Winning the War on Inflation

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Highlights:

- The pre-pandemic decade was an unusually stable one in economic terms. COVID disrupted that stability. And similar to a post-war period, we are seeing the economy now struggle to return to normal.
- At first, inflationary pressures seemed temporary. But inflation has persisted, risen and become broader based. It's the Fed's responsibility to act to reduce inflation and stabilize expectations, and we are.
- The Fed's tools work over time, so I expect inflation to come down, but not immediately, not suddenly, and not predictably. I see inflation coming down in three lanes: demand should flatten, supply chains should heal and commodities should settle. The pace of normalization is uncertain, which is understandably unsettling and leads to worries about a recession.
- We are out of balance today because stimulus-supported excess demand overwhelmed constrained supply. Returning to normal does not require a calamitous decline in activity.
- Moderating demand has a higher purpose squarely in our mandate: containing inflation. We have been reminded this year: inflation is painful and people hate it.

Thanks for that nice introduction. It's great to be back and to have the opportunity to trade views on what's happening in the economy. I'll start with my thoughts, but caution they are mine alone and not necessarily those of anyone else in the Federal Reserve System. And I look forward to your questions at the end.

I should start with some context. The pre-pandemic decade was an unusually stable one in economic terms. GDP grew consistently between 1.5 and 3 percent a year. We added jobs in every month after 2010. Core inflation stayed in the narrow range of 1 to 2 percent.

COVID-19 of course has changed all that. I like analogies, and one relevant to today's situation is the aftermath of war. War upends economies: The government invests massively; labor leaves the workplace, sadly some permanently; manufacturing plants are reconfigured to produce weapons; consumers shift their spending to support the effort.

And when a war ends, economies struggle to return to normal. There's often a fiscal hangover. Soldiers need retraining. Plants need to restart, with supply chains fragile. And, amid all this adjustment, euphoric consumers spend freely.

As a result, at the end of a war, inflation typically spikes. After both world wars, inflation rose above 20 percent. And most of us remember well the postwar Vietnam ’70s (recognizing there were multiple sources of that inflation).

With apologies to those who’ve experienced the horror of an actual war, look at the aftermath of the “war on COVID.” Six trillion dollars of fiscal stimulus has hit the economy. Workers have stayed home, with participation still well below pre-pandemic levels. Many have died. Businesses have struggled with meeting demand as supply chains proved vulnerable to the virus and consumer spending shifted in a locked down world. Post-vaccine, euphoric consumers have been revenge spending. All of that has been exacerbated by an actual war – in Ukraine – that has driven up commodity prices. As a result, we are again faced with postwar-like inflation. The CPI is at a 40-year high of 9.1 percent. The Fed’s preferred metric, PCE, is 6.8 percent headline, and 4.8 percent core.

At first, these inflationary pressures seemed temporary, driven by pandemic reopening or supply chain challenges like semiconductor chips. But inflation has persisted, risen and become ever broader based. So the Fed’s responsibility is to act to reduce inflation and stabilize expectations, and we are. You’ve likely seen that over our last four meetings we have raised rates 225 basis points, started shrinking our balance sheet and signaled there are more rate increases to come. We are committed to returning inflation to our 2 percent target and have made clear we will do what it takes.

The Fed’s tools work over time. So I expect inflation to come down but not immediately, not suddenly and not predictably. Some sectors are in oversupply; others still have cost increases they are passing on. After a decade of stability has been replaced by extreme volatility, I’d expect inflation to bounce around on its way back to our target. These significant shock waves will take time to dampen.

I see inflation coming down in three lanes.

First, demand should flatten, reducing pricing pressure. Fiscal stimulus has waned, and excess savings are being spent down. The Fed has a lot of influence here. Higher rates should slow the economy by increasing borrowing costs and disincentivizing spending and investment. We are starting to see some precautionary softening in business investment and slowing in interest-sensitive sectors like housing. Real consumer spending grew only 0.1 percent in June.

Second, pandemic supply chain challenges should heal as pandemic pressures ease and companies adjust. Manufacturers will get chips into cars at some point and – when they do – those prices should start to normalize. On the margin, weakening demand could help by giving businesses space to catch up on hiring and inventories. We’ve seen some early signals of this healing, with freight costs decelerating, large retailers announcing that they are now more than fully stocked and employers having more hiring success, but it will still take time for these pressures to fully abate.

