A Diligent Return to Price Stability

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

Markus' Academy
Princeton Bendheim Center for Finance
Princeton University
Princeton, NJ
(via videoconference)

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diligent (adj): having or showing care and conscientiousness in one's work or duties

I thank Markus Brunnermeier for inviting me to speak in the webinar series he runs as director of the Princeton Bendheim Center for Finance. I make it a point to listen to his webcast, so it is a real honor to participate in this series. 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.

Last week, the FOMC raised its target range of the federal funds rate by 75 basis points to 3-3/4 to 4 percent. We also indicated that we anticipate that ongoing increases in the target range will be appropriate in order to attain a monetary policy stance that is sufficiently restrictive to return inflation to 2 percent. Given the level and persistence of inflation, the journey back to 2 percent inflation will likely take some time. The FOMC is also continuing the process of reducing the size of the Fed's balance sheet by allowing assets to roll off, which also helps to firm the stance of monetary policy.

[Figure 1. Federal funds rate]

The move last week was the fourth 75-basis-point increase in as many meetings and the funds rate target is now 375 basis points higher than it was at the start of the year. Compared to history, this has been a brisk pace of increases in our policy rate. But compared to history, the economy is experiencing very high and persistent inflation, and the real policy rate is just beginning to move into restrictive territory. Nonetheless, overall financial conditions are tighter than at the start of the year: Treasury yields, mortgage rates, and credit spreads are higher, the dollar has appreciated, and equity prices are lower.

[Figure 2. Inflation, year-over-year]

Indeed, unacceptably high and persistent inflation remains the key challenge facing the U.S. economy. Inflation rates remain at 40-year highs. Measured year-over-year, in September, PCE inflation was still running over 6 percent and core PCE inflation moved up in September to over 5 percent. The median and trimmed-mean measures, which exclude components with the most extreme movements each month, tell a similar story of persistently high inflation.[1]

[Figure 3. Inflation, 3-month change, annualized]

A positive sign is that the three-month changes in underlying inflation measures are lower now than they were in June, although they remain high. Other positive signs are that commodity prices have moved down and goods inflation has begun to ease. This morning's October CPI report also suggests some easing in overall and core inflation. On the other hand, services inflation, which tends to be sticky, has not yet shown signs of slowing. In addition, inflation continues to be broad-based. In September's PCE inflation report, the prices of about half of the items people buy were at least 5 percent higher than they were a year ago, and we've seen little improvement in this share. Inflation is particularly difficult for people in lower-income households, who spend a larger share of their income on essentials like food, shelter, and energy, components that have seen some of the largest price increases.

[Figure 4. GDP growth and sectors]

In order for inflation to fall, there will need to be further slowing in product and labor markets, bringing demand into better balance with supply to alleviate price pressures. We are beginning to see demand in product markets slowing, partly in response to higher interest rates. Real output contracted in the first half of the year. It grew in the third quarter, but final sales to private domestic purchasers were essentially flat. Growth in consumer spending slowed and residential investment fell significantly. While equipment spending grew at a healthy pace in the third quarter, readings of new orders from the ISM and regional Federal Reserve manufacturing surveys indicate that equipment spending is likely to slow in the coming months. On the supply side, improvement in supplier delivery times and anecdotal reports from

[1] 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)

my business contacts indicate some welcome easing in supply bottlenecks. On balance, I expect real GDP growth to be well below trend this year and next year.

[Figure 5. Employment growth and the unemployment rate]

There has been a slight moderation in labor market conditions, but the labor market remains tight. Job gains have slowed to an average of about 290 thousand per month over the past three months compared to about 540 thousand per month over the comparable period a year ago and job openings are lower than they were in March. Nonetheless, there are still almost two openings per unemployed person, which is well above the level in the strong labor market in 2019. And even with some slowing in output growth, business contacts continue to report that they cannot find the workers they need. The unemployment rate, at 3.7 percent, is still very low by historical standards.

[Figure 6. Employment Cost Index]

Another indication that labor demand is outpacing labor supply is strong wage growth. The year-over-year growth rate of the employment cost index is 5 percent, well above the level consistent with price stability, based on estimates of trend productivity growth.

Although growth is slowing, there continue to be some upside risks to the inflation forecast. Russia's continuing war against Ukraine could mean gas and energy prices move higher again this winter and next winter. And I remain cognizant of the fact that economists' forecasts – private sector, the FOMC's, and my own – have underestimated the level of inflation and its persistence for almost two years. Nonetheless, I do expect inflation to begin to slow meaningfully next year and the following year, reaching our 2 percent goal in 2025. This is because the FOMC is strongly committed to returning the economy to price stability. We will be diligent in making that happen, that is, we will proceed with care and conscientiousness.

[Figure 7. Near-term and longer-term inflation expectations]

The behavior of longer-term inflation expectations reflects that commitment. Near-term expectations have risen significantly with actual inflation, and they have fallen in recent months as gasoline prices have declined. Inflation expectations over the longer term have risen much less. They remain reasonably well anchored at levels consistent with our goal and that should help to lower inflation without as large of a slowdown in activity. However, we cannot take that anchoring for granted. The longer actual inflation and near-term inflation expectations remain elevated, the greater the risk that longer-term inflation expectations become unanchored and high inflation permeates wage- and price-setting behavior and investment decisions, making it much more costly to return inflation to our goal.

