Atlanta Fed

Striking a Delicate Balance in Making Policy

By Raphael Bostic, President and Chief Executive Officer

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Even as some recent reports show underlying inflation moderating, I believe inflation remains too high. I want to reiterate that the Federal Open Market Committee (FOMC) is determined to put it on a sustainable path toward our objective of 2 percent, as measured by the Personal Consumption Expenditures price index.

Amid some signs that price pressures could be receding, a narrative has gained momentum among some commentators that the Fed should consider reversing its course of raising the federal funds rate lest we go too far and cause undue economic hardship.

While that perspective is understandable, history teaches that if we ease up on inflation before it is thoroughly subdued, it can flare anew. That happened with disastrous results in the 1970s. After the FOMC loosened policy prematurely, it took about 15 years to bring inflation under control, and then only after the federal funds rate hit 20 percent.

We don't want a repeat, so we must defeat inflation now.

Doing so without inflicting severe economic pain is a delicate balance. But striking that balance is our job, as the Fed's dual mandate is to pursue price stability and sustainable full employment. In the long run, the latter is not achievable without the former.

So, now we must determine when inflation is irrevocably moving lower. We're not there yet, and that is why I think we will need to raise the federal funds rate to between 5 and 5.25 percent and leave it there until well into 2024. This will allow tighter policy to filter through the economy and ultimately bring aggregate supply and aggregate demand into better balance and thus lower inflation.

Here's what I will need to see to consider reversing the course of monetary policy:

- A narrowing of the gap between labor supply and demand
- Higher interest rates more decisively affecting aggregate demand
- Ongoing recovery in aggregate supply
- Reduction in the breadth of inflation
- Stable inflation expectations

Let me offer a few additional thoughts on each of these.

Labor supply and demand are still unaligned

The difference between labor demand—the number of employed workers plus the number of job openings—and labor supply—the sum of employed and unemployed people—has remained above 4 million for a year. That is a dramatic shift from the conditions that prevailed before the pandemic. For roughly a year-and-a-half before February 2020, labor demand exceeded labor supply, but only by about one million. For the previous 40 years, labor supply was consistently higher than labor demand.

Over the past several months, the gap between labor supply and demand has narrowed slightly as employment growth has slowed. Business leaders tell us that, yes, it's a bit easier to fill vacant positions than it was last summer, but the tight labor market remains a top concern.

Why? Because the labor supply shortfall has been a contributing factor to nominal annual wages increasing by around 5 percent for months. We can't achieve price stability—inflation at 2 percent—with this rate of wage growth

Interest rates are not sufficiently influencing business activity

In addition to seeing progress in rebalancing the labor market, I'd need to see tighter money more significantly slow aggregate demand before I'd consider shifting policy. When businesses think customers will buy less of their product or service in the near and medium term, then they will adjust hiring and investment plans accordingly.

The increase in interest rates has slowed several sectors of the economy, most notably housing and commercial real estate. However, other parts of the economy have not slowed so much.

Consumer spending has remained robust over the past year. Economic growth as measured by gross domestic product was stronger than expected in the second half of 2022. And looking ahead, business

contacts tell us activity may well soften, but they don't anticipate a severe deterioration. So, there is more work—in the form of interest rate increases—to do.

You might infer from this that we at the Federal Reserve view a major economic disruption as a precondition to ending our policy tightening. Nothing could be further from the truth. In fact, I continue to believe that the economy packs sufficient momentum to weather higher interest rates, which will ultimately bring inflation down to our objective, without a major downturn. There may be some job losses, but my baseline forecast is for these to be mild relative to what was experienced during previous economic slowdowns.

Aggregate supply concerns are easing

Inflation is high because aggregate demand is greater than aggregate supply, in part due to severe supply chain disruptions. On this front, my staff and I are detecting strong signs of a meaningful recovery. Our Business Inflation Expectations Survey goes out to about 300 executives from various industries, and they tell us supply concerns have receded sharply. What's more, contacts at seaports report the long queues of ships we heard so much about in 2021 and 2022 have mostly cleared up. Private-sector reports show that supply chain congestion continued to ease in early 2023. So, I'm encouraged that this constraint is becoming a much less important driver of high inflation.

The breadth of inflation is still high

Additionally, my staff and I are closely watching the breadth of inflation pressures. At the beginning of the pandemic, high inflation was limited to a small number of goods, such as used cars and lumber. However, price pressures broadened as the pandemic went on. Consider the set of goods used to calculate the consumer price index, which is known as the Consumer Price Index (CPI) market basket. Last summer, upwards of 75 percent of the goods in the CPI market basket showed inflation rates of 6 percent or more. Simple math tells you that it will be very difficult to get an overall inflation average of 2 percent if inflation for so much of the basket is so high.

In recent months, we have seen the broad base of inflation narrow. But about half of the goods in the CPI market basket still show inflation rates of 6 percent or higher. While this is a welcome decline from the historically high proportions of last year, this level is still quite elevated. In the months leading up to the pandemic, for example, we were typically seeing less than 10 percent of goods in the CPI market basket with inflation at levels of 6 percent or higher. If we are going to get inflation back in the range of our target, the breadth of inflation will have to narrow considerably. We will be looking for signs that this is happening.

Psychology is critical for inflation expectations

The final guidepost I'l mention is inflation expectations, which, I've noted in a past message, have been recognized as a key factor in driving behavior. When people expect higher prices, they can sometimes make economic decisions that are likely to ensure that inflation materializes. You've no doubt heard people talk about wage-price spirals in past inflationary episodes, during which workers anticipating high inflation demanded higher wages, which in turn led firms to increase prices to cover rising labor costs.

Here the news is good. Our own Business Inflation Expectations Survey and similar measures show that expectations for inflation over the next year have steadily declined since the spring of 2022. The same story goes for expectations in financial markets and among consumers.

Psychology is critical in the inflation fight. In fact, one way I like to think about this is that the FOMC's fundamental mission is to free people from having to think about inflation as they go about their day-to-day business. That sounds straightforward. But, as I've enumerated, myriad factors go into achieving that goal.

Bottom line: when inflation is no longer top of mind, our mission will largely be accomplished. We are clearly not there yet. But I—and the Committee—are committed to doing all we can to ensure that we get there as soon as possible.