A Diligent and Judicious Return to Price Stability

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Introduction

I thank the Money Marketeers of New York University for inviting me to speak this evening. I look forward to hearing what is on your minds, but first, I would like to present some prepared remarks on the economy and monetary policy. 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.

At its meeting two weeks ago, the FOMC raised the target range of the federal funds rate by 25 basis points to 4-3/4 to 5 percent. Since the Fed began raising rates in March of last year, the cumulative increase has been 475 basis points. In addition, the Fed has been allowing assets to run off its balance sheet in a systematic way according to the plan announced last May, and this is also helping to firm the stance of monetary policy.

The Fed has taken these monetary policy actions because inflation is too high and it is eroding U.S. living standards. High inflation makes it hard for people to make ends meet. High inflation also imposes longer-run costs on our economy. It distorts the decisions households and businesses make about getting an education or training for a new job, or investing in R&D or plants and equipment. In this way, high inflation can harm the pace of innovation, productivity growth, and the potential growth rate of the economy. So it can have lasting detrimental effects on the economy.

The Fed is responsible for ensuring price stability. Fed policymakers are committed to bringing inflation back to our 2 percent goal. Given where we are on that journey, I plan to remain diligent in setting monetary policy to return the economy to price stability in a timely way and to be judicious in balancing the risks so as to minimize the pain of the journey.

The U.S. banking system is sound and resilient. But during the two weeks leading up to the March FOMC meeting, stresses emerged in a small number of banks. The Fed, the Treasury, and the FDIC took swift action to ensure that these stresses did not spill over to the rest of the U.S. banking and financial system. Had such contagion occurred it could have undermined the public's confidence in healthy banks and prevented them from doing their important work to support the savings and credit needs of households and businesses. Banks now have access to liquidity through a new Fed lending facility, as well as the traditional discount window, where they can borrow against sound collateral to ensure that they have sufficient liquidity to serve their customers. The stresses experienced in the banking system in March have eased, but the Fed continues to carefully monitor conditions and is prepared to take further steps as necessary to ensure financial stability.

In the past, when tensions like this have arisen in banking and financial markets, banks have tended to tighten credit availability, making it harder for households and businesses to borrow. In addition, if households and businesses become concerned about the outlook for the banking sector or the overall economy, they could become more cautious in their spending. Going forward, Fed policymakers will continue to assess the magnitude and duration of these effects and their implications for the outlook for inflation and employment and, therefore, for appropriate monetary policy.

Economic Growth

Incoming economic information over the first part of the year has pointed to resilience in underlying demand in product and labor markets and persistence in inflation. Partly in response to higher interest rates, tighter lending standards at banks, and tighter overall financial conditions, economic activity has begun to slow. Real GDP grew at a below-trend pace of 1 percent last year, down from a very robust pace of about 5-3/4 percent in 2021. Growth in the final quarter of last year was over 2-1/2 percent, but much of that was due to firms rebuilding inventories. Inventories aside, growth in real final sales was more modest, just over 1 percent. The slowdown in activity is seen most clearly in the housing sector. Residential investment continues to decline sharply in response to higher mortgage rates, but real estate agents and homebuilders have told us that demand has begun to stabilize. There is still a longer-run structural shortage of available housing, which suggests less downward pressure on prices than one might expect given the rise in interest rates. Construction contacts also indicated that they expect public-sector spending and future infrastructure spending to support activity.

Business fixed investment in equipment and manufacturing activity have slowed, but a few of our business contacts have said that they thought investment has been more resilient than expected given higher interest rates. Indicators suggest that consumer spending, which makes up 70 percent of GDP, grew at a relatively strong pace in the first quarter. This spending has been supported by strong household balance sheets and income growth. Debt-to-income levels of households have been fairly stable, and, in the aggregate, households have been able to service their debt in the rising interest rate environment.

On the supply side of the economy, disruptions in supply chains have generally improved, although not uniformly. Contacts report that bottlenecks have eased, and survey data indicate that delivery times have shortened. This is welcome news because price pressures can be alleviated both through further moderation in demand and further improvement in supply.

