Scobie:

... For us. We are greatly honored that you accepted our invitation. As you may know, our center has had a very longstanding relations with San Francisco Fed back to the days where Dr. Janet Yellen was in the Federal Reserve and San Francisco Fed. And in a way, we're very sorry that you couldn't come today to London in person. But we totally understand and are very grateful to you that it's made it possible to have a discussion with you.

So given that we have lots of questions and a short time, I would like to start the first question and go straight to the news that came today about which you must be pleased that the headline inflation came up as 7.7% down from 8.2%, and core inflation down to 6.3% from 6.7.

So while this is one or two readings that show the decline, at the same time, if we look closely at the data, part of the decline in our view was to do with a decline in oil prices, which came down from a high of $120 in June to low of 76.7. This is WTI. And now, the price of oil since then has been rising. And it's quite possible that headline inflation could go up again. So in a sense, making the job of policy makers more difficult. In a way, what is very important for us is to learn your views on basically at the moment the risks and how do you actually see the five-year/five-year forward other than the five-year/five-year forward, other indicators of inflation expectation that you would regard as inflation is more persistent? So over to you.

Mary Daly:

Okay. Thank you. And let me start off by saying thank you so much for shifting to a virtual event when I couldn't make the trip. I really do appreciate it. And it's an honor to be part of your series. And I'm just looking forward to the conversation.

Now, that question you asked had multiple parts. And I'm going to unpack it a little bit because I think it's useful to treat each of those parts as individual items. So let's talk about the numbers that came out today. It was indeed good news that inflation moderated its grip a bit. And the focus I'll draw really is on core inflation, which, as you said, was 6.3% over the year coming down from its 6.6, I think, was the rate last time.

I'm sorry. I didn't look at my note. But [inaudible 00:08:55]. Right. So it's come down a little bit. Most of that drop was attributable to the declining core goods prices, which we've been expecting to ease a bit as people, two things happen, supply chains recovers, production change recover. And also, people rotate to services, back to services consumption and away from such a focus on goods consumption. That just helps bring demand and supply back in balance. That's a welcome piece of news.

And so, we see that starting to happen. But one month of data is not a victory make. And I think it's really important to be thoughtful that this is just one piece of positive information. But we're looking at a whole set of information. On the other side, core services continues to rise. And that really can be attributed to a variety of things. But one of the things that's really important to focus on is housing.

Shelter costs continue to be high in the United States. Rising, the inflation tends to be high. That's a lagging variable. Once you get that in there, it takes a while to... Once house prices start to moderate or house price growth starts to moderate, it takes a while to come through all of the rental agreements and really ease the consumer pocket book on these things. And so, that's going to stick with this for a while.

But again, it's good news that the goods price inflation is starting to moderate. We'll have to see if that continues. It's good news that consumers are getting a little relief. But I know in that part of the topic with one piece of information, we're about to come up on our Thanksgiving holiday here in the United States, which is a big holiday for family and festivities and importantly food.

And if you're at the grocery store right now, you see it. In any grocery store you go to, people making tradeoffs. How many people can they invite? What are they going to serve? Are they going to trade down? Are we having a different kind of meal? Are we not having as many options because it's just very expensive? 7.7 is very limited relief. I mean it's just better than over eight. But it's not close enough to two in any way for me to be comfortable. And so, it's far from a victory.

Now, on terms of inflation expectations, which is the other thing that you know asked about, we've absolutely focused on, they've been remarkably well anchored despite the high realized inflation and we've now had for 18 months. And so, short-term expectations, of course, have risen because they move almost in lockstep with food and energy prices really. And food and energy prices have been rising at a rapid clip as you mentioned. And energy prices are quite volatile. So we could have some easing one month than turn around and get some higher readings the next month, and whereas winter rolls in and especially with the ongoing war in the Ukraine and energy supplies being so constrained, there's just some real risk that energy prices come back.

So that is an important thing to keep our eye on. But I think that what we see is that consumers and businesses and the five-year/five-year forward market participants, everyone really is smoothing through those pieces, putting them in short-term inflation expectations. But they're not really bleeding into medium and longer run inflation expectations. And that is comforting. But we can't be complacent.

And one of the reasons you'll hear Fed officials repeatedly say, "We're resolute in bringing inflation down," is we're not hanging our hands on, well, inflation expectations in the longer end haven't moved very much. So look at us, we can just be easy. We have to be resolute to bring inflation down to 2% on average. That's our goal. That's what Americans depend on. And that's what we're committed to doing. So we're going to continue to adjust policy until that job is fully done.

Scobie:

That's very interesting. And we share your views. Now basically, I mean from the recent press conferences and speeches you've given, you seem to be an advocate of moderation of the upcoming interest rates hikes and keeping money to policy tight for longer. So given Friday's job report, I was just wondering, do you still maintain this view? And how do you read the data that came out last Friday?

Mary Daly:

Sure. So I think in a starting point, let me say when we look at the data, I was taught early on in my PhD program, the data's a plural word, is a lot of things not one data point. And I think the same applies to policy making. We're not data point dependent. We're data dependent. And the data, as you already mentioned, is both the inflation. It's also the employment. We have a labor market dashboard of indicators. We're looking at all of them.

