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Restoring Price Stability in an Uncertain Economic Environment

Remarks by

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at

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It is a pleasure to join this discussion today.<sup>1</sup> Inflation is high in the United States and around the world reflecting the lingering imbalance between robust demand and constrained supply caused by the pandemic and Russia's war against Ukraine. Global supply chains have eased significantly, but by some measures they are still more constrained than at nearly any time since the late 1990s.<sup>2</sup> High inflation places a burden on all Americans, but especially lower-income families, who spend three-fourths of their income on necessities—more than twice the share spent by higher-income families. The Federal Reserve has tightened policy strongly to bring inflation down, and U.S. tightening is being amplified by concurrent foreign tightening. We are starting to see the effects in some areas, but it will take some time for the cumulative tightening to transmit throughout the economy and to bring inflation down. Uncertainty remains high, and I am paying close attention to the evolution of the outlook as well as global risks.

Higher interest rates are working to temper demand and bring it into better alignment with supply, which is still constrained. Output has decelerated so far this year by more than anticipated, suggesting that policy tightening is having some effect. Real gross domestic product (GDP) declined at an annual rate of roughly 1 percent in the first half. Real private domestic final purchases stepped down from a 6.4 percent pace last year to an annual rate of only 1.3 percent during the first half of this year.

Recent revisions to national income and product accounts data imply that the current stock of excess savings held by households is lower and has been drawn down

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<sup>1</sup> I want to thank Kurt Lewis and Daniel Villar of the Federal Reserve Board for their assistance on these remarks. These views are my own and do not necessarily reflect those of the Federal Reserve Board or the Federal Open Market Committee.

<sup>2</sup> Federal Reserve Bank of New York Global Supply Chain Pressure Index, September 2022.  
<https://www.newyorkfed.org/research/policy/gscpi#/interactive>

more rapidly in recent quarters than had been previously estimated. Indeed, by Board staff estimates, the revisions imply that the stock of excess savings held by households is about 25 percent lower, which may imply a more subdued pace of consumer spending going forward than had been projected.

Market expectations for the level of the policy rate at the end of the year are now more than twice as high as they were just seven months ago. As a result of the significant increase in interest rates and associated tightening in broader financial conditions, I now expect that the second-half rebound will be limited, and that real GDP growth will be essentially flat this year.<sup>3</sup>

The moderation in demand due to monetary policy tightening is only partly realized so far. The transmission of tighter policy is most evident in highly interest-sensitive sectors like housing, where mortgage rates have more than doubled year to date and house price appreciation has fallen sharply over recent months and is on track to soon be flat. In other sectors, lags in transmission mean that policy actions to date will have their full effect on activity in coming quarters, and the effect on price setting may take longer. The moderation in demand should be reinforced by the concurrent rapid global tightening of monetary policy.

Against the backdrop of slower output growth, we are seeing some tentative signs of rebalancing in the labor market. Anecdotal reports suggest the availability and

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<sup>3</sup> Both the Summary of Economic Projections (SEP) and private forecasters showed expectations of a above-trend 2022 growth early this year. The March SEP showed a median projection of 2.8 percent GDP growth in 2022 and a policy rate path that almost reached 2 percent by year-end. In the March 2022 Blue Chip Economic Indicators, the consensus projection for Q4/Q4 real GDP growth in 2022 was 2.6 percent, and policy expectations for year-end 2022 in the Blue Chip Financial Forecast for the same month were 1.3 percent. On a Q4-over-Q4 basis, the September Blue Chip consensus for 2022 real GDP growth was a decline of 0.1 percent. The median expectations for real GDP growth on a Q4-over-Q4 basis in the September SEP were 0.2 percent.

retention of workers are improving.<sup>4</sup> For the second month in a row, growth in monthly payroll employment stepped down, slowing from 315,000 in August to 263,000 in September. There was a sharp 1.1 million decline in job openings from July to August in the Job Openings and Labor Turnover Survey (JOLTS). The ratio of job openings to job seekers declined to 1.7; for purposes of comparison, this ratio was 1.2 prior to the pandemic.<sup>5</sup> The sharp fall in vacancies at a time when initial claims held steady at low levels provides support for the possibility that businesses that faced significant challenges finding and retaining qualified workers following the pandemic may be more inclined than in past cycles to retain rather than lay off their workers as demand weakens. In particular, there is still a sizable 1.2 million shortfall in employment levels relative to pre-pandemic levels in the in-person services sectors that accounted for the majority of September payroll gains, suggesting businesses in those sectors may still be trying to narrow that gap.<sup>6</sup>

That said, a variety of indicators suggest labor demand remains strong, while labor supply remains below pre-pandemic conditions. The unemployment rate is now at the very low level that prevailed pre-pandemic, and the volume of quits remains

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<sup>4</sup> For example, the discussion in the September Beige Book notes that “overall labor market conditions remained tight, although nearly all Districts highlighted some improvement in labor availability, particularly among manufacturing, construction, and financial services contacts. Moreover, employers noted improved worker retention, on balance.” See Board of Governors of the Federal Reserve System (2022), Beige Book (Washington: Board of Governors, September 7), <https://www.federalreserve.gov/monetarypolicy/beigebook202209.htm>.

