monetary policy, as well as the deployment of vaccinations, which has allowed the economy to reopen more fully. Growth will moderate this year compared to last year's robust pace as fiscal stimulus wanes and monetary policy accommodation is removed. But despite the risks posed by geopolitical events, my base case is that the economy will continue to grow at a pace that is above trend and which will sustain healthy job gains.

Strong demand has occurred in the face of very constrained supply in both product and labor markets. In product markets, differences in virus conditions and virus containment policies across the globe have disrupted global supply chains. At first, firms thought that these supply chain issues would be resolved fairly quickly as virus conditions improved. But successive waves of the virus continued to affect different parts of the supply chain throughout the past year, and firms continue to struggle getting necessary parts and materials through clogged ports and transportation channels.

In labor markets, the economy added 6.7 million jobs last year, and in the past three months, job gains have averaged over 580 thousand per month. The unemployment rate has fallen to 3.8 percent, only a little above its lowest level during the long expansion before the pandemic. These are extraordinarily strong labor market numbers, especially compared to conditions in the labor market when the economy had to shut down in response to the virus. In just two months, March and April of 2020, the economy lost about 22 million jobs and the unemployment rate rose to 14.7 percent. Over the course of the pandemic, many people ended up leaving the labor force, either because they lost their job or because they needed to care for children or other people affected by the virus; some decided to resign as they reassessed their careers; and many chose to retire. Labor force participation has recovered significantly over time but remains below its pre-pandemic level, and labor supply has been unable to keep up with the robust demand for labor.

As the economics and finance students at John Carroll know, when demand is out of balance with supply, prices and wages adjust. Supply chain problems have raised firms' costs of production and because qualified workers are so scarce, wages are rising at rates we have not seen in decades. Our business and labor market contacts from around the region tell us that they do not foresee wage pressures easing any time soon because labor markets are so tight. Average hourly earnings have been rising at a 5 percent pace, and workers with specialized skills in high demand, such as cybersecurity expertise, are seeing significantly higher wage gains. As one of our Reserve Bank directors put it, the economy has moved on from the Great Resignation to the Great Poaching, where firms are bidding away workers from each other at ever increasing rates of pay. While higher wages that reflect higher productivity growth are a positive for the economy, the current increases in wages are likely inconsistent with maintaining price stability.

As their costs have risen, firms have been able to pass along some of those cost increases to their own customers in the form of higher prices. Inflation readings are now at their highest levels in 40 years. While many firms and economic forecasters expected supply chain disruptions to ease in the second half of last year, supply chains remain challenged and inflation has continued to rise. Measured year-over-year, PCE inflation rose to over 6 percent in January, core PCE inflation rose to nearly 5-1/4 percent, and the Cleveland Fed's median PCE inflation reached 4 percent. And price pressures that were once seen mainly in the goods and services most directly affected by the pandemic have now broadened to other items. Eighty percent of the components used to compute the Cleveland Fed's median CPI have year-over-year inflation rates of 3 percent or more, and nearly 60 percent of components have inflation rates of 5 percent or more.

High inflation imposes a real burden on households and businesses, especially those that do not have the wherewithal to pay more for essential goods and services. The nominal wage increases over the past year have benefited many families, but for many of them, the increases have not kept up with inflation. In addition, the incidence of inflation has fallen more on lower-income consumers because they spend a larger share of their expenditures on the essentials of food, housing, clothing, and transportation and inflation in these components has far outpaced inflation in nonessentials.

The invasion of Ukraine by Russia has resulted in significantly higher and more volatile prices of energy and other commodities. Russia and Ukraine are major producers of several important commodities, including wheat and fertilizer, important for the global food supply; pig-iron, used to produce steel; palladium and neon gas, used to produce semiconductors, which are already in short supply; and nickel, used to produce stainless steel and motor vehicle parts. The invasion could further disrupt the already challenged global supply chain. So the situation in Ukraine has added to the upside risks to inflation. Unless the conflict escalates, the direct effects on the U.S. economy are likely to remain manageable. But the invasion does pose some downside risks to growth in the U.S., since higher levels of uncertainty and a sustained increase in gasoline and other prices could temper spending on the part of households and businesses. At this point, I view the upside risks to inflation stemming from the conflict as being more significant than the downside risks to growth in the U.S.

I do expect inflation to begin to move down later this year and next, but it will take some time and inflation will remain above our goal of 2 percent. At some point, the current adjustments underway to increase the resilience of supply chains will help to ease the disruptions, and energy prices will stop increasing, even if they remain somewhat elevated compared to before Russia invaded Ukraine. Monetary policy action by the Fed cannot affect those sources of inflation, but it is an important contributor to the downward trajectory of inflation in my forecast because reducing the level of monetary policy accommodation will help to better align demand with constrained supply, thereby alleviating price pressures.

