
On Taming Inflation

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Official Monetary and Financial Institutions Forum (OMFIF)
London, UK
September 27, 2022

FEDERAL RESERVE BANK OF CHICAGO

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Introduction

I'd like to take a moment to offer my condolences to the people of the British Commonwealth on the passing of Queen Elizabeth II. Her years of long service, steadfastness, and dedication during times of great change were highly respected worldwide. The world has lost a most distinguished citizen.

The last time I was invited to speak here in London was in October 2018.¹ Back then, central bankers around the globe were grappling with inflation that had been too low for quite a long time. And my remarks focused on the need for the Federal Open Market Committee (FOMC) to revise our monetary policy framework in order to counter what appeared to be entrenched impediments keeping inflation persistently below our 2 percent inflation objective.

Well, almost four years later, the economic landscape certainly looks different! In the U.S. and elsewhere around the world, what began as narrowly concentrated shocks to relative prices has spread, turning into broad-based increases in overall inflation to levels far above every central bank's target. Accordingly, monetary policymakers now are significantly tightening policy in order to bring inflation back in line with their price stability mandates.

¹ Evans (2018).

In the U.S., since March 2022 the FOMC has increased the federal funds rate—our main policy tool—by 3 percentage points. We also are reducing the size of our balance sheet at a relatively rapid clip. In order to return inflation to the Committee’s 2 percent average goal, I expect we will need to raise rates further and then to hold that stance for a while. Of course, the exact path forward for policy will depend on the evolution of the economy and risks to the outlook. My talk today will describe my thinking behind this path in more detail. 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

The incoming data on the U.S. economy have been mixed—with moderating spending, but quite strong labor demand. Following a robust recovery in 2021, gross domestic product (GDP) in the U.S. fell over the first half of 2022. Recent indicators point to softness in consumption and business investment, as well as a large decline in activity in the housing sector. Lower real disposable income and tighter financial conditions are clearly in play, most notably in the very interest-rate-sensitive housing markets, where mortgage rates have about doubled since the beginning of the year.

In contrast to these spending data, the labor market has remained very strong.

Furthermore, household and business balance sheets look pretty healthy. Considering all of the various indicators and factoring in recent and prospective changes in financial conditions, I expect modest increases in GDP over the second half of the year. I’ll get into some specifics about the numbers in a few minutes.

First, though, it's important not to lose sight of how we got here. Through two-plus years of grappling with the Covid-19 pandemic and other disruptions, the economy has shown an impressive ability to adjust and carry on. By the second quarter of 2021, activity in the U.S. had surpassed its pre-pandemic level.

In the labor market, after peaking near an astonishing 15 percent early in the pandemic, the unemployment rate in the U.S. declined quickly. Despite the recent slowdown in GDP, the labor market remains extremely tight. Job growth has been strong, and at just 3.7 percent in August, the unemployment rate is only a bit above the very low level we experienced before the Covid crisis. Furthermore, unfilled job openings at businesses and the rate at which people quit their jobs for other opportunities remain extraordinarily high.

However, over the past couple of months we've heard more reports of reduced job turnover and that some firms are finding it easier to attract qualified workers. These are signs that some of the unusual strength in labor demand may be waning. Increasing pay and more flexible work arrangements may be part of the explanation, as well as the softer growth in spending I noted earlier.

On the labor supply side, while many workers who left the labor force during the pandemic have reentered the labor market, many others have not, and today labor force participation is still well below its pre-pandemic rate. Most of this shortfall is accounted for by older workers. Of course, aging baby-boomers would have eventually retired, but the pandemic appears to have accelerated their exit from the labor force. Another factor weighing on labor supply is the quite low inflow to the U.S. labor force from immigration.

A strong labor market may help draw some of those sitting on the sidelines back into the workforce and alleviate some labor market pressure. But as time passes, I've become less optimistic that this labor supply channel will be very large. Indeed, the labor force participation rate currently does not appear far from its long-term trend.² I do, however, expect less accommodative monetary policy to be an important factor in dampening very high labor demand and bringing supply and demand conditions in the labor market into better balance over time.

