

An Update on the Economic Outlook and Monetary Policy



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Introduction

Thank you for the opportunity to speak with you today on the MNI webcast. I will focus my opening remarks on how monetary policy will foster a return to price stability, and I look forward to the question-and-answer portion of the session to hear what is on your mind. Of course, 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 Economic Challenge Is High Inflation

The key challenge facing our economy is unacceptably high inflation. Inflation has been running well above 2 percent for over a year now; it is very high not only in the U.S. but in other advanced economies around the globe. This inflation stems from many factors, but fundamentally, it reflects an imbalance between strong demand and constrained supply, which has led to significant upward pressures on prices. Inflation is the number one concern of businesses and households: this is evident in surveys and in my conversations with regional contacts. High inflation imposes a particularly onerous burden on those who do not have the wherewithal to pay more for essentials like food, gasoline, and shelter, and who now have to make some hard choices about how to spend their money.

Price stability is the foundation of a strong economy; it is necessary for ensuring that the U.S. can sustain healthy labor market conditions over the medium and longer run and that the economy can be productive and live up to its potential for everyone's benefit. The FOMC is committed to using its tools to bring inflation back down to our longer-run goal of 2 percent; it is taking decisive action to remove monetary policy accommodation to bring demand into better balance with constrained supply in both product and labor markets. Since March of this year, the FOMC has raised the target range of the fed funds rate by 2-1/4 percentage points, and it has begun to reduce the assets the Fed is holding on its balance sheet, which will also reduce accommodation. Given current rates of inflation, I believe that the Fed has more work to do in order to get inflation under control. This will entail further rate increases to tighten

financial conditions, resulting in an economic transition to below-trend growth in nominal output, slower employment growth, and a higher unemployment rate.

Economic Growth

Economic activity is beginning to slow down from last year's robust pace. It is responding to our monetary policy actions and to the tightening in overall financial conditions since last year. But the slowdown also reflects how households and businesses are responding to very high inflation and their concerns about the economic outlook, to the waning effects of the pandemic fiscal stimulus, and to slower growth abroad. Consumer spending, housing activity, and business investment have decelerated from the robust pace seen last year. Indeed, the level of real GDP decreased in the first half of this year. Despite this moderation, aggregate demand is still out of balance with aggregate supply, which remains constrained due to supply chain disruptions stemming from pandemic-related shutdowns across the globe and the war in Ukraine. Many firms tell us that they will be investing to make their supply chains more resilient to be better prepared for the future. In the meantime, supply disruptions remain a challenge and they have added to price pressures.

Analysts often use the rule-of-thumb that two consecutive quarters of negative real GDP growth means the economy is in recession. I do not believe the U.S. economy is currently in a recession because the labor market is so strong. I do believe that the risks of recession over the next two years have moved up because financial conditions are tightening globally, inflation is very high in many countries, global growth is slowing, and the devastating war in Ukraine is adding considerable uncertainty and downside risks to the growth outlook, especially in Europe.

I am in the process of preparing my submission to the Summary of Economic Projections of FOMC participants, which will be released after our next FOMC meeting in two weeks. At this point, I have not incorporated a recession into my baseline outlook for the U.S., but instead expect a fairly sharp slowing in

activity, especially when compared to the robust growth the U.S. experienced in 2021. While there is considerable uncertainty, I currently expect that the U.S. economy will return to positive growth in the second half of the year, but for this year as a whole and for next year, I expect growth to run well below 2 percent, which is my estimate of trend growth.

Labor Markets

With the economy growing below trend, I expect labor market conditions to cool, with the unemployment rate rising somewhat above 4 percent by the end of next year. Some cooling off in the labor market will put it on more sustainable footing compared to the unsustainably tight conditions that exist today. The employment report for August, released last Friday, suggests that we are beginning to see some moderation but that labor market conditions remain strong.

Last year, the economy added 6.7 million jobs, a robust average of over 550 thousand jobs per month. This year, average job gains have slowed to about 440 thousand per month. The unemployment rate rose in August, but at 3.7 percent, it remains very low. The increase in the unemployment rate partly reflects an increase in labor force participation. The participation rate of prime-age workers has returned to where one would expect it to be. Many people chose to retire during the pandemic and left the labor force, and the overall participation rate, which includes those of retirement age, has risen only gradually. A continued rise in participation would be helpful in easing the imbalance between labor market demand and labor market supply. But typically, most people do not return to the job market once they have retired. So there is little reason to think that we will see an influx of workers that is large enough to return the overall participation rate to its pre-pandemic level. Although the number of job openings has eased in recent months, labor demand is still outpacing labor supply. There is still almost double the number of openings per unemployed worker. To put this into perspective: in 2019, another time of tight labor markets, there were about 1.2 openings per unemployed worker.

