A Stronger Policy Response to Restrain Inflation

Charles L. Evans
President and Chief Executive Officer
Federal Reserve Bank of Chicago

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Introduction and disclaimer

The last time I spoke to you was in June 2020 for what was only my second of many virtual events to follow.[1] I eventually learned how to look into the camera and how to unmute myself. Still, I much prefer to interact directly with people, and it's great to be here in person with you today. I am especially looking forward to answering your questions and hearing your concerns following my prepared remarks. Thank you in advance for your insights.

Two years ago, we were just emerging from the shutdowns, unemployment was quite high, and vaccines had not yet been developed. The future looked quite uncertain. As for inflation, it was running below 1 percent and we were seeing large price declines for some items most directly affected by social distancing. Well, things sure do look different now!

In a nutshell, inflation is clearly much too high and monetary policy must be repositioned to bring aggregate demand and aggregate supply into balance. I support the quick removal of monetary accommodation that the Federal Open Market Committee (FOMC) has undertaken, increasing the federal funds rate 150 basis points since March and beginning to reduce the size of our balance sheet. And while the exact path forward for

[1] Evans (2020).

policy will depend on how the economy evolves, I expect it will be necessary to bring rates up a good deal more over the coming months in order to return inflation to the Committee's 2 percent average inflation target.[2]

Before I begin, I am obliged to remind you that the views I share with you today are my own and do not necessarily represent those of my colleagues on the FOMC or others in the Federal Reserve System.

Economic overview

Though gross domestic product (GDP) declined a bit in the first quarter of the year, underlying economic momentum continued to be strong. Importantly, growth in household consumption and business fixed investment continued at a solid pace last quarter. The top-line GDP number instead was held back by large reductions in business inventory investment and net exports, which tend to be quite volatile on a quarter-by-quarter basis. And when I look at the GDP data in conjunction with other indicators of economic activity—notably, the very strong labor market and healthy household and business balance sheets—I see the foundation for continued growth in economic activity.

Given how bleak the situation appeared in the spring of 2020—when much of the economy had shut down with the onset of the pandemic—our progress these past couple of years has been truly remarkable. How did we get here? Businesses showed ingenuity in finding ways to operate safely. The health care sector was able to develop

[2] For price stability, the FOMC seeks inflation that averages 2 percent over time, as measured by the Price Index for Personal Consumption Expenditures (PCE) from the U.S. Bureau of Economic Analysis.

and deploy vaccines extremely rapidly. And fiscal and monetary policymakers provided crucial support through prompt and massive policy actions. By the second quarter of last year, activity in the U.S. had surpassed its pre-pandemic level, and despite periodic new waves of infections, underlying growth has remained quite solid since then.

In terms of the labor market, after peaking near 15 percent early in the pandemic, the unemployment rate declined quickly and was a very healthy 3.6 percent in May of this year—essentially back to the low level we experienced before the Covid crisis. And by a number of other measures, such as unfilled job openings at businesses and the rate at which people quit their jobs for other opportunities, the labor market is downright tight. Many of my business and community contacts complain of difficulties in hiring and retaining workers, though increasing pay and other adjustments seem to be alleviating some of these issues.

Even so, the number of people actually employed is still well below pre-pandemic trends, as many workers who left the labor force during the pandemic have not reentered the labor market. Today, labor force participation continues to be held down by factors such as an elevated level of retirements and Covid-related matters, including health concerns or childcare issues. Furthermore, inflows to the labor force from immigration have been quite low.

As the pandemic recedes further, a strong labor market will likely draw many of those still sitting on the sidelines back into the workforce. This should help alleviate some labor market pressures. At the same time, I expect less accommodative monetary policy will dampen very high labor demand.

Inflation dynamics

This brings me to a discussion of what is on everyone's mind—inflation. Our preferred inflation gauge is the annual change in the Price Index for Personal Consumption Expenditures (PCE). After more than a decade of sub-2 percent inflation, it has risen quite quickly from under 1 percent when I spoke to you in 2020 to 6.3 percent in the most recent April data. What is behind this rapid run-up?

Some of it is directly related to the pandemic. With people forced or choosing to spend more time at home, households shifted their spending from services, such as travel or dining out, toward goods, such as appliances for home improvement projects or consumer electronics. Many businesses struggled to keep pace with this strong demand, particularly as they faced Covid-related disruptions in production and supply chains. Labor shortages due to the drop in participation were part of the story, too.

These factors first showed through to inflation in early 2021, as activity began to normalize. Prices rose sharply for goods that were especially sensitive to supply chain problems and for services that were just beginning to reopen from the pandemic shutdowns. But these pandemic-related and other supply-side factors are not the entire story. Notably, beginning last autumn, price pressures began to build more broadly. At first, price increases for goods spread beyond those items most directly impacted by pandemic dynamics. Higher inflation then extended to a wide range of services. The broad-based nature of these increases is a sign of widespread, general demand pressures on the productive capacity of the economy.

Inflation should moderate

Most forecasters, myself included, predict that inflation will cool down substantially over the next couple of years. Let me explain the reasoning behind my forecast.

First, over time, we will see supply chains repaired, consumption return to more normal patterns, and pandemic reopening effects fall behind us. In addition, the further recovery in labor force participation I mentioned earlier—some of it due to the strong labor market and higher wages we are seeing today—should lead to an easing of labor shortages that would benefit all sectors. As these supply-side improvements occur, price pressures will diminish.

Admittedly, these adjustments are taking much longer than I had earlier expected. And disruptions from the Russian invasion of Ukraine and unpredictable Covid-related shutdowns abroad are continuing to snarl supply, pushing prices higher for some items and adding to the overall uncertainty. But eventually these adjustments will occur: They are the hallmark of an economy in which prices provide the signals that guide resources to their most productive and profitable uses.