We're looking at housing, the real side of the economy in general. And what's going on in financial markets in terms of tight day? You put all those data together. And what we're asking is what does it look be like the economy's doing? Is it slowing its pace of growth so that demand and supply can come back into balance? And what I saw in the labor market report is signs of easing of conditions from these really rapid paces of growth in the job market to something more moderate but not at all close to what we actually need if we're going to keep things steady.

Right now, we're adding over 200,000 jobs, over 250,000 jobs per month on average the last three months. And that's far, far above the 100,000 jobs we need each month to just keep pace with the new labor force entry. So in other words, every time a new month of employment numbers come out, we need more workers to feel those things that are actually coming into the labor market. So this is causing the data to be... It's stronger than we need it to be in the longer run on employment. But it is good sign that it's slowing. It's much like the inflation data. It's good in terms of the direction. But the level's still out of balance.

Now, in terms of policy, I think it's useful to talk about how I think about pace versus level, versus length. So I'm going to use these three words, pace, level, length. So the pace of interest rate adjustments is really about the speed at which we adjust the Fed funds rate at each meeting.

The level is about where do we think we're going to be sufficiently restrictive, the level of the interest rate that would be sufficiently restrictive to bring inflation effectively down to 2%. And then, the length is the length of time we hold it in that restrictive stance to ensure that we've sustainably got inflation at 2% or that it's really coming down to that 2% goal in staying there.

And so, right now, we're moving away. And as you had mentioned, I was an advocate of thinking about this because the pace piece is really about trying to get from zero, the zero lower bound that we started at last March to something that's modestly restrictive. And there is, since we knew with clarity and certainty that the economy didn't need any more support, it's already running out of balance with inflation too high, then, it's clear to everyone that we don't need to support the economy through accommodate policy. So we can march expeditiously was the term we used, but quickly and clearly up to that modestly restrictive pace without fear of tightening. And that's what we did.

We moved at 75 basis point increments. We tightened policy historically fast. And we got ourselves from zero, which is highly accommodative to modestly restrictive, which is the stage we have now 375 to four. We got that done in just the period of time from March to now. So that's a very good outcome. And that's why the pace was effective because we needed to go... We could go quickly because we knew the destination. So now, we're shifting to what I think of as a second phase of policy making, policy tightening.

We are shifting to a phase where we're already modestly restrictive, and we're asking the question how much more restrictive do we need to be, to hit that sufficiently restrictive definition that we talked about in the FMC statement? And when we think about that, several things come into play. First of all, we have to watch the evolution of the data. And there's considerable uncertainty right now. There's uncertainty about how long inflation will persist. There's uncertainty about how quickly our monetary policy transmits through there, the long and variable lags.

There's uncertainty about how much tightening is already in the system and pent up and ready to unleash itself on the economy. And so, that combines with the lags. And then, there's uncertainty about the global economy. Right now, I spend a lot of time worrying about Europe and the UK and thinking about a winter that could be harsh. And if there's a harsh weather winter, that makes the difficulties of energy supplies even more challenging.

So that would push the headwind against global growth, for sure, not to mention the hardship that so many people would face. So all of those things matter. And it's why we need to think about getting there carefully. So my own view is that we want stepping down is an appropriate thing to think about. It seems like that's the time is now to do that. But it is not to be confused, and I'll close this answer, it is not to be confused with adjusting the terminal rate. By terminal, I don't mean the end rate we'll ever have. I mean the rate at which we would raise to hold. That rate is very dependent as the level piece.

That rate is very dependent on the evolution of the economy and all those pieces of information that I laid out. And I think the main thing that people need to know now from my vantage point is there's a lot of uncertainty about what that rate will be. What will be the sufficiently restrictive rate is not known today. And to sort of say we know that with certainty and then march towards it, then, my judgment would be imprudent. And that's why I don't support that type of running to it. I support a more gradual approach of getting to it so we can be discovering the right rate as we go.

Scobie:

That's very interesting. Thank you. I was going to refer to your staff release the paper this week suggesting that monetary policy is much tighter than the Fed fund rate on par with Fed funds at five and a quarter percent by your September meeting. And the discount meeting minutes of the Federal Reserve Board from September also showed that the San Francisco Fed Board supported a 50-basis hike instead of a 75 basis point hike last month. So I was just wondering how you putting these together, what do you need to see to support a pause in a rate hike?

Mary Daly:

So if I may, I'm going to throw out the word pause and not use it because pause means a lot of things to people. And pause often means that we stop. Maybe, that's how you meant it. That's not even the discussion item in my judgment. Pausing is not the discussion. Discussion is stepping down.

So again, go back to we've reached this modestly restrictive pace. And so now, it's about stepping down off the pace and making pace less about... the conversation less about pace. That's what the chair mentioned. And I totally support this. Let's not have the conversation about pace so much because the real conversation should be about the level in which we would hold the interest rate. And that's not right now.

