Michael Strain:

Good afternoon, thank you all for joining us. Thanks to those of you who are tuning in for the livestream and thanks to everybody who will watch the video later on at their convenience. Thanks especially to Mary Daly, President of the Federal Reserve Bank of San Francisco for being here. I will introduce President Daly in just a moment, though of course she needs no introduction. The run of show here is quite straightforward. President Daly and I will discuss economic and policy issues for about half an hour and then we'll turn to your questions. You are welcome to submit questions via email to my colleague John Towey, at John.Towey@aei.org. John.Towey@aei.org. You can find the spelling of his email address on the webpage for this event. You are also welcome to submit questions via Twitter using the #AskAEIEcon. That's #AskAEIEcon. I'll now introduce President Daly. Mary Daly became President and CEO of the Federal Reserve Bank of San Francisco in October 2018. She began her career at the bank in 1996 as an economist specializing in labor market dynamics and economic inequality.

She went on to become the San Francisco Fed's executive Vice President and Director of Research. She has also held multiple leadership positions at the San Francisco Fed and within the Federal Reserve system more broadly. She has served on numerous advisory boards including for the Congressional Budget Office, the Social Security Administration, the Office of Rehabilitation Research and Training, the Institute of Medicine and the Library of Congress. As an economist she has published widely on topics such as wage growth, income inequality, disability insurance, disability program policy and on indices of happiness. She's held visiting research positions at a number of distinguished organizations. Mary is a native of Baldwin, Missouri. I am a native of Overland Park, Kansas which I think makes us from roughly speaking the same hometown. President Daly, thank you so much for being here. It's an honor to be with you again.

Mary Daly:

Well, I'm delighted to be here, thank you so much for having me.

Michael Strain:

So let's just dive right in. Why don't we open this by giving you the opportunity to just briefly tell us how do you think things are going with the economy right now?

Mary Daly:

So I really think of it as a yes and situation, and what I mean by that is yes the economy has good momentum, yes, the economy... Looks like monetary policy is starting to have an effect, right? We see some slowing in interest sensitive sectors. We see that we feel the slowdown coming in a way that would be predicted by us raising interest rates and we still have a long way to go. Because even though the inflation data have come in, two months of CPI data have come in with some good news. We are far away from our price stability goal and why that's so important is one, it's our commitment. Congress gave us a dual mandate, price stability is one of those mandates. But also inflation takes a tremendous toll on people. It's a regressive tax, it's a tax on everybody, but it hurts low and moderate income families the most. So we are committed, resolute, united and focused on bringing inflation down and getting back to 2% inflation on average.

Michael Strain:

So let's talk more about inflation and the Federal Reserve Open Market Committee meeting that just ended. The median inflation projection from the Fed rose pretty significantly relative to the previous meeting. Media inflation projection rose to 3.5% in 2023, 2.5% in 2024. That represents an increase over

previous projections of about four tenths of a percentage point for next year. So a pretty sizable increase. I think people had thought that those projections were made prior to the release of the November consumer price index data that showed another good month of slowing. But Chairman Powell made clear in the press conference that wasn't the case. Can you explain your thinking about this? Has your concern about the longevity of inflation gotten worse over the last several months despite two good months of CPI data?

Mary Daly:

Sure. That's a terrific question and let me unpack the answer so that it's crystal clear how I think about it. So we can break overall inflation, let's say core because that is a good indication of underlying inflation and takes out those sectors that are volatile like food and energy. So let's go with core and you can separate core into three components. Goods price inflation, which is goods that supply chains were most disruptive for. Housing price inflation, shelter price inflation, which includes both homes that people own and live in and also rental prices and then core services as we call them excluding housing. So when you go to goods you see the data coming in on the last two reports. Well, it's coming in with goods price inflation falling. This is what we've been hoping for, expecting, we all knew, I think there was a general consensus among all people who do forecasts that this was going to happen. We just didn't know when. So we're finally getting the healing of supply chains we were looking for and goods price inflation is coming down. That's a good news.

It takes usually about a year for that to fully come down to its historical values, that's what history would tell us. So we're looking at that coming down gradually over the course of next year. But being a drag on the high inflation numbers we have seen. The same is can be said of housing, house price inflation is coming down. It's yet to filter completely into rental price inflation, that traditionally takes about a year as well. So once house prices start coming down you start seeing new leases form, they're coming down. But that takes about a year to fully make its way into all rental prices and see full relief on that sector. But then there's core services excluding housing and that's for things ranging from haircuts to restaurants to just the basic retail that you do. Any services you can think of, and those numbers are still quite elevated relative to their historical values and that's where we know that it usually takes quite a bit longer for that kind of inflation to come down.