Labor Markets

Employment growth has slowed over the past year, firms report that it is somewhat easier to find workers now, and the rate at which people are quitting their jobs is moving down, which is usually is a sign of a moderating labor market. Nonetheless, overall labor market conditions remain strong, with demand for workers outpacing supply. Payroll job gains averaged over 400 thousand per month in January and February, a pickup from the average monthly gain in the fourth quarter of last year. The unemployment rate remains a very low 3.6 percent, near where it has been for much of the past year. The number of job openings has varied from month to month. They are down from their level a year ago, but the ratio of openings per unemployed worker has been running between 1.7 to 1.9 over the six months that ended in February, compared with 1.2 in the six months before the pandemic started.

Recent gains in prime-age labor force participation may be helping to ease the imbalance between labor demand and supply. But this imbalance has put upward pressure on wages, and because labor costs constitute a significant share of a business's expenses, especially in the service sector, this imbalance has also contributed to high inflation. Since workers' wage gains generally have not kept up with inflation, many workers are not better off in real terms. By some measures, wage pressures are beginning to ease, but wages are still growing at an annual rate of about 4-1/2 to 5 percent. This is well above the level consistent with 2 percent inflation given current estimates of trend productivity growth. Indeed, for wage growth at this pace to be consistent with price stability, trend productivity growth would need to be 2-1/2 to 3 percent, instead of the current estimates of 1 to 1-1/2 percent. We have not seen any evidence that trend productivity growth is rising; in fact, productivity growth has declined over the past year. So, workers are still falling behind in their purchasing power and will continue to do so until we get the economy on a sustained path back to price stability.

Inflation

Several factors contributed to the sharp rise in inflation that began in the spring of 2021 in the U.S. These factors include the pandemic and how households, businesses, and monetary and fiscal policymakers responded to it, and Russia's war against Ukraine, which led to sharp increases in food and commodity prices. Imbalances arose between strong demand and constrained supply, and these led to significant upward pressures on prices in an environment of accommodative monetary and fiscal policy.

Inflation remains too high and too stubborn. The February PCE inflation data showed some improvement, but recall that, in January, the data were a bit stronger than analysts expected. So while the level of inflation is lower than it was last summer, in February, the year-over-year measures of both total

PCE inflation and core PCE inflation were in the 4-1/2 to 5 percent range, which is well above our 2 percent goal. The story is the same with other measures of underlying inflation, such as the median and trimmed-mean PCE inflation rates, which exclude components with the most extreme movements each month. Measured year-over-year, both of these measures are between 4-1/2 and 6 percent and have shown little to no improvement since their peaks last August.[1]

The disaggregated data show that the inflation stubbornness is due mainly to the prices of services. Goods inflation has been moving down over time, although it remains considerably above where it was before the pandemic. Shelter price inflation has not improved but the slowdown in housing activity and the deceleration in rents in new leases will eventually show up in the inflation statistics. Inflation in core services excluding shelter has not improved either. It tends to be sticky, is correlated with wage inflation, and is a much larger share of the overall index than goods or housing, since consumers spend a larger share of their income on these services.

For much of the pre-pandemic expansion, core goods inflation was slightly negative, on average, and falling goods prices were pulling inflation down. By the end of that expansion, inflation was nearing our target. In January 2020, PCE inflation had reached 1.8 percent and core inflation had risen to 1.7 percent. That reading reflected 0.75 percent <u>de</u>flation in core goods prices and 2.5 percent <u>in</u>flation in core services prices. That is very different from today. Since the current period of high inflation started in the spring of 2021, core goods prices have been rising, and through last September, inflation in core goods exceeded inflation in core services. To achieve our longer-run goal of 2 percent inflation, we will need to see continued sustained disinflation in both components.

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[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/en/our-research/center-for-inflation-research.aspx).

