An Update on the Economy and Monetary Policy: Perseverance in Returning to Price Stability

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Introduction

I thank the Economic Club of New York for the opportunity to speak with you today. I am looking forward to the dialog. It is likely no surprise that I will focus my prepared remarks on inflation and how monetary policymakers will persevere in fostering a return to price stability. 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.

Unacceptably high and persistent inflation remains the key challenge facing the U.S. economy. Inflation has been running well above 2 percent for almost a year and a half, and the risks to inflation forecasts are skewed to the upside. Everyone is feeling the brunt of high inflation. It is imposing a particularly onerous burden on those households and businesses that do not have the wherewithal to pay more for essentials like food, gasoline, and shelter. Lower-income households spend a higher proportion of their income on these essentials, and these components have had some of the strongest price increases. We have moved from a situation in which households and businesses could be rationally inattentive to inflation to one in which inflation is on everyone's mind, with lower-income households having to make hard choices about how to spend their money to make ends meet.

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. Without price stability, businesses and households have to divert attention to trying to preserve the purchasing power of their money, and it becomes more difficult to plan for the future and to make long-term commitments and investments. Hence, high inflation can have negative long-run implications for an economy's potential growth rate and standard of living.

The FOMC is strongly committed to using its tools to return the economy to price stability and it will persevere to make this happen. We are 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, the FOMC has reduced monetary policy accommodation by raising the target range of the fed funds rate by 3 percentage points and by reducing assets the Fed is holding on its balance sheet.

Given the current level of inflation, its broad-based nature, and its persistence, I believe monetary policy will need to become more restrictive in order to put inflation on a sustainable downward path to 2 percent. Given appropriately restrictive financial conditions, my modal outlook is that inflation will move down appreciably next year, to about 3-1/2 percent, and continue to decline, reaching our 2 percent goal in 2025. I anticipate that the return to price stability will entail a period of output growth that is well below trend over the next two years. This below-trend growth will lead to slower employment growth, with the unemployment rate moving up to 4-1/2 percent by the end of next year and up a bit more in 2024. We are likely to experience higher-than-normal levels of financial market volatility as well. At this point, indices constructed by the St. Louis Fed and the Kansas City Fed point to low levels of financial stress, but we will need to remain attentive to financial vulnerabilities.[1] With growth well below trend over the next couple of years, it is possible that a shock could push the U.S. economy into recession for a time. None of this is painless, but the high inflation we are experiencing is already inflicting pain on many people. The necessary costs incurred now for the economy to transition back to price stability are much lower than the costs borne later were inflation to become embedded in the economy, influencing wage- and price-setting behavior, investment decisions, and longer-term productivity growth. 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."[2]

[1] The St. Louis Fed Financial Stress Index is available at https://fred.stlouisfed.org/series/STLFSI3. The Kansas City Financial Stress Index is available at https://www.kansascityfed.org/data-and-trends/kansas-city-financial-stress-index/current-release/.

[2] See Paul A. Volcker, "No Time for Backsliding," remarks at the National Press Club, Washington, DC, September 25, 1981, p. 2. (https://fraser.stlouisfed.org/title/statements-speeches-paul-a-volcker-451/time-backsliding-8243)

Economic Growth

The inflation we are experiencing today 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. Indeed, both aggregate demand and aggregate supply were affected by the pandemic and by the responses of households, businesses, and policymakers to it. Mandated shutdowns and the voluntary pullback in demand for high-contact services led to a shift in spending early in the pandemic from services to goods. When the economy reopened, demand surged. This strong demand was supported by the extraordinary level of fiscal transfers and accommodative monetary policy applied during the height of the pandemic.

Economic growth is slowing down from last year's robust 5-3/4 percent pace. Indeed, the level of real GDP decreased in the first half of this year, but current estimates suggest that it resumed rising in the second half. Activity is slowing partly in response to the monetary policy actions taken this year, which have led to tighter overall financial conditions. This is most easily seen in the housing market. Housing demand increased during the pandemic as housing preferences shifted. Housing supply, which was already somewhat constrained before the pandemic, could not keep up with increased demand and house prices rose. This year housing market activity has slowed appreciably as mortgage rates have risen 3-1/2 percentage points since the start of the year. Housing starts and sales have moved down. House price inflation is beginning to ease but the year-over-year increase in house prices is still in double digits and well above pre-pandemic levels; growth in rents also remains high.

In addition to tighter financial conditions, the slowdown in economic activity more broadly 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. Both consumer spending and business investment have decelerated from the robust pace seen last year, and as the effects of the pandemic have waned, consumption has begun to shift from goods to services.

The supply side of the economy remains constrained relative to demand. There are signs that supply chain bottlenecks, which have stemmed from pandemic-related shutdowns across the globe and the war in Ukraine, have begun to ease.[3] Our business contacts tell us that supply chain disruptions remain a challenge but over time they have learned to navigate through them more effectively. They report that the larger factor holding back production is the lack of available workers.

