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Containing Inflation

March 18, 2022

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First Friday Economic Outlook Forum

Highlights:

- It's time to begin to normalize rates. The worst of the pandemic is behind us, and we are 22 months into the fastest recovery in our memory.
- The economy is no longer in need of aggressive Fed support. Instead, we need to put ourselves in a position to contain inflation. It's our job to do so — the Fed's mandate requires us to promote stable prices.
- Some worry that raising rates to control inflation necessarily drives the economy into a recession. And with the surge in energy prices since the Ukraine invasion, some even raise the topic of stagflation — a word from the 70s. The rate path we announced this week shouldn't drive economic decline. We are still far from the level of rates that constrains the economy.
- Prior to our meeting, there was much debate about whether the Fed should move faster. We have moved at a 50-basis point clip in the past, and we certainly could do so again if we start to believe that is necessary to prevent inflation expectations from unanchoring. But setting the right pace for rate increases is a balancing act — we normalize rates to contain inflation, but if we overcorrect, we can negatively impact employment, which is the other part of our dual mandate.

Thanks for having me today. It's great to be back in front of this group, and — while I regret that we had to reschedule from January — the timing might actually be better, as the world has gotten even more complicated, and the Fed has been in the news this week. So, today, I want to talk about the economy, but particularly about the topic that put the Fed in the news: interest rates. I caution these are my views alone and not necessarily those of any of my colleagues on the Federal Open Market Committee (FOMC) or in the Federal Reserve System.

You all likely saw that at this week's FOMC meeting, the Fed decided to raise interest rates 25 basis points. In our statement, we said that we anticipate that "ongoing increases in the target range will be appropriate" in order to return inflation to our 2 percent objective. The median member of the FOMC forecasted 7 rate hikes this year and 3-4 next year, moving rates modestly over most estimates of the neutral rate. In his press conference, the chair said we would start to reduce the size of our balance sheet at a coming meeting, and that could be as early as May.

It's time to begin to normalize rates. The worst of the pandemic is behind us, and we are 22 months into the fastest recovery in our memory. By the end of this quarter, GDP will likely exceed not only its pre-pandemic level, but perhaps also its pre-pandemic trend line. Consumer spending is strong, business investment is healthy and the housing market is hot. Underlying demand looks to remain robust, fueled by healthy business and personal balance sheets, the need to replenish low inventories and state governments that are flush with cash. We may see more variants — possibly the one rising today in Western Europe — but we are learning to live with COVID-19.

We now are facing a different challenge: inflation. As demand for goods exploded in the midst of the pandemic, supply chains struggled to keep up. Labor markets also became quite tight. Unemployment has dropped to 3.8 percent. In addition, the pool of those looking for a job has shrunk: Two million fewer workers are in the workforce, and immigration remains well below its pre-COVID-19 trend.[1] Consequently, wages are up: Average hourly earnings have risen 5.1 percent. And price inflation is elevated, with core PCE at 5.2 percent — the highest since April 1983. At first, these conditions seemed temporary, but they have persisted and broadened — making inflation the headline of the day and causing more and more firms to consider raising their own prices.

All of this means the economy is no longer in need of aggressive Fed support. Instead, we need to put ourselves in a position to contain inflation. It's our job to do so — the Fed's mandate requires us to promote stable prices.

You might ask how raising rates contains inflation. The answer varies over different time horizons.

Short-term changes in inflation tend to be driven by factors outside of the Fed's control. Think about the aftermath of a hurricane. Lumber prices increase temporarily as demand spikes for materials to make necessary repairs. An interest rate move wouldn't affect that dynamic. Nor should it try to: These price movements should reverse themselves with no assistance from us. Well, we are still working through the destructive impact caused by the pandemic and now geopolitics. Inflation continues to be impacted by supply chain shortages, low labor force participation and the ebb and flow of the virus — most recently causing lockdowns in Shenzhen, China. And Russia's invasion of Ukraine has affected prices of commodities like energy, aluminum, wheat and nickel.

In the medium and long term, on the other hand, the Fed's rate moves certainly do influence inflation. Milton Friedman's famous analysis showed that monetary policy operates with a lag, which he called "long and variable."

One part of how we influence inflation is quite tangible. Against a backdrop of stable inflation expectations, we raise rates and that reduces demand and eventually prices. Deposit rates increase, thereby creating more incentive to save rather than spend. The dollar appreciates, lessening demand for exports and lowering the price of imports. Borrowing rates rise, reducing capital investment and consumer spending. That's particularly true in interest-sensitive sectors like housing, auto and consumer durables. You are already seeing mortgage rates go up, for example.

