A Timely Journey Back to Price Stability: Are We There Yet? No. Will We Get There? Yes.

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Introduction

I thank Dan Walsh and the 50 Club for inviting me to speak this evening. The FOMC, which sets monetary policy in the U.S., met less than two weeks ago. So this is an excellent time to give you an update on the economy and monetary policy. 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 FOMC.

The Cleveland Fed is only a couple of blocks away from here. We are celebrating the 100th anniversary of our building this year, and we are very proud to be part of the architectural history of Cleveland. We are even prouder to be part of the civic landscape. I feel privileged to represent the Fourth Federal Reserve District, which comprises the state of Ohio and parts of Pennsylvania, Kentucky, and West Virginia, at our policy meetings in Washington. Many of you also play an important role in the monetary policymaking process because you generously provide us with insights into economic conditions, whether it be through our surveys, as members of our advisory councils, or as directors. The reconnaissance that you provide on business activity, the labor market, and financial conditions is often more timely than the official data, so it helps us evaluate not only where the economy is but where it is going. This kind of information helps me formulate my economic outlook and my views on monetary policy to foster the Fed's statutory goals of price stability and maximum employment. Thank you for this public service.

The Journey So Far

Before I turn to the outlook for the economy, it's good to recap where we've been. Before the pandemic hit in early 2020, the U.S. economy had been on very solid ground. It was the 11th year of the expansion and the labor market was very strong. The unemployment rate was at historically low levels, jobs were growing at a strong pace, and participation in the labor force was solid. After being too low for some time, inflation was near the FOMC's longer-run goal of 2 percent.

Of course, the pandemic changed all that.

The economy shut down in March 2020, and fiscal and monetary policymakers took aggressive actions to support households and businesses, ensuring that credit continued to flow and limiting lasting damage to the economy. When public health statistics began to improve in May 2020, many parts of the country began to relax some of their stay-at-home restrictions, and the economy began to reopen.

But it was not business as usual. The mandated shutdowns and the voluntary pullback in demand for high-contact services led consumers to shift spending from services to goods early in the pandemic. As health conditions improved and the economy reopened, demand surged and was supported by fiscal transfers and accommodative monetary policy. Spending has been shifting back from goods to services, although the spending levels in both of these sectors are not yet back to their pre-pandemic trends. The pandemic also led many people to leave the workforce, making it much more difficult for firms to find the workers they needed. Remote work became much more common. This led to changes in the demand for housing, and sales of new and existing single-family homes surged in 2020 and 2021. In addition, supply chains were disrupted, making it much more difficult for firms to keep up with demand for their products. The changes in spending patterns, workforce participation, housing demand, and supply chains led to a situation in which demand in both product markets and labor markets became out of balance with supply. Those imbalances occurred in an environment of accommodative fiscal and monetary policy, which led to a significant increase in inflation starting in the spring of 2021. Russia's invasion of Ukraine in February 2022 added to inflationary pressures, spurring higher prices for oil, food, and other commodities. In 2022, headline inflation reached levels not seen in 40 years, running 7 to 9 percent, depending on the measure.

Economic Developments

In response to the sharp rise in inflation, the Fed began tightening the stance of monetary policy in March of last year. Since then, the FOMC has raised the target range of the federal funds rate, its policy rate, by 5-1/4 percentage points. We are also reducing the size of the Fed's balance sheet by allowing assets to roll off in a systematic way according to the plan announced in May 2022. This balance-sheet reduction

is also firming the stance of monetary policy. The tightening of monetary policy has led to a broader tightening in financial conditions. Treasury yields, mortgage rates, and credit spreads have risen. Banks have been tightening their credit standards, making credit less available to businesses and households, but the contraction in credit has not been sharper than what one might expect given the rise in interest rates.

As this tighter monetary policy has transmitted to the broader economy, demand has begun to moderate. At the same time, supply chain disruptions have improved. Our business contacts report that bottlenecks have eased, and survey data indicate that delivery times have shortened. Businesses have also told us that they have learned how to better navigate supply issues. So demand and supply are adjusting and coming into better balance.

Real output growth has slowed from its robust pace in 2021, but the economy appears to have more underlying momentum than was apparent at the end of last year. Consumers have been particularly resilient. Consumer spending makes up about 70 percent of GDP; it has been increasing at a solid pace this year, supported by strong income growth and savings accumulated during the pandemic. Businesses have moderated their spending on equipment and software as demand has slowed, but our business contacts are more optimistic than they were at the beginning of the year that the economy will avoid a recession. In the housing market, there is a longer-term shortage of available housing; so despite the sharp increase in mortgage rates over the past two years, with the 30-year rate now nearing 8 percent, housing starts and sales of existing homes have stabilized and sales of new single-family homes are beginning to pick up again. This overall performance suggests there is more underlying momentum in the economy than we thought even just three months ago. In fact, FOMC participants' projections of economic growth this year were revised up at our recent meeting.[1] Now, instead of projecting that growth will be well below trend this year, the median projection is that growth will be a bit over 2 percent, which

[1] Four times a year, the FOMC summarizes Committee participants' projections of output growth, the unemployment rate, inflation, and the associated appropriate policy path. For the September 2023 Summary of Economic Projections, see https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20230920.htm.

is somewhat above trend. Growth is expected to slow to below trend next year as tighter credit and financial conditions and waning fiscal support for households weigh on spending.