A lot of that inflation is related to the labor market and the labor market remains quite out of balance. We have too many jobs and too few workers. So that means that wage inflation is going to be above its long run sustainable average, and we're going to have that passing through to prices and that's what we're working on right now is that's why my projection has gone up. It's really coming out of that core services and relates fundamentally to this, the ongoing strength in the labor market.

Michael Strain:

So let me ask you more about that, because I think that that kind of breakdown of inflation into those three components is very helpful. But it also highlights a concern I have about the challenge facing the Fed. So I completely agree with you, we're on a great trajectory for housing price inflation. We've already seen that we're actually having negative growth month over month in core goods inflation, core services looks a little more troubling. That's the sector of the economy that's most exposed to the labor market, most exposed to wages. Tell me what you think about this. My concern is that it will be relatively straightforward to get inflation to come down from say 7% to 4%, and that a lot of that work can be done through those first two sectors we talked about. But that when consumer price inflation really starts to bump into wage inflation, right? Average widgets have been growing at about 5% and we have 1.5% productivity growth.

So when the primary driver of inflation is wage inflation, I worry that it will be much harder for the Fed to get from four to two than it would be to get from seven to four. In order to get from four to two, that will require substantially larger increases in interest rates that will require the unemployment rate to go higher than the Fed released in its projections after the last meeting. Do you share my concern? How do you think about breaking it up into those two parts? Getting from seven down to four or five and then getting from four or five down to two?

Mary Daly:

Sure. Let me say that I use that same framework and so I agree that getting from seven to four is dependent on sectors like goods and housing that we already know how they react. We know that supply chains were the barriers in goods with some excess demand, but a lot of it was supply chain and then housing is very interest sensitive. So it reacts strongly to changes in interest rates. The way I've said it to some who have asked me is that it becomes exponentially more challenging to get each percentage point decline after you get those two things out of there. Because it is more about inflation expectations, it's more about the fact that you have... Wage inflation in part goes up because the labor market is so strong. So I like to start instead of going, how much pain will we have to go through? I start this way. I say if we have to get from four to two, and a lot of that is core services. Why is core services rising? And I go back to non inflation, but to the real economy.

The labor market is out of balance, if you want a job it's easy to find one. If you want a worker it's hard to find one and that's causing of course employers to bid up wages. But the striking fact, and I don't think everybody... We don't regularly pay attention to this. But it's really important to pay attention to, is despite nominal wage growth rising rapidly real wages have been flat and in some cases falling depending on which group you're looking at. So for the average person out there working, they're saying well I'm not even keeping up. I'm on a treadmill that just keeps making me fall behind even though I'm getting good nominal wage gains and so the way to get those two things back in balance is to bring the labor market back in balance. So you'll see in the projections for the SEP that the unemployment rate for 2023 and 2024 went up. The projections went up and some would push back on us and say, we can just reduce vacancies in the labor market and we can get there less pain, less costly.

But I just don't think so, my own projection is very similar to the SEP median. That we're going to have to go into the mid-fours or even slightly higher on unemployment to get the sort of relief in the labor market we need to bring things back in balance. The final thing I'll say about that is wage growth right now is four and a half to five depending on which series you're looking at and what sector you're looking at, and really we need it to be three and a half to four if we're going to be in that sustainable place. But the wage growth itself is not the problem. The problem is the labor market is out of balance and that's causing the effects we see just like things out balance cause price inflation in the goods sector or the housing sector.

Michael Strain:

So let me ask you two kind of follow-ups about that. I think that prior to the pandemic a number of economists questioned whether or not wage inflation actually fed through to price inflation anymore, and the argument was that price inflation was really largely determined by inflation expectations. That inflation expectations were very well anchored and that even though wages knocked up and down. Businesses didn't take that into account, at least not as much as they did say in the 1970s. How do you think about the relationship between wage and price inflation now? I feel like now people are talking quite a bit about the relationship between wages and prices without really explaining that shift and the way economists think about that relationship.