Another part is less tangible and occurs through a psychological effect over the longer term. Individuals and firms build expectations about future inflation. Firms then make their pricing and compensation decisions — and individuals make their purchase and employment decisions — in the context of those expectations. If the Fed does its part to control inflation, expectations and price and wage increases stay stable and anchored. If not, they don't, as you might argue has been happening in Turkey.

Happily, so far, U.S. expectations seem to have stayed stable. Long-term market measures of inflation compensation, derived from the TIPS indices, remain in line with our 2 percent target despite short-term inflation and inflation expectations at multidecade highs. Similarly, the Michigan Survey of 5-10-year inflation expectations has only increased modestly. Both are at levels comparable to 2013 and 2014.

Some worry that raising rates to control inflation necessarily drives the economy into a recession. And with the surge in energy prices since the Ukraine invasion, some even raise the foottopic of stagflation — a word from the 70s. The rate path we announced this week shouldn't drive economic decline. We are still far from the level of rates that constrains the economy; for my colleagues on the FOMC, this would be somewhere above their long-term projections for the neutral rate, which ranges from 2-3 percent. This week's move still leaves us a good 9-10 rate increases away from that point. So, instead of thinking about the upcoming cycle of rate increases as foreshadowing a coming recession, think of it as an indication that the extraordinary support of the pandemic era is unwinding. We are reducing that support gradually so that we can get back to a more normal position as the economic situation evolves. At that time, we can decide if we need to put the brakes on the economy or not.

Prior to our meeting, there was much debate about whether the Fed should move faster. We have moved at a 50-basis point clip in the past, and we certainly could do so again if we start to believe that is necessary to prevent inflation expectations from unanchoring. But setting the right pace for rate increases is a balancing act — we normalize rates to contain inflation, but if we overcorrect, we can negatively impact employment, which is the other part of our dual mandate. And we have some time to get to a neutral position. Inflation and employment are still being heavily influenced by pandemic-era supply and participation pressures — and more recently, the war on Ukraine — and it will take a while for us to understand and meet the dynamics of the post-pandemic economy.

Ben Bernanke once said that monetary policy is a collaborative endeavor: Clear communication and steady movement guide markets in ways that reinforce our messaging. In contrast, market surprises sometimes lead to tightened financial conditions that can cause the real economy to pull back more than we intend. So, it's worth noting that the bond market seems to already be taking our direction. As we have signaled a rate change over the last few months, market rates have moved significantly. The two-year treasury yield has gone from 0.28 in September (as of Sept. 30 close) to 1.95 (as of March 16 close) today. The five-year has moved from 0.98 (as of Sept. 30 close) to 2.18 (as of March 16 close). So, while we could move faster, we are already having more impact than you might think.

While the proven and more important tool is rates, our balance sheet moves can work in the background to reinforce this rate path. As a reminder, we began purchasing treasuries and mortgage-backed securities to stabilize financial markets in March 2020, and then continued them to support the economy through the pandemic. Our balance sheet is now about 9 trillion in assets, up from 4.2 trillion pre-pandemic. As we start to normalize rates, it is appropriate to start to normalize the balance sheet as well, and we will begin to do that soon. There is a reasonable amount of debate in the literature and in the financial markets about the impact of balance sheet reduction. For me, it's pretty simple: Our purchases reduced rates in a modest fashion; our reductions should have a symmetric effect and increase medium-term rates modestly, thereby supporting our desired rate trajectory.

To close, I want to talk about what I'll be keeping an eye on in the coming months: demand, supply and pricing. While I think all three of these areas should normalize, there are still unanswered questions. Demand should calm as rates increase, excess savings are spent, and we work through the current oil price shocks, but how much, how quickly, and in what mix of goods and services? Supply should recover as COVID-19 recedes, supply chains are remediated and workers rejoin the workforce. But how long will this take, and how much upside does the labor force have? And inflation should move toward target as pandemic and geopolitical pressures ease and policy normalizes. But how fast will that happen, and what will be the impact of this period on inflation expectations? These answers will dictate the pace with which we use our tools; put another way, they will provide us with ongoing feedback about how to adjust policy in order to keep inflation expectations anchored and keep inflation on a medium-term path back to our 2 percent target.

I hope this was a useful way for you to understand how to think about policy and how we use our tools — and now I am open to questions.