Dallas Fed

Speech by President Lorie K. Logan

The U.S. economic outlook and monetary policy

Dallas Fed President Lorie Logan delivered this address on Jan. 18, 2023, at The University of Texas at Austin McCombs School of Business as part of her 360° in 365 Listening Tour of the Eleventh Federal Reserve District.

Thank you, Dean [Lillian] Mills, for the kind introduction and the warm welcome to the University of Texas.

The Federal Open Market Committee (FOMC) has been tightening monetary policy for the past year to bring inflation back to our 2 percent target. One of the questions I'm asked most often is: How much more will we do? More specifically, how high will we raise interest rates? Or, as my family used to ask on our road trips back home to Kentucky: Are we there yet?

Those of you who have taken family road trips know that, sometimes, the best way to handle this question is not to answer it.

The same is true today in monetary policy. Just as I was committed to completing those long drives, the FOMC is committed to reaching our goal of restoring price stability. But considering the uncertainties we face, I don't find it particularly helpful at this time to lock in on a peak rate or the precise path rates will follow. Rather, we need to keep our eyes on the economic and financial outlook and lay out a strategy that is both flexible and robust so we are best positioned to achieve our goals however the outlook evolves.

I'll start today's journey by discussing inflation: where we are today and the outlook from here. I'll then turn to the outlook for the second, equally important, component of the FOMC's monetary policy mandate: maximum employment. Finally, I'll discuss financial conditions and what I see as a flexible and robust monetary policy response. As always, these views are mine and not necessarily those of my FOMC colleagues.

Inflation

Inflation over the past two years has been much too high. The FOMC aims for 2 percent annual inflation as measured by the price index for personal consumption expenditures, or PCE, but inflation has averaged 5.8 percent at an annual rate since January 2021.

This high rate of inflation weakens our economy. People's incomes fall short of the cost of rent and groceries, and new research at the Dallas Fed finds that the rising cost of living is particularly stressful for lower-income households. Businesses can't plan well when they don't know what they'll pay for materials or be able to charge their customers. And the longer high inflation continues, the greater the risk that prices and wages rise just because people think inflation will remain high—a spiral that would significantly increase the cost of bringing inflation down. In sum, price stability is foundational for a healthy economy and labor market over time.

In my view, the run-up in inflation has had two sources. Special circumstances, now mostly in the rearview mirror, pushed up prices in particular sectors, like energy, manufactured goods and housing. But inflation then spread to a broad set of services, and this broader inflation is what shapes the outlook today.

The pandemic and Russia's invasion of Ukraine have made energy prices remarkably volatile. In March and April 2020, as global economic activity slowed, the price of oil fell from $60 per barrel to around $20. Then, as the economy recovered while fossil fuel production remained low, the price steadily climbed through mid-2022. Last year, Russia's war caused additional volatility around this trend. Natural gas prices have fluctuated even more, and in Texas, we've also seen enormous spikes in the wholesale price of electricity during some winter storms.

Energy prices are quite noticeable in our daily lives and quite important to the economy here in Texas, where oil and gas production makes up more than 11 percent of state GDP and half of state exports. But because energy inflation tends not to persist, the recent drop in energy prices doesn't greatly change the inflation outlook.

Turning to goods, responses to the pandemic disrupted global supply chains just as consumers shifted to consuming more goods and fewer services. The natural result was that prices of goods rose.

Statistical measures suggest that supply-chain pressures peaked in December 2021 and have now recovered substantially, though not fully. Correspondingly, goods prices have started to fall. Continued recovery in supply chains should help hold down goods inflation going forward, although there are risks from China's transition out of zero-COVID policies and the disruptions resulting from Europe's energy crisis.

In the housing market, people fortunate enough to be able to work remotely during the pandemic often wanted bigger homes. They also considered locations far from their offices—in some cases, across the country. And mortgage rates fell to historically low levels in 2020 and 2021. All of this drove up demand for housing.