Absent such action, with inflation already at very high levels and demand outstripping supply, there are rising risks that too-high inflation will become imbedded in the economy and persist. This can happen if consumers and businesses begin to doubt whether inflation will return to 2 percent over the medium to longer run and their rising expectations about future inflation become part of their pricing plans and wage demands. Consumers and businesses are paying a lot of attention to inflation, and their expectations of inflation over the short term, about one year out, have risen with actual inflation rates. So far, their expectations of inflation over the longer term have risen but remain at levels consistent with our longer-run goal of 2 percent inflation. That is a positive, but persistently high inflation readings impose rising risks that longer-term inflation expectations could become unanchored and this has implications for monetary policy. In an economy that is near our maximum employment and inflation goals, with longer-term inflation expectations that are well anchored, it is appropriate for monetary policy to look through supply shocks that temporarily raise inflation above target. But in the current environment, it seems too risky to allow the high inflation readings to persist and just wait until the supply-side factors putting upward pressure on prices abate. From a risk-management perspective, the Fed needs to take action to reduce excess demand and bring demand into better balance with constrained supply in order to better anchor inflation expectations and put inflation on a downward path to our longer-run goal of 2 percent.

Monetary Policy

The FOMC has begun that process. As I mentioned earlier, at last week's meeting we raised the fed funds rate target range by one quarter of a percentage point and said that we anticipate that ongoing increases will be appropriate. We also said that at an upcoming meeting we would begin to reduce the amount of assets that we hold on our balance sheet. We will do that in a predictable manner primarily by adjusting the reinvestment amounts of the principal payments we receive on our assets. Other details of the plan for reductions are being finalized. The plan will draw on our experience during 2017 to 2019 when we reduced our balance-sheet assets, which had grown in the wake of the Great Recession. But the balance sheet is much larger, in terms of both the dollar value of assets and assets relative to GDP, and inflation is much higher than it was then. So it is appropriate to start reducing the balance sheet sooner and proceed at a faster pace this time. One benefit of this plan is that we will be removing the downward pressure our holdings put on yields at the long end of the yield curve while we are raising rates at the short end, thereby reducing monetary policy's distortionary effects on the shape of the yield curve as normalization proceeds.

In setting policy, the FOMC is always driven by the pursuit of its dual mandate goals of price stability and maximum employment. Inflation is very elevated and labor markets are tight by many metrics, yet monetary policy remains at emergency levels of accommodation needed earlier in the pandemic. We need to bring monetary policy into sync with the current state of the economy. Our intent is to remove accommodation at the pace necessary to bring inflation under control while sustaining the expansion in economic activity and healthy labor markets. Because longer-run inflation expectations are still anchored, and there is strong underlying growth momentum in both product and labor markets, I am optimistic we can achieve this by reducing excess demand via our policy actions. I view getting inflation under control as important for both parts of our mandate. The best thing monetary policy can do to support a healthy labor market is to ensure that the expansion is sustained, and that means taking appropriate actions to return to price stability.

Based on my current outlook and my assessment of the risks to the outlook, I believe it will be appropriate this year to move the target range of the fed funds rate up to its longer-run level, which I estimate to be about 2.5 percent, and to follow with further rate increases next year. My path is somewhat steeper than the median path in the March Summary of Economic Projections of FOMC participants, which also has the funds rate moving above its longer-run level next year.

Of course, the ultimate pace at which monetary policy accommodation is removed will need to be data driven and forward looking. Given the underlying strength in the economy and the current very low level of the funds rate, I find it appealing to front-load some of the needed increases earlier rather than later in the process because it puts policy in a better position to adjust if the economy evolves differently than expected. If by the middle of the year, inflation is not beginning to moderate, we could speed up our rate increases. But if inflation is moving down faster than expected, we could slow the pace of rate increases in the second half of the year compared to the first half. The implications of the unfolding situation in

Ukraine for the medium-run economic outlook in the U.S. will also be a consideration in determining the appropriate timing and pace of our monetary policy actions.

As we have seen over the past two years, the economy can evolve differently than expected. The pandemic is not behind us yet, and unfolding geopolitical events could affect the U.S. economy. So as the FOMC recalibrates monetary policy to meet today's inflation challenge, I will stay attuned to evolving economic and financial conditions and their implications for the outlook, and I will remain committed to achieving our goals of price stability and maximum employment on behalf of the public.