Inflation dynamics

This brings me to a discussion of what is the principal issue facing the economy in the U.S. and elsewhere—inflation. The Fed's preferred inflation gauge is the annual change in the Price Index for Personal Consumption Expenditures (PCE). After more than a decade of missing our average 2 percent target to the downside, PCE inflation has risen quite quickly—from under 1 percent in mid-2020 to 6.3 percent in the most recent July data. With food and energy prices excluded, so-called core PCE prices rose 4.6 percent over the past 12 months.

What is behind these rapid increases? Some of these increases are directly related to the pandemic. Earlier in the pandemic, with many 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 goods-producing businesses struggled to keep pace with this strong demand, particularly as they faced Covid-related disruptions in production

² After many years of sustained economic growth leading up to the Covid crisis, labor force participation had been higher than demographic and other trends would have predicted.

and supply chains. Labor shortages due to a broad-based drop in labor force participation were part of the story, too.

In the U.S. these factors first showed through to inflation in early 2021, as overall 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 factors are not the entire story.

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, including rent and owners' equivalent rent (OER), which account for a significant portion of household spending and where price increases tend to be rather persistent once they get going. Overall, the broad-based nature of these increases is a sign of widespread, general demand pressures on the productive capacity of the economy.

Of course, higher inflation is plaguing other industrialized economies as well. The U.S. experience is roughly in the middle of the pack. Here in the UK, for example, the consumer price index increased almost 10 percent over the past year.³ And across Europe the readings have been similarly high. There are differences in individual countries' inflation experiences. Increases in durable goods prices contributed more to inflation in the U.S. than in other Organisation for Economic Co-operation and Development (OECD) countries for which the comparable data are available, while rapid increases in food and energy prices intensified by the ongoing war in Ukraine

³ The UK's consumer price index data are available online, <https://www.ons.gov.uk/economy/inflationandpriceindices>.

were more important factors in the UK and many other industrialized economies.⁴ Even though the experiences differ, the rapid increase in inflation has created similar challenges across the world for consumers whose incomes may not have kept pace with rising prices and for monetary policymakers who are tasked with stabilizing prices.

Inflation should moderate

Though the recent inflation data have been disappointing, most forecasters, myself included, anticipate that inflation in the U.S. will cool down substantially over the next couple of years. Let me explain the reasoning behind my forecast. Much of the same logic applies to other industrialized economies as well, though there undoubtedly will be differences depending on the particular circumstances faced by each.

First, even though some problems still remain, there are a number of signs that supply chain difficulties are improving: Ports are less congested, freight costs are falling, and supplier delivery times are improving. But all is not well yet. For example, for quite a while, a shortage of microprocessors held back the production of motor vehicles. Well, the chip shortage seems to be largely resolved, but shortages of other parts are now reportedly limiting assemblies. The problems at the parts suppliers appear related to difficulties they are still having in staffing production lines.

Over time, we will see supply chains further repaired. We will also see consumption return to more normal patterns. In the U.S. we may also see some further recovery in labor force participation, though as I mentioned, I think the prospects for this are limited. As these supply-side improvements occur, price pressures will diminish somewhat.

⁴ Hobijn et al. (2022).

Admittedly, these adjustments are taking much longer than I had expected. And disruptions from the Russian invasion of Ukraine and unpredictable Covid-related shutdowns, notably in China, have continued to snarl supply. But eventually these adjustments will occur: They are the hallmark of an economy in which prices and wages 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 outsized increases in wages and prices are the new norm and incorporate those expectations into their decision-making. At shorter time horizons, measures of inflation expectations picked up a lot beginning early last year as people took notice of the higher prices they'd been encountering. They have come down some lately with lower energy prices, but they still remain quite elevated. But the good news is that, in general, measures of longer-horizon 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.

Now, these perceptions can change and aren't something we can take for granted. I believe the Federal Reserve's strong policy actions and communications have played an important role in anchoring long-run inflation expectations by demonstrating and

conveying our commitment to bring inflation back into line with our 2 percent average objective. The public and markets appear to believe we will be successful. But it is up to us to follow through and do our job.