But homes can be built only so fast, so in the short run, prices soared. Austin was perhaps the national epicenter of this effect, fueled by domestic migration and the boom in technology jobs. House prices rose 58 percent here, outstripping all other major Texas metros and straining affordability for working-class and middle-class families.

Housing prices nationally and in Austin are now cooling as mortgage rates have risen. However, our research at the Dallas Fed finds that changes in house prices take around 18 months to feed into measures of housing inflation, which are based on average rents. The main reason for the lag is that rents adjust infrequently as leases turn over. Our research suggests it could be mid-2023 or later before year-over-year housing inflation begins to fall. Still, I'm confident relief will come.

What's more concerning is the way inflation has spread to the broader economy. About half of personal consumption consists of what are called core services excluding housing. This category includes everything from health care to transportation to entertainment to dining out. Early in the pandemic, prices of nonhousing services were soft as many consumers stayed home. But as the economy reopened, inflation began to broaden. Core services inflation excluding housing has now been running in a range of 4–5 percent for close to two years, and while headline inflation has softened notably in the last few months, this category has stayed high.

Broad-based and persistent services inflation surprised many forecasters who thought inflation would come down when shocks like supply-chain disruptions had dissipated. Moreover, it's hard to point to special circumstances that suggest services inflation will go away on its own. Rather, I see elevated services inflation as a symptom of an overheated economy, particularly a tight labor market, which will have to be brought into better balance for the overall inflation rate to return sustainably to 2 percent.

Employment

The labor market is important in its own right for monetary policy, given the FOMC's mandate to achieve both price stability and maximum employment. But in addition, because the tight labor market appears to be driving the broad-based services inflation we are seeing today, the outlook for inflation hinges in large part on how much and how rapidly the labor market eases.

Services prices depend substantially on labor costs, and wages have been growing at about a 5 percent annual rate by a variety of measures. For that kind of wage growth to be consistent with 2 percent inflation over the long run, productivity would have to rise at a 3 percent annual rate. Yet output per hour worked grew at an annual rate of only 1 and a quarter percent from 2012 through 2019, and there is little indication it has accelerated since then. So, absent a dramatic rise in productivity, it seems likely that returning inflation to 2 percent will require wage growth to slow substantially. That may take time. Respondents to the Dallas Fed's Texas Business Outlook Surveys expect more than 5 percent wage growth in 2023, which is down significantly from what they saw in 2022, but still quite elevated.

Other statistics also point to an unsustainably tight labor market. As of November, there were 1.7 job openings for every unemployed person in the United States. This is down from a peak of two openings per unemployed person last March but still well above the ratio of 1.2 openings per unemployed person in 2019—which was thought at the time to be a very strong labor market. Payrolls have been growing by more than 200,000 workers per month. And even without looking at the statistics, you can see how tight the labor market is when your favorite restaurant or store cuts its hours because it doesn't have enough workers.

But some other information is starting to point to a slower labor market. While job growth has remained robust in the payroll survey of employers, numbers based on a household survey are significantly lower since last spring. And a much-larger dataset called the Quarterly Census of Employment and Wages (QCEW) shows a sharp slowing in employment growth in the second quarter of last year. In fact, when benchmarking Texas jobs data to the QCEW, which the Dallas Fed does regularly, the revisions reduced Texas job growth from 4.7 percent to 3.4 percent, annualized, for the first 10 months of 2022. Some business contacts also tell me their hiring plans are slowing. In addition, wage pressures moderated in the latest national report on average hourly earnings. I'd need to see a lot more data, though, to be convinced the labor market is no longer overheated.

To achieve better balance, labor supply will have to increase, or labor demand will have to decrease.