Labor market conditions remain strong but are moderating, bringing labor demand and supply into better balance. The unemployment rate in Ohio is 3.4 percent, near its historical low. But our business contacts say they are seeing some easing in the labor market, with increases in job applications and in the number of candidates coming in for interviews. Only a small number of firms told us that they plan to lay off workers this year. But many firms said they are slowing their hiring and fewer businesses are hoarding workers since it has become easier to hire. We are seeing the same thing in the national job market. The national unemployment rate is low, at 3.8 percent, with August's rise in the unemployment rate mainly reflecting an increase in labor force participation. Job growth has slowed over the course of the year, with payroll gains averaging 150 thousand per month over the past three months compared to about 300 thousand per month over the first three months of the year. The number of job openings has also been declining, but the ratio of job openings to unemployed workers is 1.5, which is still above the 1.2 level seen in the strong labor market conditions in 2019.

Wage pressures are easing by some measures. Firms in our District tell us they are not having to adjust compensation as frequently as in the last few years except for those workers with specialized skills and in sectors with shortages, including nursing. Expected wage increases among our contacts have moved down, but at 4 percent, they remain higher than wage gains seen before the pandemic. In the nation, wage growth is still well above the level consistent with 2 percent inflation given current estimates of trend productivity growth. While increased labor force participation by prime-age workers is helping to ease the imbalance between labor demand and supply, it seems likely that labor demand conditions will also need to ease further to bring wage growth down to levels consistent with 2 percent inflation. In the September FOMC projections, the median participant expects the unemployment rate to rise over the next year, but only a little, to 4.1 percent, which is consistent with a moderating but still solid labor market.

Inflation

The Fed's inflation goal is 2 percent, measured by the annual change in the price index for personal consumption expenditures, or PCE inflation. Inflation has been running well above the Fed's goal for more than two years. The good news is that the overall economy remains relatively strong, and at the same time, we are making discernable progress on the journey back to price stability. Inflation levels, both the headline numbers, which include food and energy prices, and measures of underlying inflation, including the core, median, and trimmed-mean measures, have moved down from their peaks. Measured year-over-year, total PCE inflation peaked at 7 percent in June of last year. As of this August, it has fallen to about 3-1/2 percent, despite the recent rise in oil prices. Other measures that strip out the components with the most extreme price movements each month and which tend to give a better indication of the inflation trend are also improving. The Cleveland Fed's Center for Inflation Research produces and tracks a number of inflation indicators.[2] The Cleveland Fed's median PCE inflation measure peaked at just over 6 percent in March and is now down to 4-1/2 percent. And core PCE inflation, which omits food and energy prices, peaked at over 5-1/2 percent last year and moved down to under 4 percent in August. The progress is even easier to see when you look at the price changes over shorter time horizons, such as three-month or six-month annualized inflation rates, and when you look at inflation in the prices of goods excluding food and energy.

Despite the progress, inflation remains too high. We will need to see continued progress on inflation in goods prices. Since consumers spend a larger share of their income on services, services have a higher weight in the inflation indices.[3] So we also need to see more progress on inflation in the prices of services. Inflation in housing services, measured by rents and the imputed rents for owner-occupied

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[2] 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/center-for-inflation-research).

[3] About 65 percent of the total consumption basket is core services compared to about 23 percent for core goods. The rest of the basket comprises energy (4 percent) and food at home (8 percent). Housing services, a component of core services, constitute about 15 percent of consumers' total spending.

housing, remains elevated but has begun to slow, reflecting moderating rent inflation in new leases. But inflation in core services excluding housing has shown little improvement over time.

Moreover, the risks to the inflation forecast remain tilted to the upside. We have been helped on the inflation journey by the fact that despite high inflation rates, medium- and longer-term inflation expectations remain reasonably well-anchored in a range consistent with the Fed's goal of 2 percent inflation. But oil prices are now increasing. There is the potential that they will pass through to other core prices and stall progress. In addition, because gasoline prices are particularly salient for households that have to fill up their cars or trucks once or twice a week, rising gasoline prices could begin to make consumers think inflation will be rising again. If so, higher inflation could become embedded in people's view of the economy and affect their behavior in ways inconsistent with price stability.[4] In fact, when we asked our regional business contacts their expectations for inflation, the mean response was nearly 4 percent for the year ahead and 3.2 percent for the next five years, considerably higher than our target.

While we have not yet completed the journey back to price stability, there should be no doubt that the FOMC will get the job done. To achieve our longer-run goal of 2 percent inflation in a sustainable and timely way, we will need to see continued sustained disinflation and that will likely require further moderation of demand in both product and labor markets. This brings me to monetary policy.

