Fed Unfiltered, Transcript
4/12/22 – Lael Brainard, Interview: WSJ Live Streamed

Nick Timiraos:

Governor Brainard, thank you so much for joining us. It's a pleasure to have you with us today.

Lael Brainard:

Well, thank you. It's a pleasure to join you for this conversation.

Nick Timiraos:

And thank you to all of those who are joining us live on Twitter and YouTube.

Nick Timiraos:

Governor Brainard, let's get into it. This morning, the Labor Department said that consumer prices rose 1.2% in March to a year-over-year rate of 8.5%, a new four-decade high. Core prices excluding food and energy were somewhat less boomy, rising three-tenths of a percentage point. Was there any takeaway for you from this report? Does it change your outlook or your preferred path for policy in the coming months?

Lael Brainard:

Yeah, I think there are two developments in the CPI inflation data for March that were notable. The commodities price shock associated with Russia's invasion of Ukraine is driving that very high top-line inflation number you see. And in particular, in today's CPI reading, energy prices accounted for nearly 70% of the monthly headline reading, particularly gasoline prices at the pump, and food contributed another 10%. Those price increases are particularly painful for lower-income families who spend a larger share of their income on food and transportation.

Lael Brainard:

The CPI data also showed a notable slowdown in core inflation. It fell from 0.5 month over month the last few months to 0.3 in the latest print. And core inflation is the component of inflation that most closely reflects the strength of domestic demand and I'm most focused on for purposes of assessing the appropriate path of monetary policy. And then looking within that, I think it's notable that core goods, which has been the source of an outsized amount of core inflationary pressure, moderated more than expecting, more than I had anticipated.

Lael Brainard:

So if you look in terms of the overall core CPI, the prices in core goods have been responsible for almost half of the increase in core inflation over the past year, even though they normally account for only about a quarter of the overall. So it's very welcome to see the moderation as a category, and I'll be looking to see whether we continue to see moderation in the months ahead.

Lael Brainard:

We did see some upward pressure in core services and in particular in energy price-sensitive airfares, but there was some moderation in rent, which is also notable. I wouldn't take a lot of signal from any one month of data, but I will be watching carefully for a continuation of this kind of pattern, with moderating core inflation and a declining number of categories seeing outsized price increases in the months ahead. And as we've said, inflation is too high and getting inflation down is going to be our most important task.

Nick Timiraos:

Thanks, Governor Brainard. Since this is the WSJ's Job Summit, I'll talk a little bit about, or I'll ask you a little bit about the labor market and might come back to inflation in a minute. You gave a speech last fall talking about the prospect for a durable recovery in labor participation or the number of people who are either working or looking for work. And on one hand, more workers looking for jobs might take some of the boil off of wage growth that we've seen. On the other hand, it's possible, I guess, that an increase in overall incomes as more people come into the job market could keep demand elevated. So how has your outlook for the labor market changed over the last six months?

Lael Brainard:

Yeah. So I think what we've seen in the labor market and the economy overall is very strong demand, demand that has been particularly concentrated in durable goods relative to services. And that is also, I think, reflective of the pandemic. And then labor supply that has been slow to respond to that really strong labor demand for reasons that appear to be quite clearly related to the pandemic. And you see that in the surveys, whether it's been caregiving constraints or fears of the virus that have been keeping people from returning to the labor force.

Lael Brainard:

So right now, we're seeing a historically high level of job openings, which reflects that the demand for workers is well above the current supply. But what has been very encouraging in the last few months of the employment reports is that we are seeing a rebound in participation. It's normal for labor force participation to recover more slowly than unemployment declines in most recoveries, but this cycle it's been particularly acute, again because of pandemic constraints.

Lael Brainard:

So as we see in the last two months of employment data, you had prime-age labor force participation jumping for women in the most recent and for men in the report prior to that. But the share of the population that's employed is still about one- percentage point below its pre-COVID level. And participation rates are also still down. So there's room to run there.

