Returning to Price Stability

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Introduction

It is a great pleasure to be with you today, and I thank Jackie Gamblin for the kind introduction. As many of you know, in addition to being CEO of JYG Innovations, Jackie is also a director of the Federal Reserve Bank of Cleveland. I'd like to take this opportunity to thank Jackie for her public service to my organization and to the country. Jackie and her fellow directors provide a wealth of information on the economic circumstances of households and businesses in their regions. The information comes from their own firms and customers, as well as other business and community contacts like you. In the unprecedented environment we have all had to confront since the start of the pandemic, I cannot overstate the value of this reconnaissance in helping me and my colleagues at the Fed formulate monetary policy.

Indeed, since I last spoke at this breakfast four years ago, much has transpired. At that time, the economy was in the ninth year of an expansion; labor markets were strong; and inflation was finally moving up to our 2 percent goal after running below this goal for some time. The Fed was continuing to increase its policy rate, the fed funds rate, to be consistent with these healthy economic conditions and the outlook. The economic expansion continued for another two years, until the pandemic changed all that. The resilience shown by households and businesses over the past two challenging years has been truly remarkable. Yet many challenges remain; in particular, inflation, which is at a 40-year high, is a serious burden for households, businesses, and the overall economy. Today, I will focus my remarks on how monetary policy will foster a return to price stability. Of course, the views I present will be my own and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee.

The Economy

The key challenge facing our economy is unacceptably high inflation. Inflation has been running well above 2 percent for over a year now; it is very high not only in the U.S. but in other advanced economies around the globe. This inflation stems from many factors, but fundamentally, it reflects an imbalance

between strong demand and constrained supply, which has led to significant upward pressures on prices. Various surveys and my conversations with regional contacts reveal that inflation is the number one concern of businesses and households. It imposes a particularly onerous burden on those who don't have the wherewithal to pay more for essentials like food, gasoline, and shelter, whose inflation rates have been particularly high.

Price stability is the foundation of a strong economy; it is necessary for ensuring that the U.S. can sustain healthy labor market conditions over the medium and longer run and that the economy can be productive and live up to its potential for everyone's benefit. The FOMC is committed to using its tools to bring inflation back down to our longer-run goal of 2 percent; it is taking decisive action to remove monetary policy accommodation to bring demand into better balance with constrained supply in both product and labor markets. Since March of this year, the FOMC has raised the target range of the fed funds rate by 2-1/4 percentage points, and it has begun to reduce the assets the Fed is holding on its balance sheet, which will also reduce accommodation. Given current rates of inflation, I believe that the Fed has more work to do in order to get inflation under control. This will entail further rate increases to tighten financial conditions, resulting in an economic transition to below-trend growth in nominal output, slower employment growth, and a higher unemployment rate.

Economic Growth

In fact, we are beginning to see activity slow down from last year's robust pace. In part, this can be attributed to our monetary policy actions and the tightening in overall financial conditions compared to a year ago. But it also reflects households' and businesses' responses to very high inflation and their concerns about the economic outlook, as well as the waning effects of the pandemic fiscal stimulus, and slower growth abroad. Consumer spending, housing activity, and business investment have decelerated from the robust pace seen last year. Indeed, real GDP moved down in the first half of this year. In the first quarter, the main contributors to the decline in output were declines in net exports and government

spending and slower inventory investment, but consumer and business spending remained solid. The second quarter saw slower growth in these components as well. While manufacturing surveys suggest activity has moderated, firms in our region tell us that their strong order books should keep them busy at least through the end of the year. In response to higher mortgage rates, residential investment, one of the most interest-rate-sensitive sectors of the economy, also fell quite sharply in the second quarter. Yet, because the supply of housing has not kept up with demand, housing prices and rents remain quite elevated.

Indeed, supply constraints have posed a significant challenge across a variety of sectors since the economy reopened after the pandemic shutdowns. In product markets, firms have had to deal with a cascading set of disruptions to their global supply chains. These disruptions stem from pandemic-related shutdowns across the globe and the war in Ukraine, which has further constrained supplies in energy, metals, and agricultural commodity markets. Firms in Dayton and other parts of our region tell us that the supply challenges have lasted longer than they expected and they have had to be creative in meeting those challenges. Some manufacturers are stockpiling large volumes of materials to have them on hand to meet future demand or to fill their backlogged orders. Other firms are custom making parts to substitute for those that are unavailable. Many have been trying to adjust their inventories to be better prepared to meet current and future demand, which explains some of the overstocking at the end of last year, followed by slower inventory building this year. Many firms tell us that they will be investing to make their supply chains more resilient to be better prepared for the future.

