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Inflation and the Fed's Response

Tim Sablik & Tom Barkin

Tim Sablik: I'm Tim Sablik, a senior economics writer at the Richmond Fed. My guest today is Tom Barkin, president and CEO of the Richmond Fed. Tom, thank you very much for taking the time out of your busy schedule to come talk with me today.

Tom Barkin: Glad to be with you.

Sablik: Last year was an eventful one, to say the least. This seemed like a good time to reflect on all that happened in 2022, and maybe get your thoughts on the economy in 2023.

From the Fed's perspective, I think it's safe to say that the biggest economic story of the last year was inflation. Inflation started rising in 2021. By the end of that year, the Fed had signaled it would start taking action to bring inflation down. Can you provide an overview of the Fed's actions in 2022, and maybe share your perspective on why the Fed responded as it did?

Barkin: Let me just take you back to the end of last year. GDP had grown in the four quarters before December 2021 at 5.7 percent. Inflation was at 6.2 percent. With demand that strong and inflation that high, it just made no sense for us to keep stimulating the economy.

So, we prioritized containing inflation. We started raising rates in March, we accelerated the path during the summer, and we've now moved the overnight rate to 4.3 percent. That's the fastest tightening pace in 40 years. We also started reducing our balance sheet. It's now down over about $400 billion from its peak. And there's more still to come.

Why did we do it? Well, if there's one thing that this generation has re-learned, it's that we hate inflation. Inflation is unfair, if you feel like you got a raise because your boss finally noticed your capabilities and then you have to give the raise back at the gas pump. It creates uncertainty about where to invest, when to invest. And it's exhausting. It's exhausting to shop around for better prices. It's exhausting to have to deal with suppliers trying to push price increases. If we don't do something about inflation, the question is who will?

Sablik: Right.

When inflation first started rising, there was a lot of debate about its underlying causes and whether the Fed should act right away or wait to see more data. Was there a turning point for you when it seemed clear that the Fed would need to take action to bring inflation down, and what clarified your views on that?

Barkin: Let me take you back to spring of 2021. Inflation had been very stable, basically 2 percent for the prior 30 years. In March and April 2021, for the first time in anyone's memory, we started seeing inflation pop.

If you looked at what was popping on inflation, it was two categories: cars and travel. In the case of cars, people couldn't get chips into cars. That was elevating pricing. In the case of travel, it had had a huge deflationary challenge during the pandemic and it was only now reopening.

That data just looked temporary. I started to worry in July because now it wasn't just March and April, it was May and June. Inflation had sustained.

When I look back on my forecasting, the thing I missed is I really thought — and maybe others did, too — that the economy would ease in September of 2021. Schools were going to reopen, COVID was hopefully going to be behind us. There were these enhanced unemployment benefits that were going to ease, so the expectation was a lot of workers were going to get back in the workforce. That would lower some of the labor pressure we'd seen, which would lower some of the cost pressure and eventually price pressure. In September, unfortunately, people really didn't come back to work the way I'd expected. When that happened, that's when it became clear to me and we started announcing our change, you may remember, in November of 2021.

Sablik: Right.

So, the Fed has now been tightening for a year, raising rates, as you said, at a historically fast pace. What effect is that having on inflation in the economy so far?

Barkin: Monetary policy works most directly through financial markets. Borrowing becomes more costly, so capital investment slows. So does consumer spending, especially in interest-sensitive sectors like housing and auto and consumer durables. The dollar strengthens. That lowers export demand and lowers import prices.

In all of these most direct cases, the effects [of the Fed's tightening] have been substantial. The dollar and the euro aren't far away from 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.

It takes a little longer in less interest-sensitive segments. And it's important to remember that some of the effects of the pandemic are still with us. Excess savings and the return of consumer borrowing to pre-pandemic levels are still funding strong consumption, especially for services like travel. Billions in fiscal appropriations are still being distributed, like the infrastructure bill. Strong pandemic-era order pipelines and the need for replenishing inventories are still sustaining businesses.

That's the demand side. On the inflation side, most estimates are that it takes another six to 12 months before these demand pullbacks quiet the rate of inflation. With demand slowing but still resilient, labor markets healthy and the added and unfortunately enduring shock of the war in Ukraine, it shouldn't be a surprise that inflation — while likely past its peak — is still elevated. That, of course, is what makes the case for us to stay the course.

Sablik: Some have argued, as you said, that monetary policy changes take some time to fully ripple through the economy. There have been arguments that the Fed should pause at the start of this year to assess the impact of last year's actions before deciding what to do next. What are your thoughts on that?

Barkin: It made sense to move quickly last year. The way I think about it is we were taking our foot off the gas. Now we're in a different place — forward-looking, real rates are positive across the curve. As a result, I'm confident that our foot is unequivocally on the brake. When you've got your feet on the brakes — think of an icy road — it just makes sense to steer more deliberately, as we're working to bring inflation down in the context of the lags that I was just talking about.