Lael Brainard:

And more broadly, I expect demand to moderate. Fiscal is going to be a drag this year. Financial conditions are tightening. We're going to get some spillover from slower growth abroad. And so I do expect those supply constraints to lift at the same time as we see demand moderating. And that's why we can expect to see the recovery sustain even as we bring inflation down.

Nick Timiraos:

In the Fed's most recent projections at your March meeting, many of your colleagues saw the unemployment rate holding at 3.5%, near current low levels over the next few years. That's below the 4% level that you or your colleagues estimate is likely to materialize over the long run. Those projections also saw inflation coming down to 2% over the next few years, even though interest rates don't rise very much above 2%. Now, Larry Summers said recently that this is an example of wishful and delusional thinking. And so I wonder how is it that you can have inflation coming down closer to 2% with the labor market staying possibly quite tight?

Lael Brainard:

Yeah. So I think the forward trajectory of demand is set to moderate. And that's for a number of reasons. Again, just going through them really quickly. Fiscal support is a substantial drag this year. Financial conditions are already tightening. And when we think about what affects business investment, household, durable goods purchases, it's really those broader financial conditions facing businesses and households. And we've already seen a nearly two-percentage point increase, for instance, in mortgages. So those financial conditions will also bring demand to a more sustainable level.

Lael Brainard:

And we also should see some rotation of demand as pandemic constraints continue to lift. We should see some return to historic patterns of greater relative demand for services and less pressure in that supply constraint, durable good sector. And of course, as we were just discussing, on the supply side I'd expect to see continued improvements in labor force participation.

Lael Brainard:

So as we continue to move forward on our plan to move the financial conditions to more neutral levels using both our policy rate and balance sheet tools, I'd expect to see labor demand coming down. And that should take place in large measure through reduction in the current very elevated level of vacancy. So I think there's plenty of room for businesses to reduce the number of job openings. And so I don't see that as we go forward on this path of moving monetary policy to a more neutral level. I really see that as being consistent with both bringing inflation down and sustaining the recovery.

Nick Timiraos:

Two big developments so far this year, of course, have been Russia's invasion of Ukraine. You referred to this last week as the seismic geopolitical event. And then also, we're seeing some pretty sharp lockdowns again in China. How do those two developments change the outlook you have for inflation this year and perhaps next year?

Lael Brainard:

Yeah. So Russia's invasion of Ukraine is, as you said, it's a seismic geopolitical event. It's a human tragedy. But it is also a very important contributor to inflationary pressures, in particular we're already seeing it through commodities prices. We talked about this morning's really large increase in prices at the pump. That really reflects the Russia shock. And it probably skews risks to the upside and inflation into the downside on economic activity, particularly abroad but that can have some implications here.

Lael Brainard:

So we've already seen prices of energy and other commodities moving up. We've seen that in nickel, for instance. We're seeing it in other areas like fertilizer. And of course, we've seen the price of Brent Crude moving up by about 12% on net since the invasion. And there are also likely to be some knock- on effects for global supply chains as Europe, for instance, takes on board this large shock to natural gas prices that can be expected to both affect demand and supply. And that can have some knock-on effects here. The longer the conflict persists, the more it escalates, the greater the potential risks, again, to the upside on inflation and to the downside on activity.

Lael Brainard:

You also mentioned China. China is right now continuing its zero-COVID lockdown policy. Seems to be having a notable effect on activity. It certainly has the potential to lengthen out some of those constraints that we've seen in supply chains. We've certainly seen with the previous surges that they've led to port shutdowns in China. They've led to increased chip delays. And so there too, this is just another set of inflationary shocks. And of course, the economy has sustained now a number of these kinds of inflationary shock from external events, whether it be pandemic, now Russia-Ukraine, lockdowns in China. We've seen a lot of resilience, but we've also seen very high inflation.

Nick Timiraos:

You spoke in a speech last September about good reasons to expect a return to pre-COVID inflation dynamics. You cited underlying structural features of a relatively flat Phillips curve, where lower unemployment rates don't necessarily push prices up all that much, low equilibrium interest rates, low underlying trend inflation. Is that still your base case scenario for once we get through this period?

