Loretta Mester, Interview: on Washington Post Live, 8/2/22

Loretta J. Mester (00:42):

We've already seen interest rates have an effect in the housing sector, where the housing sector is pulling back from the heights that it had seen. So we want to see some moderation demand. What we're going to be navigating though, is setting our policy rates, our interest rates so that we can maintain a healthy economy and healthy labor markets as we go through this period.

David J. Lynch (01:12):

Hello, and welcome to Washington Post Live. I'm David J. Lynch, Global Economics Correspondent here at The Post. And today, I'm joined by Loretta Mester, president and CEO of the Federal Reserve Bank of Cleveland, for a discussion about inflation and the state of the US economy.

David J. Lynch (01:29):

President Mester, welcome.

Loretta J. Mester (01:31):

Hey, thank you. Great to be with you.

David J. Lynch (01:34):

Now, first things first, you mind if I call you Loretta?

Loretta J. Mester (01:37):

I would love that, and I think that's very good. And I'll call you David?

David J. Lynch (01:42):

Fair enough. I've been called worse.

Loretta J. Mester (01:45):

So have I.

David J. Lynch (01:47):

I'd like to start with a question about an issue that's gotten a lot of public attention recently, and it boils to whether the US is or is not in a recession. And on the one hand, we've learned recently that the economy has now been shrinking for two consecutive quarters, which meets one conventional test of recession. On the other hand, Fed Chair Jerome Powell says he doesn't think we're in a recession. And the quasi-official body that will ultimately make the call on this, the National Bureau of Economic Research, will look at several data points, not just output or GDP.

David J. Lynch (02:24):

So, I'm curious: Where do you come down? Are we in a recession or are we not, and how much of a difference does it make to Fed policymaking?

Loretta J. Mester (02:33):

So, I don't believe we're in a recession. I think the MBER looks at a number of different criteria, as you mentioned. Certainly, activity has slowed, and you're right, the GDP report showed negative growth for two quarters in a row, but you have to actually look at the composition of that growth to discern what parts of the economy are slowing.

Loretta J. Mester (02:54):

We don't have a slowdown in labor markets, and that's two key factors that go into calling a recession. Usually, when a recession is in place, you will see the labor market deteriorate pretty rapidly. And certainly, right now, the labor market is very healthy. And you know, we haven't seen that kind of broad-based pullback in activity across sectors, and that's also something that's important when you think about a recession.

Loretta J. Mester (03:22):

But you asked a good question, is how much does it matter for where Fed policy is right now, and in some sense, our policy has been to raise interest rates in order to cool down the demand side of the economy. And so, seeing some pullback in activity is actually what we wanted to see in terms of getting excess demand better into alignment with that supply side of the economy which, as you know, has been constrained. And so, part of the mechanism through which the Fed policy actually works is by bringing demand into better balance with supply, and I think that's what we're seeing in some of the data points right now, but certainly it hasn't slowed enough, A, to call it a recession; and B, to even see that moderation in demand showing through yet to a moderation and a cooling-off of price increases and inflation. And that's what we're engineering here in terms of our policy. That's the mechanism through which it's going to be affecting inflation.

David J. Lynch (04:27):

Right. We've had a related question from a member of the audience, which may be a critique of the media, as much as anything else. Let's take a look at that. This comes from Sam Gorovitz from New York, and he asks, "Why so much focus on the label recession, as if it's useful to force a yes or no decision onto a situation that's far more complex and nuanced than that?"

Loretta J. Mester (04:56):

Well, I agree. I mean, we're in a challenging environment. You know, I'm an economist, so a lot of times we don't talk about recession, per se; it's are we growing below or above trend? And my forecast for this year is that we'll be growing below trend, but that's necessary in order to get price increases, inflation under control. We haven't seen inflation cool at all. In fact, the monthly reports show that inflation hasn't even stabilized, yet, at a very high rate. So, again, part of the mechanism that we're trying to do with our policy tools is to bring that inflation under control. We're committed to doing that and that's very important. That's a foundational piece of a healthy economy. We have to get inflation under control and that's what we've been about this year and we'll continue to be about until we get inflation under control.

David J. Lynch (05:58):

So, whether we are or aren't in a recession, the current moment, the current economy is really quite distinctive. We've got a global pandemic, war in Europe, commodity price shocks, supply chain

disruptions all at the same time. And a lot of very smart people, including at the Fed, have been wrong about the economy at various points over the past year or two.