Second, tighter monetary policy plays a very important role in my forecast of lower inflation. It is needed to pull back on aggregate demand and keep it from pushing too hard on today's still-challenged supply conditions. It is also needed to prevent current large price increases from becoming embedded in pricing dynamics and longer-run inflation expectations. Inflation will be much more difficult to rein in if households and businesses start thinking current outsized increases in wages and prices are the new norm and incorporate those expectations into their decision-making.

Measures of inflation expectations over shorter time horizons picked up a lot early last year and remain quite elevated. This is understandable as people took notice of the higher prices they've been encountering. But, in general, longer-horizon measures of inflation expectations have remained within a range that is consistent with our 2 percent inflation objective. This is true in most surveys or in the compensation for inflation that is priced into financial market assets, suggesting households and businesses see the primary drivers of inflationary pressures as being shorter-lived. And I believe the Federal Reserve's policy actions and communications have played an important role in anchoring these expectations by demonstrating and conveying our commitment to bring inflation back into line with our 2 percent average objective.

Policy adjustments

So, with this in mind, what comes next for monetary policy? Last week, the FOMC voted to raise the federal funds rate target by 75 basis points to a range of 1-1/2 to 1-3/4 percent and indicated that more rate hikes will likely be in order.[3] This tightening comes at the same time that we continue to reduce the size of our balance sheet.[4]

How much more tightening might be necessary? One way to gauge this comes from the Committee's quarterly Summary of Economic Projections (SEP) released last week, which presents FOMC participants' forecasts of key economic variables over the next three years and for the longer run.[5] The median projection for the federal funds rate is for it to be in the range of 3-1/4 to 3-1/2 percent by the end of this year and 3.8 percent

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[3] This was the largest federal funds rate hike in 28 years.
[4] Federal Open Market Committee (2022b).
[5] Federal Open Market Committee (2022a).

by the end of 2023. With projected inflation taken into account, the inflation-adjusted interest rates in this path are modestly above where the FOMC sees the long-run neutral rate—in other words, this path should have a modestly restrictive influence on the economy. My own viewpoint is roughly in line with the median assessment.

Of course, rates are not on a preset course: The FOMC will react to changes in the economic landscape as they occur and will adjust policy accordingly in order to achieve our goals of full employment and price stability. This flexible data-driven approach was on full display at the FOMC meeting we held last week. Until just before the meeting, most or our communications had been telegraphing that a 50 basis point rate increase was in store. However, the Friday before we met, the Consumer Price Index (CPI) report for May was published. In it, the overall CPI accelerated and core inflation—which strips out the volatile food and energy components and is a better indicator of underlying inflation trends—remained quite high.[6]

This was quite disappointing, as the previous couple of reports had contained some hints of moderating inflation. For example, prices for core goods—where we would expect easing supply chain pressures to show up first—rose strongly in May after recording a slight decline, on balance, in March and April. Furthermore, rent and owners' equivalent rent experienced large increases in May. Inflation in these components tends to be fairly persistent; furthermore, rent is an unavoidable

[6] The Consumer Price Index increased 1.0 percent in May, and core CPI increased 0.6 percent; these changes brought the 12-month increases for the two measures to 8.6 percent and 6.0 percent, respectively. In normal times, inflation as measured by the Consumer Price Index from the U.S. Bureau of Labor Statistics usually runs about 0.3 to 0.4 percentage points higher than our preferred inflation gauge—the Price Index for Personal Consumption Expenditures.

expenditure that challenges many low- and moderate-income households, and as such, its inflation is particularly harmful. In addition, that same day there was a worrisome upside surprise in a key measure of long-run household inflation expectations.

This bad news on inflation was an important consideration for my supporting a 75 basis point hike in the federal funds rate instead of the 50 basis point increase we had signaled earlier. And as Chair Powell noted in his press conference after the FOMC meeting, this view was shared by most of the Committee.

The outlook

So what does all of this mean for the outlook for growth, employment, and inflation? Let us return to the FOMC's Summary of Economic Projections.[7] For GDP growth, the median projection for this year is 1.7 percent—a good deal lower than the FOMC median projection made in March, though still close to the underlying trend in GDP growth. Growth is projected to stay near this pace in 2023 and 2024. Some increase is expected in the unemployment rate, with it rising to 4.1 percent by the end of 2024. This still represents a healthy labor market by historical benchmarks; indeed, it is quite close to where the Committee sees the unemployment rate settling at over the longer run.

As for inflation, with supply-side improvements, somewhat restrictive monetary policy, and trend-like growth, I expect inflation will moderate significantly. My colleagues do as well. According to the median SEP, after increasing to 5.2 percent this year, total PCE

[7] Federal Open Market Committee (2022a).

inflation is expected fall to 2.6 percent in 2023 and 2.2 percent in 2024—just marginally above our 2 percent target.

Conclusion

Of course, all forecasts are subject to a great deal of uncertainty and risks. And, unfortunately, many of those risks appear to be to the downside: Supply-side repair could continue to move too slowly; events in Ukraine or further Covid-related shutdowns in China or other countries could put additional pressure on costs; and monetary policy may, on the one hand, not rein inflation in enough or, on the other hand, weigh too heavily on employment.

So we must be watchful and ready to adjust our policy stance if changes in economic circumstances dictate. I recognize we have some difficult work ahead of us. But I can assure you that we will always set policy with the goal of progressing toward our dual mandate objectives of maximum inclusive employment and 2 percent inflation as expediently as possible.

Thank you, and now I look forward to your questions.

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