Right now, we're trying to think about what the level of restriction would be that would be sufficiently restrictive. And there's some likely more rate hikes in our future. That's what I see in the data right now. I just have to return us to the conversation about inflation we had a moment ago. 7.7 is not price stability. That's not our goal. Our goal is average of 2% And we need to see that it's moving down towards that average of 2% over time. And I just don't have that in the forecast just now.

Right now, my own forecast is that inflation is higher than our target at the end of 2023. And that's with more restrictive policy than we currently have. So again, I think let's shift from the pace and to the level. And in terms of the work you highlighted that Andrew Forrester on the San Francisco team with co-authors did, I think this work is incredibly important. And really, I'm glad you highlighted it. The importance of it is that it has an insight that we really need to be thoughtful of as policy makers. The insight is that the Federal funds rate, the policy rate as we call it, that used to be a sufficient statistic for where the tightness of policy was because it was our only tool.

But for a while now, we've had two other tools, forward guidance and balance sheet. And both of those also affect the financial conditions, the tightness of policy. And what he and his colleagues have done is they've indicated that if we put current financial conditions in the typical funds rate space, the funds rate would actually be about two percentage points higher than it currently is printing.

And so, now, they're hot off the presses, he did the estimates right when we took the 75 basis point increase at the last meeting. And now, the proxy rate is over 6%, so about two percentage points higher than the rate that we have currently in place. This is just an indication that we have to be mindful when we say cumulative tightening of financial conditions as we did in our FOMC statement.

The cumulative tightening is not only what's in the pipeline of the things we've done, but what's the impact because of our forward guidance, our balance sheet policy, and our funds rate increases. What's the impact on tighter financial conditions? And not being mindful of those things will really put us in a position where we could risk over tightening. So that's why I think this work is so important because there's two things I have at the base of... It's like the foundation of how I'm thinking about policy right now.

One is resolute. I have to be resolute. And the other is mindful, resolute to giving inflation down and mindful that a variety of things are shaping up in the economy right now that we have to be keenly focused on if we're really going to balance the risks of under and over tightening and put economy in the best chance of making a smooth transition to a more sustainable place.

Scobie:

Thank you very much. I was wondering in the light of the data that has come today on inflation, are you likely to revise your forecasting for the SEP coming up for the December meetings?

Mary Daly:

Well, it wouldn't be in line of this data particularly. I guess I'll reiterate that I don't find that I'm data point dependent. I'm looking more at a confluence of data that come in and then what does that mean for the outlook for the economy? So in September, let's use the SEP instead of my particular SEP estimate. But let's use the SEP. We came in at about 4.6 as the ending rate if I remember correctly. And you just, let's call it, four and a half for the sake of the example.

But now, I think my own view is that we probably will have to tighten a little bit more than that to be sufficiently restrictive. I guess I can share little bit on the more higher terminal rate side than the SEP itself. I was one rate hike above the median. And the reason for that is that I looked at the persistence of inflation. I mean, inflation's just really... When it gets into core services, that is harder historically to bring down. And it takes more effort on the Fed's part to do so.

We also have had just a persistence of... I mean the good inflation coming down now is very welcome. But it has been higher than we had forecasts for a while. And I personally find myself in this position as a policy maker. I would rather move a little bit higher and have to come back than to move a little bit less high and have to then tell people we're going to go higher because, at some point, it does seep into inflation expectations.

And Chair Powell said in his press conference, and I think it's worth highlighting, that we have the tools that we can cut interest rates if we need to. And I don't want to be over-tightening to the point where we throw the economy into a sharp recession. But if we're talking about a rate hike on either side, I want to fully get inflation sustainably down to 2% on average. And the motivation I have is really twofold.

Americans are struggling and particularly those who are at least able to bear. And it's just eroding their purchasing power. It's eroding their real wages. It's just eating away at their lives and livelihoods. And the second thing is that it's the commitment we've made. What we do know from the 1970s and '80s, that painful Volcker disinflation that we took that one of the mistakes that was made in the '70s is that the Fed said, "Well. Okay. We've got it coming down, so now we'll stop raising rates. We'll stop trying to fight it back." And then, it sort of reared its ugly head again and got solidified in psychology.

I am not prepared to make that mistake. We want to make sure this doesn't seep into psychology, embed itself in inflation expectations, and then find ourselves in that very [inaudible 00:26:45] situation. So I'm looking to not make unforced errors on either side, neither by overcorrecting and then having to have a painful recession that was unwarranted or under-tighten and find ourselves with inflation higher than we want for longer than we want. And we have to put the economy through more discomfort and pain to bring it down. And that's why policy making takes this prudence. It takes mindfulness because the only chance we have of doing that well is to be very thoughtful about how we're doing it.

Scobie:

Well, at least compared to UK, you can be comforted that families here who are... mortgages are hurting very much. I mean immediately a lot of people have had to refinance. And when they had a choice, maybe some to go to a five-year fixed when interest rate was very low. And now, they find themselves with a two-year fixed, they have to basically remortgage. And their monthly mortgages have rocketed, I mean literally rocketed.