David J. Lynch (06:25):

And so, I wonder as an economist, as you try to look through all this, whether you still trust the same models, indicators, economic relationships that you would have looked to for guidance before the pandemic or has it just become much more difficult to fathom exactly what's happening and to predict where we're going?

Loretta J. Mester (06:52):

Yeah, that's a great question. As you know, our models are built on historical relationships in the data, and you're exactly right. This is in many ways unprecedented. But I still want to use the models because it does give us guidance about taking a whole lot of indicators and putting them through the models give you some insights.

Loretta J. Mester (07:16):

But you have to take the models and even in the best of times our models are predictive, but we know there's error bands around the models. And that's part of the work of the Fed, is one of the reasons that we spend a lot of time talking to business contacts, labor market contacts, community development people in our districts. Is really to get that really deep, textured, anecdotal information that can help us evaluate where the economy is and where it's going. A lot of times the anecdotal information will be disparate, but it will point to things before it will show up in official statistics. So, in an economy like this, which is, in many ways, unprecedented, it is really important to augment our data and our models with other information. And we've been doing that throughout the pandemic at every reserve bank and at the Board of Governors, looking at a lot of new and different information.

Loretta J. Mester (08:18):

At the Cleveland Fed, we have an inflation research center, and they've been doing surveys to actually touch base with consumers throughout this whole pandemic so we could get some information on what the behavioral actions they are taking. Were they staying home and not spending, not going out because of fear of the virus? Were they starting to come back when the economy opened? Right now, of course, we're very interested in inflation and inflation expectations, on how that's affecting consumer behavior. So, again, we have to augment our usual tools and our usual models because of the unprecedented nature of this economy at this time. But I think that that kind of process will serve us well into the future, as well. It's always good to have more information and to have that inform your view.

David J. Lynch (09:17):

Well, and certainly the GDP data that we make a great deal of in the press comes out every quarter. It helps shape... I think plays a major role in shaping public perceptions of the economy's health. But we have an audience question now about its usefulness as a tool, and this comes from Randall Olsen in Oregon, who asks, "What are your thoughts regarding using GDP to measure the economy?"

Loretta J. Mester (09:51):

Well, it is a measure of activity, I mean, has a very specific purpose. We like to look at it in terms of adjusted for inflation because you could have a high GDP level that's high because... in nominal terms, but not high in terms of real terms. And it gives you a benchmark against which you can sort of evaluate whether you're growing at your estimated trend growth or whether you're growing below trend. So, are you living up to your potential? So, as a measure of activity, I think it's a very useful summary measure. As you know, it's quarterly, so it's not as timely. There are other measures that come in more timely that go into the GDP measures.

Loretta J. Mester (10:37):

We'll get retail sales data that will tell us a lot about consumption spending, and we get other monthly indicators, and even weekly indicators, that go in. But as a measure of activity, I think it's a good measure. As a measure of other aspects that are important for people, we wouldn't use it to necessarily measure wellbeing. But as a measure of activity and whether the economy is living up to the potential growth it could support, I think it's a useful measure, yes.

David J. Lynch (11:12):

There does seem to be a mismatch, though, or a potential mismatch, between the GDP data which shows an economy that's shrinking, and labor market data that shows we've added two-and-a-half million new jobs since the beginning of the year. How could all these additional workers end up producing less stuff? Is it unusual to have this sort of disconnect between GDP and labor market, and what do you make of it?

Loretta J. Mester (11:43):

Yeah, it is unusual; it's not unprecedented. We've seen slower growth and maybe turn a little bit negative. I mean, if you look at the first quarter negative number in GDP, that was really driven by the external sector inventories and then, net exports, if you looked at consumption spending, that was still very healthy. So, again, that wasn't quite a puzzle.

Loretta J. Mester (12:05):

The second quarter, we are starting to see a slowdown in domestic spending investment, and of course the housing sector, which is very much related to the interest rate changes we've been putting in place. And even personal consumption was weaker than what we think of as being the trend in personal consumption growth.

Loretta J. Mester (12:23):

But that slowdown, usually you do see it part and parcel with a weakening in the labor market, but so far, we've not seen that. The labor market remains very strong. But as you know and as you pointed out, a lot of what's happening in this economy is being driven by the pandemic, and then the pandemic response. And so, we are in a very unusual time, in many ways challenging to sort of read through those data. But so far, the moderation in demand has not shown through into a real moderation on the labor markets. Firms are still seeking more workers than there are unemployed, and we'll just have to wait and see if we're going to see some moderation, there.