Mary Daly:

Sure. Well even when we were back in the time when people were talking about this flat Phillips curve and the basic fundamental relationship between wages and prices had broken. I would always say this, "Well, let's just forget about being economist and let's just use common sense or business sense." Right? If your input costs rise, you try to pass those on to your prices. But then there are factors that prohibit you from doing that and I've called those wedges. So there's a relationship between wages and prices, that's fundamental right? And employers, it's wages are like another input cost. It's the largest input cost that most employers face, so is the labor compensation so they want to pass it through. But there were all kinds of things interrupting that process and one of those things was just global competition, just driving down the ability to pass things on because you'd be beaten out by a competitor. So the gains were all coming out of efficiency and other things like that. So that was a period when it was pretty fierce and you didn't see it much pass through.

Now because of a variety of things, most importantly the pandemic, but also the war in Ukraine. You have supply constraints, input costs are rising all over and importantly there's not that kind of competition to get things down. All employers, all firms are trying to scramble for workers and you're seeing that translated to wage growth. The interesting thing you compared it to the 1970s is that in the 70s it was one for one. Prices went up, wages went up, then prices went up, wages went up. I mean the correlation there was something close to 80% correlation between wage growth and price growth. Now you don't see that one for one because the labor market, that's why real wages are falling. Because inflation's been rising so rapidly that wages just haven't been keeping up with it and it's partly because of these other wedges as well that it's really hard for firms. They're trying hard to find workers, compensate them, be in these conditions and factor out how much is persistent versus temporary.

Those are challenging things and on the worker side, you're getting great wage increases and you're falling behind and that's why inflation is such a toxic thing in an economy. It permeates everybody's decision-making and everybody's wellbeing and that if you want to ask why does the Fed paying so much attention to inflation? Well one it's our job, we've committed to do it. But the second one is because inflation is toxic and we need to get it back down to 2% on average in order for the things that we're used to permeate.

Michael Strain:

Let me ask you more about the labor market. So I think the labor market is interesting in the sense that we don't really have a problem of excess employment right now. Employment is kind of roughly where it was prior to the pandemic, lower than where it would've been under the pre pandemic trend. Labor force participation rates are lower than they were prior to the pandemic. The employment rate is lower than it was prior to the pandemic. The employment rate for the demographic slice of workers who are too old to be in school, but generally speaking too young to be retired is kind of roughly in the same place that it was. It's not significantly higher than it was and yet we're talking a lot about the labor market being overheated, which I agree that it is. Chairman Powell talked a little about missing workers in the press conference. Can you say a little more about the supply and demand dynamics in the labor market and a little more about where the workers have gone?

Mary Daly:

Sure. This is something we have to pay a lot of attention to. The labor market's just like any other market, and so there's demand for workers but the supply has been relatively sluggish to respond and so the question is why? Well, there are many things you can point to and there's not one that's driving at all. But let me go through the things that have been really important. The first one is I'm going to start

with older workers who were probably going to retire. So when Covid hit, they were probably within five to seven years of retiring, they just retired and drove. So we said that they pulled their retirements forward and they just retired during the pandemic and when you ask these workers, why did you do that? In surveys are when I have my meetings across, I have nine states in the United States. So I spent a lot of time traveling through those states and asking people, "Why did you leave the workforce? I mean, you could get a good wage now if you went in."

They say, "Well, I was afraid for my health. Now I'm helping with the grandkids, I've moved back to where my children live so I can be helpful." Even though schools are fully back in session and things are working, there's still a lot of out of school days that we didn't have before. Because now when your kid's sick, that kid stays home and so that's disruptive for working parents. So that's one of the things going on with older workers and then it's coming back into the labor market. You're factoring in several things. You're factoring in how much wage growth am I getting? Well, real wages have been flat to falling depending on who you are. So that's not a big incentive and then of course you have these other things that are keeping you out. So that's one big group that we're missing in terms of they just didn't come back at the level that they had pre pandemic. Then on the prime age, what we often call prime age although I dislike that term more and more the further I get from that group.

Which is usually considered 25 to 54, so every year I inch past that I'm like I don't like that naming convention. But seriously, that's the group where the bulk of your work life before you start to see retirements is in that age range. So we see that coming back to almost pre pandemic levels, but not quite and you would've thought that it would be growing more rapidly. But that's where we've had a challenge for at least a decade, is that prime age labor force participation in the United States has been behind other industrialized nations, other industrialized competitors and that owes to a lot of things. But something that's really been salient in the current recovery and expansion is childcare, that there's just childcare access. Because there's just fewer people providing it, that is just lower than it was prior to the pandemic and now it's much more costly. So think you're a lower moderate wage earner and you have two earners and now you've got flat real wages, maybe slightly rising, slightly falling depending on where you are. So that's not going to really be the incentive.