<sup>5</sup> The current ratio is calculated as the number of job openings at the end of August in the most recent JOLTS release, divided by the number of unemployed persons reported in the September 2022 Current Population Survey.

<sup>6</sup> The total shortfall in the level of employment in September 2022 relative to the level in February 2020 from the retail trade, educational services, local government education, health care and social assistance, and leisure and hospitality sectors was 1.16 million.

elevated.<sup>7</sup> This supply–demand imbalance in the labor market is reflected in strong wage growth. The employment cost index increased by an annual rate of 6.3 percent over the second quarter—its highest level in decades. A more-timely data source, average hourly earnings, decelerated slightly to a 4.4 percent annual rate over the third quarter, down from 4.6 percent annual growth in the second quarter. Although it is well above levels consistent with 2 percent inflation, wage growth has been running below current inflation.

Strong wage growth along with high rental and housing costs mean that inflation from core services is expected to ease only slowly from currently elevated levels. In contrast, core goods have been expected to return to something closer to the pre-pandemic trend of modest disinflation as a result of demand rotation away from goods to services, coupled with the healing of supply chains and declining core import prices. Disinflation in core goods would help to offset the inflationary pressures in services. During the five years before the crisis, core goods made a small negative contribution to inflation. The contribution of core goods to inflation swung sharply into positive territory in 2021, and had started to step down somewhat in the middle part of 2022.<sup>8</sup> So the surprise in the August inflation data was the large contribution of core goods inflation to overall inflation at a point in the post-pandemic recovery when many forecasts anticipated this contribution would continue moderating.

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<sup>7</sup> As shown by the data from the Federal Reserve Bank of Atlanta’s Wage Growth Tracker, through August the 12-month moving average of median wage growth among job switchers was nearly 2 percentage points higher than those who remained in their same role, with 6.9 percent growth for job switchers as opposed to 5.0 percent growth for those who remained in the same role. For more information, see <https://www.atlantafed.org/chcs/wage-growth-tracker>.

<sup>8</sup> Expressed on an annualized basis, the average monthly contribution from core goods to total PCE inflation in 2021 would be 1.6 percent. For data going back to 1987, the contribution of core goods to total PCE inflation on a 12-month basis reached its peak in February 2022 at 1.8 percentage points and came in at 1.3 percentage points in August 2022.

Since the pandemic, significant supply and demand imbalances have coincided with large increases in retail trade margins in several sectors. In some sectors, the increase in the retail trade margin exceeds the contemporaneous increase in wages paid to the workers engaged in retail trade, although this is not true in food and apparel. The return of retail margins to more normal levels could meaningfully help reduce inflationary pressures in some consumer goods, considering that gross retail margins are about 30 percent of total sales dollars overall.

For instance, among general merchandise retailers, where the real inventory-to-sales ratio is 20 percent above its pre-pandemic level, retail margins have increased 20 percent since the onset of the pandemic, roughly double the 9 percent increase in average hourly earnings by employees in that sector.<sup>9</sup> In the auto sector, where the real inventory-to-sales ratio is 20 percent below its pre-pandemic level, the retail margin for motor vehicles sold at dealerships has increased by more than 180 percent since February 2020, 10 times the rise in average hourly earnings within that sector.<sup>10</sup> So there is ample room for margin recompression to help reduce goods inflation as demand cools, supply constraints ease, and inventories increase.

Despite the higher prices for a broad set of goods and services, market- and survey-based measures of longer-term inflation expectations are within ranges consistent with expectations that inflation will return to 2 percent over the medium term.<sup>11</sup> Treasury

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<sup>9</sup> See, for example, Josh Ulick and Suzanne Kapner (2022) “From Walmart to Gap, Which Retailers Have the Most Excess Inventory?” *Wall Street Journal*, June 9, <https://www.wsj.com/articles/from-walmart-to-gap-which-retailers-have-the-most-excess-inventory-11654776000>.