And Bank of [inaudible 00:27:56] hasn't tried yet completely. I mean it's just only 175 basis points and in a little bit before when we have 11% inflation. So it's a very precarious situation that we have. Your kind of mortgage situation is much better in terms of people have the option of having 30 year. And nothing like that could be ever offered here.

So on the other side, I wanted to ask you about the impact of the dollar on the actual inflation. Obviously, US economy is not that exposed to imports and exports as some of the European countries. But nevertheless, I mean the strong dollar must have some impact on lowering the inflation. So for us, it's a really amazing number of... I mean surprise. I changed money when I was going to the IMF recently at 107. That's unheard of. This happened back in October. So I was interested in your views to see how you see the impact of the dollar on the inflation.

Mary Daly:

Sure. Absolutely. If I may, I'm going to go back and just say one thing about mortgage rates. So in the United States too, because I think it's useful, it's very interesting how the mortgage systems in different countries play out as rate adjustments are made. But in the United States, one of the things that has happened is we started talking about raising interest rates back in November, raising them earlier than back in November of 2021, raising them earlier than we had anticipated.

And immediately, you started to see mortgage rates start to creep up. And then by the time we got to February, they had risen quite considerably. And what all of that forward guidance did is it really accelerated some of the refinancing for people to restructure their debt obligations. So if you were in a variable rate mortgage or you were an adjustable path, you were moving into 15, 30-year fixed pretty quickly.

And then, once the rates went up, refinancing activities sort of stalled altogether. And then, it started filtering into new originations and ultimately into housing prices themselves. So that transmission mechanism in the United States still works fairly well from monetary policy to the housing market. We've seen it actually work fairly quickly this time around. But it is something that people can prepare for a little bit more in terms of the general population because we're not in that everyone has to refinance of the three to five-year frequency. So that is a really interesting difference in terms of the impact of rate increases on the budgets of citizens basically.

So now, in terms of the dollar, so the thing that is important to say is that we don't make dollar policy. We're adjusting the interest rate to achieve our two goals, full employment, price stability. Those are the ones that Congress gave us. But as we adjust the interest rate and for a variety of other reasons, the dollar does fluctuate in value relative to other currencies.

And so, right now, the dollar is strong. And what you see is the normal situation that occurs. It's hard on our exporting sectors because our goods just got more expensive and those sectors, you see employment slowing in those sectors. You see growth slowing in those sectors. And then, of course, it has the opposite effect on our imports. Imports are cheaper. And so, it tempers the inflation coming from imported goods, which has an overall tempering effect on mostly goods price inflation.

So those two things are happening. When you net them out, economists study this constantly to see what is the offsets of those. What's the pass-through of import prices to broader prices, et cetera. And I think there will be a little bit of import price inflation that tempers our overall inflation number, especially in the good sector. But it's not the primary thing that matters for the inflation numbers we're seeing.

As I mentioned earlier, a lot of the things going on for us in the United States, which is a little different than Europe, in the UK. We're about 50% of our excess inflation comes from demand, and about 50% comes from supply. So we still have this demand strength, domestic demand strength that's simply outstripping the supply of goods and services available. And so, it's about bringing that demand back in balance and getting particularly for services inflation back at the levels that we're accustomed to and so that we can get to that 2% goal.

So I definitely look at the strength of the dollar. But through the effects on imports, of course, import prices, the effect on export sectors, just the real output there. And I think another piece that it definitely see is worth noting is about the effect on global growth. As you mentioned, some countries are negatively affected by the strengthening dollar and so global growth is. It's a headwind to global growth, which means it's a headwind to domestic growth.

In the US, we think of the global economy as tailwinds, neutral or headwinds. That's how I think of it. And definitely, global growth is a headwind right now because we have variety of things going on. We have COVID, still in parts of Asia, and then the COVID lockdowns that China has to undertake or does undertake. We have the worrying Ukraine disruptive to so many things, people's lives and livelihoods but also energy and food and other commodities. So all of these things matter for how the US will fare going forward. And it's another one of those...If you put the list of things I want to be mindful about, another one of those things is the global economy.

And part of that is the fact that so many central banks to fight high inflation are raising interest rates. And so, that's synchronized but uncoordinated tightening we're all doing actually is another factor we have to think about because our proxy rate probably reflects of the Fed funds rate. That proxy funds rate probably reflects some of that. But there's amplification mechanism that goes on when all central banks tighten simultaneously even when we're not coordinating our policy tightening past.

Scobie:

Absolutely. And the last question is basically you seem to disagree with market pricing in rate cuts next year. And we share that view, let me say. But we don't believe that there's going to be any rate cut. I don't know how they get that idea [inaudible 00:34:51]. So is there an inflation scenario which in your view would justify a rate cut next year and basically various surveys say they are 4.2% sort... It could be 4.2% year-on-year inflation with a wide range of broad spectrum going from 2.4 to 7.5% year-on-year. And some think this inflation could go down to 3.2% by September, 2023.

Mary Daly:

Yeah. Let me just start with this. I mean I think it's very challenging to think in the hypotheticals of what could happen in certain conditions-

Speaker 3:

Reporting in progress.