You have structural challenges with getting childcare or it's really, really expensive and then of course transportation costs have gone up to get to work. So the rate of return on that extra work isn't what it used to be, and that's a factor holding the labor supply back as well. So come all the way back to that what do I say? How do I think about it as a labor economist? I say that if we can get inflation down, which is the job then the real wage starts to be the incentive for people to come back in. Transportation costs start to fall, childcare costs start to fall. But in the United States we have a more challenging problem that the Fed can't do anything about. We don't have any of these levers, and that is we need more childcare if we're going to have people fluidly go back and forth into the labor force and that's something we just don't have. We had a shortage before the pandemic and now we have a severe shortage.

Michael Strain:

Let me ask you a little more about the outlook. There's been a discrepancy I think between what the Fed thinks the outlook looks like and what bond investors think the outlook looks like. Bond investors, for example are expecting much lower inflation than in the Fed's recent projections. Why do you think that discrepancy exists? How do you think about the outlook among investors?

Mary Daly:

Well to be honest with you I don't quite know why markets are so optimistic about inflation, but I speak of them as priced for perfection. If the goods priced inflation goes down exactly as we can project, if the housing price or shelter price inflation goes down exactly as we think and the core services excluding housing is purely cyclical. There's nothing persistent in there and it goes down as the economy slows, then you could achieve what the markets have priced in. But policymakers in particular, we don't have the luxury of pricing for perfection because we have a price stability mandate. So we have to imagine what the risks to inflation are and to me they still are on the upside for the reason we talked about just a moment ago. The core services housing is largely a reflection of the labor market strength and right now the labor market is strong and I don't see a dramatic slowing in the labor market starting to take place.

So that means that wage growth will be above its long run sustainable average of three and a half to four, and we're going to find that that passes through to price inflation. So for me I want to tell the American people this, that we are resolute in bringing inflation down. Not just getting to that level where you said it's easy to get to four for instance, and harder to get. We're going to go until the job is well and truly done which is 2% on average inflation. That means that I have a tighter path of policy, a higher terminal rate or a higher peak rate for the funds rate. I have it held longer than some of the bond investors would have predicted. But that's what I think we are going to need to do at this point right now in order to bring price stability back to give that back to the American people. If the data come out better then of course policy will do as it's always done, adjust.

But it is really important for us to continue to say that we don't see anything right now but hope in the inflation data and I get confidence out of evidence, not hope. So I'm hopeful we're in a good track, but I won't be confident until I see repeated evidence that inflation is truly back on a path for 2% in the coming couple of years.

Michael Strain:

So that's a good segue into a more explicit discussion of monetary policy and less about the economic outlook. Let me begin with kind of a 30,000-foot question. We're doing this interview right now, it'll be covered in the media when other Federal Reserve Bank presidents or members of the board of governors give interviews that's covered in the media and the media has this kind of hawk, dove categorization. I wonder where do you think you fit? Do you think those categories are outmoded or do you think of yourself as a hawk or a dove?

Mary Daly:

Well, so I guess let me start this way. We have 19 participants on the FMOC and we have two labels. So how likely is that going to be a good description of anyone really? So I think that's a starting point that just doesn't make logical sense that we'd be able to sort people into a couple of camps. So I also don't really love labels, frankly I've been labeled my whole life. First it's I'm a high school dropout, then I'm a labor economist. My gosh, how can I do monetary policy? There's a sense where we say labels and then we think we know what people are going to do-

Michael Strain:

Your predecessor Janet Yellen was a labor economist.

Mary Daly:

Yeah, I know. So that gave me a lot of hope and here I am. But seriously I think labels, the reason we don't want to use them is 'cause they have grave shortcomings that mean that we're simplifying things beyond what is really important if we're going to get the information out. So when I think of it, if you

looked at the media coverage for instance before the FOMC. You would've thought that nobody agreed on anything and that we were in these two opposing camps and then you get the summary of economic projections and you find out that all of us have individually come up with a policy path that has a pretty tight range. If you really just look at it's 475 to 525 and then with 5.1 is the middle, and then you think oh okay, well and what are they going to do in terms of cutting? And everybody has rates holding for 23. The reason for that is we're all committed to the same thing, achieving our goals, price stability, full employment.