<sup>10</sup> For additional information, see Alana Semuels (2022), “I Paid \$3,000 Above Sticker Price for My New Car. You Probably Will Too,” *Time*, September 29, <https://time.com/6218046/new-car-prices-over-msrp>.

<sup>11</sup> Although the Survey of Professional Forecasters saw large increases in expected inflation for 2022 and 2023 between the first- and third-quarter surveys, reflecting the shocks to inflation between the periods in February and August when those surveys were conducted, the implied 5-to-10-year inflation expectation

Inflation-Protected Securities–based measures of five-year, five-year-forward breakeven inflation compensation are currently at 2.15 percent, roughly 10 basis points below their level at the start of the year. The median of inflation expectations over the next 5 to 10 years in the Michigan survey ticked down in September to 2.7 percent, below the 2.9 to 3.1 percent range in which it had been fluctuating since July 2021 and back within the range that was common before the 2015 decline in this metric.<sup>12</sup> Currently, there is a greater dispersion than usual of views about future inflation in survey responses.

Previously this reflected a rise in expectations for significantly above-target inflation, but now that dispersion also reflects expectations on the part of one quarter of respondents that prices are likely be the same or below their current level 5 to 10 years in the future.

In order to bring inflation down and to keep inflation expectations solidly anchored at 2 percent, the Federal Reserve has increased the federal funds rate target range by 300 basis points in the past seven months, and both market and policymaker surveys indicate additional increases through the end of this year and into next year. In addition, balance sheet shrinkage is now proceeding at its maximum rate, reinforcing the move to a restrictive stance. Broader U.S. financial conditions have tightened rapidly in response: The two-year Treasury yield has moved above 4 percent for the first time since 2007, and the 10-year yield is near its highest level in over a decade at 3.9 percent. Corporate bond yields have risen even more, as investment- and speculative-grade corporate bond spreads have increased about 80 basis points and 170 basis points,

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remained at 2 percent throughout the surveys conducted thus far in 2022. See <https://www.philadelphiafed.org/surveys-and-data/real-time-data-research/survey-of-professional-forecasters>.

<sup>12</sup> For additional information, see <https://data.sca.isr.umich.edu>.

respectively, over the year. Mortgage rates have more than doubled since the beginning of the year. The Board's broad dollar index has appreciated 11 percent year to date.<sup>13</sup>

Monetary policy tightening is also proceeding rapidly abroad. Many central banks in large economies have raised rates by 125 basis points or more in the past six months, and yields on 10-year sovereign debt in Canada, the United Kingdom, and the largest euro area economies have seen increases on the order of 190 to 360 basis points this year.<sup>14</sup>

The combined effect of concurrent global tightening is larger than the sum of its parts. The Federal Reserve takes into account the spillovers of higher interest rates, a stronger dollar, and weaker demand from foreign economies into the United States, as well as in the reverse direction. We are attentive to the risk of further adverse shocks—for instance, from Russia's war against Ukraine, the pandemic, or China's zero-COVID policies. And we are also very aware that the cross-border effects of unexpected movements in interest rates and exchange rates, as well as worsening external imbalances, in some cases could interact with financial vulnerabilities. In this environment, a sharp decrease in risk sentiment or other risk event that may be difficult to anticipate could be amplified, especially given fragile liquidity in core financial markets. In some countries, the realization of these risks could pose challenging tradeoffs for policy.

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<sup>13</sup> The Federal Reserve's broad trade-weighted dollar index is based on 26 currencies of major U.S. trading partners. It is published in Statistical Release H.10, "Foreign Exchange Rates," available on the Board's website at <https://www.federalreserve.gov/releases/h10/current/default.htm>.

<sup>14</sup> The central banks of the United States, the United Kingdom, Canada, the euro area, Australia, New Zealand, Norway, Sweden, and Switzerland together account for 49 percent of nominal global GDP measured in dollars at market exchange rates. Each of these central banks has raised its policy rate by at least 125 basis points in the past six months.



That said, the real yield curve is now in solidly positive territory at all but the very shortest maturities, and the entire real curve will soon move into positive territory with the additional tightening and deceleration in inflation that are expected over coming quarters. Monetary policy will be restrictive for some time to ensure that inflation moves back to target over time. It will take time for the cumulative effect of tighter monetary policy to work through the economy broadly and to bring inflation down. In light of elevated global economic and financial uncertainty, moving forward deliberately and in a data-dependent manner will enable us to learn how economic activity, employment, and inflation are adjusting to cumulative tightening in order to inform our assessments of the path of the policy rate.