[Figure 8. November FOMC statement forward guidance]

We have moved rates up expeditiously this year, starting from a very accommodative stance to a stance that is becoming restrictive. The focus had been on how quickly we could get to that restrictive stance. Now the focus can shift to the appropriate level of restrictiveness that will return the economy to price stability in a timely way. Given the current level of inflation, its broad-based nature, and its persistence, I believe monetary policy will need to become more restrictive and remain restrictive for a while in order to put inflation on a sustainable downward path to 2 percent. As indicated in the FOMC statement last week, in determining the pace of future increases, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments. All of these factors figure into the economic outlook and risks around the outlook, which inform our policy decisions.

Precisely how much higher the fed funds rate will need to go and for how long policy will need to remain restrictive will depend on how much inflation and inflation expectations are moving down, which depends on how much demand is slowing, supply challenges are being resolved, and price pressures are easing. To help me make the assessment of how high and how long, I will be looking at a variety of incoming information and data, including the official statistics, survey evidence, and reports from our business, labor market, and community contacts, which are more forward looking than other data sources. In December, the Committee will be releasing a new set of economic projections, which will incorporate each participant's thinking about the appropriate path of policy.

The transition back to price stability will take some time and will not be without some pain. It is likely that there will continue to be higher-than-normal levels of financial market volatility, which can be difficult to navigate. With growth likely to be well below trend, it could easily turn negative for a time. Business contacts tell us that given how hard it has been to attract and retain workers over the last two years, they intend to keep their workers even as the economy slows. If so, we could see less of an increase in the unemployment rate than is typical in an economic slowdown. However, it is also possible that the unemployment rate could go up more than anticipated and this would impose difficulties on households and businesses.

But it is important to remember that the current very high inflation is painful as well, as less well-off people and businesses struggle to make ends meet. Moreover, we should not underestimate the consequences of continued elevated inflation on the long-run health of the economy. Without price stability, businesses and households have to divert their attention to trying to preserve the purchasing power of their money. It becomes more difficult to plan for the future and to make long-term commitments, and decisions regarding investments in physical and human capital are distorted. Without price stability we will not be able to sustain healthy labor market conditions over the medium and long run, which is inconsistent with the maximum employment part of our dual mandate. This means that continued high inflation can have negative long-run implications for an economy's potential growth rate and standard of living. So returning the economy to price stability remains our priority.

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. Tightening too much would slow the economy more than necessary and entail higher costs than needed. Tightening too little would allow high inflation to persist, with short- and long-run consequences, and necessitate a much more costly journey back to price stability. We will need to be very diligent in setting monetary policy to return the economy to price stability and be judicious in balancing these risks so as to minimize the pain of the journey.

Despite the moves we have made so far, given that inflation has consistently proven to be more persistent than expected and there are significant costs of continued high inflation, I currently view the larger risks as coming from tightening too little. As policy moves further into restrictive territory, the effects of our cumulative tightening will work through to the broader economy, and I anticipate that we will see inflation pressures ease. At that point, I expect that my view of the balance of these risks will shift, and I will welcome that shift because it will mean that inflation is moving down in a meaningful way.

Figures for
"A Diligent Return to Price Stability"

