Returning to Price Stability: In It to Win It

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Introduction

Let me begin by thanking David Kotok and the Global Interdependence Center for inviting me to speak at today's conference. The GIC has a long tradition of organizing sessions to inform us about the important issues affecting the world's economies. I am grateful that I have been able to participate in many GIC events over the years.

Today, my topic will be the outlook for the U.S. economy and the appropriate monetary policy settings that will return our economy to price stability. The views I present will be my own and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee.

Because the Super Bowl was played just this past Sunday, I titled my talk "In It to Win It" because the Fed is committed to getting inflation back to our 2 percent goal. But, of course, returning the economy to price stability is not a game: it is an imperative for sustaining healthy labor markets and our standard of living. The very high inflation the economy has experienced for almost two years has been painful for households and businesses, especially those with fewer resources, as they have had to cope with increasing costs and make hard choices about where to spend their money. Organizations that offer services to lower-income households have also been struggling with higher costs, limiting their ability to offer aid to as many people. High inflation also imposes longer-run costs on our economy because it distorts the decisions households and businesses make about building human capital and investing in R&D, plants and equipment, and other forms of physical capital. These decisions ultimately affect the pace of innovation, productivity growth, the potential growth rate of the economy, and improvement in our living standards. Because of the negative costs of high inflation, the Fed is resolved and focused on returning to price stability in a timely way: we are in it to win it.

Last year, in the wake of very high inflation, the Fed took deliberate action to remove monetary policy accommodation. Over the course of 2022, the FOMC raised the federal funds rate, our policy rate, by

4-1/4 percentage points and began reducing the size of the Fed's balance sheet by allowing assets to roll off. At the meeting two weeks ago, the FOMC took another step and raised the target range of the federal funds rate by 25 basis points to 4-1/2 to 4-3/4 percent and the balance-sheet reduction continues.

Several factors contributed to the sharp rise in inflation, which started in the spring of 2021 in the U.S., but has also occurred in other advanced economies around the globe. These factors include the pandemic and how households, businesses, and monetary and fiscal policymakers responded to it, as well as Russia's war against Ukraine. An imbalance arose between strong demand and constrained supply, which led to significant upward pressures on prices in an environment of accommodative monetary and fiscal policy.

Incoming economic information shows that our monetary policy actions are having the intended effect of slowing demand and reducing price pressures. In addition, supply chain disruptions are easing, which is also helping to alleviate some of the imbalance between aggregate demand and aggregate supply. This is good news, but further monetary policy action is needed to ensure that inflation is on a sustainable downward path to 2 percent.

Economic Growth

Economic growth slowed considerably last year, and I expect that growth will be well under trend this year. Real GDP grew at a below-trend pace of 1 percent last year, down from a very robust pace of about 5-3/4 percent in 2021. Growth in the final quarter of last year was almost 3 percent, but much of that was due to firms rebuilding inventories. Abstracting from inventories, growth in real final sales was a more modest 1-1/2 percent, suggesting some dampening in underlying momentum.

Interest-rate-sensitive sectors have been experiencing the sharpest slowdown. Residential investment continues to decline sharply in response to higher mortgage rates. Business fixed investment and

manufacturing activity have slowed. Consumer spending, which makes up 70 percent of GDP, has held up, reflecting the strength in household balance sheets. But it has slowed from the robust pace seen in 2021.

On the supply side of the economy, supply chain disruptions have improved but not uniformly across sectors and products. The Federal Reserve Bank of New York's Global Supply Chain Pressure Index fell appreciably during 2022, although it remains above its pre-pandemic level.[1] Some of the improvement in this index last month reflects better delivery times from China, consistent with China easing its zero-COVID policy and reopening its economy. Our business contacts tell us that transportation bottlenecks and delivery times have improved compared to last year but that certain products, including computer chips and electric generators, remain difficult to source.

Labor Markets

Despite the slowdown in growth, labor market conditions remain strong, with labor demand continuing to outpace labor supply. After some moderation over the past year, there was a sizable gain in payrolls in January, with the economy adding over 500 thousand jobs. The number of job openings moved down somewhat over the past year, but there are still 1.9 openings per unemployed worker. The unemployment rate has been running at about 3.5 percent for the past year, a 50-year low, and it actually edged down in January. Despite these strong numbers, anecdotal reports from our business contacts suggest that conditions are easing in the labor market, except in healthcare where significant hiring challenges remain due to a national shortage of skilled and unskilled healthcare workers. Although they do not intend to reduce their workforces, many of our business contacts have tempered their demand for workers and those that are hiring say it has become easier to find the workers they need.

[1] The Federal Reserve Bank of New York's Global Supply Chain Pressure Index is available at https://www.newyorkfed.org/research/policy/gscpi#/overview.

