Transcript:
AP interview with Cleveland Fed President Mester

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WASHINGTON (AP) — Here is a transcript of an Associated Press interview Tuesday with Loretta Mester, president of the Federal Reserve Bank of Cleveland.

Q:

In the past two weeks, we've had a jobs report that suggests wage growth is slowing. We've had the inflation report that showed three months of declining core inflation figures. Have you been encouraged by these reports? And how have they changed your outlook on policy?

Loretta Mester:

Well, it's very welcome news to see that inflation is starting to come down, I think that that's important input into how we're thinking about where policy needs to go. I mean, the December CPI report, which was the latest data point, that was basically largely as expected and so the way I think about what the most recent monthly numbers are telling us is that we can have some confidence or more confidence about the inflation projections, which do have inflation moving down this year.

So you remember last year inflation was really exceeding expectations of any forecasts and of course, that wasn't welcome news. Now, we're starting to get some reports that suggest that okay, maybe inflation is beginning to come back down.

My own view is that it's going to take more policy action, to be assured that inflation is on a sustained downward path to 2% but I will — I do acknowledge that we've got some welcome news there. And similarly on the labor market, the labor market conditions remain very strong. It's still the case that labor demand is outpacing labor supply. I mean, if you think about job openings, yes, they have come down a bit, but there's still many more job openings than there are available workers.

Wage growth, while there's been some tempering in that as well, it's still well above the level that you would need for consistency with price stability. So if you think about wages, a sustainable wage increase would be reflecting productivity growth or trend productivity growth plus 2% inflation.

The other thing about wage growth, as I like to point out to people is that yes, it's been strong but it's not keeping up with inflation. So workers are not getting — they're still feeling the brunt of that high inflation even though they are making higher wages in nominal terms. So it still is the case that inflation is the number one concern of the economy, for both businesses and for households, because it really is costly to actually have inflation running at the levels it's running.

Q:

What does that mean for the next meeting? Would you support a rate hike of a quarter point — another step down? Or how are you thinking about that?

Loretta Mester:

Well, my own view is that we're going to have to get the funds rate above 5% in order to get inflation, really on a sustained downward path to 2%. Two percent, of course, is our long run goal. And so, you know, that was at the December meeting — coming out of the December meeting, the statement said, we're going to need ongoing increases.

You know, how much at any one particular meeting is probably less important this year than it was last year where everyone was focused on that. But to my mind, we showed at the December meeting that the economy and the financial markets were able to handle that (one-half percentage point) increase. We're not at 5% yet, we're not above 5%, which I think is going to be needed given where my projections are for the economy.

So I just think we need to keep going, and we'll discuss at the meeting how much to do at any one particular meeting. But my projections and my view of the economy is that we need to do more, we need to get above 5% and then hold it there for some time until we get that, you know, inflation expectations very well anchored at 2% — are consistent with 2% –and inflation on that downward path. That doesn't mean we have to keep increasing interest rates until inflation reaches 2%. Because we have to realize that our policy actions do affect the economy with some lag. But we're just at the start of a restrictive policy stance and I think we need to be higher than current levels in terms of the funds rate.

Q.

On that note of the level being more important, potentially, than the pace of hikes. Can you say a little more about where your dot was on the December statement of projections and how had that changed since September? What can you tell us about the

Loretta Mester:

Yeah, so I was a bit higher than the median SEP projection for 2023. But that's because I saw — see more — a little bit more persistence in inflation than the median forecast in the December projections, but that's an important point to underscore to people that are going to be reading and hearing this — is that the projections for appropriate policy are part and parcel of projections for the economy.

So when they — if my projections for the economy were to evolve, like if we do get inflation coming down faster than I'm projecting, then I might have to adjust my current policy path. If we get other conditions, suppose inflation was, you know, remaining higher than projected, then we might have to address our policy path the other way. So, again the projections for the policy path are dependent on what we're forecasting or what each participant forecasts for the economy and they evolve as the forecast evolves.