Lael Brainard:

Yeah. So I think it is too early to have great confidence in what the post-pandemic, post-Russia- Ukraine contours of the new normal are likely to be. In terms of the level of the real long-run neutral rate of interest, the rate of interest that economists think of as being consistent with full employment and low, stable inflation, there are good reasons to think that will continue to be at levels that are quite low relative to the historical experience. But again, I think we need to see how the economy evolves.

Lael Brainard:

Clearly, we've experienced a series of very large inflationary shocks, and the committee is committed to bringing inflation back to our 2% goal. And our framework is very focused on the keeping inflation expectations anchored at 2%. So I think there, we can anticipate that inflation will also return to those levels over time.

Lael Brainard:

And of course, we have a labor market that over a longer period of time has proven to be quite elastic, but in the short run has been very affected by COVID. And so it'll take more time than I think anybody would have anticipated to be able to assess those contours of the new normal.

Nick Timiraos:

You spoke last week in a speech about moving policy settings expeditiously to be closer to a neutral interest rate. And you spoke a little while ago about getting financial conditions to a more neutral level. Where is right now, or maybe by the end of this year, where might a neutral interest rate or a neutral rate setting when combined with the runoff of the Fed's asset portfolio, where might that be around the end of this year? Where is a neutral rate in your view?

Lael Brainard:

Yeah. So it's a good question. The neutral rate is a longer-run concept. As I noted earlier, it's the level of interest rate that's neither expansionary nor contractionary when the economy is at full employment with stable inflation.

Lael Brainard:

In terms of where the policy rate is likely to be heading over time, I'd say both the last projections that we had from the committee as well as the minutes and market pricing, the median funds rate path does rise over the course of this year. And we've indicated that it's likely we'll decide as soon as May to start reducing the size of the balance sheet in which case those reductions could come as soon as June. And the combination of policy actions along these lines should bring the overall policy stance to a more neutral setting over time.

Lael Brainard:

But it's important to note that I don't look at one number and I certainly don't just look at the policy rate because it's the combined impact of our balance sheet and the policy rate on financial conditions. So when I look at financial conditions, I'm really looking at the kinds of conditions that are facing businesses and households as they decide whether to make investments. And there I think the communications about our policy plans have already been tightening those broader financial conditions over the past really four to five months considerably more than you might be able to discern from just looking at the policy rate alone.

Lael Brainard:

So if you look at over the calendar year of 2022, market implied policy rate expectations for the end of this year have risen quite a lot. Policy-sensitive rates have risen by similar amounts. So we've seen the two-year nominal yield going up by a considerable amount relative to earlier this year or the end of last year. And five and 10-year Treasury yields are about 140 and 120 basis points higher. And so those are all reflecting communication. And as I think I might have mentioned, if you look at the 30-year fixed rate mortgage, it's almost two-percentage points higher year to date as a result of expectations about our policy path, and again, the combination of the balance sheet with increases in the policy rate.

Nick Timiraos:

There certainly have been more aggressive expectations built into financial markets because of the change in the Fed's communications. So it's, of course, not just the one rate increase. But as you sit here today, thinking about where the economy is, if the goal is to get interest rates closer to neutral more quickly this year, does that mean that you're prepared to support raising rates in half-percentage point increments at the next Fed meeting or even at the next two Fed meetings?

Lael Brainard:

Well, I would say that in terms of the communications from the committee, you saw that we've said, for instance, in the most recent minutes that the committee expects to move the stance of monetary policy toward a neutral posture expeditiously. And we are committed to bringing inflation back down to 2%. We're doing that by tightening monetary policy methodically. And it's through a series of interest rate increases as well as beginning that balance sheet runoff, with a decision coming, could be as soon as May which would lead to reductions in that balance sheet starting in June.

Lael Brainard:

In terms of exactly what the right pace of that set of increases in the policy rate from meeting to meeting, I don't really want to focus on that. But I would just say the combined effect will bring the policy stance to more neutral posture expeditiously later this year.