Mary Daly:

I will simply say that in terms of on that front, I'll simply say that the Federal Reserve policy making, all of us have historically maintained the idea. And this is not just me and weren't the time I've served. But just historically that you respond to the economy you have.

So if economic conditions change in a way that we don't project or we don't have even our risk assessments, then, of course, we would move policy to accommodate and work with those conditions. But I tend to think in the most likely scenarios and even in the risks around those most likely scenarios, and here's what I see. You mentioned that some people have inflation coming down to 3.2%. I'll just remind everyone on the call that's not 2%.

2% average inflation is our goal. And we need to see positive traction on getting to that number. And so, that's why I have focused on the raise and hold strategy. So you raise the interest rate to a level that you think is sufficiently restrictive so that if held over time, you can reliably and sustainably move inflation to 2% over time. And that is still the policy path.

And if you looked at the SEP in September, you saw that policy path. You saw that the dots go up. They reach a level, even though there's a disagreement about what the exact level is. There was amazing amount of continuity among the dots because there's amazing amount of continuity among the FMC participants as you hear when you talk about... When you listen to them. And we have to be resolute to bring inflation down. We're united in that commitment.

So then, how do we think we do that? Well, it's raising the rate and then holding it for a length of time that is sufficient to bring inflation reliably back to 2%. And so, I don't see anything in the incoming information that has changed that the look of that path, the dynamics of that path since the September SEP. So the material thing that could change is where we think that that point is where we just start holding. And that could change. And the chair said that in his press conference. It's an all likelihood that will go up a little bit in the December SEP.

But we've got a lot of information coming in between this meeting and the December SEP at December meeting. And so, we'll have to continue to watch that. And we'll adjust as the economy shows how persistent inflation is and how much momentum still exists that we will have to bridal back to bring and always why would we bridal things back? I mean I get asked this a lot. Why would you bridle the economy? Isn't it good to have growth? It is good to have growth. But we all know and I know that you all believe this is that we need to have demand and supply imbalance because if demand consistently on strip supply, then we know what the outcome of that is. And we're living through that right now. High inflation.

Scobie:

Well, thank you very much. I'm going to open it up to the audience. Anybody who has a question, please, raise your hand. And we can see it on the side of the Zoom. So the first question goes to Johnson Ratcliffe. If you unmute yourself and ask your question.

Johnson Ratcliffe:

Hi, Professor Scobie. Thank you. Now, we submitted our questions to you via email as you know. And you've asked three out of four of them. So I'm very happy to see my time to my client, Vandit Shaw. Vandit, if you want to unmute and ask your question, I'm very happy for you to take my time.

Vandit Shaw:

Hey. Thanks a lot, John. I appreciate that. Mary, thank you for taking the time. One of the things that you mentioned was that you wanted to continue adjusting the rate until you thought that the job was fully done. If I could just break that into two parts. When you think about the job being fully done, is that there's a risk that we kind of get to 4%, 5% fairly quickly? But then there's a view that the next move lower from 5% to two, to 2-1/2% is stickier.

So would you think that just staying at a sufficiently restrictive level is adequate to get the down from five to two, 2-1/2 or do you think you need to keep raising rates up to a point where that number really does start going into the two, three kind of region? Thank you.

Mary Daly:

I'm really glad... Yeah. Thank you so much for the question. It's really helpful. So there is a little bit of confusion, I think. And it's a good time to clarify this. And the chair said this is press conference. So I'll also refer you to his remarks. I think they pulled this quote in financial time story this morning on US inflation numbers. And I think it's really a good point to make is that certainly we want to continue being to be in our restrictive stance until we know the job is well and fully done.

But that doesn't mean the test has never been we'll keep raising it 75 or we'll just keep raising rates until we see 2% or we see big declines to towards 2%. That's why you have to be very mindful. It is really about what is your expected path of inflation. And is it coming reliably? Are you confident? Are we confident it is coming reliably and sustainably down to 2%?

So from my own view, we get to the point just as we said in the FOMC statement, we get to the point where policy is sufficiently restrictive, and we hold it over a period of time which will be evaluating as we hold it until we see that inflation's really well on its way to getting to 2%. But because of the lag in monetary policy and importantly if you look historically at what data lagged the most, inflation is one of the most lagging variables.

You see it adjusted in the intra-sensitive sectors of the real economy. Then, it takes hold and eventually adjusts the labor market. And then finally, you see it feed through to inflation. So if you waited until inflation literally hit 2% before you made any determination about where policy should be, you would likely overtighten them. So that's why we have to be so thoughtful about how the lags play in. But, of course, we don't know with a capital T truth what the lags really are. We're going to have to estimate those and look for those. And we're going to have to look at the data, the backward-looking data, which is the published data.

We're going to have to look at, talk to people, think about what we're hearing from our business leaders, our workers about what they're expecting their wage increases will be and forecast out and then check our forecast constantly against the incoming information. So that, I think, please, I want you to be, as you walk away from this meeting is my own view is this, that sufficiently restrictive is a level of the interest rates that if we hold it there for a period of time, we are confident inflation can come down. And we will continue to evaluate that.