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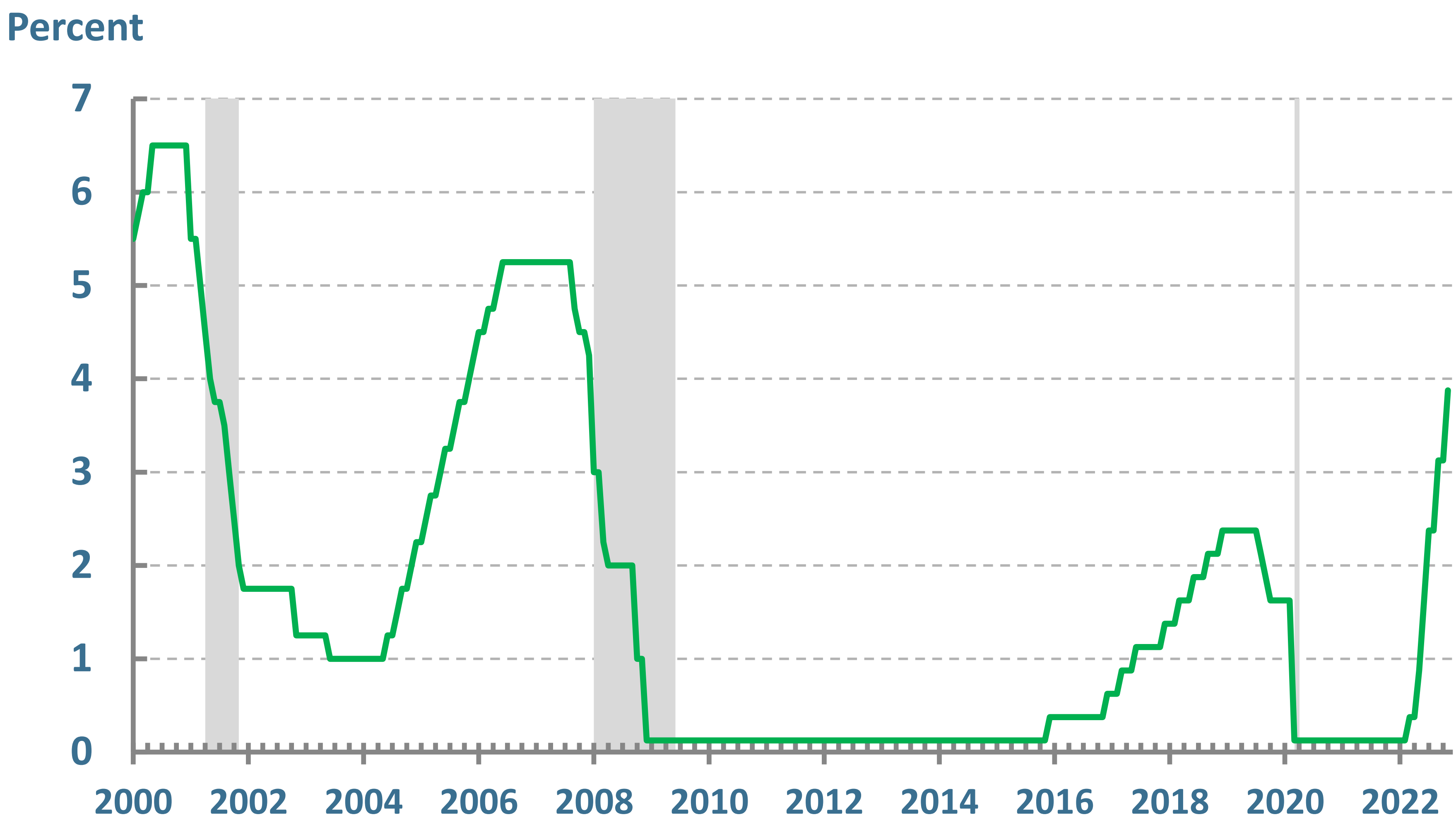
Figure 1. The FOMC has raised the fed funds rate target by 375 basis points so far this year



Source: Federal Open Market Committee via Haver Analytics
Monthly data, end of period, midpoint of target range starting in Dec 2008: Last obs. November 2022

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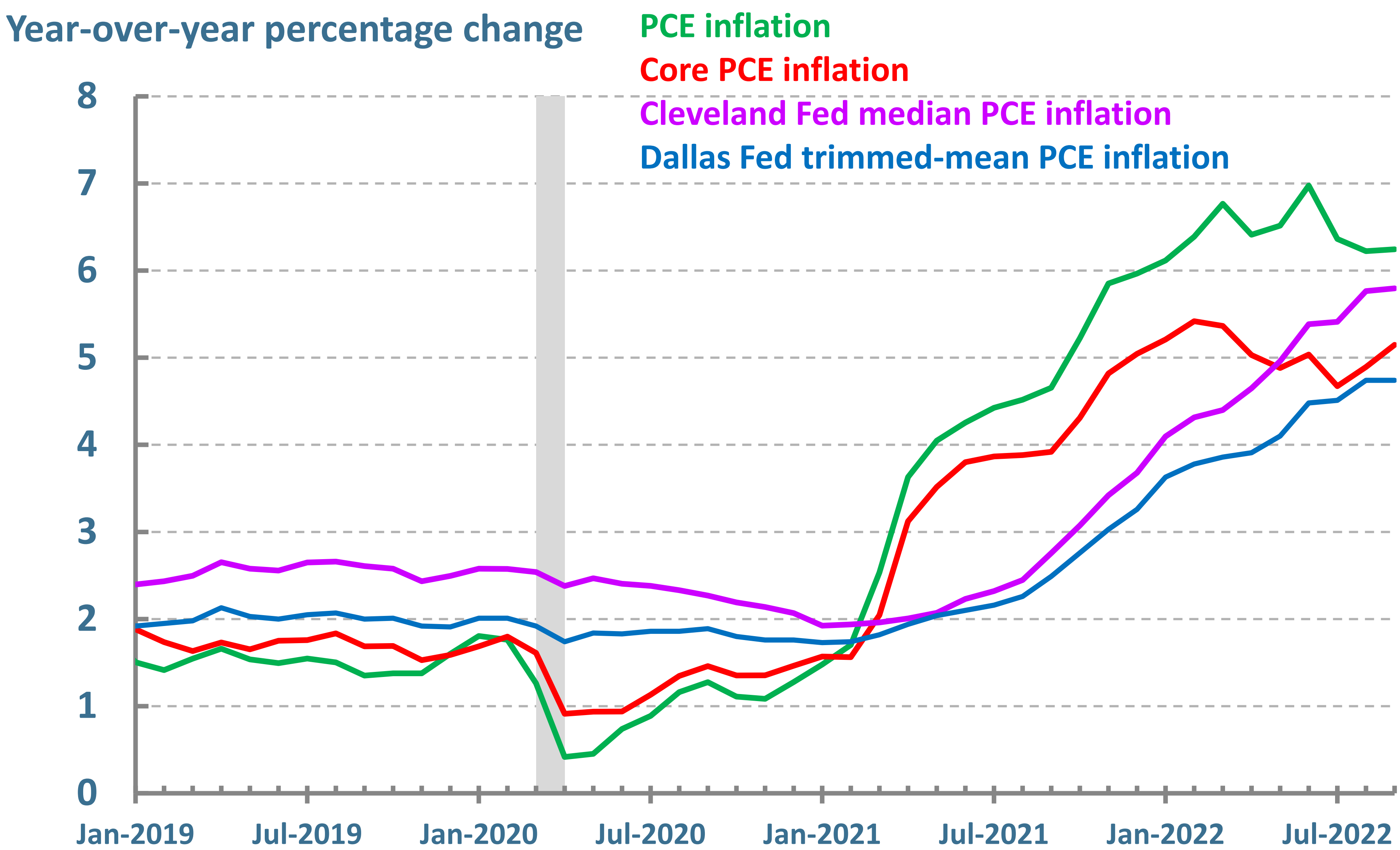
Figure 2. High inflation has been persistent and broad-based