Right now it's clear full employment is being met, where we're really off is price stability and so that we're taking the policy remedies that restore the part of our mandate where we're missing. So I guess what I would say to this is that people like to do that type of thing, but it is not actually a good description of anyone and the final thing I'll say there is. We only use hawk dub in this very narrow set of what I call Fed followers. The average people, I talk to the people out there in the community every day, my business contacts. That's not how they think of it. They say only one thing right now, when are you going to get inflation down and how hard is it going to be? So that's where my focus is.

Michael Strain:

Let me remind our audience please to send in questions to John.Towey@aei.org. You could find that email address on the webpage for the event or to tweet them using the #AskAEIEcon. More on monetary policy. I saw a column written by Peter Orszag, the Obama administration official former CBO director. When talking about monetary policy he said the following, he said, "With antibiotics it's better to take all your medicine even if you're already feeling better after a couple of days. With steroids when using moderation they can reduce inflammation and control reactions but take too much or for too long and you can risk the whole immune system." Do you think that interest rate increases are more like antibiotics or more like steroids? Is there is a real risk that one extra dose of tightening can cause huge problems? Or instead, should we think about monetary policy, interest rate increases as something that just kind of gradually affects the economy and it takes a while to really understand what the effects are?

Mary Daly:

Well, I have a rule in my head that never use analogies about medical things because I'm not a doctor of medicine, I'm a doctor of economics. So I'm going to step outside of the medical metaphor and I'm going to go to how I think about that question, which is a really good question. Right? So how I think about monetary policy is there is a risk always of doing too little and doing too much. So what are the cost of doing too little? Well, the cost of doing too little is that inflation embeds itself in psychology and you end up in a situation where now inflation is high and it's very challenging to get it down. We've experienced such an episode and done so in my lifetime and then we had to have the Volcker disinflation, which was the necessary reaction to that embedded psychology. We do not want to repeat that. I saw the cost personally that it took on people who went from having high inflation.

Which made it hard to afford anything to now no jobs, which made it hard to buy anything either and so that's something we absolutely want to avoid. Right now we don't have inflation embedded in the psychology, so we want to make sure that that does not happen. The cost of doing too much of course are also real. Those costs are you can throw the labor market... If you overreact to the high inflation and you do too much, you can throw the economy into a troubling and deep recession and then that's hard to come back from. But the policy we've taken today in my judgment, what we've done so far is not achieving either one of those things. It's not doing too much, it's not doing too little. So far what we've done, and I would call this our first phase of tightening. We have simply taken the accommodation we

had offered during the pandemic out of the economy and got rates into modestly restrictive territory. This next phase of tightening phase two is more challenging.

We have to then figure out, and we'll do that meeting by meeting with data dependents and looking at the risks. What is the peak rate that would be sufficiently restrictive to bring price stability back? Then we'll be in that third phase of tightening, which is how long should we hold it? All of those things together are how I think about doing monetary policy. It's really a staged piece. We've finished phase one, we're now in phase two, eventually we'll get to phase three in 2023 and in all of those I'm weighing the cost of doing too little against the cost of doing too much. I guess I want to end this answer with this. When we talk about the cost of doing too much we always talk about inflation expectations in psychology because those are real. But something I'm hearing a lot lately from my contacts, whether they're small businesses, community members, workers, is there a real cost to high inflation right now? It is not a pain-free situation. Americans everywhere are paying a tax with high inflation and those least able to bear it are paying an exceedingly large tax.

So it's about reducing that pain while we don't do unnecessary pain to the labor market. But we don't see really close to that right now, right now we have a labor market that's strong and inflation that's too high.

Michael Strain:

So how do you know when to stop? Do you wait for the unemployment rate to hit a certain level and that tells you to stop? Or do you think to yourself we've done a lot of tightening and we need to sit back and see whether the unemployment rate hits a level that we deem too high?

Mary Daly:

So here's how I think about it. I think about it as we have to... And we put this in our FOMC statement in the November meeting, and we still have in there in December because this is how it works. Right? We already have done a lot of cumulative tightening and monetary policy. So that's already in the pipeline and we have more plans. So that's in the pipeline. Then we understand that monetary policy acts with a lag. We don't know how long those lags are, which is why the third part of that statement is so important that we put out which is we will continue to watch the evolution of the economic and financial data. So we know there are lags, which means we can't wait till inflation gets to 2% before we stop raising rates. I mean that would be the kind of unforced air that causes over tightening. We have to account for the lags, but we don't know what they are looking ahead. We have to watch the data to see where they are. So it's really experiential learning and looking at the whole dashboard of indicators.