I don't want you to leave with the impression we would never change that. But I do absolutely. That's how I'm thinking about where we land before we hold and we're not there yet. Of course, we have more work to do. We will do that in coming meetings. But then, the holding part is important. And I want to add one other thing to the holding piece. As inflation goes down, so say we get to a level of interest rate and we hold it. As inflation comes down, policy becomes more restrictive.

So that is something to keep in mind. We move the interest rate up. And we hold it. But as inflation comes down, the real interest rate is going up. So then, policy is becoming more restrictive. So we have to think about that as well. As you can see, there's a lot of things going into this calculation that make it not as easy to just say this number, that number, this month, that month, which is why we are so data dependent. And I'm hearing a lot of talking on the background. But I don't know where that's coming from. But I'll point that out to you, Professor Scobie.

Scobie:

Thank you very much. The next question goes to Marcus Petersen. If you could unmute yourself.

Marcus Petersen:

Yeah. Hi. Thanks very much for doing this, President Daly. We appreciate it. So I wanted to switch gears for a moment and spend some time on the balance sheet and then specifically the composition of Fed liabilities, which I know it can be a technical subject. But I think it's been a little bit interesting that we've seen the ON RRP stay relatively elevated and reserves come down relatively quickly. I wonder what you're thinking is on the path of the composition of the Fed's balance sheet into year end and around potential dead ceiling dynamics and whether or not there's some concern around the pace of reserves or there's still this expectation that we've seen in the minutes and in some of the staff notes that have repeated the sentiment that eventually the on ON RRP should decline and maybe that happens before reserves decline to uncomfortably low level. Thank you.

Mary Daly:

Sure. So every time we are in a situation where we're reducing the balance sheet and markets are moving for a variety of reasons. We're not the only reason that the firms and businesses and market participants are moving things around. Then there's this question of how much of what we're seeing in this case ON RRP is technical adjustments, technical features that we expect to resolve versus something needs to be changed in the pace of our adjustments.

And we rely heavily on the New York Fed's markets staff to really think a part about those issues and we deliberate those issues. But right now, I'm just going to be in agreement with the Fed staff that right now we continue to think that our balance sheet policy is on track. It's continuing to be... Market's continuing to be well functioning. We continue to think that this is appropriate. We will, at some point, have to talk about the pace of our rolling it off. But that time is not today. That time is later.

And I think it's a good opportunity that highlighted different issue really. But it's related. It gets related in conversations for people is that there's a real distinction between what we do as monetary policy makers and our path of policy, and what we think about on market functioning. And I know you all in the UK just came through a period of that. These are very different things. And because the balance sheets involved oftentimes in both, there's a bit of conflating of those two things.

But what we do with the balance sheet roll off, that is separate than the market functioning. In this case, your particular question, they're very related, of course. But I continue to think what the Fed staff thinks that Fed's market staff in particular, that it is resolving itself over time. And I'm not especially concerned about the ON RRP right now. But it bears watching. It constantly bears watching to see if this is going, if we need to make adjustments and we're prepared to make adjustments, should we? But right now, I see the path of our balance sheet roll off and the path of our policy be well absorbed by a marketplace.

Scobie:

That's very interesting. Maybe, I should mention the discussions we had with Bank of Japan. And they were always very wary of the idea of actually selling bonds into the market that the Central Bank holds, whereas balance sheet runoff is much more viable and much more credible policy. And I think you're doing absolutely the right thing on that side. The next question goes to Michael Michaelides.

Michael Michaelides-Carmignac:

Hi, good afternoon, President Daly. Thank you very much for the call. If I could just ask a little bit about the... So I think we would understand your policy of slowing down but not stopping on the Fed funds rate. And I guess a couple of the reasons, at least as I understand them is that one, of course, you mentioned that how much tightening is already in the system and the lags there. But then, also presumably as a Central Bank, you're a little bit concerned about if there's any kind of real wage resistance or if inflation settlements in wages stay high, don't come down to the inflation sort of consistent level. And that's what you're waiting to find out. How would you characterize the mix of the different things you're looking at? I mean there's many reasons to slow. But I guess some may be more important than others. So some insight on your thinking that would be great.

Mary Daly:

Sure. So let me think about the wage issue for a minute. So we don't have any evidence of a wage price spiral dynamic forming. Certainly, that's theoretically possible. And we look for evidence all the time to see if that's happening. But we don't see that.

One of the things we see in wages, there's two things I'd like to mention here. The first thing is that in the United States, real wages are falling and quite dramatically on average, 9% over the last two years. Real wages, average real wages are falling. So that's really hard on American families and workers who depend on their real incomes, not their just nominal income. So we have this piece where nominal wages are rising at a brisk pace, out of balance with long run productivity growth and 2% inflation.

But real wages are falling. And so, that's the price of high inflation. The second thing that's interesting in terms of this wage price dynamic is that short-term inflation expectations. Another piece of research that San Francisco Fed researchers have done that I really will point you to is that they found that if you look at inflation expectations and wage demands, wage demands really get based off short term inflation expectations, not medium or longer term inflation expectations.