Source: Bureau of Economic Analysis, Federal Reserve Bank of Cleveland, Federal Reserve Bank of Dallas via Haver Analytics

Monthly data: Last obs. Sept 2022

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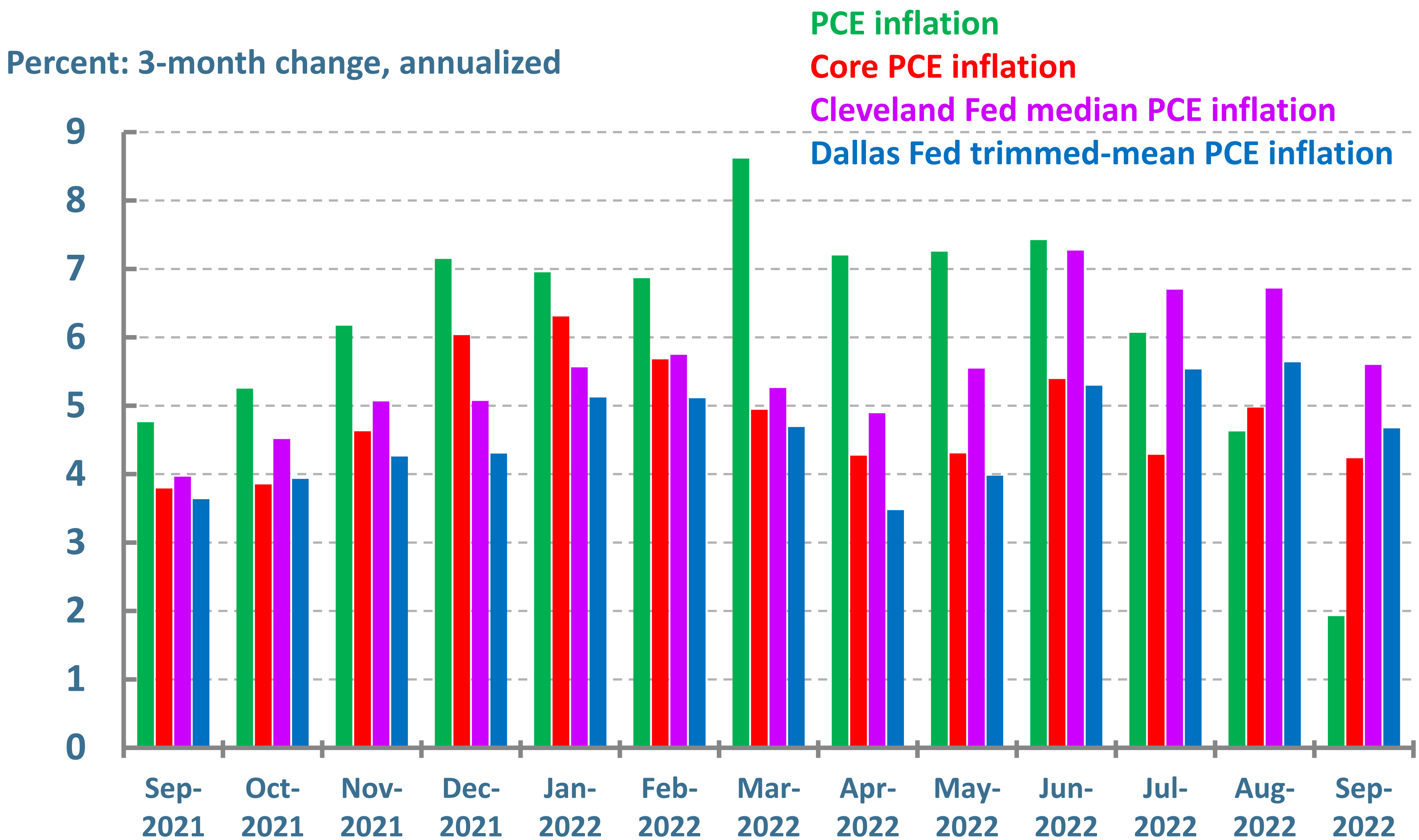
Figure 3. Decline in PCE inflation reflects lower energy prices. There has been less decline in underlying measures.