So the ones I look at are not just the headline numbers for unemployment and inflation, but what's going on in the labor market. What do quits look like? What does job finding look like? What happens to vacancies? Are there help wanted signs? Just if you go out in your communities, are the help wanted signs coming down? And when you go to your favorite store, they have the normal hours you expect because they have full amounts of workers. That's a labor market sign. On the inflation side, do I see sales starting to reemerge at retail outlets? Do I see the price of things... There's a particular place I go for services for my haircut. They just keep crossing out the prices and writing in new ones and when I see that stop happening, I'm like okay we're starting to get some relief on inflation. So there's a lot of published data we can look at, but this is where talking to people, being out there.

It's really where the 12 reserve banks, the regional Feds... People often [inaudible 00:37:15], "Why do we have those?" Well, here's a really important reason we have them. We have people all over the nation in these 12 reserve banks talking to people who run businesses, who have nonprofits, who are workers and unions and asking them what is it like out there? How's it going? What's happening? That

gives us the forward-looking information we need to ensure that we do our best at not over tightening or under tightening. That's how I make my decision.

Michael Strain:

Let me ask you about one of those indicators. I've been really surprised by the durability of consumer spending. My expectation was that following... So I think there's a lot to be said for this revenge spending way of thinking about this and I thought there would be a lot of revenge travel over the summer. "I'm going on that trip I don't care what the price of the airline ticket is or I don't care how expensive the hotels are. I've been cooped up at my house for years." But then I expected in the fall going into the winter that consumer spending would soften considerably and maybe it did last month. Retail sales that just came out yesterday looked softer than were expected. But on the whole, I've been surprised by how consumer spending has held up. This of course has a direct implication for consumer price inflation, 'cause when demand is growing faster than supply you see prices go up. Have you also been surprised about consumer spending? What do you think accounts for its strength and durability and how long do you expect this to last?

Mary Daly:

Well the resiliency of the American consumer, all of us would be part of that has been surprising to me and here's the things that I think relate to it, and I understand that term revenge spending and things. But I really think of it this way. We have published data or survey data that says people aren't very optimistic or sentiment's down, but you don't see it in actions. You see it in actions and people are buying things, they're doing the things in their lives and it really makes sense to me. I mean, we were hunkered down for a long time and it's not just frustrating. You can't do what you want. It actually takes you away from the things that make meaning in your life, like seeing family or going on trips and seeing places and I see that momentum still there. Las Vegas right now, which is in my district and I recently visited it's booming. People want to see each other, people are coming from all over the country, meet up, they go and do these things.

That is just a sign to me that people really want to be with each other, they want to partake in services, they want to do things. So you can't do them though if you don't have money and so there I really say it's a tale of two pandemics still. We're starting to see the people in the lower part of the income scale really feel the tax of inflation and so the spending is going to slow. But for people above the median, there's really a lot of excess savings still available of people who didn't spend during the pandemic and now have excess money to spend freely on things and showing great interest in doing so. So that is a strength that it kind of surprised me how long the momentum would last when a slowing economy is clearly ahead and how much excess savings people had accumulated. We have some information about that, but it's not particularly great and we're starting to get more but that's something that's really surprised me on the strength.

The other thing that is not surprising is if you just do a simple calculation on the strength of the labor market, it would predict that consumer spending would remain strong. Because one of the main things that would bridal consumer spending is a slowing labor market, and we haven't seen that yet. So as we start to see the labor market slow down and get more imbalance, I would expect then that to filter through to consumer spending. Especially when there's not that excess savings buffer being so high to propel it even when a slower labor market comes about. So I'm looking for a slowdown in 2023 as the labor market comes into balance. But I've also recognized we've been waiting for that to happen for a while, it hasn't happened yet. So my confidence will rise when I see the evidence that it's occurring.

Michael Strain:

Let me ask you a question that came in from Chris Rugaber at the Associated Press. He writes, "Your colleague John Williams at the New York Fed says that the Fed's benchmark rate needs to rise higher than the rate of inflation in order to get inflation under control. Do you agree, and in what timeframe do you think that needs to happen?"