Nick Timiraos:

Because it takes time for monetary policy to influence the economy, we hear right now economists talking a lot about a soft landing, where the Fed is able to raise interest rates to moderate the pace of growth but avoiding a recession. Of course, achieving a soft landing implies that the Fed will stop raising interest rates before it's too late. So I wonder, do you see any stopping rule or maybe even a slowing rule that would guide your thinking about when a slow down or even a pause in removing policy accommodation would be appropriate?

Lael Brainard:

Yeah. So it's a good question. I don't have a stopping rule per se. This is a very unusual recovery. It's just been made more complicated, as if the pandemic was not complicated enough, by Russia's invasion of Ukraine. So I don't want to be too rigid in how I think about the appropriate course of policy over the remainder of this year and into next year. I do expect the combined effect of moving the policy rate to a more neutral level and commencing balance sheet reduction to have the effect of bringing inflation down, seeing some moderation in demand while the supply side catches up a bit.

Lael Brainard:

And then I think by moving expeditiously towards a more neutral posture, it provides the committee with optionality in either direction. And so that'll give me the ability to monitor a set of indicators, very importantly, of course, inflation and employment, also inflation expectations, as well as how the labor market is responding. And that'll provide a sense of how the policy rate might evolve beyond that point, depending on how much progress we're seeing in particular on inflation and how well the labor market is holding up.

Nick Timiraos:

So Governor Brainard, what is the goal of Fed policy right now? I hear some people who say that if what's driving inflation is a disrupted supply chain or insufficient supplies of oil or computer chips or housing in city centers, how will higher interest rates address those problems that we're seeing? What is the goal of what the Fed is trying to do right now?

Lael Brainard:

Well, I think the goal is very straightforward. We're committed to bringing inflation down to 2% over time while continuing to sustain the recovery. And you're right that the very high inflation we're seeing right now is the result of a series of inflationary shocks associated both with the pandemic, the Omicron and Delta variants, and most recently with Russia's invasion of Ukraine. And those are supply shocks.

Lael Brainard:

What the Federal Reserves tools are well suited for is helping to bring demand into balance with supply over time. And so there I think the kinds of tightening and financial conditions that we've talked about, not just what you see in the federal funds rate, but that broader set, whether it be the two-percentage point increase in mortgages, whether it be the increase in the cost of credit for businesses, those broader set of financial conditions will help to moderate demand, particularly in areas where demand has been extremely hot, durable goods, for instance. And fiscal is also going to be a drag this year. The global economy looks to be slowing more broadly. That'll also spill over into the U.S. All of those things should, along with our plans on monetary policy, bring demand into better balance with supply and alleviate that very high inflation that you've been seeing.

Nick Timiraos:

So you said over time that inflation should come down to 2%. Over how long do you think it will take inflation to come back to 2%?

Lael Brainard:

Yeah. So I'm very wary of making predictions. I think we all should be. We have most recently seen a geopolitical shock from Russia's invasion of Ukraine. I don't think that was in my inflation outlook a year ago. It certainly wasn't. Omicron and Delta were surprises even to many public health experts, and certainly also hard to predict those kinds of shocks. So I think we're in a period of very high uncertainty. I think it's really important to emphasize that.

Lael Brainard:

So I'm going to be very cautious about making predictions. But I am looking to the month-to-month data to get a sense of what's happening on core, core inflation, which is more tightly connected to demand. And there again, I think we saw a moderation this month in that core goods inflation where we had been seeing outsized contributions to inflation for some time. And it's those kinds of developments that will give me confidence that we are going to be successful in achieving our 2% goal. Precisely how long that's going to take, I think it would be very difficult to estimate right now just given uncertainty around Russia-Ukraine, uncertainty around China COVID, and still uncertainty around the pandemic.

Nick Timiraos:

You noted, there's a long list of unusual, unprecedented, choose your adjective, developments that the global economy has come through. And so when people talk about achieving a soft landing, I wonder Governor Brainard, are there any historical analogies or antecedents that you could point to where the Fed is facing something that they attempted back in the past? Is this more like the 1970s? The 1950s? Are there any analogies here that you think are most relevant to either the present circumstance or what it is the Fed is trying to achieve?