Analysts often use the rule-of-thumb that two consecutive quarters of negative real GDP growth means the economy is in recession. I do not believe the U.S. economy is currently in a recession because the labor market remains very strong. I do acknowledge that the risks of recession over the next year or two have moved up because financial conditions are tightening globally, inflation remains at high levels in many countries, and the devastating war in Ukraine adds considerable uncertainty and downside risks to

the growth outlook, especially in Europe. That said, at this point, I have not incorporated a recession into my baseline outlook for the U.S., but instead expect a fairly sharp slowing in activity, especially when compared to the robust growth the U.S. experienced in 2021. While there is considerable uncertainty, I currently expect that the U.S. economy will return to positive growth in the second half of the year, but for this year as a whole and for next year, I expect growth to run well below 2 percent, which is my estimate of trend growth.

Labor Markets

With the economy growing below trend, I expect the current very strong labor market conditions to cool, with the unemployment rate rising somewhat above 4 percent by the end of next year. Some cooling off in the labor market will put it on more sustainable footing compared to the unsustainably tight conditions that exist today.

The economy added 6.7 million jobs last year, an average of over 550 thousand jobs per month, which is very robust. There are widespread reports from a broad spectrum of firms about how hard it has been to find workers. Even so, employment growth has remained very strong this year. Job gains averaged about 460 thousand per month over the first half of the year, and they accelerated in July. The unemployment rate fell to 3.5 percent, matching the lowest level reached during the long pre-pandemic expansion. Although the number of job openings has eased in recent months, they remain at historically high levels: there are close to 2 openings per unemployed worker; in 2019, another time of tight labor markets, there were about 1.2 openings per unemployed worker.

A variety of reasons have contributed to people leaving the workforce early in the pandemic and then only slowly returning. These include responsibilities for caring for children or other family members; fear of the virus; reevaluation of their careers; and retirement. Reduced immigration has also constrained labor supply. The participation rate of prime-age workers has returned to where one would expect it to

be. Overall participation, which includes those of retirement age, has improved, but only gradually. Typically, most people don't return to the job market once they have retired. So there is little reason to think that we will see an influx of workers large enough to return the overall participation rate to its pre-pandemic level.

Firms have been using a variety of ways to attract and retain staff, including offering more flexible work schedules, signing and retention bonuses, expanded benefits, and higher base wages. Wage pressures have been building up for a while and show little sign of abating. The employment cost index for private industry workers accelerated over the six months ending in June, rising at a 6.0 percent annual pace. Even so, these wage increases have not kept up with inflation, so workers' purchasing power is being eroded. Higher wages that reflect higher productivity growth don't contribute to inflation, and they are a positive for both workers and firms. But current wage increases are not consistent with inflation returning to our 2 percent goal. With trend productivity growth estimated to be around 1-1/4 to 1-1/2 percent, wage growth will need to moderate to around 3-1/4 to 3-1/2 percent to be consistent with price stability. As former Fed Chair Paul Volcker pointed out in the midst of his fight against very high inflation in 1981: "[Wage gains], when they are not grounded in real growth and productivity, are a kind of economic 'shell game' in which rising incomes disappear at the supermarket or the shoe store… ."[1]

Inflation

As their costs have continued to rise, businesses have been raising the prices they charge their customers and finding little resistance. Over the past year, price pressures have broadened across goods and services, and despite some moderation in economic activity, inflation readings continue to be at the highest levels in 40 years. To assess the inflation situation, I look at a variety of measures. The Fed has set its inflation target in terms of PCE inflation. Measured year-over-year, PCE inflation came in at about 6-1/4 percent in July; CPI inflation was 8-1/2 percent. These readings were down slightly from their June

[1] Volcker (1981a), p. 2.

readings, mainly reflecting a sharp drop in the price of gasoline and energy. This was welcome news, but we have to guard against wishful thinking becoming a substitute for compelling evidence.