My expectation is that with tighter financial conditions, demand in product and labor markets will continue to moderate. Output growth will likely be well below trend this year and pick up a bit next year. Employment growth will slow, with the unemployment rate rising to 4-1/2 to 4-3/4 percent by the end of the year. So far, high inflation has not unanchored medium- and longer-term inflation expectations, which remain at levels reasonably consistent with our 2 percent inflation goal. The continued anchoring of inflation expectations is an important factor underpinning my outlook that we will see a meaningful improvement in inflation this year, with inflation moving down to about 3-3/4 percent this year, continuing to improve next year, and reaching our 2 percent goal in 2025. In my modal projection, to put inflation on a sustained downward trajectory to 2 percent and to keep inflation expectations anchored, monetary policy moves somewhat further into restrictive territory this year, with the fed funds rate moving above 5 percent and the real fed funds rate staying in positive territory for some time.

My forecast is similar to the modal forecasts of FOMC participants released two weeks ago, although I see somewhat more persistent inflation pressures than the median forecast among participants. Of course, I also recognize that there is heightened uncertainty around the outlook and, in such an environment, it will be particularly important to continue to collect and assess the whole panoply of incoming information, not only official government statistics but also regional information gathered from our business, labor market, and community contacts; a variety of surveys on economic and banking conditions; and higher-frequency data such as credit card spending. All of this information can help us determine not only where the economy has been but where it is going, which is important when setting appropriate monetary policy since it affects the economy with a lag. The FOMC likes to say that its policy decisions are “data dependent.” It would be wrong to interpret this phrase as saying that we will react to one or two data points. Instead, I view “data dependent” as shorthand for saying that incoming economic information informs my economic outlook and my assessment of risks, which, in turn, inform my view of appropriate monetary policy. (You can see why we needed shorthand!)

Monetary Policy

In making its monetary policy decisions, the FOMC is always guided by its strong commitment to achieving its statutory goals of price stability and maximum employment. The FOMC has come an appreciable way in bringing policy from a very accommodative stance to a restrictive one. We have taken actions to address the stresses that emerged last month in the banking system. Our decision in March to raise the fed funds rate by another 25 basis points reflected the persistence in underlying inflation and the need to move policy into a sufficiently restrictive stance to return inflation to 2 percent over time.

Precisely how much higher the federal funds rate will need to go from here and for how long policy will need to remain restrictive will depend on how much inflation and inflation expectations are moving down, and that will depend on how much demand is slowing, supply challenges are being resolved, and price pressures are easing. The FOMC indicated in its March statement that it anticipates that some additional policy firming may be appropriate. In determining the extent of future increases in the target range, the FOMC 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.

Even before the recent stresses, banks had begun to tighten their credit standards. Credit has become less available as interest rates have risen. This is the typical way in which monetary policy tightening transmits to the broader economy. The recent tensions in the banking system could well result in banks further tightening their credit standards, and households and businesses may become more cautious in their spending. Directionally, we know that credit conditions are likely going to be somewhat tighter, and we will be assessing the magnitude and duration of these effects on the economic outlook to help us calibrate the appropriate path of monetary policy going forward.

Financial Stability

Let me conclude by noting that this is standard operating procedure for monetary policy: evaluating the implications of economic and financial developments for the economic outlook and adjusting the monetary policy path if needed. This is different from using monetary policy to address the stresses in the banking or financial system instead of pursuing our monetary policy goals.

In fact, both price stability and financial stability are important for a healthy economy, and I do not see a tradeoff between the two. Well-formulated and well-communicated monetary policy that achieves our dual-mandate goals of maximum employment and price stability supports financial stability by allowing households, firms, and financial institutions to make better investment, saving, borrowing, and lending decisions. A healthy financial system provides valuable credit, risk-management, payment, and liquidity services to households and businesses in support of a sound economy. An unstable financial system can propagate adverse macroeconomic shocks over broad economic sectors and over time to the detriment of macroeconomic stability.

Because a safe, sound, and resilient banking system is of first-order importance to our economy, it is vital that we effectively use our microprudential tools of regulation and supervision and our macroprudential tools, including stress tests, to keep the banking system safe, sound, and resilient. Doing so has the benefit of allowing monetary policy to remain focused on bringing inflation back down to 2 percent in a timely way. This is a very important duty because returning to price stability is necessary for the long-run health of the labor market, the overall economy, and the stability of the financial system.

Thank you for your attention. I look forward to our discussion.