Source: Bureau of Economic Analysis, Federal Reserve Bank of Cleveland, Federal Reserve Bank of Dallas via Haver Analytics

Monthly data: 3-month change, annualized: Last obs. Sept 2022

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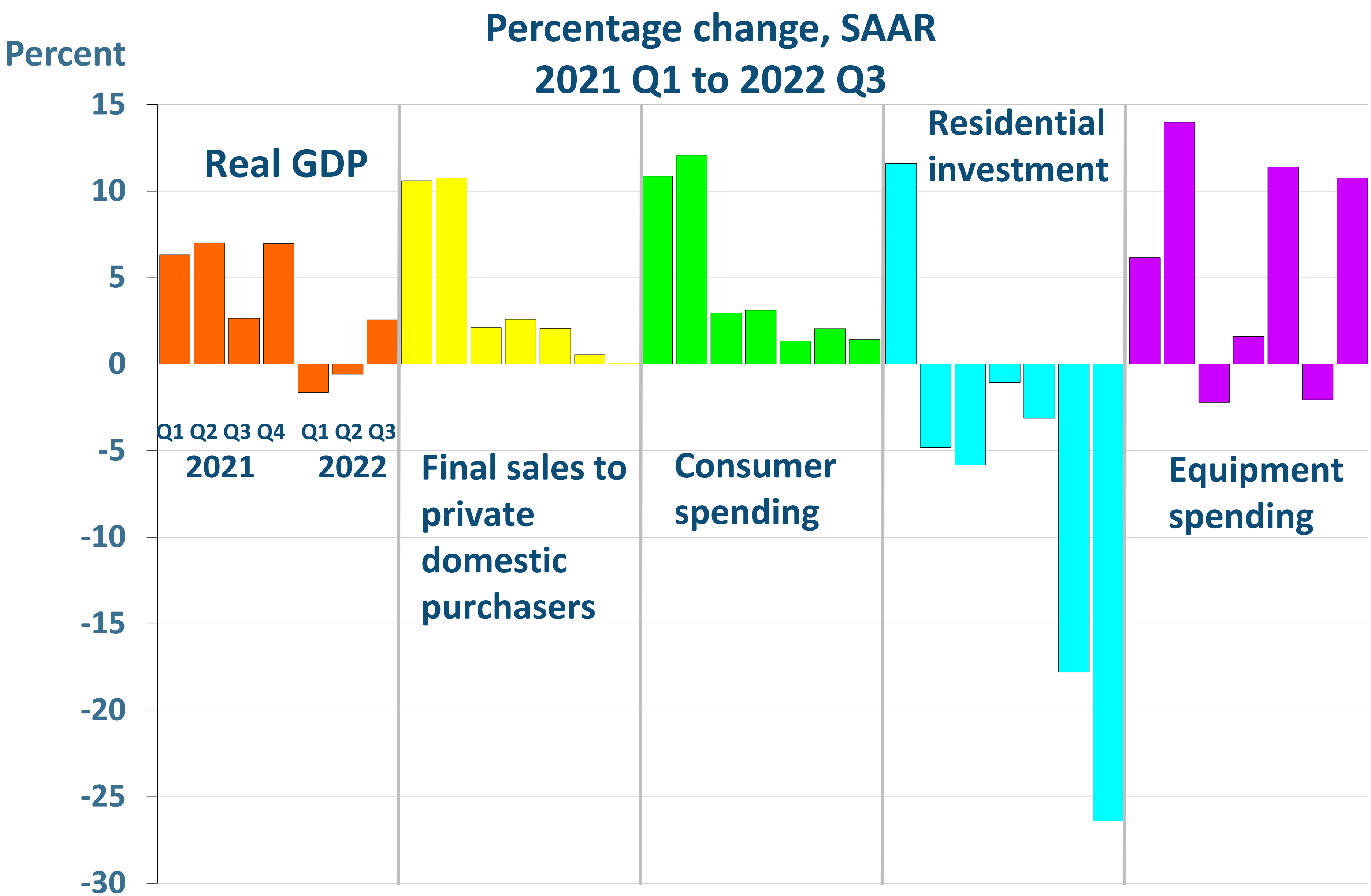
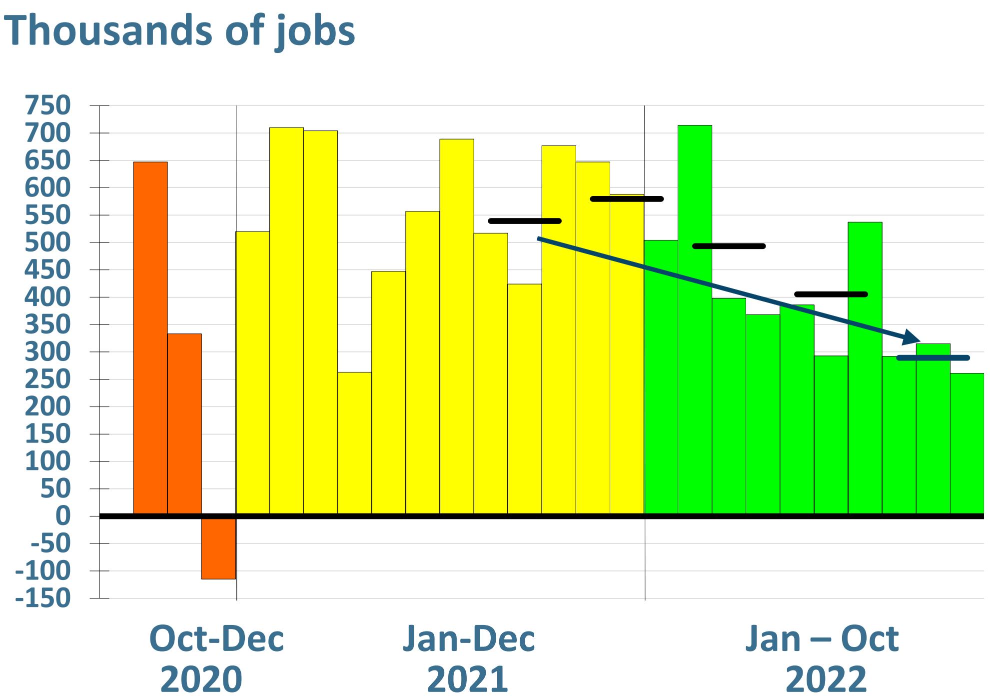
Figure 4. Output growth has slowed