So if you think back to last year, inflation came in much higher and it was — proved to be more persistent over the year than we had thought it would be at the beginning of the year. And those policy projections in the SEPs evolved to reflect what appropriate policy would be given the way the economy was evolving.

Q:

Given the changes we've seen in the last three inflation reports and some of the signs of slowdown in wages, do you take much encouragement from that? And do you see the chances of a soft landing perhaps being higher than they were a few months ago?

Loretta Mester:

Well, I do take encouragement for the fact that we're starting to see policy actions affect demand, right, because — what we're trying to do is we're trying to set our monetary policy to get demand into better alignment with supply. We know that both in product markets and labor markets demand has been well above supply. We're starting to see that, we're starting to see some slowing, especially in the mortgage market, the housing market, because of higher mortgage rates. We're seeing it in some manufacturing conditions are easing off.

We still have some ways to go. And that's why I think we've made a lot of progress on the funds rate. I do believe we need to keep going a little bit more to get to a sufficiently restrictive stance so that we can get that inflation really sustaining — on a sustainable path to 2%. But at least we see now that policy is having the intended effect.

And now what we're trying to do is make sure that this journey back to price stability is done in the least painful way possible. I'm encouraged by the fact that we still have healthy labor markets, we just do have demand in the labor market outpacing supply. And as we continue on this journey, they're going to come into better alignment.

So again, I think we have more work to do here in terms of our policy rate, but I do think we're beginning to see the kind of actions that we need to see. You know, if you think about where we're seeing the declines in inflation, it's in the goods part of the inflation report. If you look at service inflation, that's still very persistently high. And that does tend to be the more persistent part of inflation. So again, good signs that things are moving in the right direction, gives me a little more confidence that the projection of inflation coming down this year, is is on track, but still more work to do to make sure that we get back to price stability.

Q:

Well, you touched on something I wanted to follow up on, which is, as you know, Chair Powell has talked about three different buckets of inflation drivers, one being goods, as you mentioned, and the other of course shelter costs. And then as you also touched on core services, excluding housing Do you agree with that framework? And he's certainly cited wages as a driver of the services part. Do you agree with all that and what does that imply for where the Fed goes next?

Loretta Mester:

I think that's a pretty good decomposition to give you some insight into what's been happening with the inflation numbers since the pandemic. You remember when the economy had to shut down in the early stages of the pandemic, right? You had to shift your spending from services to goods and that excess demand was there, really buoying goods prices, and of course, the supply chain issues that firms ran into again contributed to those higher goods prices.

So that lens kind of gets you to focus in on a little bit on where have the price pressures been. Then when the economy reopened and people could go out and we saw service spending pick up and some shift from goods to services, we got higher inflation on the service side. And housing, of course, is being affected by the fact that early on, people wanted more space because of working from home. There was demand for housing, people were moving.

Now we're starting to see some of that pressure in the housing market come off because higher mortgage rates have lessened demand for housing and housing activity. So again, we are seeing some some signs that housing prices and the components and the shelter components in our inflation measures will come down, but typically it takes quite a while. So if you look at new leases — rents and new leases have come down quite a bit. But work from the Cleveland Fed has shown that it takes about a year for that to show up in the inflation measures.

So to parse out the way the chairman did those three parts, you can see we've made some good progress on core goods prices. They've been moving down in recent months. Energy prices, as you know, have been moving down since June. They're more volatile, they could go up again, depending on what happens in the war in Ukraine, we'll have to see, and then in terms of housing coming, perhaps coming down but it'll take a while. And then that stubborn real — the stubborn part really is that services, excluding shelter, and that just takes — it's going to take I think more effort and more work from the Fed to calibrate our policy to make sure that that's going to move down as well.

So, again, you know, I think we're on a good track. I think we're starting to see our policy actions do what they're intended, but I do believe we have to continue raising from the current level of the funds rate, and then hold for a while so that we get back to price stability in a timely way.

