An Update on the Economy and Monetary Policy

Loretta J. Mester
President and Chief Executive Officer
Federal Reserve Bank of Cleveland

Philadelphia Council for Business Economics
Philadelphia, PA
(via videoconference)

June 2, 2022

Introduction

I thank Michael Weiss and the Philadelphia Council for Business Economics (PCBE) for inviting me to speak today. It is nice to be back in Philly, if only virtually. I spent many years at the Philadelphia Fed and fondly remember attending many of the PCBE's programs, which were held at the Bank. The conversations were always relevant, with attendees providing a variety of valuable insights into the economy, financial markets, and policy. So I am looking forward to engaging with you today. But before we start, I need to remind you that the views I present will be my own and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee.

The key challenge facing the economy is unacceptably high inflation, which reflects the imbalance between strong aggregate demand and constrained aggregate supply. The FOMC is committed to using its tools to get inflation under control, on a downward trajectory to its longer-run inflation goal of 2 percent, and the Committee has begun the process of repositioning monetary policy. This recalibration reflects the evolution of economic conditions, the economic outlook, and the risks around the outlook, and as the recalibration proceeds, it will continue to do so.

The Economy

Last year, despite the ongoing challenges posed by the pandemic, U.S. economic growth was very strong. Real GDP grew at an annual rate of 5-1/2 percent, the highest since 1984 and well above the trend growth rate, which I estimate to be about 2 percent. Growth this year has been expected to slow from this robust pace, and in the first quarter, growth actually turned negative. But the details of the report suggest that demand momentum remained strong. The main contributors to the decline in output were declines in net exports and government spending, and slower inventory investment. The decline in net exports reflected a pullback in foreign demand for our exports amid continued robust domestic demand for imports. Government spending fell but remained at a high level. The pace at which firms invested in inventories was still very strong, just not as strong as the robust pace seen in the fourth quarter. Supported by savings accumulated during the pandemic, consumer spending grew at a solid pace in the first quarter, and growth in business fixed investment was solid as well. The April personal consumption data indicate that even though consumers are paying higher prices, they are continuing to spend. Indeed, adjusted for inflation, consumer spending increased on nondurable goods, durable goods, and services.

Strong demand has occurred in the face of very constrained supply in both product and labor markets. Product markets have had to deal with a cascading set of disruptions to supply chains, reflecting differences in virus conditions and virus containment policies across the globe. China's zero-COVID policy has further disrupted supply chains, and Russia's dastardly invasion of Ukraine has further constrained supplies in energy, metals, and agricultural commodity markets. Some of our business contacts have characterized the situation as akin to Whac-A-Mole. As soon as they figure out how to solve a problem in one part of their supply chain, a problem arises in another part. This has meant that the supply chain disruptions have lasted a lot longer than businesses expected. For example, last December, almost two-thirds of our business contacts who were having supply chain problems thought they would see meaningful improvement this year. Now only a third do. Firms have told us that managing their supply chains and their workforce to meet demand has taken attention away from other activities, such as new product innovation, which could affect the longer-run competitiveness of their firms. The recent industrial production data indicate that manufacturers have been able to maintain solid production, even if doing so has taken considerable effort.

Hiring and retention have also required significant effort by businesses. Labor markets are very tight. The economy added 6.7 million jobs last year, and monthly payroll gains have averaged above 500 thousand over the first four months of this year. The unemployment rate has fallen to 3.6 percent and is near the lowest level reached during the long pre-pandemic expansion. Labor force participation remains below its pre-pandemic level. A variety of reasons have contributed to the reduced supply of workers and people leaving the workforce and then only slowly returning to work during the pandemic. These include responsibility for caring for children or other family members; fear of the virus; reevaluation of their careers; retirement; and reduced immigration. Over time, participation has improved significantly, but labor supply has not been able to keep up with robust labor demand. Job openings are at historically high levels: there are almost 2 openings per unemployed worker; in 2019, another time of tight labor markets, there were about 1.2 openings per unemployed worker. The performance of the labor market over the past two years is even more remarkable when you think back to the early months of the pandemic. In just two months, March and April of 2020, the economy lost about 22 million jobs – about the number it had gained over the long pre-pandemic expansion – and the unemployment rate rose to 14.7 percent. Conditions are vastly different now.