Loretta J. Mester (13:11):

I would say that we could very well see some moderation on the employment side in terms of demand for employment without seeing that much of an increase in unemployment. So, the labor markets can stay healthy as we go through this, but we need to wait and see how things will evolve.

David J. Lynch (13:31):

Let's move on to inflation, since rising prices are really topic number one for most members of our audience. Inflation is a global problem. The US isn't alone in having historically high rates of price increases. But I wonder what your view is of the argument that you hear from some domestic critics of the administration, that the president's last round of the fiscal stimulus, the American Rescue Plan, did make our inflation problem worse, if only at the margins. Do they have a point?

Loretta J. Mester (14:06):

Well, I mean, as you point out, there's an imbalance between the demand side of the economy, and the supply side. We know that supply is constrained. We hear from our firms still that there are very much disruptions still in the supply chain, in some cases getting a little better, but in other places, still very much in place, and firms have had to deal with that.

Loretta J. Mester (14:30):

Demand was boosted during the pandemic by both monetary policy and by fiscal policy, and I think that was appropriate. I think people forget the depth of the pandemic, how uncertain everything was and how we didn't really know what was going to be happening going forward. And now, the job is, is to really get the demand side of the economy, into better balance with the supply side. The Fed has tools to do that. We have our interest rate policy and that's what we've been embarking on. And we have more work to do, because we have not seen that turn in inflation.

Loretta J. Mester (15:11):

What we want to do is see it on a sustainable downward path towards our longer-run goal of 2%, and we have not seen that; we have more work to do.

David J. Lynch (15:21):

As you say, the Fed has been engaged in raising interest rates since March, more to come. We have an audience question, though, that looks ahead to when we might start to see a turn. And this comes from Lee Haberman in Canada. He asks, "What are the data points or indicators upon which the Fed will rely to determine when the tightening cycle has accomplished its goal of returning inflation to acceptable levels?" What do you look for?

Loretta J. Mester (15:53):

Right. I want to see very compelling evidence, first, that the monthly changes, month-to-month changes are moving down. And then, I want to make sure that I'm seeing that on a sustainable downward path. The risk management approach to this is you wouldn't want to conclude too quickly that inflation is on a downward path because of how high it is, and how much risk there is that if it remains high, it could become embedded in the economy. And that's what we're trying to make sure will not happen with our policy. So I'm going to be looking at... And I want to see it broadly across many inflation measures, not just one, not just two, even though our goal is in terms of PCE or personal consumption expenditure

inflation, which is our preferred measure at the Fed. There are a number of other indicators that I'll want to see. So, that's on the inflation side.

Loretta J. Mester (16:55):

Gauging whether we're seeing the moderation on the demand side, of course we're going to be wanting to look at labor markets. We have a dual mandate. We're very focused on making sure that we bring inflation down because that is the bedrock of making sure that we'll have sustainable healthy labor markets over the medium and longer run. If we don't get back to price stability, we won't have a strong economy and the economy won't be able to maintain good and healthy labor markets. So, again, this is really about doing what we can with our tools. We look at a number of monthly statistics to gauge and weekly statistics and that anecdotal evidence to really gauge where we are on that journey and where the transition of the economy towards price stability is, and we're going to continue to do that as we go through this process.

David J. Lynch (17:52):

Forgive me, my next question may sound like it's come from the Department of Wishful Thinking, but I would like to ask you about a couple of intriguing hints that suggest that maybe, just maybe, inflation could be starting to ebb.

David J. Lynch (18:07):

On Monday, we got the ISM manufacturing data released, which showed that the prices the factories were paying for their inputs had fallen quite significantly from the month before. And there was also an anecdotal sign of some progress in a tweet from Elon Musk, and he wrote, "Inflation might be trending down. More Tesla commodity prices are trending down than up."

David J. Lynch (18:38):

What do you make of both of those data points?

Loretta J. Mester (18:43):

Yeah, I mean, I would characterize it, if you squint you can sort of maybe see some start of some of those prices coming down. Commodity prices, we've seen that. In our district, we get reports from a lot of our firms also saying there are pockets of some of the commodity prices coming down, which is good. But again, there's other parts of the inflation report that aren't good. If you look at shelter prices, rents are up. And typically, on the supply side of the economy, the supply prices, they will be more persistent. So, that's going to bleed through and that'll probably keep inflation up.