Labor supply has been weak coming out of the pandemic. The labor force is several million people below what we would have expected by now based on prepandemic trends. You might be surprised that rapidly rising wages haven't encouraged more people to look for work, but because wages haven't risen as fast as inflation for most workers, the incentive to work isn't necessarily that strong. Labor supply is also held back by a substantial number of early retirements, as well as deaths and lingering illness from the pandemic and structural challenges like the lack of child care for working parents and a decrease in immigration. Beyond that, employers tell me that when workers are available, they often lack the necessary training or skills.

While all these constraints are at play in Texas, the state has been a bit of an outlier. The labor force here is 5 percent above its prepandemic level, thanks to accelerating migration from other states.

Addressing the structural challenges is critical for the Texas and U.S. economies in the long run. Developing a larger, higher-skilled workforce will help ensure we have a strong economy for everyone. At the Dallas Fed, we're committed to partnering with communities in our region and using our research to help advance solutions. But that work takes time. So when it comes to the current elevated inflation, the FOMC has to respond by tightening monetary policy to reduce demand.

Interest rates

What do I mean by tightening monetary policy? The FOMC's primary tool is the target range for the federal funds rate, an overnight interest rate. Since the start of 2022, we have raised this target by 4.25 percentage points, the largest one-year increase in four decades. In addition, since June 2022, we have been reducing our holdings of Treasury and agency mortgage-backed securities.

Both of these tools push up interest rates for consumers and companies throughout the economy. Financial conditions have, therefore, tightened significantly. The 10-year nominal Treasury yield is up nearly 2 percentage points, and mortgage rates are up nearly 3 percentage points, since the start of 2022. Importantly, since the September FOMC meeting, real medium-term interest rates as measured by the yields on Treasury Inflation Protected Securities have averaged above 1.5 percent. That is a significantly restrictive level given that most estimates suggest the neutral real interest rate is below 1 percent.

In moving forward, we need to manage two risks. And in both cases, the risk is not just that of getting a slightly different outcome than we'd prefer, because the financial system and economy sometimes shift in abrupt and nonlinear ways. The most important risk I see is that if we tighten too little, the economy will remain overheated, and we will fail to keep inflation in check. That could trigger a self-fulfilling spiral of unanchored inflation expectations that would be very costly to stop. We must stay focused on bringing inflation back to target in a timely way. At the same time, if we tighten too much or too fast, the labor market could weaken much more than is necessary to control inflation. Those job losses would be very costly, too, particularly for the most vulnerable in society.

There is much we don't know about how 2023 will unfold. There is uncertainty, first of all, about how much and how rapidly the economy will respond to tighter monetary policy—the famous "long and variable lags." We also could get good news, like an unexpected increase in labor supply or gains in productivity that would allow inflation to fall without as much slowing of economic activity. Wage pressures could ease more rapidly than expected if the labor market proves not to be as overheated as many statistics suggest. Or, less happily, challenges like new geopolitical headwinds or rising inflation expectations could emerge. Financial conditions could ease or tighten for reasons unrelated to U.S.

economic developments and monetary policy, and to maintain appropriate conditions to achieve our policy goals, it might be necessary to respond with a different policy path.

In this environment, I believe we need a strategy that is both flexible and robust.

To put ourselves in the best position to manage the risks, I believe we shouldn't lock in on a peak interest rate. Rather, we need to continually and carefully assess what the incoming data imply about the economic outlook and adjust course accordingly.

That assessment will not be simple. I mentioned some of the mixed messages in the labor market data, and I expect that the data and qualitative reports will become even more mixed as the economy slows.

Now, if you're on a road trip and you encounter foggy weather or a dangerous highway, it's a good idea to slow down. Likewise if you're a policymaker in today's complex economic and financial environment. That's why I supported the FOMC's decision last month to reduce the pace of rate increases. And the same considerations suggest slowing the pace further at the upcoming meeting.

To be clear, I don't see the argument for a slower pace as depending very much on the latest data. Nor should a slower pace signal any less commitment to achieving our inflation goal, any more than slowing the car would suggest you don't want to get back home to Kentucky.