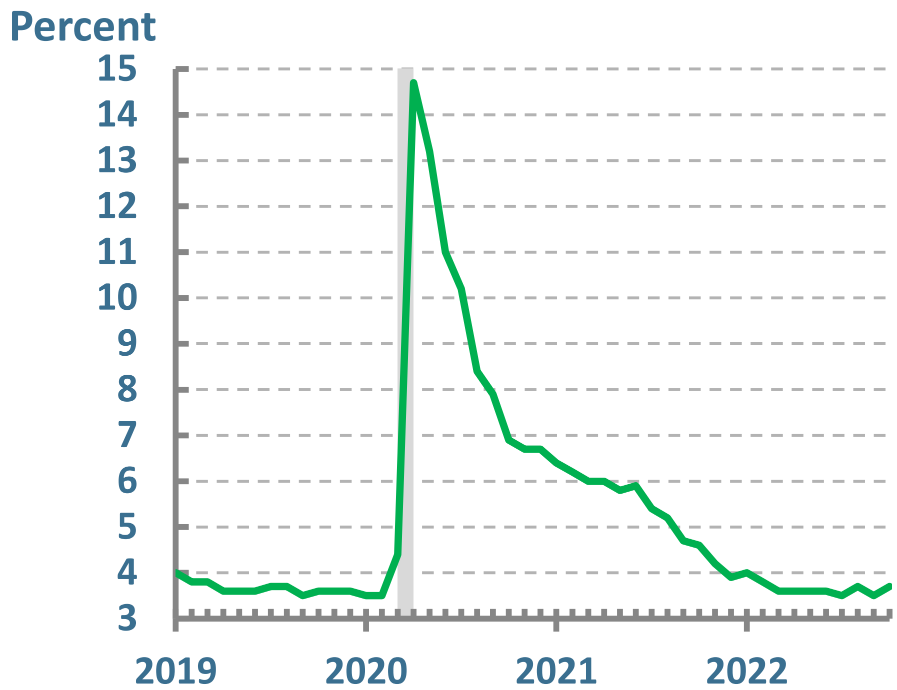
Source: Bureau of Economic Analysis via Haver Analytics
Quarterly data: Last obs. 2022 Q3

