Fed Unfiltered, Transcript
10/21/22 – Charles Evans, Speech: 2022 Community Bankers Symposium

Charles Evans:

It's really wonderful to be here. This is a really important, interesting conference to attend. Gosh, I thought I had created this conference. I guess it began before me. It really is terrific to see everybody. This is just one of those unusual periods where you can still find yourself going to an event and saying, "This is our first in-person meeting in how many years?" I was in London and people said that to me. I was at the CNBC Studio and they said, "You're the first in-person guest that we've had." That was two weeks ago. I go, "That's unbelievable," but very unusual at times. It's so great to see so many bankers, community bankers here. We've all worked so hard under difficult circumstances.

During COVID, we went to having virtual meetings. We had so many council meetings, CDAC meetings where we just weren't able to welcome everybody here into the bank, and so it's great to see everybody here. I really enjoyed interacting with bankers and community bankers over the years. Just in August, I was in Iowa twice talking with bankers and business people, and I was in Southern Indiana as well, and I just had some really fascinating discussions about business challenges, what everybody is working to overcome, worker shortages, high prices, making sure everybody is able to find work and take care of themselves. So, it's really great to be here. Let me share some views that I have for the national outlook. It's really more unusual than so many times that I've spoken to this group.

In the United States and elsewhere around the world, what began as narrowly concentrated shocks to relative prices has spread, turning into broad based increases in overall inflation to levels far above every central bank's target. Accordingly, monetary policy makers now are significantly tightening policy in order to bring inflation back in line with their price stability mandates. Since March, 2022, the Federal Open Market Committee has increased the federal funds rate, our main policy tool, by three percentage points. We also are reducing the size of our balance sheet in relatively rapid clip.

Federal Reserve is committed to returning inflation to its 2% average goal. To do so, I expect we will need to raise rates further, and then to hold that stance for a while. Of course, the exact path for policy will depend on the evolution of the economy and risk to the outlook. I know bankers are familiar with the current situation, so I won't spend too much time discussing the incoming data, which as you know has been mixed. Household and business spending have been moderating. Lower real disposable income and policy induced tightening and financial conditions are clearly in play. This is most notable in the interest rate sensitive housing markets where mortgage rates have about doubled since the beginning of the year.

In contrast, the labor market remains strong. Robust job growth, elevated job openings and quits, and an unemployment rate that's at the very low level we experienced before the COVID crisis. However, over the past few months, we've heard more reports from our business and community context of reduced job turnover, and that some are finding it easier to attract qualified workers. These are signs that some of the unusual strength in labor demand may be waning, increasing pay and more flexible work arrangements may be part of the explanation, as well as the softer growth in spending.

As of yet, these anecdotal reports haven't shown through strongly in the aggregate data, although job growth has moderated some from its extremely rapid pace. A report a couple of weeks ago on job openings in labor turnover survey, and that contained a notable drop in vacancies. On the labor supply side, while many workers who left the labor force during the pandemic have reentered the labor market, many others have not. Today, labor force participation is still well below its pre-pandemic, right? Most of this shortfall is accounted for by older workers, as the pandemic apparently accelerated the retirement decision for many baby boomers who would've eventually exited from the labor force anyway.

I spoke to a number of people who said, "It's just sort of been normal that we can have workers with a lot of skills, say, in manufacturing and whatnot. They're in their sixties and they're still going to work a few years. They fill in really importantly. More recently, they're not interested in overtime. Overtime was always an important part of that proposition. They're not interested in working weekends either, and then eventually maybe they just stop and they retire early." These are folks who were probably going to retire in a few years anyway, so they may not come back, because that would be the normal retirement part. That's part of what's going on, it seems to me.

Another factor weighing on labor supply is the quite low inflow to the US labor force from immigration. A strong labor market may still help draw some of those sitting on the sidelines back into the workforce and alleviate some labor market pressure. Last year I expected the labor supply response to be fairly large, but as time passes, I become less optimistic that this channel will provide much relief from labor market pressures. Indeed, the labor force participation rate currently does not appear far from its long term trend, which has been declining for quite a long time, so policy adjustments are needed to bring inflation into line with our goal.

That brings me to a discussion of what is the principle issue facing the economy in the United States and elsewhere around the world: inflation. After more than a decade of missing our average 2% target to the downside, PCE inflation has risen quite quickly. From under 1% in mid 2020 to 6.2% in the most recent data, excluding food and energy, core PCE prices rose 4.9% over the past 12 months. Reducing inflation to a level consistent with the Fed's 2% objective will require a period of restrictive financial conditions to restore better balance between supply and demand economy wide. This will generate below trend growth and some softening of labor market conditions. But ensuring low and stable inflation is a prerequisite for achieving the sustained strong labor market outcomes that bring benefits to everyone in our society.

These broad contours are demonstrated in the FOMC's latest summary of economic projections. The SEP dot plot shows that most FOMC participants are looking at something like another 100 to 125 basis points of rate increases this calendar year, with the median projection for the federal funds rate then rising a bit further to 4.6% at the end of next year. This monetary restraint is clearly showing through in the projection for GDP growth, which the median participant sees running somewhat below its long run rate over the next year and a half or so, before moving back up to trend in the projection period. The unemployment rate is projected to rise to 4.4% by late next year, it's currently three and a half percent, and then remain near that level in 2024 and 2025. While this does represent a noticeably softer labor market when compared with today's, these certainly are not recession like numbers.