Contacts across a broad spectrum of firms tell us it has been very difficult to find workers. They have been using a variety of ways to attract and retain staff, including offering more flexible work schedules, signing and retention bonuses, expanded benefits, and higher base wages. The employment cost index for private industry workers accelerated over the six months ending in June, rising at a 6.0 percent annual pace. More recent reports suggest that wage pressures may be beginning to stabilize, but they remain high. Even so, for many workers their wage increases have not kept up with inflation, and their purchasing power is being eroded. With trend productivity growth estimated to be around 1-1/4 to 1-1/2 percent, wage growth will need to moderate to around 3-1/4 to 3-1/2 percent to be consistent with price stability.

Inflation

As their costs have continued to rise, businesses have been raising the prices they charge their customers and finding little resistance. Despite some moderation in economic activity, inflation readings continue to be at the highest levels in 40 years. Measured year-over-year, PCE inflation came in at about 6-1/4 percent in July; CPI inflation was 8-1/2 percent. These readings were down slightly from their June readings, mainly reflecting a sharp drop in the price of gasoline and energy. This was welcome news, but we have to guard against wishful thinking becoming a substitute for compelling evidence.

In my view, it is far too soon to conclude that inflation has peaked, let alone that it is on a sustainable downward path to 2 percent. Measures of the underlying inflation trend did not uniformly decline in July,¹ and given developments related to the ongoing war in Ukraine, gas and energy prices may move higher again later this year. In addition, services inflation, which tends to be persistent, is at its highest

¹ Only the core PCE inflation rate, which excludes food and energy, declined in July. Measured year-over-year, core CPI inflation and the median and trimmed-mean inflation rates, which exclude the components with extreme movements, were either stable or actually increased. The Federal Reserve Bank of Dallas produces the trimmed-mean PCE inflation rate. The Federal Reserve Bank of Cleveland's Center for Inflation Research produces the median and trimmed-mean CPI inflation rates and the median PCE inflation rate and provides analyses of inflation and inflation expectations to inform policymakers, researchers, and the general public.

level since the early 1990s, with growth in housing rent and shelter costs likely to keep inflation elevated for some time. In my view, it will take a while for inflation to return to the Fed's 2 percent goal. But I do expect inflation to move down into a range of 5 to 6 percent for this year and then to make more progress toward our goal over the next two years, because I expect the Fed to take further action to make it so.

Monetary Policy

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. Monetary policy cannot affect the supply-side factors that have contributed to the very high inflation readings. Instead, it works on the demand side of the economy. The Fed is being resolute and intentional in tightening financial conditions to bring demand into better balance with supply to alleviate price pressures. Since March, we have raised the target range of the fed funds rate a cumulative 2-1/4 percentage points and financial conditions are tighter than they were at the end of last year.

In addition, in June we began to reduce the size of our balance sheet according to the plan announced in May.² 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 in our balance sheet is being done primarily by adjusting how much we reinvest of the principal payments we receive on our assets. Without asset sales, the process could take three years or so. I would favor the FOMC's considering selling some of our agency mortgage-backed securities at some point during balance-sheet reduction in order to speed the return of our portfolio's composition to being primarily Treasury securities.³ Holding

² Starting in September, the Fed will allow up to \$60 billion per month of Treasury securities and up to \$35 billion per month of agency securities to run off the balance sheet. 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. See the Federal Open Market Committee (2022b).

³ As indicated in the minutes of the March 2022 FOMC meeting, FOMC participants generally agreed that after balance-sheet reduction was well underway, it would be appropriate to consider sales of agency mortgage-backed securities. See the Federal Open Market Committee (2022a), pp. 4-5.

mainly Treasuries will help to minimize the effect of the Fed's holdings on the allocation of credit across economic sectors.⁴

As is always the case, we will be calibrating our monetary policy based on the implications of incoming information for the economic outlook and on the progress toward our monetary policy goals. Monetary policy acts with a lag on the economy. It is unlikely that we have seen the full effect on households and businesses of the rate increases we have implemented so far. Moreover, because of the lagged effects of monetary policy, it would not be appropriate to continue moving rates up until inflation is back down to 2 percent. That said, given the current level of inflation and the economic outlook, I believe that further increases in our policy rate are needed.

