Richmond Fed

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2023 Economic Outlook

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Highlights:

- We still have work to do. Inflation is too high, and we will need to stay on the case until it is sustainably back to our 2 percent target. We have forecasted additional rate increases this year.
- That said, we have slowed the pace of those increases. Now, with forward-looking real rates positive across the curve, it makes sense to steer more deliberately as we work to bring inflation down.
- The experience of the ’70s showed that if you back off on inflation too soon, it comes back stronger, requiring the Fed to do even more, with even more damage.
- If you change the target before it is achieved, as some have recently advocated, you put the Fed’s credibility at risk, which in turn increases the sacrifice required in order to control inflation.
- And if you think supply chain improvements and our actions to date are enough to bring inflation down quickly, then our more gradual rate path should limit the harm.

Thanks for inviting me to speak today. I enjoy these January economic outlook conferences. The timing is great to reflect on the past year and then look forward. So, I will try to share my reflections on both, with a particular emphasis on the Fed and the economy. These are my thoughts alone, and not those of anyone else in the Federal Reserve System.

A year ago, the economy was booming. GDP grew 5.7 percent year-over-year in the fourth quarter of 2021, driven by the post-COVID-19 reopening, and the deployment of excess savings built from fiscal stimulus, suppressed pandemic-era spending and equity appreciation. The unemployment rate was at 4 percent, on its way to matching its 50-year low. Inflation, on the other hand, was 6.1 percent headline and 5.2 percent core; it had sustained, broadened and become a problem.

During the pandemic, the Fed supported demand by taking rates to zero and buying trillions in government bonds. But at our December 2021 meeting, we announced the tapering of our asset purchase program and forecasted the start of rate increases in 2022. It was time to prioritize containing inflation.

And that's what we did last year. We started raising rates in March, accelerated the pace during the summer and have now moved the overnight rate to 4.3 percent. That is the fastest tightening pace in 40 years. We also started reducing our balance sheet this summer; it is down over $400 billion from its peak with more to come.

Why did the Fed move so aggressively? Well, the logic was straightforward. With inflation so high and demand so strong, it made no sense to keep stimulating the economy. Doing so could further put inflation expectations at risk. So, we removed that stimulus as fast as we thought we could.

But I'd also make the case on an emotional level. Last year reminded all of us how much we hate inflation. Inflation creates uncertainty. As prices rise unevenly, it becomes unclear when to spend, when to save or where to invest. Inflation is exhausting. It takes effort to shop around for better prices or to handle complaints from unhappy customers. And inflation feels unfair — the wage increase you earned feels arbitrarily taken away at the gas pump. We all hate inflation and — when I look in the mirror — I ask, "If the Fed doesn't do something about it, who will?"

So how is it working?

Monetary policy works most directly through financial markets. As borrowing becomes more costly, capital investment slows. So does consumer spending, especially in interest-sensitive sectors like housing, auto and consumer durables. The dollar strengthens, lowering export demand and import prices. All these effects have been substantial. The dollar and the euro are now close to parity. Investment in structures is down. Mortgage rates more than doubled last year, bringing the housing market down from its pandemic high. Asset valuations have dropped, without any significant structural market disruptions.

Demand reduction in less interest-sensitive segments tends to take a bit longer. And remember that the pandemic era is still partly with us. Excess savings and the return of consumer borrowing to pre-pandemic levels are funding continued strong consumption, especially for services like travel. Billions in fiscal appropriations are still being distributed. Strong pandemic-era order pipelines and the need for inventory replenishment are sustaining businesses. Employers who fought hard to hire scarce workers are reluctant to fire them. The unemployment rate remains at the historically low rate of 3.5 percent (and we are still adding jobs, 223,000 in the December report).

Once demand weakens, studies estimate it can take another six to 12 months before those pullbacks quiet the rate of inflation. So, with demand slowing but resilient, labor markets healthy, and the added and enduring shock of the war in Ukraine, it shouldn't be a surprise that inflation — while likely past peak — is still elevated. The 12-month headline PCE remains at 5.5 percent, and the core is at 4.7 percent. Wage gains are still higher than pre-pandemic levels.

Where is the Fed headed next?

Let me start by saying we still have work to do. Inflation is too high, and we will need to stay on the case until it is sustainably back to our 2 percent target. We have forecasted additional rate increases this year.

That said, we have slowed the pace of those increases. We moved quickly last year, but what we were doing was taking our foot off the gas. Now, with forward-looking real rates positive across the curve and therefore our foot unequivocally on the brake, it makes sense to steer more deliberately as we work to bring inflation down in the context of the lags I just discussed.

To that end, the last three months' inflation prints have been a step in the right direction, but I would caution that while the average dropped, the median stayed high. That's because the average was distorted by declining prices for goods like used cars that escalated unsustainably during the pandemic. I

saw one commentary celebrating that core CPI less shelter actually declined. But we all know what people care most about: food and gas and shelter.

With the Fed resolute on inflation, that brings me to the outlook for the economy.

This has been the most predicted potential recession in memory. But, despite some scares earlier in the year, the data we've seen on spending, investment and employment keep pushing the timeline out — unless you are in housing or sell into a low-income customer base, or are a deal maker or are dependent on digital advertising.

In the rest of the economy, firms know the Fed is taking strong action to combat inflation and realize that creates downturn risk. They believe many of the artificial elements supporting consumer spending will likely wane over time. They have updated their Recession Playbooks and may even be working the items on the first page, like headcount freezes or discretionary spend reductions. But most haven't turned the pages yet given their demand remains solid.

But they might. Perhaps because inflation remains stubbornly high and requires more from us. Perhaps because a sector moves in unison as recently happened in tech. Or perhaps because of unexpected outside events like those that drove the last three recessions.

I get a lot of questions about whether the Fed should remain this committed given that risk. I guess my simple answer is that everyone hates inflation, and we are the ones mandated to address it. The Fed's objective isn't to hurt the economy; it's to reduce inflation.

The experience of the '70s showed that if you back off on inflation too soon, it comes back stronger, requiring the Fed to do even more, with even more damage. If you change the target before it is achieved, as some have recently advocated, you put the Fed's credibility at risk, which in turn increases the sacrifice required in order to control inflation. And if you think supply chain improvements and our actions to date are enough to bring inflation down quickly, then our more gradual rate path should limit the harm.

And I should use this moment to remind you that inflation doesn't come from statisticians. It comes from the sum of actions of individual firms. (So, if any of you in the audience have a price increase in the works, feel free to help us all out by backing off.)

I like analogies, and one that hit me recently was hiking down a narrow trail after having climbed a mountain. The peak of course being inflation. You are tired. If you go too fast, you could easily slip; so you move deliberately. There's always a chance a storm could come up and muddy the trail. A path that seems solid could give way, forcing you to an alternative route. But you know your map is good, your tools are high-quality and there's still a lot of daylight left. So, like you, I'm looking forward to getting down this particular mountain, and telling the story of how we did it — preferably in front of a warm fire.

With that, let me open it up for questions and comments.