A slower pace is just a way to ensure we make the best possible decisions.

We can and, if necessary, should adjust our overall policy strategy to keep financial conditions restrictive even as the pace slows. For example, a slower pace could reduce near-term interest rate uncertainty, which would mechanically ease financial conditions. But if that happens, we can offset the effect by gradually raising rates to a higher level than previously expected.

My own view is that we will likely need to continue gradually raising the fed funds rate until we see convincing evidence that inflation is on track to return to our 2 percent target in a sustainable and timely way.

The evidence I'm looking for to gain confidence in the inflation outlook includes some further and sustained improvement in the inflation statistics, as well as a clear change in the underlying factors—like the imbalance of aggregate supply and demand and resulting very tight labor market—that have been producing high inflation. And I think we need to see the economy evolving more or less as forecasts predict. When inflation repeatedly comes in higher than the forecasts, as it did last year, it is hard to have confidence in any outlook.

I will also be attentive to how financial conditions respond to the economic data and monetary policy. Ultimately, financial conditions need to be sufficiently restrictive to restore price stability. Even after we have enough evidence to pause rate increases, we'll need to remain flexible and raise rates further if changes in the economic outlook or financial conditions call for it.

The Fed's balance sheet

While the fed funds rate target is our primary tool, the runoff of asset holdings is another important component of tighter policy. We expanded our balance sheet during the pandemic to support economic growth and the flow of credit to households and businesses. Now that the economy has recovered, it is important to allow these assets to mature to help restore price stability.

Unlike with the fed funds rate, we are not adjusting asset runoff in response to the economic outlook. Rather, because our assets back our liabilities, like currency and bank reserves, the path of our assets will depend on the need for those liabilities. As our assets run off, our liabilities also fall. We can continue that process as long as we are providing enough currency and reserves for the payments, banking and financial systems to function smoothly.

Just like with interest rates, you could ask how long that is. Here, too, I think the right answer is more about strategy than numbers. Bank reserves are currently far more than ample. And more than $2 trillion of excess liquidity is parked in our overnight reverse repo facility. If we saw some modest money market rate pressures in this environment, I would not interpret it as a sign that liquidity is scarce. It would simply be an incentive for banks to redistribute liquidity where it's needed.

The process of redistribution from the overnight reverse repo facility to banks won't necessarily be perfectly smooth. Banks can't perfectly predict deposit outflows. But over time, if a bank sees reserves fall lower than it would prefer, it can attract more funding by increasing the rates it pays on deposits or wholesale borrowing. I think it is important to allow markets to work to redistribute liquidity in this way, so that the FOMC can reduce the balance sheet to an efficient size. In addition, the Fed's Standing Repo Facility (SRF) provides a backstop against excessive interest rate pressures or shortfalls in reserves. I would be comfortable seeing some temporary usage of the SRF while balances in the overnight reverse repo facility remain high, as part of the process of redistributing liquidity.

With the SRF as a backstop and the power of market incentives to redistribute liquidity, I am confident that we have room to continue running off our assets for quite some time. Exactly how long that is will depend on a careful assessment of the financial environment. The financial system is constantly evolving. We can't pinpoint the amount of liquidity that will be needed over time. We'll need to watch the outlook and adjust our balance sheet strategy appropriately so that liquidity levels don't fall too low.

Conclusion

In conclusion, the FOMC is committed to delivering a healthier economy, with maximum employment and stable prices. To achieve this, I expect we will need to continue increasing the fed funds rate. In my view, we shouldn't lock in on a peak interest rate or precise path. Instead, I believe it's appropriate to gradually raise rates, carefully assess financial conditions and the outlook, and remain flexible to adjust as needed, so we can robustly manage the risks we face.

Thank you. I'd be happy to answer some questions.

About the Author

Lorie K. Logan is president and CEO of the Federal Reserve Bank of Dallas.

The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.