SPEECH

The Right Tools for Our Time

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Good afternoon. I'm so pleased to be here with you today. We've waited a long time to gather in person. And I think we can all agree that meeting in this charming location was worth the wait. For most visitors, Eltville is renowned for its wine and roses. But for economists, it's a place to convene for weighty discussions on monetary policy. Given the events happening around the world today, there is much to discuss.

We are meeting at a time of significant economic challenges and uncertainties. Inflation has reached levels not seen in decades, both in the United States and in many other countries. And recent events—including the war in Ukraine, lockdowns in China, and other supply disruptions related to the ongoing Covid-19 pandemic—are exacerbating near-term inflationary pressures and uncertainty about the global economic outlook.

The challenge for monetary policy today is clear: to bring inflation down while maintaining a strong economy. This, of course, is at the heart of the Federal Reserve's dual mandate of price stability and maximum employment. Although the task is difficult, it is not insurmountable. We have the tools to return balance to the economy and restore price stability, and we are committed to using them.

Before I go any further, I will give the standard Fed disclaimer that the views I express here are my own and do not necessarily reflect those of the Federal Open Market Committee (FOMC) or anyone else in the Federal Reserve System.

Overheating

Whenever I talk about monetary policy, I start with the Federal Reserve's dual mandate: price stability and maximum employment. With the unemployment rate back to very low pre-pandemic levels, and a variety of indicators showing the labor market is very strong, maximum employment has been achieved. But, with inflation rising to unacceptably high levels, we are far from our longer-run goal of 2 percent inflation. High inflation harms those who are most in need. Too many families are now struggling to meet the increasing cost of necessities. I am resolutely focused on restoring price stability, which is the foundation for a vibrant and healthy economy.

Over the past year, inflation has increased rapidly and dramatically to levels last seen in the early 1980s. A year ago, overall inflation, as measured by the percent change in the personal consumption expenditures (PCE) price index, was 2.5 percent. In March, it was 6.6 percent. A portion of this sharp rise reflects global increases in food and energy prices. But, even excluding energy and food costs, the "core" inflation rate has increased from 2 percent a year ago to 5.2 percent today.

Three major imbalances are contributing to an overheating economy and high inflation. First, the effects of the pandemic have significantly increased demand for certain categories of spending, especially for durable goods and housing. This increase in demand is occurring while supply in these sectors is being adversely affected by the pandemic.

The case study for this dynamic is the automobile sector. The combination of high demand and supply shortages has led to historically low inventories. Customers are lining up to buy cars but are finding the dealer lots empty. It's a seller's market, and prices have soared. New car prices are up nearly 15 percent since the start of the pandemic, and used car prices have skyrocketed, rising more than 50 percent.

Another prominent example is housing. With remote work policies in place, many people have relocated—buying larger homes in the South, in the suburbs, and in more affordable cities. This shift has caused demand for housing in some regions to far outstrip supply, while new housing construction has been held back by shortages in labor and materials. The imbalance between demand and supply has led to bidding wars. Homes have sailed off the market at record prices, with many purchased sight unseen. This combination of high demand and crimped supply has also resulted in rapid increases in rents, especially for apartments coming onto the market.

The second major imbalance is in the labor market, where overall demand far exceeds existing supply. The ratio of job vacancies to the unemployed is near its all-time high, workers are quitting jobs at a record rate, and employers are bidding up wages. This sizzling hot labor market is also related to the imbalance between demand and supply for goods and housing, as businesses seek to hire more workers to help meet the high demand. And labor supply shortages and rising labor costs are contributing to price pressures across a wide range of goods and services.

Finally, global imbalances in supply and demand have also contributed to supply-chain problems that have affected the availability and costs of shipping, as well as a variety of inputs into production—including semiconductor chips used in making cars. The war in Ukraine and recent lockdowns in China have further constrained the global supply of goods and commodities, including food and energy.

Turning Down the Heat

With clear signs of demand exceeding supply and an economy running too hot, the primary focus of monetary policy is to turn down the heat and restore price stability.

Although we are facing highly unusual and challenging circumstances, I am confident we have the right tools to achieve our goals. In fact, we have an advantage over previous inflationary episodes: Our monetary policy tools are especially powerful in the very sectors where we see the greatest imbalances and signs of overheating—such as durable goods and housing. Higher interest rates will cool demand in these rate-sensitive sectors to levels better aligned with supply. This will also turn down the heat in the labor market, reducing the imbalance between job openings and available labor supply.

While the Federal Reserve on its own cannot address the global nature of inflation, we are not acting alone. Many other central banks are also taking steps to curb inflation. Taken together, these actions should help restore balance to supply and demand globally. That, in turn, should help diminish supply-chain bottlenecks and reduce inflationary pressures.

Taking Action

In the United States, the FOMC is taking strong actions to restore balance and bring inflation down. So far this year, the FOMC has raised the target range for the federal funds rate by 75 basis points, including a 50-basis-point increase announced after our meeting last week.[1] In addition, the FOMC has indicated that it anticipates that ongoing increases in the target range will be appropriate. I expect the FOMC will move expeditiously in bringing the federal funds rate back to more normal levels this year.

The FOMC also announced last week that starting June 1st, it will begin reducing the size of its holdings of U.S. Treasury securities and agency debt and agency mortgage-backed securities, as described in the Plans for Reducing the Size of the Federal Reserve's Balance Sheet.[2] The reduction of the balance sheet will play out over the next few years, eventually bringing the Federal Reserve's securities holdings to a level consistent with the ample reserves framework that the FOMC reaffirmed in January when it released its principles for balance sheet reduction.[3]

Economic Outlook

Even before it took these actions, the FOMC communicated a path of raising the target federal funds rate and reducing the balance sheet. Those communications and subsequent actions are having a meaningful effect on broad financial conditions. For example, since the beginning of the year, both two-year Treasury yields and 30-year fixed mortgage rates have risen more than 2 percentage points. We have seen a significant tightening of financial conditions abroad as well.

Our monetary policy actions will cool the demand side of the equation. I also expect that over time, the factors contributing to supply shortages will be resolved, so that some of the rebalancing will be accomplished through increases in supply, both in the United States and around the world. For 2022, I expect core PCE inflation to be nearly 4 percent, before falling to about 2 ½ percent next year. I expect inflation to further decline to close to our 2 percent longer-run goal in 2024.

I expect the labor market and economy to continue to show strength and resilience. For 2022, I expect GDP growth to be around 2 percent and the unemployment rate to remain around its current low level.

Conclusion

Reducing inflation to our longer-run goal while keeping the labor market strong is the challenge of our time. The ongoing pandemic and war in Ukraine bring a tremendous amount of complexity and uncertainty. We will need to be data dependent and adjust our policy actions as circumstances warrant. We have the right tools, and we will use them to meet this challenge.