Q:

And given the stickiness of services inflation that you mentioned, does that mean the Fed really needs to see a rise in the unemployment rate get that under control — a significant rise? In econ terms, how much stock are you putting in a Phillips Curve relationship here between unemployment and inflation?

Loretta Mester:

One of the things that's been interesting about this period is that we have seen job openings, the demand for labor has well outpaced the supply of available workers, and so I do expect that as we get demand and supply in the labor market back into better balance, we'll see some increase in the unemployment rate, but remember, the unemployment rate is really extremely low by historical standards. It's like multiple decades low.

So that increase in the unemployment rate could very well — most of that rebalancing in the labor market could be much more on the demand side than is typical in a typical economic slowdown. So I'm anticipating we'll see some increase in the unemployment rate, but that it'll be less than one would typically see in an economic slowdown.

I do have economic growth being well below trend. And that's going to temper the labor market, but it's just — we're in a period where demand — labor demand is still quite strong and quite a bit stronger than supply and so you can get that action of rebalancing on the demand side more than on the supply side.

Q:

Well, let me switch gears a little and ask about the restrictiveness of the Fed funds rate. I think you mentioned that that's just getting into restrictive territory. How would you define that? Do we need to see a Fed funds rate that is positive after adjusting for inflation and how positive and how do you calculate that?

Loretta Mester:

So if you think about — what you're saying is like, adjust the nominal funds rate by some inflation measure. We can talk in a minute about which one you use. I do think we need to be in positive territory. If you look at the long run projections of the Federal Reserve or the FOMC participants the long run nominal Fed funds rate is two and a half — about two and a half (percent). And with an inflation target of two, that means the long run real fed funds rate is one-half (percent).

So to be restrictive you probably need to be above that. And if you adjust the current level of the funds rate by either projections of inflation over this year, or even if you — certainly if you adjust for current inflation we're not in a restrictive stance. So one way to think about it is let's adjust for an inflation projection, by the end of this year, we still need to move the rate up.

My own rate is above 5% as is, I think 17 of the 19 participants on the FOMC also had a rate above 5% in the last projection. So again, if you look at policy rules that a lot of economists like to look at, they're all showing that we need to move the rate up into restrictive territory, meaning positive, and so we just need to continue on.

What any — that terminal rate at any particular meeting — is really going to be driven with how the economy evolves. So at this point we need to be above five. Pretty much all policymakers believe that. How much above five, it's going to depend on how the economy evolves. If it looks like inflation is on on path, we hold there for a while, let things develop. We get convincing evidence it's moving back down, then we rethink it. But at this point, right, we're not at a point where we're sufficiently restrictive. And if you look at the statement coming out of the December FOMC meeting, we indicated that we need to see some more increases in the funds rate to make sure that we're going to hit our dual mandate goals, in particular price stability is really important that we make sure that we get back to that in a timely way.

Q:

Well, looking at the economic data, would you support say a pause by the March or May meetings — I mean, what would you need to see to support a pause? Would the continuation of the kind of inflation readings we've been seeing, would that be enough? What else would you need to look at?

Loretta Mester:

I would need to see inflation moving down faster than we've seen, right? Because right now, the inflation numbers have come in about as I forecasted. The last CPI report I didn't think of as being a surprise, it was basically as expected. So those are good things in the sense that they're consistent with the forecast that inflation will move down this year.

But inflation moving down this year, in my forecast is contingent upon policy getting to that sufficiently restrictive stance, which in my view, is above 5% and above — a little bit above the median that was in the SEP, as well.

Q:

And how are you thinking about the balance of risks? Have any events shifted that? Or are we still in a situation where you see the main risk being that the Fed doesn't tighten enough?

Loretta Mester:

We always — when we're doing this tightening of policy, always have to be — or transitioning policy — always have to weigh those risks, as you pointed out, the risks of tightening too much, which could slow the economy more than necessary, and entail higher costs than needed to get back to price stability, versus the tightening too little, which allows this high inflation to persist.