Loretta J. Mester (19:23):

So, again, we might see goods inflation and commodities inflation come down but at the same time see the services side... I said supply side. I meant services side of the economy stay up and that's what we got to keep watching for. And that's when I say compelling evidence. It can't be just a one-month oil prices went down in July, that will feed through to the July inflation report, but there's a lot of risk that oil prices will go up in the fall. It's got to be sort of a sustained, several months of evidence that inflation has first peaked. We haven't even seen that yet, and then is moving down.

Loretta J. Mester (20:05):

So, I welcome some moderation in some of these pockets, but again, I think it would be inappropriate and actually not a good idea to cry victory too early and then allow this inflation, which has been stubborn and unacceptably high continue on without taking the action we need to put it on that downward, sustainable path to 2%

David J. Lynch (20:31):

And so, what do you make of the financial market's reaction to what the Fed has been doing? As you know, there are a couple of metrics, the 10-year breakeven, the five-year/five-year forward that show that the markets or investors, in aggregate, seem to think you're winning the battle. And their expectation of future inflation is down now to about two-and-a-half percent, not all that far from the Fed's goal, although still a bit elevated.

David J. Lynch (21:04):

Do the markets just have it wrong? Are they misunderstanding what you're about, or do they see something that the Fed doesn't?

Loretta J. Mester (21:13):

Well, they look at the same data that we look at, and I'm sure that they're coming out with their forecasts. I just haven't seen anything that would suggest that we've seen inflation even level off yet, let alone come down that downward path.

Loretta J. Mester (21:27):

So, I mean, there's a mix going on in the market in terms of also whether they think growth will slow more, as well, and that's also going into those market expectations. But in terms of what I look at and what I'm viewing, it's really important that inflation expectations stay well-contained.

Loretta J. Mester (21:46):

So, I welcome the fact that at least the TIPS market and those inflation index protected securities are showing that inflation compensation has moved down. It was elevated. So, that's a good thing. That helps make the battle against inflation a bit easier. But again, we need to see really compelling evidence that inflation is moving down, and my view is that we haven't seen that yet.

David J. Lynch (22:15):

I'd like to get your thoughts also on some new research out from authors including the former Treasury Secretary, Larry Summers, suggesting that the so-called natural rate of unemployment, the level of joblessness that's consistent with price stability has gone up since the pre-pandemic era, up to something like 4.9% from 3.6% before.

David J. Lynch (22:43):

Does that suggest that we should expect unemployment to get up to 5%, maybe a bit more than 5% before inflation is truly brought under control?

Loretta J. Mester (22:57):

Well, that's a deep question in the sense of that's suggesting the mechanism through which this is going to work is through a Phillips curve relationship between inflation and unemployment. And as probably some of your listeners know, the Phillips curve has been really flat, so that mechanism may not be the mechanism through which this will work. There are other estimates that suggest that the natural rate of unemployment hasn't moved up because... There was a good theory that why, during the pandemic, it could have gone up, and that was about matching efficiency. Was it harder for people to find jobs? Was it taking longer to find jobs? That doesn't seem to be characterizing this labor market. At this point, I think that's not what's characterizing this. I think it's just the economy had very, very strong demand and employers wanted more workers than were available. And that's what's still true in the data that we're seeing.

Loretta J. Mester (24:04):

I do think that we'll see some increase in unemployment as we go through this cycle, because again, labor demand is outstripping the labor supply, and we might see some of those monthly numbers adjust. But we need to have that moderation happen in order to make sure we get back to a healthy economy in terms of price stability that's necessary for that healthy labor market sustained over time. And so, again, the transition, every month we could see some different data. I think we have a narrow path to actually engineer this so that we don't see a strong increase in unemployment, but we'll have to see. We have to see how this evolves, and that's why watching of the data and watching what's happening in the economy is going to be very, very important as we go through this.

Loretta J. Mester (25:00):

The economy is transitioning. Some of what we're seeing is part of that transition, but the moderation we've seen in some of the numbers in activity have not yet shown through to any kind of moderation on the inflation side. And the inflation is hurting a lot of people. So, again, this isn't really a choice now between labor versus prices. This really is a necessary... If we're going to have a strong labor market going forward and a healthy labor market going forward, we're going to need to get price stability, and this is the way we're going to do it. So, I don't really see a trade-off here at all. I think this is just a necessary thing that we have to do in order to get back to price stability.