With demand out of balance with supply in both product and labor markets, prices and wages have moved up significantly. When costs first started to rise, firms told us they were reluctant to pass on these higher costs to customers. But as costs have continued to rise, firms have been passing higher costs on in the form of higher prices and finding little resistance. Inflation readings are now at their highest levels in 40 years. Measured year-over-year, in April, total PCE inflation was over 6-1/4 percent, core PCE inflation was nearly 5 percent, and the Cleveland Fed's median PCE inflation was over 4-1/4 percent. When inflation started to move up earlier last year, it was concentrated mainly in goods and services most directly affected by the pandemic and its effects on supply chains, such as used cars and home furniture. As the economy reopened, people who accumulated savings when things were shut down have been able to travel and eat out more, and prices for these and other services are now rising sharply. Indeed, price pressures have broadened to a wide set of goods and services. One way to see this is to look at the 44 components that are used to construct the Cleveland Fed's median CPI inflation measure. Measured year-over-year, median CPI rose at a 5.2 percent rate in April, with 64 percent of components having year-over-year inflation rates of 5 percent or more, and 82 percent of components having inflation rates of 3 percent or more. In contrast, a year ago, the median CPI measure of inflation was 2.1 percent, and

41 percent of components had inflation rates under 2 percent.[1]

Wage pressures have also built up over time. The employment cost index for private industry workers accelerated over the three months ending in March, rising at a 5.8 percent annual pace. Higher wages that reflect higher productivity growth are a positive for the economy, and a higher level of wages represents a shift of income share from capital to labor. But the current pace of wage increases is inconsistent with maintaining price stability.

Monetary Policy

In making its monetary policy decisions, the FOMC is always guided by its strong commitment to achieving its goals of price stability and maximum employment. While monetary policy cannot affect the supply-side factors that have contributed to the very high inflation readings, it can affect the demand side of the economy. The Fed is committed to using its tools to get inflation under control by tightening financial conditions to bring excess demand into better balance with constrained supply.

The FOMC raised its policy rate by 25 basis points at its March meeting and by another 50 basis points at its May meeting, and the Committee indicated that it believes ongoing rate increases will be appropriate. In addition, yesterday the Fed began reducing the size of its balance sheet according to the plan announced in May. Reducing the amount of the Fed's securities holdings will help to lessen downward pressure on longer-term interest rates by returning duration to the market. The reduction will be done primarily by adjusting the reinvestment amounts of the principal payments the Fed receives on its assets. Without asset sales, the process could take three years or so. The Fed is starting by allowing up to $30 billion per month of Treasury securities and up to $17.5 billion per month of agency securities to run off its balance sheet. In three months, these caps will rise to $60 billion per month for Treasuries and

---

[1] The median CPI and median PCE inflation measures are maintained by the Cleveland Fed's Center for Inflation Research and are available at https://www.clevelandfed.org/en/our-research/center-for-inflation-research.aspx.

$35 billion per month for agency securities. To the extent that maturing Treasury coupon securities are less than the monthly cap, Treasury bills will make up the rest of the runoff up to the cap. As securities run off the asset side of the Fed's balance sheet, the Fed's liabilities, which include reserve balances, will also decline. The balance sheet will continue to shrink until reserve balances are close to the level the FOMC judges is consistent with implementing monetary policy via its ample reserves operating regime. In this regime, reserve levels are ample enough that control over the federal funds rate and other short-term interest rates is executed primarily through setting the Fed's administered rates and active management of the supply of reserves is not needed.

With the interest rate moves we have made so far, the current target range of the federal funds rate is 75 to 100 basis points. This is well below the range of estimates of the longer-run nominal policy rate that would be neutral in the sense of neither stimulating nor restraining economic activity when inflation is 2 percent. For example, in the March Summary of Economic Projections of FOMC participants, the range of estimates of the longer-run fed funds rate was 2 to 3 percent. My own estimate is 2-1/2 percent. If inflation were 2 percent, with longer-term inflation expectations anchored at levels consistent with the 2 percent goal, this would imply a neutral real fed funds rate of 1/2 percent. But in the current high inflation environment, the real fed funds rate remains very negative. So given economic conditions, ongoing increases in the fed funds rate are called for. Unless there are some big surprises, I expect it to be appropriate to raise the policy rate another 50 basis points at each of our next two meetings.