And finally, there’s the commodities lane, items like oil and wheat. Global events are driving this part of inflation, and the Fed has little influence here. But we are seeing over the last two months, the dollar strengthening and gasoline and even the broader range of commodities dropping from peak pricing levels. Hopefully commodities will continue to normalize and not be victim to further events (like a natural gas shut-off in Europe).

These three lanes are hard to forecast, so the pace of normalization is uncertain. As a result, our commitment to bring inflation to target, which hopefully you welcome, leads to worries about a recession. That’s especially true now that we have seen two consecutive quarters with negative (albeit noisy) estimates of GDP growth. Recession fears are a little inconsistent with an economy adding almost 400,000 jobs a month and with unemployment near its historic low at 3.6 percent. But I understand the concerns.

First, inflation has made consumer and business sentiment quite negative. In the most recent Michigan Survey, consumer sentiment was near its record low. The percentage of small business owners who expect better conditions over the next six months dropped to the lowest level in that survey's history in June. Typically, sentiment this low is associated with a weakening like the one we are seeing in consumer spending and business investment. Some call that "talking ourselves into a recession."

At the same time – as I mentioned – inflation is moving the Fed to increase rates. Historically, eight of the last 11 Fed tightening cycles have been followed by some sort of a recession.

That change in policy may well be making markets skittish. That's understandable: The Fed hasn't moved this quickly in over 20 years. Markets had a rough first half of the year, and market trauma sometimes can cause investors and businesses to pull back.

Those who look more closely for signals point to flashing lights coming from the 2-10 yield curve, a closely watched recession predictor that has now inverted. When short-term interest rates are higher than long-term ones, markets see risk on the horizon. The 2-10 yield curve has predicted eight of the last seven recessions.

Another frequently cited signal has been the dramatic recent increase in oil prices, which has occurred in advance of most of our past recessions.

There's also a fear about what else may come our way. We've already seen multiple supply side challenges, including pandemic-era shortages, the war in Ukraine and the lockdowns in China. Each has fanned the flames of inflation and raised questions about future demand. Who knows what is coming next?

So there is a path to getting inflation under control. But a recession could happen in the process. If one does, we need to keep it in perspective: No one canceled the business cycle. We are out of balance today because stimulus-supported excess demand overwhelmed supply constrained by the pandemic and global commodity shocks. Returning to normal means products on shelves, restaurants fully staffed and cars at auto dealers. It doesn't have to require a calamitous decline in activity. Indeed, lower prices may create room for consumers to spend again. As for financial markets, they are not the economy. And baselines matter. Equities are down this year but still significantly up from pre-pandemic levels. We might soon have the same conversation about houses were prices to slip after two years of extraordinary gains.

Most importantly, moderating demand has a higher purpose squarely in our mandate: containing inflation. If there is any lesson that's been relearned in the last year, it is that inflation is painful, and everyone hates it.

Why do we hate inflation so much? Inflation creates uncertainty. As prices rise unevenly, it becomes unclear when to spend, when to save or where to invest. Inflation is exhausting. It takes work to shop around for better prices and for firms to handle complaints from unhappy customers and negotiate with insistent suppliers. And inflation seems unfair. In the '70s, those who owned a house with a cheap mortgage benefited; those on fixed incomes did not. Workers who feel they have earned wage gains feel arbitrarily pinched at the gas pump. Homeowners like their sale price but can't believe their purchase price. Businesses work to capture value through pricing but feel they're being taken advantage of by suppliers.

Stabilizing expectations by getting inflation to target creates the certainty that enables growth and supports maximum employment. Inflation got under control after World War I, setting up the Roaring '20s. It got under control after World War II, setting up the prosperity of the '50s and '60s. It lingered for far too long after the Vietnam War – a period we don't want to repeat. So the Fed is committed to getting

inflation under control. We may or may not get help from global events and supply chains, but we have the tools, and we have the credibility with households, businesses and markets required to deliver that outcome over time and we will.

And with that, I'd welcome your questions and insights.