We will need to move policy into a restrictive stance in order to put inflation on a sustained downward trajectory to 2 percent. That means that short-term interest rates adjusted for expected inflation, that is, real interest rates, will need to move into positive territory and remain there for some time. Right now, nominal short-term interest rates are lower than expected inflation, so short-term real interest rates are still negative and monetary policy is still accommodative. My current view is that it will be necessary to move the nominal fed funds rate up to somewhat above 4 percent by early next year and hold it there; I do not anticipate the Fed cutting the fed funds rate target next year. But let me emphasize that this is based on my current reading of the economy and outlook. While it is clear that the fed funds rate needs to move up from its current level, the size of rate increases at any particular FOMC meeting and the peak fed funds rate will depend on the inflation outlook, which depends on the assessment of how rapidly aggregate demand and supply are coming back into better balance and price pressures are being reduced.

⁴ One potential way to implement sales would be to sell agency securities up to the cap in any month in which principal payments were less than the cap. This is similar to our treatment of Treasuries. Another way to implement sales would be to set a monthly floor on reductions, which would be met first by principal payments received and then by sales. See Mester (2022a).

Making that assessment will remain challenging because there is a high level of uncertainty surrounding the outlook for the global economy. Both the demand side and the supply side of the economy will be affected by a variety of forces, including the war in Ukraine and the energy situation in Europe, the global economic outlook, the sentiment of consumers and businesses and their reaction to elevated inflation readings, changes in supply chain disruptions, and labor force participation.

In formulating my monetary policy views, I will be guarding against declaring victory over the inflation beast too soon. Doing so would put us back in the stop-and-go monetary policy world of the 1970s, which was very costly to households and businesses.⁵ Before I conclude that inflation has peaked, I will need to see several months of declines in the month-over-month readings.

I will be carefully watching measures of inflation expectations, particularly expectations of inflation over the medium and longer term. The rise in inflation expectations since last year has been concentrated in shorter-term expectations, which tend to move with gasoline prices and the prices of other salient items like food. Nonetheless, medium- and longer-term expectations remain at the upper end of the range of values consistent with our 2 percent inflation goal, and they could move up further depending on inflation developments over the balance of the year. A risk-management perspective on monetary policymaking strongly argues against being complacent about a rise in longer-term expectations. If longer-term inflation expectations were to become unanchored and move above levels consistent with our longer-run inflation goal, high inflation would become embedded in the economy, affecting the actions of both firms and consumers; at that point, it would be considerably more difficult and more costly to bring inflation down. Better economic outcomes are achieved when policymakers assume that rises in inflation and inflation expectations are persistent and act forcibly to bring both down.⁶ Such action gives the public

⁵ For a short, readable history, see Sablik (2013).

⁶ See Mester (2022b), De Pooter, et al. (2016), Walsh (2022), and Schnabel (2022).

more confidence that policymakers are committed to ensuring price stability, and this helps to anchor the public's expectations about inflation, reinforcing the effect of the policy action itself.

Commitment and Follow-Through

The return to price stability will take some time and a lot of fortitude. There will be bumps along the road. Financial markets could well remain volatile as financial conditions tighten further; growth could slow more than expected and return to negative territory; and the unemployment rate could move above estimates of its longer-run level. This will be painful in the near term but so is high inflation. High inflation imposes costs on households and businesses in both the short and long run. It eats into savings and makes it hard to plan for the future. Perhaps Paul Volcker said it best as he fought inflation in the 1980s: "...failure to carry through now in the fight on inflation will only make any subsequent effort more difficult, at much greater risk to the economy."⁷

In summary, price stability is the foundation for sustaining maximum employment and a healthy, productive economy over time. I do not view the current situation as one in which there is a tradeoff between our two monetary policy goals. If we fail to take decisive action to get inflation down and firmly anchor inflation expectations, we will not be able to sustain healthy labor markets over the medium and long run, to the detriment of the public.

⁷ Volcker (1981), p. 2.

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