David J. Lynch (25:44):

And how about a risk that the World Bank, among others, have warned of, and that's stagflation, which you and I remember from the 1970s. All of our audience may not understand the term, which describes a period with very anemic, disappointing growth, and yet continuing high rates of inflation.

David J. Lynch (26:06):

Does the recent data that you've seen coming in make you any more or less concerned about that risk?

Loretta J. Mester (26:14):

Well, we're going to see some slower growth, because as I said, we're going to need to see that, and growth is going to need to be below trend before we get back to price stability. So, in that sense, yeah, we're going to see some high inflation numbers coupled with some slow growth numbers. I don't consider that stagflation, because I think of stagflation as being something that lingers on. I think of this as being the transition path back to price stability. So, I think of it differently.

Loretta J. Mester (26:42):

But it's also true that it is going to take some time for inflation to come down. This is not going to come down quickly. It's because inflation has been affected by so many things going on, outside of monetary policy. As you know, the war in Ukraine affected commodity markets and food prices and energy markets, and that's going to have an effect that may linger for longer. The Fed, we're raising our interest rates. That takes a while to work through the economy. So, it will take a while to get inflation back to 2%, but what we can do is use our tools to get it on that sustainable downward path. And so, that's what I'm looking for, is I need to see that happening, and so far, we haven't seen that.

Loretta J. Mester (27:32):

That might mean that growth will be slow. I mean, my forecast is for below trend growth this year and into probably next year, before it then picks back up. And I wouldn't consider that a bad outcome. I would consider that what's necessary to get this back to price stability with healthy labor markets.

David J. Lynch (27:57):

I want to ask you a final question about institutional credibility. This is an era, as you know, where many Americans have lost faith in the "elites" and societal institutions across the board, certainly the press, politicians, the Supreme Court, big business. Nobody trusts anything, anymore.

David J. Lynch (28:20):

I wonder how you assess the Fed's credibility after the last year or so we've gone through where top officials were repeatedly reassuring Americans that the price increases we were experiencing last year would be transitory, that they'd be really a passing phenomenon. That turned out not to be the case. We've now got the worst inflation in 40 years, perhaps for understandable reasons. But I wonder what you think about the Fed's credibility in this moment and whether that's something you worry about.

Loretta J. Mester (28:53):

Well, we certainly worry about our credibility because, as you know, it's very important for the economy that they believe and understand that the Fed will use its tools to get inflation under control. We are very much committed to that. I think you pointed out earlier that the financial markets seem to believe that. So, in terms of that, maybe we have some credibility. But the American people are also incredibly important, that they understand why we're doing what we do, why we're doing the policy actions that we're taking right now, and that they believe that we will get inflation under control.

Loretta J. Mester (29:31):

I think in the interactions I've had in the district, the people do believe that we're on the right path here. They understand what we're doing. But partly why I very much like being invited on shows like yours is so that we can explain what we're doing, why we're doing it, the rationale for our decisions. But it is a challenging environment, and we are reading the data as best we can, and when we do see that, we pivoted, I think, last year, and that's all we can hope to do. Is that continue to be very much reading the information, doing the best we can with it, and being willing to pivot when the evidence suggests it's time to move of what we said. And you've seen that, I think, through this cycle, as we've started to raise interest rates.

Loretta J. Mester (30:26):

We've tried to be as transparent as we can about our thinking, but we haven't hesitated to move in a different direction if the data and the evidence supports it, and that's what we're trying to do. We're trying to use our... best to our ability, to read where the economy is and where it's going and to set appropriate monetary policy. And that's my commitment, is that I'll continue to do that as we go through this.

David J. Lynch (30:56):

Great. Unfortunately, we are going to have to leave it there because we are just about out of time.

David J. Lynch (31:01):

Loretta Mester, thanks very much for being with us, today.

Loretta J. Mester (31:05):

Thank you. It's my pleasure.

David J. Lynch (31:08):

And thanks to all of you for joining the conversation. And to see what additional interviews we have coming up, please go to washingtonpostlive.com where you'll see the whole roster, and we appreciate you watching today. For The Washington Post, I'm David J. Lynch. Thanks again.