Atlanta Fed

Risk Management Is Key to Monetary Policy in Uncertain Times

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You may have noted that this summer's data showed glimmers of good news on the fight against inflation. The key word here is "glimmers." It is clearly much too early to claim victory. Inflation remains much too high, and month-to-month swings in any economic statistic can be unpredictable.

We understand inflation is causing pain for many Americans. Regaining price stability remains the Federal Reserve's top monetary policy priority. That commitment is unshakable.

The Federal Open Market Committee (FOMC) has moved, and will continue to move, expeditiously but carefully to bring inflation back toward our objective of 2 percent as measured by the personal consumption expenditures price index.

Yet getting a handle on today's economy is extremely challenging. The profound effects of the pandemic and attendant policy responses continue to shape macroeconomic conditions. Consider that in just two-and-a-half years, the US economy suffered its sharpest drop in overall output since World War II, followed by a rapid resurgence in demand, a dramatic imbalance between labor supply and demand, widespread supply and shipping constraints, and an inflation rate that surged from about 1.5 percent to 9 percent over the past 17 months.

The big picture is fuzzy

We've been through a lot. And economic signals are still scrambled.

To start, the broadest measure of activity, gross domestic product (GDP), showed that the economy contracted in the first two quarters of 2022. There were unusual circumstances that explain some of these data, but it seems apparent that activity slowed. Anecdotally, our contacts in retailing tell us higher prices are forcing low- and moderate-income consumers in particular to buy less-expensive products and forgo discretionary purchases. Meanwhile, trucking firms are reporting slackening demand.

On the flip side, other data describe an economy that is fundamentally stable. Employment growth this year continues strong, averaging 471,000 new jobs a month through July. As of July, total nonfarm employment returned to its prepandemic peak. Even our business contacts who voice concern about the direction of the economy are, nearly to a person, quick to add that their own business is healthy.

Moreover, we hear anecdotes and see other evidence suggesting that supply chain problems could be easing, perhaps this year. Data point to a shift in consumer spending toward a more normal mix, away from a heavy concentration in goods, like we saw early in the pandemic, and toward services. As a result, goods prices have climbed more slowly in recent months.

Still, even as certain inflationary pressures appear to be ebbing, we know we have a fight ahead. Food and rent prices, categories that hit lower-income consumers especially hard, continued their climb in July. And while goods prices show signs of moderating, core services inflation continues to drift upward, and inflation in services prices tends to be more persistent than goods inflation. (See the Atlanta Fed's Sticky-Price CPI.) Finally, while the July consumer price index report represented a reprieve in the pace of price increases, it also makes clear that price pressures remain stubbornly widespread and not confined to a few items.

Since August 2021, more than two-thirds of the "market basket" of products and services that federal statisticians use to calculate inflation has posted monthly price increases of greater than 3 percent at an annual rate, while more than half of the market basket has been rising at rates above 5 percent since last September. Keep in mind, we aim for 2 percent inflation. Put simply, those numbers constitute a clear signal to monetary policymakers that price pressures remain elevated and broad-based.

In an environment fraught with unknowns, the last thing the Fed wants to do is add to the uncertainty. While clear analogies to our recent experience are scarce, history is instructive on this point. What economists have come to call stop-and-go monetary policy—tightening in the face of rising inflation but then reversing course abruptly when unemployment rises—arguably helped to fuel inflation during the late 1960s and 1970s. Partly as a result, elevated inflation took root and policymakers ripped it out of the economy only after a pair of recessions in the early 1980s.

Two key questions

As the Committee confronts this immense challenge, I think two key questions should frame the policy debate. One, given that we are at or near a neutral policy stance, where monetary policy neither stimulates nor restricts economic growth, what level of rates would be appropriately restrictive? Two, how long will it take monetary policy to affect GDP and inflation?

Arriving at answers to these questions is not straightforward. We must weigh the risk of our policy action from both sides—moving either too aggressively or too timidly has downsides.

If history ultimately shows that we have not moved aggressively enough, the biggest danger is that inflation becomes entrenched in the minds of consumers and business decision makers. If consumers and companies make spending decisions with the assumption that prices will keep rising, the likelihood increases that inflation will last a long time.

How? The dynamics are reasonably straightforward. If workers think they need to gird their finances against ongoing inflation, then they negotiate for ever-higher pay. In turn, firms will continue to raise prices to offset rising labor costs, which typically represent the biggest single expense for companies. This could trigger a self-perpetuating "wage-price spiral" like we saw during the Great Inflation of the 1970s and '80s. Beyond that, if individuals believe prices will keep climbing, they are more likely to buy today while prices are relatively low, putting additional upward pressure on prices.

That's why we pay such close attention to inflation expectations. If inflation expectations become what economists call "unanchored"—that is, they rise and stay high—then the Committee might have to take drastic action and tighten policy quickly and dramatically, possibly triggering severe economic disruption. While we haven't seen expectations become unanchored—and recent readings in fact show them ticking down slightly—that risk grows the longer inflation stays high.

Like moving too little, being too aggressive with rate hikes entails risk. Most broadly, severe policy tightening can slow economic activity and lead to increased unemployment. In such a scenario, those at the lower end of the income and wealth spectrum tend to suffer first and worst, as they do with the effects of the elevated inflation we are trying to wring out of the economy.

Be assured, my colleagues and I are acutely aware of the risks that our policy decisions carry. I am proceeding carefully and with a healthy dose of humility. The Fed can't fix everything. We understand that today's economy is subject to myriad influences largely beyond the reach of monetary policy. Ongoing supply chain disruptions, geopolitical events such as wars and trade disputes, shortages of available workers, and ongoing wealth and income inequality are important economic forces that monetary policy is not equipped to directly address.

That said, monetary policy is a powerful tool and our most effective means to bring inflation under control, which is a key part of the Fed's mandate. Therefore, as one monetary policymaker, I will stay vigilant and closely monitor not only inflation but also labor markets and an array of economic vital signs that help guide us in calibrating the appropriate policy stance.

In pursuit of that stance, I think it is worth emphasizing that monetary policy does not produce immediate results. History and a convincing body of research tell us that our policy tools work with a lag. Monetary policy tightening tends to affect other economic indicators such as the housing market, which has already notably slowed, before it meaningfully influences underlying inflation. That broad impact makes it critical that we pay attention to how all parts of the economy are evolving and remain steadfast if, as is likely, inflation doesn't fall right away.

Even though it will take time to see the full effect of the policy adjustments we have made to date, I don't think we are done tightening. Inflation remains too high, and our policy stance will need to move into restrictive territory if inflation is to come down expeditiously. That said, incoming data—if they clearly show that inflation has begun slowing—might give us reason to dial back from the hikes of 75 basis points that the Committee implemented in recent meetings. We will have to see how those data come in.

On the bright side, numerous factors give me optimism that a repeat of the "Great Inflation" of the 1960s through the early 1980s is not in the offing. As I noted, economic fundamentals such as labor market growth are holding up. Consumers and businesses in the main are in sound financial shape. Supply pressures, according to our readings, should start easing, maybe this year. Finally, research is finding that more flexible work arrangements such as working from home could limit upward pressures on wage growth that might fuel a wage-price spiral.

In closing, let me repeat that my FOMC colleagues and I are firmly committed to bringing inflation down while keeping the economy as strong as possible for American families. Uncertain times like we've experienced during the past couple of years call for a risk management approach to monetary policy. With the harm that higher prices cause Americans, and the risk of slower economic growth that accompanies higher interest rates, I will be resolute, but purposeful, in my view of the appropriate pace of tightening monetary policy.