Labor Markets

We are seeing some signs of moderation in the labor market, but overall conditions remain very strong and labor demand is still outpacing labor supply. The number of job openings has fallen this year, but there are still 1.7 openings per unemployed person. Back in 2019, another time of tight labor markets, there were about 1.2 openings per unemployed worker. Last year, job gains averaged over 550 thousand per month. This year, through September, job gains have eased to an average of 420 thousand per month, but that is still very strong job growth by historical standards. The unemployment rate is lower now than it was at the start of the year, and at 3.5 percent is at a 50-year low. The participation rate of prime-age workers has returned to where one would expect it to be based on demographics. 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 demand and supply. But typically, most people who have retired and have begun to receive Social Security payments do not return to the job market. I don't expect to get much help from immigration either: net migration

[3] The Federal Reserve Bank of New York's Global Supply Chain Pressure Index (GSCPI) has fallen appreciably this year but remains above its pre-pandemic level. And if transportation costs rise again, supply chain pressures may also begin to rise. The GSCPI is available at https://www.newyorkfed.org/research/policy/gscpi#/overview.

has been declining since the late 1990s. So it is likely that much of the rebalancing will need to come on the labor demand side. This could occur mainly through firms reducing the number of workers they are seeking rather than through layoffs. Indeed, many employers have told us that because it has been so hard to attract and retain workers over the past two years, they will strive to keep them on their payrolls even if demand for their products slows down. This would result in a smaller rise in the unemployment rate than has been seen in other economic slowdowns.

The imbalance between labor demand and supply has put upward pressure on wages. The employment cost index for private industry workers accelerated over the six months ending in June, rising at a 6 percent annual pace. If you squint, more recent reports suggest that wage pressures may be starting to stabilize. For example, average hourly earnings rose at about a 4-1/2 percent annual pace in the three months ending in September, compared to a little over 4-3/4 percent in 2021. With trend productivity growth estimated to be around 1-1/4 to 1-1/2 percent, nominal wage growth will need to moderate to around 3-1/4 to 3-1/2 percent to be consistent with price stability. Even with the moderation in nominal wage growth that will occur as the economy returns to price stability, workers will be better off. In real terms, workers have been losing ground because wage increases have not kept up with inflation. Indeed, since April of last year, wages adjusted for inflation have been declining. If real wages continue to decline, it will be difficult to attract people back to the workforce, exacerbating the imbalance in the labor market.

Inflation

Despite some moderation on the demand side of the economy and nascent signs of improvement in supply side conditions, there has been no progress on inflation. Inflation readings have persisted at the highest levels in 40 years. Measured year-over-year, in August, PCE inflation was still running over 6 percent and CPI inflation was over 8 percent. The core measures, which omit food and energy prices, and the median and trimmed-mean measures, which exclude components with the most extreme movements each month, tell a similar story of broad-based, persistently high inflation.[4] I note that we look at these measures not because food and energy prices or the prices of other volatile components, such as apparel, are not important parts of a household's consumption basket. Indeed, our long-run inflation target is based on total PCE inflation, which includes all components. But we look at these alternative measures because they can give us a better sense of where inflation is likely going. Measured year-over-year, these underlying inflation measures all moved up in August. The month-to-month changes in the inflation measures have shown no real decline, so we cannot even say inflation has peaked yet, let alone that it is on a sustainable downward path to 2 percent. 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 level since the early 1990s, with growth in housing rent and shelter costs likely to keep inflation elevated for some time.

In my view, even with appropriate monetary policy actions, given inflation dynamics, it will take a couple of years before inflation returns to the Fed's 2 percent goal. But I do expect to see meaningful progress over the next year as output growth and employment growth slow and there is some improvement in supply side conditions. A key factor in this outlook is that medium- and longer-term inflation expectations remain anchored at levels consistent with our 2 percent goal despite current high inflation readings. This anchoring should help to bring inflation back to our goal without as large a change in the output gap. It is the job of monetary policymakers to ensure that inflation expectations remain well anchored.

[4] The Federal Reserve Bank of Cleveland produces the median and trimmed-mean CPI inflation rate and the median PCE inflation rate. 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 inflation measures and analyses of inflation and inflation expectations to inform policymakers, researchers, and the general public. (https://www.clevelandfed.org/our-research/center-for-inflation-research.aspx)

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. And as always, we are 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 so we need to be forward looking. It is unlikely that we have seen the full effects on households and businesses of the latest rate increases we have implemented and it would not be appropriate to continue moving rates up until inflation is back down to 2 percent. But it is also the case that based on Fed communications, financial conditions began to tighten well before our first rate increase in March and those effects have been passing through to the economy. Yet high inflation persists, an indication that we need to increase rates further.