In my view, it is far too soon to conclude that inflation has peaked, let alone that it is on a sustainable downward path to 2 percent. First, measures of the underlying inflation trend did not uniformly decline in July. Only the core PCE inflation rate, which excludes food and energy, declined. Measured year-over-year, core CPI inflation and the median and trimmed-mean inflation rates, which exclude the components with extreme movements, were either stable or actually increased.[2] Second, in the coming months, goods inflation may slow in response to easing demand and the appreciation of the dollar, but the prices of energy and other commodities are set in global markets, and developments related to the ongoing war in Ukraine may lead to higher prices later this year. Third, inflation in the prices of services tends to be more persistent. Services inflation is at its highest level since the early 1990s, and growth in housing rent and shelter costs, which represent a large share of measured inflation, will likely keep inflation elevated for some time. All of this suggests that it will take a while for inflation to reach the Fed's 2 percent goal. I expect inflation to move down into a range of 5 to 6 percent for this year and then to make more progress toward our goal over the next two years, but it will require further action on the part of the Fed to make that so.

Monetary Policy

In making its monetary policy decisions, the FOMC is always guided by its strong commitment to achieving its congressionally mandated goals of price stability and maximum employment. Monetary policy cannot affect the supply-side factors that have contributed to the very high inflation readings. Instead, it works on the demand side of the economy. The Fed is being resolute and intentional in

[2] The Federal Reserve Bank of Cleveland produces the median and trimmed-mean CPI inflation rate and the median PCE inflation rate. The Federal Reserve Bank of Dallas produces the trimmed-mean PCE inflation rate. The Federal Reserve Bank of Cleveland's Center for Inflation Research produces inflation measures and analyses of inflation and inflation expectations to inform policymakers, researchers, and the general public.

tightening financial conditions to bring demand into better balance with supply to alleviate price pressures. Since March, we have raised the target range of the fed funds rate a cumulative 2-1/4 percentage points and financial conditions are tighter than they were at the end of last year.

In addition, in June we began to reduce the size of our balance sheet according to the plan announced in May.[3] Reducing the amount of the Fed's securities holdings will help to lessen downward pressure on longer-term interest rates by returning duration to the market. The reduction in our balance sheet is being done primarily by adjusting how much we reinvest of the principal payments we receive on our assets. Without asset sales, the process could take three years or so.[4]

Monetary policy acts with a lag on the economy. So even though other financial conditions, like mortgage rates, have adjusted, it is likely we have not yet seen the full effect of the rate increases we have implemented so far on households and businesses. Given the lagged effects of monetary policy, it would not be appropriate to continue moving rates up until inflation is back down to 2 percent. As is always the case, we will be calibrating our policy based on the implications of incoming information for the economic outlook and on the progress toward our monetary policy goals. That said, at our last meeting, the FOMC indicated that it anticipates that ongoing rate increases in the fed funds rate will be appropriate. I certainly agree with that view.

Given the current level of inflation and the economic outlook, I anticipate that policy will need to move into a restrictive stance in order to put inflation on a sustained downward trajectory to 2 percent. In my

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[3] Starting in September, the Fed will allow up to $60 billion per month of Treasury securities and up to $35 billion per month of agency securities to run off the balance sheet. To the extent that maturing Treasury coupon securities are less than the monthly cap, Treasury bills will make up the rest of the runoff up to the cap. See the Federal Open Market Committee (2022b).

[4] As indicated in the minutes of the March 2022 FOMC meeting, FOMC participants generally agreed that after balance-sheet reduction was well underway, it would be appropriate to consider sales of agency mortgage-backed securities. Sales would help to speed the return of our portfolio's composition to being primarily Treasury securities, consistent with the FOMC's stated desire to minimize the effect of the Fed's balance-sheet holdings on the allocation of credit across economic sectors. See the Federal Open Market Committee (2022a), pp. 4-5.

view, that means that short-term interest rates adjusted for expected inflation, that is, real interest rates, will need to move into positive territory and remain there for some time. Right now, nominal short-term interest rates are lower than expected inflation, so short-term real interest rates are still negative and monetary policy is still accommodative. The current level of the fed funds rate is near the range of estimates of its longer-run nominal level, and when inflation is at 2 percent and inflation expectations are consistent with 2 percent inflation, this longer-run level would be neutral in the sense of neither stimulating nor restraining economic activity. But in the current high-inflation environment, a 2-1/2 percent nominal funds rate is still accommodative and the Fed has more work to do. My current view is that it will be necessary to move the fed funds rate up to somewhat above 4 percent by early next year and hold it there; I do not anticipate the Fed cutting the fed funds rate target next year. But let me emphasize that this is based on my current reading of the economy and outlook. While it is clear that the fed funds rate needs to move up from its current level, the size of rate increases at any particular FOMC meeting and the peak fed funds rate will depend on the inflation outlook, which depends on the assessment of how rapidly aggregate demand and supply are coming back into better balance and price pressures are being reduced.