On the supply side, labor force participation has stabilized below its pre-pandemic level. Over time, it has become apparent that this lower level of participation reflects structural factors such as the high level of retirements over the pandemic, reduced immigration, changes in preferences, and the difficulty in finding affordable childcare.

An indication that labor demand is outpacing labor supply is strong wage growth. Labor costs constitute a significant share of a business's expenses, especially in the service sector. The strong increase in wages has contributed to higher inflation, yet workers' wage gains generally have not kept up with inflation. So, in real terms, many workers are not better off. Recent data and reports from business contacts suggest that as the economy has slowed, wage growth has started to moderate from its peak last summer. Nonetheless, nominal wage growth is still around 4-1/2 percent. Given current estimates of trend productivity growth of between 1 and 1-1/2 percent, this means wage growth is still about 1 to 1-1/2 percentage points above the level consistent with price stability.

The imbalance between labor demand and supply will need to continue to shrink to alleviate wage pressures. Since there is little reason to think that labor force participation will increase significantly in the coming months, labor demand will need to moderate further to reduce the imbalance. I expect that with the economy growing well below trend, the labor market will cool off, with slower employment growth and a rise in the unemployment rate. But this moderation in labor demand could come mainly from firms deciding not to add to their payrolls rather than cutting their staffs. Indeed, many contacts have told me they plan to do all they can to retain workers through the slowdown, given how hard hiring has been over the past couple of years. This suggests we will see less of an increase in the unemployment rate than is typical in an economic slowdown.

Inflation

Inflation remains well above our goal of 2 percent. Recent monthly readings show inflation has eased

from its high point last summer, and short-term inflation expectations have moved down with it. In December, the year-over-year measure of headline PCE inflation moderated to 5 percent, compared to 7 percent in June, with declining energy prices contributing to the decline in overall inflation. Underlying inflation measures have also shown some improvement. In December, core PCE inflation was about 4-1/2 percent compared to 5 percent in June. Looking at the most recent 3-month period, core PCE inflation is down to 3 percent. The median and trimmed-mean PCE inflation rates, which exclude components with the most extreme movements each month, have also improved in recent months but to a lesser extent.[2]

The improvement in the monthly readings in core inflation has come from the goods sector, where PCE goods prices fell about 3 percent, annualized, over the past three months. Some of that decline reflected an unsustainably sharp drop in used car prices. So goods inflation is likely to move up in coming months. Shelter price inflation has not improved, but it is expected to ease later in the year as housing activity continues to weaken and the deceleration in rents in new leases passes through to the inflation measures. Core services inflation excluding shelter has not improved. It tends to be sticky, is correlated with wage inflation, and has a large share in the overall index, since consumers spend a larger share of their income on services than on goods.

For much of the pre-pandemic expansion, core goods inflation was slightly negative, on average, and falling goods prices were pulling inflation down. By the end of that expansion, inflation was nearing our target. In January 2020, PCE inflation had reached 1.8 percent and core inflation had risen to 1.7 percent. That reading reflected 0.75 percent de̲flation in core goods prices and 2.5 percent in̲flation in core

[2] The Federal Reserve Bank of Cleveland produces the median and trimmed-mean CPI inflation rate and the median PCE inflation rate. The Federal Reserve Bank of Dallas produces the trimmed-mean PCE inflation rate. The Federal Reserve Bank of Cleveland's Center for Inflation Research produces inflation measures and analyses of inflation and inflation expectations to inform policymakers, researchers, and the general public (https://www.clevelandfed.org/en/our-research/center-for-inflation-research.aspx).

services prices. That is very different from today. In the current period of high inflation, which began in the spring of 2021, core goods prices have been rising, and for much of this period until recently, inflation in core goods has exceeded inflation in core services. To achieve our longer-run goal of 2 percent inflation, we will need to see continued sustained disinflation in both components.

My expectation is that we will see a meaningful improvement in inflation this year and further improvement over the following year, with inflation reaching our 2 percent goal in 2025. But my outlook is contingent on appropriate monetary policy.

Monetary Policy

In making its monetary policy decisions, the FOMC is always guided by its strong commitment to achieving its statutory goals of price stability and maximum employment. The FOMC has come an appreciable way in bringing policy from a very accommodative stance to a restrictive one, but I believe we have more work to do. Precisely how much higher the federal funds rate will need to go and for how long policy will need to remain restrictive will depend on how much inflation and inflation expectations are moving down, and that will depend on how much demand is slowing, supply challenges are being resolved, and price pressures are easing. At this juncture, the incoming data have not changed my view that we will need to bring the fed funds rate above 5 percent and hold it there for some time to be sufficiently restrictive to ensure that inflation is on a sustainable path back to 2 percent. Indeed, at our meeting two weeks ago, setting aside what financial market participants expected us to do, I saw a compelling economic case for a 50-basis-point increase, which would have brought the top of the target range to 5 percent.