Mary Daly:

Well, I think that that's an easy thing to agree with. So the question is not that really, it's about how do we calculate that. Right? Because people use different calculations. So if you look at the SEP, let me just direct attention back to the Summary of Economic Projections. If you haven't already looked at it's very scintillating, it's available on the website of the Board of Governors and what you'll find is that the peak funds rate is about 5.1 for the median SEP and the inflation rate at the end of 23, which is at the same time is 3.5. So that means that the rate is above inflation and that's what restrictive policy looks like. You have a restrictive policy because the real rate of interest is above zero, it's restraining the economy and the SEP confirms that that's what the median SEP participant sees.

Michael Strain:

Let me ask you a little bit about the interaction of fiscal and monetary policy. I guess the first question I would ask is, does the new Congress matter to the Fed? The Congress that was just elected that will take office in January?

Mary Daly:

So we say this a lot, but I want to unpack it a little bit that the Fed is an independent central bank and that independence is predicated on us being apolitical. We are not reactive to whatever party the elected officials come from because those are different kinds of decisions. Congress gave us our mandates, gave us our responsibilities and then we execute them for the American people. That's the job that Congress expects of us and that's the job we're up to. So the answer to your question is it isn't relevant for monetary policymaking who is in office at that point in time. We of course watch how fiscal policy is moving forward because it affects the economy and that will help us understand how to adjust monetary policy to achieve our dual mandate goals. But which party is in power in Congress or whether Congress is transitioning isn't really relevant for our policy making. Because Congress depends on us to do our jobs for the American people with the goals that they gave us, full employment price stability.

Michael Strain:

A question from Rich Miller at Bloomberg, "Chair Powell has said it's likely that restoring price stability will require policy at a restrictive level for some time. Over the last five interest rate cycles the average hold at peak rate was 11 months. Is that a good way of thinking about what is meant by for some time?"

Mary Daly:

That's a reasonable starting point. We maybe have to do a little more because it's been here for two years, remember we haven't been in a situation like this in a long time. So I would say you could start with that and I think that's pretty consistent with what you see in the SEP, the Summary of Economic Projections for the median. We raise the rate in 2023 and then hold it throughout 2023. We hit that peak rate and hold it, there's no rate cuts projected in that median forecast, and that would be a reasonable starting point. But the data will determine how we actually do it, that's the important thing to know is that these are projections sitting right where we are today. But we've repeatedly as a group

and Chair Powell reiterated this, I will reiterate it from my own point of view. That we have to be data dependent. We can project, but then we have to watch and if the data come in stronger than we've penciled in we'll have to respond more strongly. If inflation falls back much more quickly than we've anticipated, then we will respond.

That's what nimble policy looks like. But right now I sit here and I think 11 months is a reasonable starting point. But I'm prepared to do more if more is required.

Michael Strain:

So I'm expecting a recession next year. I wouldn't be shocked if we didn't have one, but my baseline expectation is that there will be one. The Fed does not expect there to be a recession, but does expect there to be a considerable slowdown in economic growth. My guess is that if we were to have a recession next year or a significant slowdown that given the composition of the Congress we won't have a big stimulus package. What are the implications of that for the Fed? You mentioned that the Fed keeps an eye on fiscal policy because that affects the economy. If we have a slowdown Congress doesn't do anything, fiscal policy doesn't do anything. Does that have implications for how long the Fed holds the funds rate at a high level?

Mary Daly:

Well, if I can I'll unpack that a little bit so I can give an answer to each parts of those. The first piece is that I'm very much aligned with the median for the summary of economic projections, the SEP. I expect a slowdown, the growth to be well below our trend rate. That's going to feel like slow growth to people. We are going to feel like we're in a sluggish economy, though I absolutely anticipate that. But when you think about how the things in our economy respond that support people through these slower times, a lot of that is already built in. It's these automatic stabilizers that we have in place. So when people lose their job, they get unemployment insurance and that doesn't take a new act of Congress. That's just something built into the system, and so it gives an automatic stabilization to people who become unemployed as the labor market slows. Then the important thing is getting inflation down quickly enough that we can have we back on the path of trend growth so that those jobs come back rapidly.