Lael Brainard:

Well, I certainly think that it is helpful to think about a variety of past cases, both where we saw hard landings and soft landings, to try to inform our thinking about the appropriate path of policy and what indicators I and my colleagues should be looking at to gauge whether we're seeing the kind of progress that we need to see on inflation in particular. But I don't think there's one good analogy in the sense that this is a quite unique, again, set of circumstances.

Lael Brainard:

The combination of a pandemic and war, I think is pretty unusual here. And of course, we go into these shocks with very well-anchored inflation expectations. And as I look across the dashboard of indicators on inflation expectations, longer-term inflation expectations remain well anchored. That's enormously important and will be very helpful to us. When I look at the strength in the labor market, there too I see a very high number of job openings. And there I think there's quite a bit of capacity for labor demand to moderate among businesses by actually reducing job openings without necessitating high levels of layoffs, for instance.

Lael Brainard:

So I think there's some unique features here that make this both very challenging but also are important in terms of my thinking about what policy path on both policy rate hikes and balance sheet runoff will be sufficient to get us to the 2% goal.

Nick Timiraos:

How should we weigh the restraint that comes from shrinking the Fed's asset portfolio versus raising the short-term interest rate? For example, how much of an increase in long-term rates do you model from the perspective runoff of those asset holdings?

Lael Brainard:

Well, our jobs would be a lot easier if we had a precise estimate of that and it was a robust, precise estimate, just as would be true in our discussion earlier about the full set of financial conditions that constitute neutral financial conditions. But it's certainly in the case, in our approach to getting inflation down that the balance sheet will play an important role in removing monetary policy accommodation, operating in the background, while the federal funds rate serves as our primary active tool. The balance sheet runoff will have and probably already the expectation of it, it probably does already have important effects on financial conditions. And so together, I think it's important to recognize that removing policy accommodation through both tools has a greater combined effect than either tool on its own.

Lael Brainard:

In terms of estimates of how great an increase in the federal funds rate is equivalent to a given amount of runoff of the balance sheet, there's a range of estimates. I've certainly seen estimates that I think are widely accepted in the literature that our balance sheet rundown could be worth two to three additional rate hikes over the entire course of the rundown. But I have to say, any such estimates come with really wide confidence intervals.

Lael Brainard:

And so if you think about how do you build a direct comparison between the two tools, it's really how much of a reduction the balance sheet would have an equivalent effect on 10-year Treasury yields as an increase in the federal funds rate of one-quarter percentage point. And we think of those reductions, of course, as permanent increases. And so again, wide range of estimates in terms of precisely what those would be. I would not hang my hat on any particular number. But it's very clear from all those estimates that the reduction in the balance sheet will contribute to monetary policy tightening over the life of the runoff and that is in addition to the kind of tightening that we might see through the policy rate.

Nick Timiraos:

We're almost out of time, but before we finish, our WSJ Survey of Economists this past week found that our respondents estimated a 28% chance of a recession over the next year. How do you see the risks of a recession over the next few years? Does 28% seem too low, about right, or too high?

Lael Brainard:

Yeah. So look, the U.S. economy enters this period of elevated uncertainty with a very strong labor market and significant underlying economic momentum. And that, I think, bodes well for the ability to bring inflation down while also continuing to sustain the recovery and ensure that it's an inclusive recovery.

Lael Brainard:

I look at the same things everybody else does. I certainly remain attentive to the shape of the yield curve, and I'm well aware of the historical significance of inversions. But I think that there are different parts of the yield curve that are informative. And certainly, the forward part of the yield curve really doesn't signal anything of concern there. Sort of later part of the yield curve, watching that very carefully. But there are other data points, inflation, inflation expectations, the evolution of activity, that are going to be extremely important as I gauge what the right pace of removal of accommodation is. And again, I think there are good reasons to think that we can bring inflation down over time, seeing a moderation of demand while the supply side continues to recover and we continue to see strength in the labor market.

Nick Timiraos:

Well, on that bright note, we are out of time. Thank you again, Governor Brainard, for joining us today.

Lael Brainard:

Well, thank you, Nick. It's a pleasure.

Nick Timiraos:

And thank you to everyone who joined us on Twitter and on YouTube.