So people can hold a view that the Fed will eventually get inflation down. But they'll ask for wage increases to offset the real burdens. And you can see why that would be the case if real wages are falling, right? You're making a good nominal wage. But you realize by the time you pay for gas, food and housing, you're falling behind. Then, you hear that wage negotiation.

Now, the good news in the US on this front is that last year, I do a lot of... I have the 12... I'm sorry. I'm in the 12th district. I have the nine. It's early here. Just give me a little grace on that. But I have the nine western states. And so, we talked to businesses, worker groups, community leaders. And I spent a lot of my time out in the field talking to people to get forward-looking information. And here's something that I've learned in the last couple of months.

Last year, my contacts, and this was true if they were unions or if they were firms, they were saying that wage increases of four and a half to 5% was what they were asking for. And now they're thinking of three and a half to four. And because the economy has changed and, one, food and energy prices have come down, which is little relief. But also, people see the economy slowing. And they don't want to move into these higher wage increases. I mean workers are less willing or less likely to ask for such high wage increases because they see the economy slowing. They see bright spots of inflation coming down.

So from that vantage point, I think there's less evidence that there's a wage price spiral and more evidence that the policy efforts we've made so far are starting to work their way through the economy. And we'll find ourselves next year, hopefully, in a much better situation than we sit in today. But there's more work to do. And we'll keep at it until the job is well and fully done. And I'm glad I explained what well and fully done meets earlier. But does that answer your question?

Michael Michaelides-Carmignac:

Yes. So I guess a little bit of backward induction, it seems that you are slowing policy is not so much to look at if there's a real wage resistance. It's a lot more about just seeing when and how big the impact of the lagged hikes is.

Mary Daly:

Yeah. So I mean will go back. I don't mean to keep repeating it. But I think it is really important. For me, he slowing is all based on this. It's based on the fact that you go really fast when you know where you're headed. So we knew, for sure, we needed to take the accommodation out of the economy. So it was quite easy to go at 75 basis point increments because we knew where we were going.

But now if you take the SEP and you even say we move up to... Say that the SEP goes up a little bit in December. Say that it goes up to an interest rate of 5% as the rate will hold at, that's only 100 basis points higher than we have now. Right now, we're 375 to four. So we have to 100 points to get to five. Well, that means we're in a stone's throw of that. And the pace of adjustments doesn't need to be as rapid. And it gives you the opportunity to really pay attention to the critical aspects of the cumulative tightening of policy, including how tight our financial conditions relative to the Fed funds rate, that research we've talked about already, and also the lag and monetary policy, which, of course, they take time to work their way through.

So we're seeing in the housing market. But right now, we're only seeing the starting points in the other parts of the real side of the economy. And we haven't yet really seen it in inflation. I mean we've seen a little bright spot on the data today. But again, I can't iterate enough that one month of data, positive data on inflation does not a victory make. And 7.7 is not price stability.

Scobie:

Thank you very much, President Daly. There's a lot of information in what you gave. And we're very grateful to you for that really good explanation. The next question goes to Nikhil Sharma. Could you-

Nikhil Sharma:

Thank you, President Daly for the... Yeah. Thank you, President Daly for the insightful comments. Just following up on a point that you made, CPI's obviously a lag indicator and probably so is NFP. So I was very curious, what are some of your favorite forward-looking indicators for inflation. And timing wise, where do you think you face that choice between shifting focus from fast part inflation forward inflation if growth starts to slow down?

Mary Daly:

Sure. Great question. So they've all been really good questions. I appreciate them. So in terms of forward looking, so one of the things... Let's talk about inflation first. One of the things that I mentioned already is really pushing up core services inflation as shelter prices. So those are not just home prices. They're not just owner's equivalent rent prices. But they're also rental prices themselves.

And so, one of the areas where I really look to see if we're getting the step down in inflationary pressures in shelter is in new leases. So if you look at rental price inflation, those are old leases and new leases all mixed together. But if you pull out new leases, you are seeing actual declines in those lease prices relative to the level of rents out there right now. If you took average rents, new rents, new leases on and rents associate with that are lower.

So that to me is an indication. This is working its way through the economy. But it'll take a while for everybody to turn their lease over. And so, you just see that in the average rental prices. And so, when you do the year over year owner occupied rent, rental equivalent, and you do the rental prices, the averages are still high even though the new leases are coming down. So that's a leading indicator.

Another leading indicator that I look at, and now let's go to the labor market, is what are the new wage offers? What are the wage offers to new workers? So we get a new group of workers coming in all the time, and especially when students graduate from college and we look at what are new workers getting relative to existing workers?

And for a while, we were seeing every new worker just getting more and more than the existing average. But when the economy starts to slow, a leading indicator is that starts to stabilize. You can look at also job switchers if it's another aspect of the new worker. So where are job switchers getting? Are people who switch jobs getting higher wages than the firm they go into or are they getting about the same as the average?