The other automatic stabilizers are things like the support system, food stamps and other things that kick in when people fall below a certain income. Those things are all there without Congress passing any new legislation and I think that's a recognition that there's going to be what we call normal kinds of slowdowns, ups and downs in the economy and hopefully very few of them will be like something we just experienced with the Great Recession. That's a very unusual event, we hadn't had anything that deep since the Great Depression. Those are rare and deep events as opposed to the more typical recessions which last less than a year or a little over a year and these automatic stabilizers help people through them. But all of this comes back to policy will be nimble, we will adjust to the economy we have. But what is top priority right now is bringing inflation back down to 2% on average because it's our goal of course, and price stability is so important.

But also because it's already extracting a tax from Americans and I'll say it again because it's so important, especially those who are the least able to bear it.

Michael Strain:

Chairman Powell said that the FOMC will only cut the funds rate when it's confident that inflation is moving down in a sustained way. What do you think would constitute inflation moving down in a sustained way?

Mary Daly:

So let me speak for myself here, in no way the committee. But what I'm looking for is continued progress on goods inflation and as you and I talked about goods inflation once it starts and the supply... Barring any additional disruption in supply chains, you'd expect this to just come down gradually but completely. Then there's the housing price inflation. Again, with a tighter interest rate environment you would expect that to go as it is. So I'm really looking for movement in core services excluding housing, which to me means that the first thing I would see is a labor market that's coming back into balance. Jobs available, workers who want jobs are coming back in alignment. I'd like to see that. Then I'll see that show through to core services excluding housing, and that will be the third piece of this inflation puzzle. But what I really do need to see is that because that's how we're going to get back to 2%. If we simply had goods price inflation and housing price inflation return to their historical norms, but services including housing were still high we wouldn't get back to 2%.

So we've got to see progress there to be confident that we can start reducing the policy rate. I think if I may Michael, it's really important to you to remind people too that as inflation comes down, a given policy rate is more restrictive in real terms. Right? Because the real rate of restrictiveness is the nominal rate minus inflation. So as inflation falls policy becomes more restrictive, so we have to balance that as well.

Michael Strain:

Let me ask you a final question. It doesn't get a lot of attention, but that I think is very important certainly over the longer term. FOMC participants are asked for all sorts of things and they come out with the dot plots and all the things we've been talking about. One of those is the long run neutral rate and the median rate was unchanged in the projections from the last meeting. But three participants raised their estimate of the longer run neutral rate. This rate has all sorts of implications for whether the economy will return, "To normal," after the pandemic and the kind of surge of fiscal and monetary policy support and all the issues that have affected supply chains and economic supply. Will the world look the same on the other side of that as it did in 2019? That rate is influenced by massive global forces related to demographics, related to economic growth in developing nations, related to the balance between global savings and global investment opportunities. How do you think about the long run neutral rate?

Mary Daly:

Well, first I think of that as one of the top questions we have to grapple with in the coming year. Because as we come out of the pandemic, we're back to thinking about the longer run. We call them the star variables, right? The fundamental factors that guide how we think about the economy, and the piece that you said in your list is really how I think of it. There's a global savings supply and a global investment opportunity demand, and those things come together to determine the neutral rate of interest. That thing that clears that market. We have to go back in and ask ourselves do the factors that affected that and push the neutral rate of interest down after the Great Recession. It was all in train population growth as you said, demographics, slower productivity growth all over, that really had this factor going down. So our star moved to something like 0.5 off of its historical norm of closer to two. So you have to go back in and ask are those factors still there, and what kind of force are they putting on global savings and demand for investments?

The answer is not known right now. I mean I've seen studies here and there, but we have to do a full court press for researchers, policymakers, etc, really asking those questions again and I'm going to remain open-minded to whether it's gone up or gone down. The reason I haven't moved mine is that we

are in a point now where there's so many cyclical forces that it's hard to separate the cyclical forces from the more persistent ones that will ultimately determine global savings and global demand for investment. But I think that's the 2023 issue, we should come out of next year having a much more clear understanding of whether the pandemic changed things more than just temporarily and I'm sure it did. The question in hand is by how much?

Michael Strain:

Let me thank everyone for tuning in for this conversation. Let me thank everyone who will watch the video of this later on and let me thank especially Mary Daly. Mary, thank you so much for being with us today. Thank you for your leadership and thank you for your service during such an important time in national and global economic affairs. Thank you so much.

Mary Daly:

Thank you, always a pleasure Michael to be here with you. Great discussion, I appreciate it.

Michael Strain:

Thank you.