In order to put inflation on a sustained downward trajectory to 2 percent, policy will need to move into a restrictive stance. 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. Although we have raised the nominal fed funds rate by 300 basis points, policy is not yet restrictive. The median projection for the longer-run nominal fed funds rate in the September Summary of Economic Projections (SEP) of FOMC participants is 2.5 percent, which is my own estimate as well.[5] This means that if inflation were 2 percent, and inflation expectations were well anchored at levels consistent with that goal, a real fed funds rate of half of a percent would be neutral in the sense of neither stimulating nor restraining economic activity. But that is an important "if." Currently, inflation and shorter-term inflation expectations are well above 2 percent. If we adjust the current nominal fed funds rate by the SEP median projection for inflation next year, which is 2.8 percent, policy is still a tad accommodative. Further funds rate increases

[5] See Federal Open Market Committee, "Summary of Economic Projections," September 21, 2022. (https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20220921.pdf)

are needed to get policy into a restrictive stance, and the median fed funds rate path in the SEP has rates moving up to 4.4 percent by the end of this year and to 4.6 percent next year.

Because I see more persistence in inflation than the median SEP projection, the funds rate path I submitted for the September SEP was a bit higher over the next year than the median path, and I do not anticipate any cuts in the fed funds target range next year. But let me emphasize that this is based on my current reading of the economy and outlook, and I will adjust my views as warranted based on the implications of incoming economic and financial information for the outlook and risks around the 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. Given lags in the data, the reconnaissance we receive from our contacts about what is happening on the ground in real-time will be particularly important in assessing the effects of the cumulative tightening on the economy. Making this assessment will be challenging because both the demand and the supply sides of the U.S. economy will continue to be affected by a variety of factors. This includes economic and policy developments in the rest of the world, which can affect the U.S. economy through trade and financial market channels.

We will be operating in an uncertain environment for some time. High uncertainty is usually associated with being cautious, and being cautious is often associated with acting inertially. But in the current environment of high and persistent inflation, a risk management, robust control approach counsels that being cautious does not mean doing less. Instead, it means being very careful to not allow wishful thinking to substitute for compelling evidence, leading one to prematurely declare victory over inflation and pause or reverse rate increases too soon. It means not being complacent that inflation expectations will remain well anchored in this high inflation environment but taking appropriate actions to keep them anchored.

It has been very helpful that medium- and longer-term inflation expectations have moved up less than short-run expectations. They are below current inflation readings, an indication that the public believes that inflation will move back down. Yet the recent declines in medium- and longer-term expectations occurred as gasoline prices declined; the jury is still out about whether these readings will rise again if gasoline prices move back up. In addition, every month that inflation remains highly elevated raises the chances that inflation expectations will become unanchored and that firms and households will begin to make decisions based on persistently high inflation. If that were to happen, returning to price stability would be more difficult and much more costly in terms of lost output and higher unemployment. Even if one doesn't think an unanchoring of inflation expectations is the most likely scenario, the costs of being wrong are high given the current state of the economy. So the robust control approach encourages strong action to keep expectations anchored to prevent the worst-case outcome from actually occurring.[6] In my view, in the current environment, being cautious means that the FOMC should persevere in taking policy actions to return the economy to price stability.

Summary

In summary, inflation remains very elevated and is placing a large burden on households and businesses. The FOMC is committed to taking appropriate action to tighten financial conditions by raising the fed funds rate and continuing to reduce the assets on the Fed's balance sheet in order to return the economy to price stability. Monetary policy is moving into restrictive territory and will need to be there for some time in order to put inflation on a sustained downward path to our 2 percent goal. We will be looking at a variety of incoming data and collecting economic and financial information from our business, labor

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[6] See Loretta J. Mester, "Inflation, Inflation Expectations, and Monetary Policymaking Strategy," remarks at the Distinguished Speaker Series, Massachusetts Institute of Technology, Golub Center for Finance and Policy, Cambridge, MA, September 26, 2022 (https://www.clevelandfed.org/newsroom-and-events/speeches/sp-20220926-inflation-inflation-expectations-and-monetary-policymaking-strategy) and Loretta J. Mester, "Acknowledging Uncertainty," remarks at the Shadow Open Market Committee Fall Meeting, New York, NY, October 7, 2016 (https://www.clevelandfed.org/newsroom-and-events/speeches/sp-20161007-acknowledging-uncertainty).

market, and community contacts to help guide our policy decisions. As is always the case when we are transitioning monetary policy, we will need to continue to weigh the risks of tightening too much against the risks of tightening too little. Given current economic conditions and the outlook, in my view, at this point the larger risks come from tightening too little and allowing very high inflation to persist and become embedded in the economy. As the effects of tighter policy work through the broader economy, I expect my view of the balance of these risks will shift, and I am looking forward to that time because it will mean that we have made meaningful progress on the transition back to price stability.