Monetary Policy

At its recent meeting, the FOMC decided to maintain the target range of the fed funds rate at 5-1/4 to 5-1/2 percent and to continue to reduce the Fed's securities holdings. In determining the extent of additional policy firming that may be appropriate, the FOMC will be assessing incoming economic and

[4] Cleveland Fed researchers find that households form their expectations of inflation based on their lifetime experience of inflation, which means that acting to bring down inflation in a timely way to limit experience with high inflation will yield longer-term benefits. See Mathieu O. Pedemonte, Hiroshi Toma, and Esteban Verdugo, "Aggregate Implications of Heterogeneous Inflation Expectations: The Role of Individual Experience," Working Paper No. 23-04, Federal Reserve Bank of Cleveland, January 2023. (https://doi.org/10.26509/frbc-wp-202304)

financial developments as well as the cumulative effects of the tightening done so far, since we know that monetary policy affects the economy with a lag. The economic projections released by the FOMC in September indicate that the median participant thinks another rate increase will be appropriate this year and that monetary policy will have to be held sufficiently restrictive for a while in order to get inflation back down to 2 percent.

This is consistent with my own reading of economic conditions, the outlook, and the risks to the outlook. At this point, I suspect we may well need to raise the fed funds rate once more this year and then hold it there for some time as we accumulate more information on economic developments and assess the effects of the tightening in financial conditions that has already occurred. But whether the fed funds rate needs to go higher than its current level and for how long policy needs to remain restrictive will depend on how the economy evolves relative to the outlook. There is considerable uncertainty around the outlook: for example, the slowdown in the Chinese economy, the possibility of an extended UAW strike, and the potential for a government shutdown later this year all pose some risks around the outlook. So policy decisions will need to be guided by actual progress on our dual mandate goals, in particular, whether the good rate of progress we have seen on inflation over the past three months is sustained and whether labor market conditions remain healthy as they moderate. This will require us to carefully monitor economic, banking, and financial market developments and to collect reports from our regional contacts, so that we can set monetary policy in a way that balances the costs over time of over-tightening vs. under-tightening monetary policy. Tightening too much would slow the economy more than necessary and entail higher costs than needed to get inflation back to our goal. Tightening too little would allow high inflation to persist, with short- and long-run consequences, and would necessitate a much longer and more costly journey back to price stability.

A Timely Return to Price Stability

Let me conclude by explaining why I think it is important that we return the economy to price stability in a timely way. I want to guard against becoming complacent with moderating inflation if the pace of that

moderation implies it is going to take longer and longer to achieve the Fed's 2 percent goal. Many forecasters have been underestimating the persistence of inflation since the beginning of this high-inflation episode. FOMC participants have been pushing out the date of when inflation is expected to return to our goal. For example, the June 2021 median FOMC projection had core inflation moving down to 2.1 percent in 2022. A year later, the median projection had core inflation not reaching our goal until after 2024, and now, according to the median projection in September, our 2 percent goal is not expected to be reached until 2026.

When inflation persists at levels above our goal of price stability, the price level is moving up faster than we would like and households and businesses have to pay those higher-than-desired prices. Since the first quarter of 2021, when inflation began to rise, inflation has been running at an annualized pace of nearly 5-1/2 percent, while worker compensation (as measured by the employment cost index for private workers' compensation) has risen less, at an annualized rate of just over 4-1/2 percent. This means that despite sizable increases in nominal wages, compensation adjusted for inflation hasn't been keeping up with the high rate of inflation over this episode. This is likely part of the reason Cleveland Fed surveys find that people have a strong dislike of high inflation.[5]

High inflation also imposes longer-run costs on the economy. It makes it harder to plan for the future, and it affects people's decisions about getting an education or training for a new job and businesses' decisions about whether to invest in new plants and equipment. These types of investments in human and physical capital help determine our economy's pace of innovation and productivity growth and therefore its potential growth rate and our longer-run standard of living. It is costly to our economy in both the short and the long run to allow inflation to remain so high for so long.

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[5] See Ina Hajdini, Edward S. Knotek II, John Leer, Mathieu Pedemonte, Robert W. Rich, and Raphael S. Schoenle, "Low Passthrough from Inflation Expectations to Income Growth Expectations: Why People Dislike Inflation," Federal Reserve Bank of Cleveland Working Paper No. 22-21R, March 2023 (https://doi.org/10.26509/frbc-wp-202221r).

Finally, getting inflation back to 2 percent in a timely way puts the economy in a better position to weather the next shock, whenever it occurs. An economy that is at maximum employment and price stability is a stronger economy and one that is more resilient to shocks.

Summary

So, in summary, the economy is on a good path. Demand is moderating and supply conditions are improving. Labor market conditions remain strong, but the imbalance between labor demand and supply is narrowing and firms are finding it easier to find the workers they need. Progress is being made on inflation, but the level of inflation remains too high. We are likely near or possibly at the peak of the fed funds tightening cycle. Now our task turns to ensuring that we keep monetary policy restrictive for long enough to be confident that inflation returns to our 2 percent goal in a timely way. We are not there yet, but we will get there because price stability is critical 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.