So those are all leading indicators in the labor market along with quits. We've seen quits moderate a bit. When quits start to moderate, people are not as confident in the labor market. So you put those things together. There are other ones, I start... There's a traffic indicator. You can look at actual traffic of driving... But I mean a retail traffic, you can look at these real-time retail traffic indicators. And then, you can look at sales per customer, the average return you get for every person who walk through your store.

And so, I watch those kind of carefully too because if I see traffic falling off and sales values falling off, then, I see, okay, the customers are pulling back. The final piece of it, leading indicator information that I will talk about, and I know you probably have heard this before from other regional Fed presidents, but one of the great aspects of having the regional Feds and the Federal Reserve system, and I guess the people who put this together back in 1913, the Fed Reserve system thought of this is that you have 12 reserve bank presidents out there spending a good portion of their time collecting information from being in conversation with people.

What are you going to do? What are your hiring plans look like? What is your projected revenue stream? So we were able to, here in the 12th district, talk about the tech layoffs that you see materializing now six, eight months ago because we were having conversations with people about where the layoffs were likely coming, why were they there? Why were they coming in the first place? And what would be the impact on overall tech sector growth?

And so, that really comes from talking with people. And so, I spend my time talking to workers, union groups, small businesses, medium businesses, large businesses, community leaders. And that augments and gives us insight into how people are thinking about the economy, and what they're putting their real money towards, which helps us be looking forward when we're faced with published data that often is just backward looking.

Nikhil Sharma:

Thanks. That's great. Thank you.

Scobie:

Thank you very much, President Daly. Is Jasper Levixton on the call? He sent his question. Well, maybe, I can just read it to you. Oh, are you here? Okay. His question is, "Why is the huge increase in the corporate sector's profit margins, rarely, if ever, mentioned in the board's remarks on sources of inflation?"

Mary Daly:

So the profit margins fluctuate for a variety of reasons. And economists study those and find that they fluctuate for a variety of reasons. So when we think about inflation, we look not just at the fluctuations over time, but what's generally true. So something I spend a lot of time thinking about is what's the labor share of income in the United States. And for a while, that was just plummeting for decades. And now, you started to see it stabilize a little bit.

And so, when I think about those things and whether those dynamics have changed. And when I look at the sources of inflation that are really apparent, the ones that matter most to policy making is that calculation I shared with you earlier. So there's a lot of things that are causing inflation to be high. But I have a tool. As a policy maker, we have tools that only treat one part of this. And that is the excess demand inflation. The other aspects of inflation that are there, we do not have the tools to treat.

And so then, people say, "Well, maybe you can't treat this at all." And let me dispel that idea as well. So in Europe and the UK, you actually are facing a different situation than we are. A lot of the inflation, at least if you do a standard decomposition, a larger share of the excess inflation is energy related.

But in the United States, about half of the inflation is supply, supply chains, energy disruptions, all of those things. And about half of it is demand, excess demand that is out of step with supply. And so, the Fed is specifically able to treat that piece of inflation. And that's what we spend our time talking about when we end up... Chair Powell does a press conference or when we're out talking about it. We talk about the part of inflation that we have a tool for.

And then, we leave the other parts of inflation where we have no tools to the fiscal side of our house. And the way an independent central bank works effectively, and it has been an effective thing for the United States and other countries for a long, long time, is we don't comment on things we don't have decisional rights or tools for because that would be inappropriate. Our job is a narrow one. And we try to do that well.

Scobie:

Thank you very much. The last question goes to Mr. Martin Lucik. Are you on the call? If you could unmute yourself. Hello. Okay, I'll read. It says, "In a recent Bloomberg interview, you expressed your reservation about hump-shaped yield curve saying that interest rate should stay higher for longer. Is there an inflation scenario or a broad macroeconomic scenario, which in your view should justify a rate cut in second half of 2023?" I think you answered it.

Mary Daly:

I think I answered that question earlier. But, I'll just say, again, it's really hard to think in hypotheticals. But the Fed is historically been prepared and this Fed is no different. I can say that with great confidence that we'll respond to the conditions we face. But right now where we're focused, this inflation is too high. It's been too high for too long. And our job is to restore price stability.

Scobie:

Well, thank you so much, President Daly. This is really wonderful. We really appreciate the calls that were so clear, so elaborate, and so insightful. We very much hope to invite you again. And as I mentioned, our doors are always open. If you come to London, we hope you do make the trip to Senate House where we are based. So all the best. And I would also like to thank all your colleagues who worked so hard on this particular event. They were all marvelous. And we appreciate it. But most of all-

Mary Daly:

Well, thank you.

Scobie:

... thank you so much for your time. It was fun-

Mary Daly:

Thank you. It was my pleasure. And thank you again for being so flexible to accommodate my change of plans. Just a reminder, the pandemic remains with us a little bit. It's just loosening its grip. But thank you again for this. It's been a terrific conversation. And I look forward to seeing you sometimes soon.

Scobie:

Sure. Thank you very much.

Mary Daly:

All the best.

Scobie:

Bye-bye.

Mary Daly:

[inaudible 01:04:20] Bye-bye.