Figure 5. Labor markets remain tight

Monthly change in payroll employment and 3-month average change

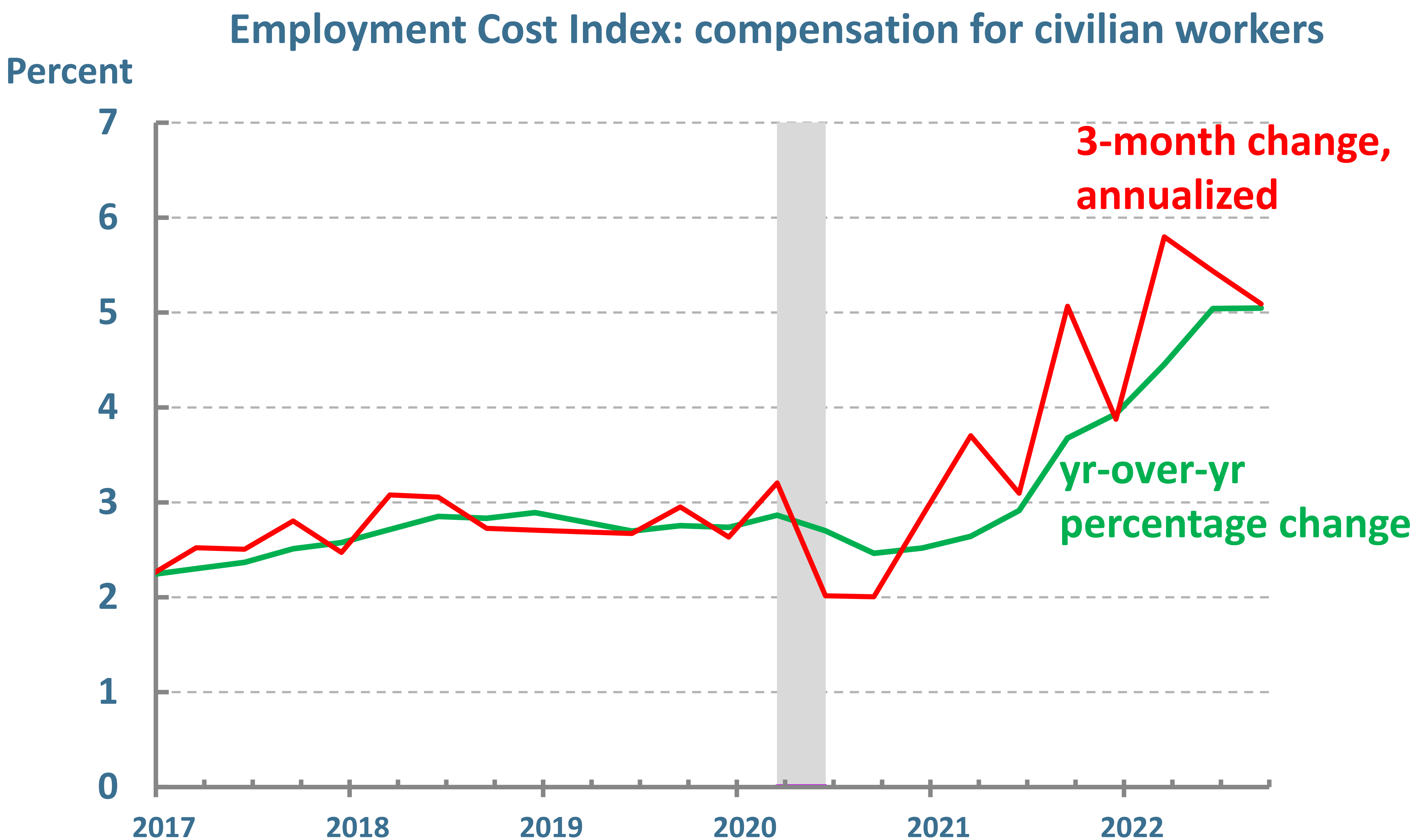


Unemployment rate



Source: Bureau of Labor Statistics via Haver Analytics
Monthly data: Last obs. October 2022

Figure 6. Compensation growth is well above the level consistent with price stability



Source: Bureau of Labor Statistics via Haver Analytics
Quarterly data: Last obs. 2022 Q3