As for inflation, with supply side improvements, restricted monetary policy and below trend growth, inflation is expected to moderate significantly. According to the median participant, total PCE inflation is expected to fall to 2.8% in 2023, and eventually return to our 2% target by the end of 2025. Now, that's the total PCE that's got food and energy included in it, and energy is expected to come down and food is so high. We're hoping that will come down to core, when you take those out, is projected to be 3.1% at the end of next year, and that's probably a bit optimistic still as well, unfortunately. I should note that my personal forecast is broadly in line with these median numbers that I've been mentioning, this is pretty optimistic.

I said this. These are not recessionary numbers. Why might this make sense? In some, the consensus baseline is projecting a large decline in inflation over the next year and a half, but with only a modest increase in the unemployment rate, that would be a pretty good looking soft landing, so let me talk about that. I'll begin with some familiar observations about the role that relative price adjustments and supply chain problems played in the rapid increase in prices. The pandemic induced a shift in household spending, from services, such as travel or dining out, towards goods, such as appliances for home improvements, projects, or consumer electronics. Many goods producing businesses struggled to keep pace with this strong demand, particularly as they faced COVID related disruptions in production and supply chains.

Labor shortages due to a broad-based drop in labor force participation were part of the story too. Inflation began to pick up in early 2021 as prices rose sharply for goods that were especially sensitive to supply chain problems, and for services that were just beginning to reopen from the pandemic shutdowns. It's taken us time to get there, but today there are a number of signs that supply chain difficulties are improving. Ports are less congested, freight costs are falling, and supplier delivery times are improving, and with the pandemic bounce back behind us, some heat is coming off items such as airfares and hotel prices, but it's not all well yet.

For example, for quite a while, a shortage of microprocessors held back the production of motor vehicles, and this first appeared when in about April of '21, used car prices went up by 10%. That's in one month, not annualized 10%. Then the next month they went up 7%, then the next month they went up 10% again. They went up 40% over the course of 12 months. Why? Microprocessors weren't available, new vehicles weren't available. People bought a lot of used cars. Plus, the rental car companies had sort of shed their inventories and were trying to get cars back. Well, now the chip shortage seems to be largely resolved, but shortages of other parts are now reportedly limiting assemblers.

In turn, the problems that parts suppliers appear related to difficulties they are still having in staffing production lines. I'm sure we've all heard many other anecdotes that highlight this interaction between the labor market tightness and supply chain issues. Looking ahead, supply chain repair will continue, and consumption patterns should normalize. We may also see some further recovery in labor force participation. Though, as I mentioned, I think the prospects for this are limited. Admittedly, these adjustments have taken much longer than I had expected, and disruptions from the Russian invasion of Ukraine and unpredictable COVID related shutdowns, notably in China, haven't helped.

But progress has been made, and more is coming, and the reduced price pressures from these supply side adjustments are an important factor in my forecast for declining inflation. However, over the past year or so, we've seen a lot more inflation than can be explained by changes in relative prices. We've experienced a broad-based increase in inflationary pressures that monetary policy must address. Without a period of restrictive policy, inflation will come down some, but not to anything near our 2% objective. The required monetary response will restrain aggregate demand. We've seen increases in rent, shelter, prices and other services. They've increased dramatically, and these are very inertial price increases, and they take time to turn around once they get up to a high level.

That's a challenge for monetary policy. There are lags in inflation and how it responds to monetary policy. Even though we've front loaded our monetary policy response and things are very restrictive at the moment, it's going to take time still to work on these more stubborn high price increases. So, that's going to complicate our path and ultimate path to a peak federal funds rate. I see the nominal funds rate rising to a bit above four and a half percent early in 2023 and then remaining at this level for some time while the FOMC assesses how our policy adjustments are affecting the economy. When you factor in inflation expectations and the reductions in our balance sheet, we'll be at something equivalent to a nearly 2% real funds rate at this time that's an inflation adjusted nominal rate, 2%.

I personally think that four and a half to four and three quarters is restrictive all by itself. As I mentioned, we're expecting inflation to be coming down next year, and so that's how you get to about a one and a half percent real rate. Then because we're reducing our balance sheet, what's referred to as quantitative tightening is going to probably be worth another 35 to 50 basis points of restrictiveness. Then there's also been other financial market volatility that probably adds a bit to restrictiveness. I think that gets you about two percentage points on the real side, and that's on the high side of when monetary policy has been trying to address difficult situations like inflation. So, I think that's about the right policy, but there remains a lot of uncertainty.

So, I feel that this is the level that's needed to facilitate market adjustments by bringing aggregate demand into better balance with aggregate supply and to ensure that long run inflation expectations remain in check. Our rapid pace of rate increases has fast tracked our arrival to such a restrictive stance. Front loading was a good thing. Given how far below neutral rates we were, after all, we were still at zero to 25 basis points in March, but overshooting is costly too, and there's great uncertainty about how restrictive policy must actually become. So, this is going to put a premium on the strategy of getting to a place and a level where policy can plan to rest and evaluate data and developments.

I think that's where we are in terms of the economy and the monetary policy setting. We've got a meeting coming up. As Julie mentioned, I'm retiring in January of next year, so every time I said we will have to be thinking about this, it's kind of like, well, not so much longer. I'll certainly be paying attention to all of that, but it's really been terrific to lead this organization for the last 15 years. We've had such a wonderful executive management team that I work with, Julie and her staff, and I hope that shows through when they show up and work with your banks so that we get to a nice place for the entire economy and the communities that you live in.

So, it's been great being here and seeing you. I know you've got a great day ahead of you. I have met with Admiral Rogers a few times in the past, and he was gracious enough to come and speak to my colleagues, other Federal Reserve presidents in Richmond a few years ago, and we just continue to learn so much about the risks that we're all facing and how we have to be very careful when it comes to cyber risks. So, I'm sure it's going to be really educational. It's going to continue to add to how we should be thinking about this. Thanks so much.