At that point, the nominal funds rate will be nearing the lower end of estimates of the longer-run neutral rate and the balance-sheet reduction will have been underway for two months. The FOMC will then be well positioned to consider the appropriate pace at which to continue removing accommodation over the balance of the year and assess how high rates will need to go. In my view, with inflation as elevated as it is, the funds rate will probably need to go above its longer-run neutral level to rein in inflation. But we cannot make that call today because it will depend on how much demand moderates and what happens on the supply side of the economy. So, we need to continue monitoring economic and financial developments closely to gauge the balance between demand and supply and the evolution of price pressures. Making this assessment will be challenging because a variety of forces will be affecting the demand and supply sides of the economy as the year progresses. The ongoing war in Ukraine and the COVID lockdowns in China pose upside risks to inflation but downside risks to growth. On the demand side, broader financial conditions have already tightened considerably, as markets have anticipated further rate increases in light of the Fed's forward guidance. For example, the 30-year mortgage rate was under 3 percent last September and is now about 5-1/4 percent, and recent data suggest some tempering in housing market activity. It could be that the relatively swift tightening in financial conditions means that monetary policy will transmit throughout the economy faster than in past cycles and that demand will moderate more quickly, too. The effects of the fiscal stimulus provided during the pandemic are also waning, which will help to moderate growth. In addition, elevated inflation readings may also result in a pullback in spending more generally. On the supply side of the economy, with some luck, supply chain disruptions will begin to abate and labor market participation will continue to rise, helping to ease supply constraints and allowing supply in product and labor markets to come into better balance with demand. But we cannot rely on luck.

With both demand-side and supply-side factors contributing to high inflation, and because inflation tends to be persistent, it will likely take some time for inflation to reach our longer-run goal of 2 percent. I will be looking for compelling evidence that inflation is on a downward trajectory toward our 2 percent goal, and before I conclude that inflation has peaked, I will need to see several months of sustained downward monthly readings of inflation. I have not seen that yet. On the positive side, the monthly increases in the core PCE price index were relatively stable over February, March, and April. But in April, the monthly readings of both core CPI inflation and the Cleveland Fed's median PCE inflation reversed the declines seen in March. Rising rents and rising prices of energy, agricultural products, and other commodities can be expected to continue to feed through to overall inflation for a time.

In my view, a risk-management approach argues for being cautious about declaring that inflation is on a sustainable downward path because the inflation risks are to the upside and because the longer inflation runs above our goal, the higher the risk that longer-term inflation expectations will become unanchored, thereby making the return to price stability much more costly. We already see that medium- and longer-term inflation expectations have moved up over time. The Board staff's measure of common inflation expectations, which summarizes a number of measures, has been rising and is at the upper end of the range of values seen since 2005.[2] Some of that rise has been driven by increases in near-term expectations; for example, the Cleveland Fed's measure of year-ahead indirect consumer inflation expectations, which is based on a nationwide survey of adults with more than 10,000 responses each week, moved above 7 percent for the week ended May 28, 2022, compared to around 4 percent a year ago.[3] But even though longer-term inflation expectations have moved up by less, I do not think it is prudent to ignore the rise given the serious harm that would be caused were longer-term expectations to move above levels consistent with our 2 percent inflation goal and high inflation were to become embedded in the economy. So, if by the September FOMC meeting, the monthly readings on inflation provide compelling evidence that inflation is moving down, then the pace of rate increases could slow, but if inflation has failed to moderate, then a faster pace of rate increases could be necessary.

In the current environment, there is heightened uncertainty around the outlook. The risk of recession has risen, but because underlying aggregate demand momentum and the demand for labor are so strong, a good case can still be made that as demand and supply come into better balance, a sharp slowdown can be avoided, with growth slowing to a trend pace this year, labor market conditions remaining healthy, and inflation moving down to a 4-1/2 to 5-1/2 percent range this year and declining further next year. Of course, if there is anything we have learned over the past two years, it is that the economy can evolve

[2] See Hie Joo Ahn and Chad Fulton, "Research Data Series: Index of Common Inflation Expectations," FEDS Notes, Board of Governors of the Federal Reserve System, March 5, 2021 (https://doi.org/10.17016/2380-7172.2873).

[3] The Cleveland Fed's measure of year-ahead indirect consumer inflation expectations is available at https://cebra.org/programs/idd/indirect-consumer-inflation-expectations/.

differently than expected and we should be ready for that.

Commitment and Follow-Through

As this period of recalibration of monetary policy continues, the FOMC will need to be resolute and intentional in removing policy accommodation to tighten financial conditions at the pace needed to get inflation under control. This will take fortitude. There will be bumps along the road. Financial markets could remain very volatile as financial conditions tighten further; growth could slow somewhat more than expected for a couple of quarters; and the unemployment rate could temporarily move above estimates of its longer-run level. This will be painful but so is high inflation. 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. I do not see the current situation as one involving a trade-off between our two monetary policy goals. If we fail to do what is necessary to get inflation down, we will not be able to sustain healthy labor markets over the medium and longer run, to the detriment of the public we serve. So in formulating my policy views, I will remain focused and committed to using our policy tools to achieve our monetary policy goals of price stability and maximum employment.

Thank you for this opportunity to explain my current views on the economy and monetary policy.