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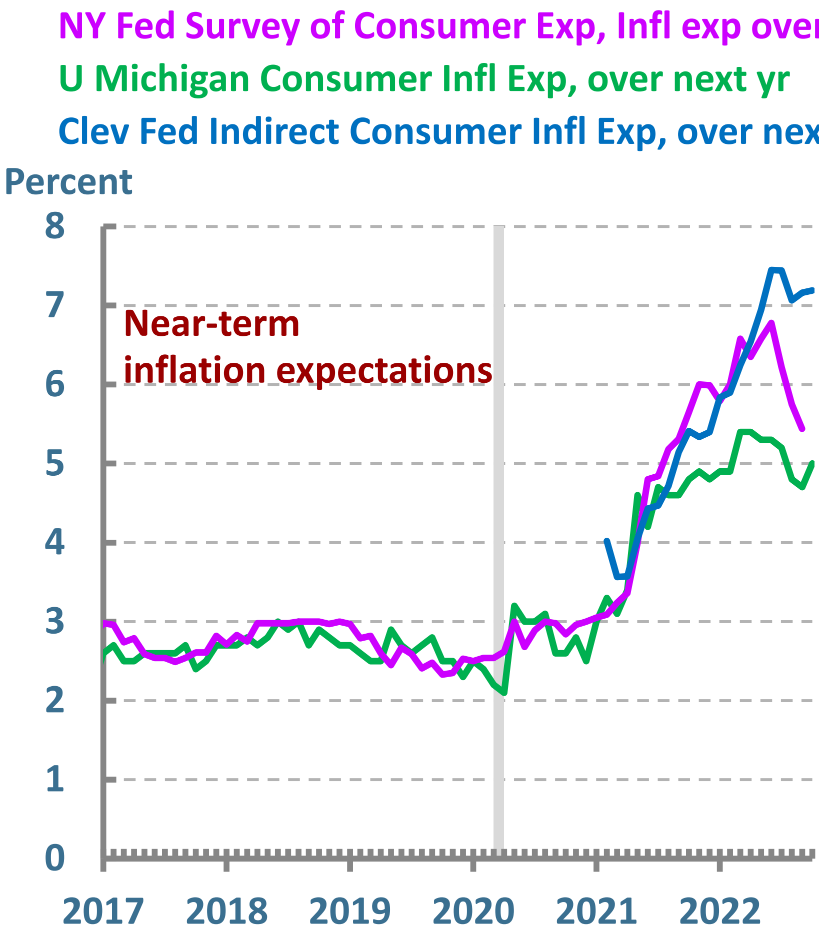
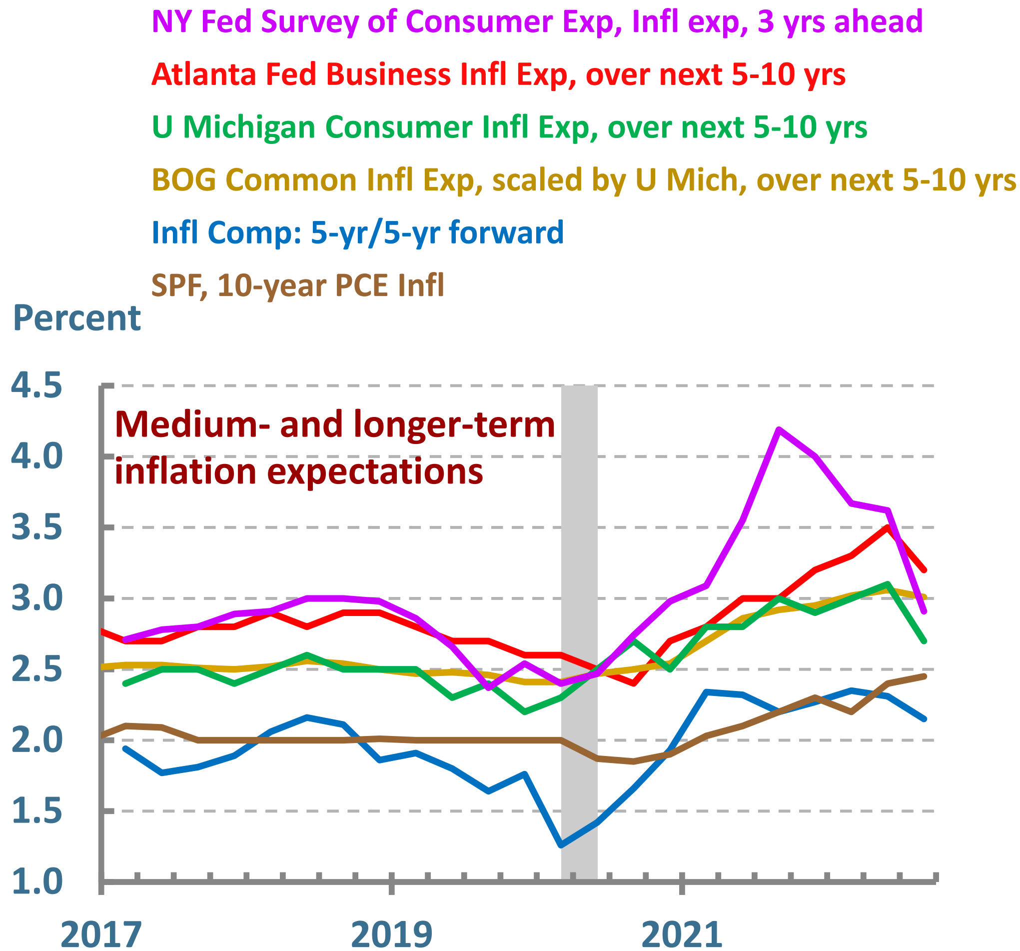
Figure 7. Near-term inflation expectations have moved up with inflation. Medium- and longer-term inflation expectations are lower than current inflation and have remained reasonably well anchored.





Source: Federal Reserve Board, Federal Reserve Banks of Atlanta, Cleveland, Philadelphia, and New York, University of Michigan via Haver Analytics

Monthly data for near-term measures (weekly avg for Clev Fed): last obs. Oct 2022 for U Mich and Clev Fed and Sept 2022 for NY Fed

Quarterly data for medium- and longer-term measures (last month of qtr for NY Fed, U Mich, and Infl Comp): last obs. 2022Q3

Figure 8. Monetary policy going forward

November 2022 FOMC statement:

The Committee anticipates that

- ongoing increases in the target range will be appropriate…
- in order to attain a stance of monetary policy that is sufficiently restrictive…
- to return inflation to 2 percent over time.

In determining the pace of future increases in the target range, the Committee will take into account

- the cumulative tightening of monetary policy,
- the lags with which monetary policy affects economic activity and inflation,
- and economic and financial developments.

Three considerations:

- How fast
- How high
- How long

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