Making that assessment will remain challenging because there is a high level of uncertainty surrounding the outlook for the global economy, with a variety of forces affecting the demand and supply sides of the economy. The war in Ukraine and the energy situation in Europe could impose further costs on the people in that region and on the global economy, posing downside risks to growth but upside risks to inflation. A souring in consumer and business sentiment and reactions to elevated inflation readings could result in a larger than anticipated moderation in activity. There are some potential positives on the supply side of the economy. The newly passed fiscal package may have a larger effect on productivity growth and inflation over the near term than current private-sector estimates suggest.[5] And with some

[5] Analysis by Penn Wharton Budget Model (2022) indicates that the Inflation Reduction Act would reduce cumulative government deficits by $264 billion over the 10-year budget window, have no meaningful effect on

luck, supply chain disruptions will abate faster than anticipated and labor market participation will continue to rise, helping to ease supply constraints in product and labor markets and bringing supply into better balance with demand. But we cannot rely on luck.

It would be a mistake to declare victory over the inflation beast too soon. Doing so would put us back in the stop-and-go monetary policy world of the 1970s, which was very costly to households and businesses.[6] In assessing the appropriate stance of policy, I will be looking for compelling evidence that inflation is on a sustainable downward trajectory to our 2 percent goal. Before I conclude that inflation has peaked, I will need to see several months of declines in the month-over-month readings. I will also be carefully watching measures of inflation expectations, particularly expectations of inflation over the medium and longer term. Currently, consumers and businesses expect inflation to be well above 2 percent over the next year. While recent readings of medium- and longer-term expectations have eased off a bit, they have moved up over time and are at the upper end of the range of values consistent with our inflation goal. Research indicates that changes in the prices of particular salient items, including gasoline and food, can have an outsized effect on households' inflation expectations.[7] Gas prices have come down from recent highs but with the uncertainty surrounding world oil supply, gasoline prices could rise again, and food prices might remain high.

We need to be particularly attuned to inflation expectations. If longer-term inflation expectations were to become unanchored and move above levels consistent with our longer-run inflation goal, high inflation would become embedded in the economy, affecting the actions of both firms and consumers; at that point it would be considerably more difficult and more costly to bring inflation down. A risk-management

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inflation in the near term, but would reduce inflation by 0.1 percentage point by the middle of the first decade. See Penn Wharton Budget Model (2022).

[6] For a short, readable history, see Sablik (2013).

[7] For the effect of experiences from high-inflation eras on inflation expectations, see Malmendier and Nagel (2016). For the effect of salient prices on inflation expectations, see Coibion and Gorodnichenko (2015), Cavallo, Cruces, and Perez-Truglia (2017), D'Acunto, et al. (2021), and Campos, McMain, and Pedemonte (2022).

perspective strongly argues against policymakers being complacent about a rise in longer-term expectations. Instead, better economic outcomes are achieved if policymakers assume rises in inflation and inflation expectations are persistent and act forcibly to bring both down. It is good to remember that inflation expectations are determined not only by movements in inflation but also by policymakers' actions to follow through on their strongly stated commitment to price stability, thereby justifying the public's belief in our commitment.

Commitment and Follow-Through

The return to price stability will take some time and a lot of fortitude. There will be bumps along the road. Financial markets could well remain volatile as financial conditions tighten further; growth could slow more than expected; and the unemployment rate could move above estimates of its longer-run level. This will be painful in the near term but so is high inflation. High inflation imposes costs on households and businesses in both the short and long run. It eats into savings and makes it hard to plan for the future. If we fail to take the actions needed to get inflation down and firmly anchor inflation expectations, we will not be able to sustain healthy labor markets over the medium and long run, to the detriment of the public.

As Paul Volcker said as he fought inflation in the 1980s: "…failure to carry through now in the fight on inflation will only make any subsequent effort more difficult, at much greater risk to the economy."[8] That statement is as true now as it was then. That is why I remain resolute in setting monetary policy to return the economy to price stability, which is the foundation for sustaining maximum employment and a healthy, productive economy over time.

[8] Volcker (1981b), p. 2.

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