And high inflation has both short and long run consequences for the economy. And if we were to allow that to happen too much, then it would just be more costly to get back to price stability. So we're always — that's always in the mind of a policymaker.

My own view is that given that inflation really proved to be much more persistent than we expected last year than we thought it would be at the start of the year, and the fact that we still have very high levels of inflation. I mean, we — it's good that we seen some movement down, but the level of inflation still is very high, and that high inflation does, you know, impact households, and businesses. Routinely if you look at surveys, both on the household side and the business side, they continue to cite high inflation as one of their number one, or the number one, problem that they're dealing with.

So all that together, I still see that the larger risk coming from tightening too little. If we don't get inflation back down, it can impact the long run health of the economy as well as the short run health of households and businesses. So, you know, to my mind, we've got to be very diligent in setting our policy to get back to price stability, but of course, we're going to be judicious in doing that. We're going to balance those risks as we go. And I do hope that we're gonna get to the point, you know, where I can say, Okay, I think we're at a point now that we pause, the balance of risks — kind of balance, those two risks balance. I'm not at that point yet.

Q:

Well, one question on an internal matter. In the last minutes in December, it said that no member of the FOMC anticipated a rate cut this year. And a couple of people have mentioned to me, how is that known? It's not necessarily inherent in the statement of economic projections. Did Chair Powell ask for a show of hands or how did that come about?

Loretta Mester:

Well, you know, at all FOMC meetings, we discuss the economy, we discuss our policy paths. So, it's not too surprising that the people that said that you can't infer that necessarily from the standard SEP releases. That's correct. But you know, as we do in all policy meetings, we're always discussing policies in

the meeting. And that became — and that's why it's in the minutes because the minutes do reflect the discussions at the meetings. So yes, that's what it turned out to be.

One thing to remember again is that the appropriate policy paths of any particular policy maker is dependent on their view of how the economy is going to evolve. So the fact that, you know, nobody said that they thought it would be appropriate or nobody's path had a cut in the funds rate in 2023, with a few more words it should be, because of their view of how the economy is expected to evolve, and how inflation is expected to evolve, no one thinks that it'll be appropriate to move the funds rate down in 2023.

And of course, as the statement does say, if you look at the full FOMC statement, we acknowledge that if the economy evolves differently than we're projecting, policy might have to be different as well. So we are very much tying our views on policy to how the economy and the risks around the outlook evolve. But that statement in the minutes was implicit in the section that we're talking about — the participants views of the outlook, if that makes sense.

Q.

Yeah. And then I just wanted to ask you about quantitative tightening. Regarding the mortgage backed securities, I wanted to get a sense of how you're thinking about — will there be a point where the Fed has to sell those — the Fed has not had to sell securities before so certainly, there are questions about how that might affect the market, the mortgage backed securities market.

Loretta Mester:

I mean, I do think that it's important that the Fed get the balance sheet back to a size and composition that's mainly Treasury. And I do think eventually, we might have to sell some of the mortgage backed security portfolio in order to get to that point, you know, in a timely way.

However, this is not top of mind now at all, in my sense. I don't think we need to do that now. I think the job one right now is getting inflation back down and getting back to price stability. We are letting the balance sheet run off and that you know, passive way — the balance sheet shrink through that passive way. And so that's part of the tools that we're using to get inflation back down.

And our main policy tool, of course, is the Fed funds rate. And that combination has been working as we've talked about, we do see some welcome news on inflation. We — so I think we're at a good spot, with the runoff. I think eventually we will — I'd like to have a discussion within the committee about if we were wanting to move that faster, when we're farther along and inflation, getting inflation back down. How would we go about doing it? What would the implications be, etc. But we don't need to have that discussion right away. I do think it's a worthwhile discussion to have at a future date.

Q:

Great, OK. I appreciate your time. And thanks again for doing this.

Loretta Mester:

Well, thanks for inviting me.