So you might ask, "Boy, the last three months inflation prints have been a lot lower. Doesn't that mean we've got the problem solved?" I'd caution that while the average has dropped, the median has still stayed high. That's because the average has been distorted by falling prices for a few goods, like used cars, that escalated unsustainably during the pandemic. I saw one commentator celebrating that the core CPI less shelter has declined over the last three months. But, of course, we all know what people care about. They care about food and gas and shelter. Until we're confident that the things people care about are under control, I think we've still got a ways to go.

Sablik: Related to this discussion about the fight against inflation and how much further the Fed has to go, another big question as we start this year is whether the economy will enter a recession. There are some signs of some weakening, but then in other places such as the labor market, things still look pretty strong. What are your thoughts about the likelihood of a recession in 2023?

Barkin: I read somewhere that this has been the most predicted potential recession in memory. Honestly, if you go back to the middle of the year, the data was coming in negative and so it looked like we might be headed into one. But if you look at the data we've seen over the last six months — whether it be spending or investment or employment — it just keeps pushing the timeline out.

I should caution that's true *unless* you're in a sector like housing, or if you sell into a low-income customer base, or if you're dealmaker, or — as the tech firms showed us last month — dependent on digital advertising. Everywhere else, business is fine. They know the Fed is taking strong action about inflation, and they realize that creates downturn risk. They believe many of the artificial elements that I talked about that are supporting consumer spending are probably going to wane over time.

The way I think about it is everybody's got a recession playbook in their drawer. Most companies have taken it out and updated it. They may even be working the items on the first page, like slowing down hiring or discretionary spending. But most haven't turned the pages yet and the reason they haven't turned the pages is it's hard to cut back when your own demand still remains solid.

But I do realize there's a risk that they might, and they might because of what we need to do to fight inflation. They might because sectors tend to move in unison as recently happened in tech. Or, don't forget that the last three recessions were actually driven by stuff that was basically unforecastable — the Great Recession, the pandemic, or 9-11. Maybe something comes weighing in from outside.

Sablik: In addition to keeping your eye on all these things happening in the economy, you also traveled quite a bit in 2022. You met with many community members across the Richmond Fed's [Fifth] District. How did those meetings help you in your role as a Fed bank president and a monetary policymaker?

Barkin: When I interviewed for this job in late 2017, I told the search committee that I really felt like it was important that the Richmond Fed understand and represent our entire District, and that I personally was committed to being on the ground throughout the District. (For anyone who's bored, you can go on the website — we've actually got a little map of where I'm out and when I'm out.) I'm not doing it just because I like to travel. I'm doing it because we get real value as an institution.

When you talk to people in the business community and the nonprofit community, you learn what's underneath the data. Consumer demand would be a good example. It looks solid overall, but as I said a second ago, it's very different if you are a lower-price retailer than if you're one who sells to upper-income customers.

It also helps us understand turning points in the economy. When we reopened after COVID, I remember hearing from someone who ran a shopping center in western Virginia that they had just seen a lot of traffic, particularly the Tennessee side because Tennessee reopened before Virginia. You get a sense in that case of unmet consumer demand.

You also get to see differences across geographies. I was out from June of 2020, in a socially distanced way, all through the District and you could see the difference between D.C. and South Carolina in terms of economies being open, in terms of what's happening to downtowns.

Finally, I'll just say our Bank has made a real investment in being present and understanding the particular challenges of the small towns in our District. Every month, I'm in multiple small towns trying to understand how the economy is working for those folks in our District.

Sablik: If you had to narrow things down, are there specific data points that you're going to be keeping a close eye on in this year or questions that you're hoping to get answers to?

Barkin: We have seen three good months on the inflation prints. I'd like to see them continue. Is inflation calming? That's really the core question for this year.

I think underneath that, I want to understand the labor market. Is it cooling? What's happening to wages? What's happened to employment? Underneath that, I want to understand what's happening to the broader demand, particular for companies who may or may not be thinking about increasing prices.

Beneath all that is this question of how much of the pandemic-era economy are we going to be left with. I'm not just talking about working from home. I'm talking about spending on goods versus spending on services. I'm talking about the vitality of in-town retail versus suburban retail. There's a bunch of stuff we adopted over the last couple of years that may or may not lead to a different economy going forward.

Sablik: Yeah, I think those are definitely the big, million-dollar questions out there right now.

Tom, thanks again so much for taking the time to come on the show today.

Barkin: Glad to. For those of you listening, we really are focused and engaged as the Richmond Fed on being on the ground. We really want to hear from you and what you're saying.

Sablik: I'll remind listeners, as always, that you can check out our website, Richmondfed.org, where you can sign up to receive alerts on all of Tom's latest speeches and essays and all the latest research and keep track of all the places that Tom is going. If you enjoyed this episode, please consider leaving us a rating and review.