My view of appropriate policy is contingent on my economic outlook, which is informed by incoming data, the real-time reconnaissance provided by our regional contacts, and a variety of economic models and analyses. The FOMC likes to say that its policy decisions are data dependent, but that doesn't mean

we react to one or two data points. Instead, I view "data dependent" as shorthand for saying that incoming economic information informs my economic outlook and assessment of risks, which, in turn, informs my view of appropriate monetary policy.

In addition to my economic outlook, my policy views are also importantly influenced by risk-management considerations, including the risks to the economic outlook and my assessment of the costs of continued high inflation to households, businesses, and the longer-run health of the economy.

It is welcome news to see some moderation in inflation readings since last summer, but the level of inflation matters and it is still too high. January's CPI inflation report showed a jump in the monthly rate of overall inflation and no improvement in underlying inflation. The report provides a cautionary tale against concluding too soon that inflation is on a timely and sustained path back to 2 percent.

I continue to see the risks to the inflation forecast as tilted to the upside for a number of reasons. Russia's continuing war in Ukraine adds uncertainty to the inflation picture, particularly for food and energy prices. While energy prices have moved down, partly because of mild winter weather in Europe, they could move up again, as could food prices. Indeed, in January, energy prices in the CPI rose strongly and food prices also advanced. These items constitute a sizable share of the consumption basket for many households, particularly those with lower incomes. They also influence short-term inflation expectations.

China is another source of risk. On the one hand, the reopening of China is helping to ease supply chain disruptions. But China is also a major world economy and increasing demand there will put upward pressure on commodity prices.

Several private-sector forecasters do not expect inflation to return to 2 percent until sometime next year. According to the median in the December FOMC Summary of Economic Projections, this goal will not

be reached until 2025.[3] If that comes to pass, it means that inflation will have been above 2 percent for over 4 years, and well above 2 percent for much of that time. Even that forecast could turn out to be optimistic. Some recent research by economists at the Cleveland Fed presents a plausible case, based on a model and historical relationships in the data, that inflation could end up being much more persistent than current projections, despite the actions the FOMC has taken.[4] While this research has not altered my view that there will be material improvement in inflation this year, it does inform my view that the risks to inflation remain on the upside.

The upside risks to inflation and historical experience suggest to me that the costs of undershooting on policy or prematurely loosening policy still outweigh the costs of overshooting. Under-tightening raises the risk that inflation will settle in stubbornly above our goal, imposing both short-run and long-run costs on households and businesses. It could result in longer-term inflation expectations moving higher, which would make it much harder and more costly to return to price stability. Over-tightening also has costs, but if inflation begins to move down faster than anticipated, we can react appropriately.

Given the risks and costs, we need to be prepared to move the federal funds rate higher if the upside risks to inflation are realized and inflation fails to moderate as expected or if the imbalances between demand and supply in product and labor markets persist longer than anticipated.

Summary

In summary, inflation remains too high and it is the responsibility of the FOMC to bring it down. So the FOMC is resolute in continuing to bring monetary policy to a sufficiently restrictive stance to ensure that

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[3] The December 2022 Summary of Economic Projections of FOMC participants is available at https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20221214.pdf. The FOMC will release a new set of projections after its March meeting.

[4] See Randal J. Verbrugge and Saeed Zaman, "Post-COVID Inflation Dynamics: Higher for Longer," Working Paper No. 23-06, Federal Reserve Bank of Cleveland, January 2023. (https://doi.org/10.26509/frbc-wp-202306)

inflation returns to our 2 percent goal in a timely way. Tighter financial conditions will result in growth well below trend this year and some cooling off in labor markets, with slower employment growth and an increase in the unemployment rate from its very low level. These developments will help to alleviate price and wage pressures. As a result, I expect to see good progress on inflation this year.

We are operating in an uncertain environment and economic conditions can evolve in unexpected ways. With growth well below trend, it wouldn't take much of a negative shock to push growth into negative territory for a time. Most of our business contacts are preparing for a mild recession. Similarly, inflation dynamics over this expansion have been influenced in important ways by the pandemic and the war in Ukraine, and we need to be very open to the idea that inflation can evolve differently than we expect. To help me formulate my economic outlook and policy views over the year, I will be looking at a variety of incoming data and collecting economic and financial information from our business, labor market, and community contacts.

The transition back to price stability will take some time and will not be without some pain. There will be some bumps along the way as the economy slows, but high inflation is also very painful. I do not view the current situation as one in which there is a tradeoff between our two monetary policy goals because returning to price stability in a timely way is the best way to ensure a healthy labor market over the longer run. So I plan to remain diligent in setting monetary policy to return the economy to price stability and to be judicious in balancing the risks so as to minimize the pain of the journey.

In short, I remain in it to win it.