Policy adjustments

Reducing inflation to a level consistent with the Fed's 2 percent objective will require a period of restrictive financial conditions. These will generate below-trend growth and some softening of labor market conditions and restore better balance between supply and demand conditions in the U.S. My FOMC colleagues and I are acutely aware that this slowdown will, unfortunately, cause difficulties for some households and businesses. Yet, failing to restore price stability would result in far greater costs.

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 3 to 3-1/4 percent and indicated that further rate increases will likely be in order. Also, as previously announced, in September we stepped up the pace at which we are reducing the size of our balance sheet.

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 to four years and for the longer run.⁵ The median SEP projection is for the federal funds rate to be in the range of 4-1/4 to 4-1/2 percent by the end of this year, though I would note almost as many FOMC participants wrote down 4 to 4-1/4 percent for their

⁵ Federal Open Market Committee (2022).

end-of-year numbers. So most think we're looking at something like another 100 to 125 basis points of rate increases this calendar year. The median projection then has rates rising a bit further, to 4.6 percent at the end of next year, and then declining to 2.9 percent over the subsequent two years. My own viewpoint is roughly in line with the median assessment.

How should we benchmark this policy path? Here, it is useful to think of where real, or inflation-adjusted, rates are relative to some benchmark of neutrality. When making economic decisions, people naturally think about the future. With the median federal funds rate projected to be 4.4 percent by the end of the year and with core inflation next year forecast to be 3.1 percent, the real federal funds rate would be something like 1.3 percent. This is above the 1/4 to 1/2 percent range most FOMC participants see as the long-run real neutral rate, and so by this calculation, it's clearly restrictive. And though the estimates are subject to a great deal of uncertainty, the reduction in our balance sheet is worth something like an additional 35 to 50 basis points of policy restraint.

Given that the funds rate was essentially at zero just seven months ago, this has been quite a pivot in monetary policy. In light of this expeditious repositioning—and because the full effect of tighter financial conditions takes time to show through to output and inflation—at some point it will be appropriate to slow the pace of rate increases and eventually let policy rates sit at a plateau for a while in order to assess how our policy adjustments are affecting the economy. As always, though, 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.

I know some are uncomfortable with the idea that the Fed provides projections for policy rates in the SEP, knowing that ultimately we will see a different path for rates if economic conditions or risks turn out otherwise. Some say this is a good reason not to provide such projections at all. I strongly disagree with this view. How can it be a bad thing to reveal how we see the base-case scenario playing out? Think how much uncertainty and costly volatility we would have unnecessarily generated this past year if we had not augmented our policy moves with guidance about our plans for the ultimate level for the federal funds rate. Indeed, in this rate cycle the information in the SEPs and other Fed communications likely has strongly assisted in tightening financial conditions quickly and substantially without the large dislocations in financial flows that have at times accompanied past changes in the trajectory of policy. There was no taper tantrum this time.

The outlook

So, what does all of this mean for the U.S. outlook for growth, employment, and inflation? Let us return to the FOMC's Summary of Economic Projections.

For GDP growth, the median projection for this year is only 0.2 percent, which is consistent with growth averaging only about 1-1/2 percent over the second half of the year. Growth is projected at 1.2 percent in 2023, below the 1-3/4 percent most see as the underlying trend. So monetary restraint is clearly showing through in these numbers. Real GDP growth is expected to return to trend in 2024 and 2025.

Under this GDP forecast, the unemployment rate is projected to rise to 4.4 percent by late 2023 and then remain near that level in 2024 and 2025. While this does represent a noticeably softer labor market when compared to today's, we are not looking at recession-like numbers. Indeed, the peak projected unemployment rate is less than a half a percentage point above where the FOMC sees the unemployment rate settling at over the longer run.⁶

As for inflation, with supply-side improvements, restrictive monetary policy, and below-trend growth, I expect inflation will moderate significantly. After all, that's the goal.

According to the median SEP projection, after ending this year at 5.4 percent, total PCE inflation is expected to fall to 2.8 percent in 2023 and 2.3 percent in 2024 before returning to our 2 percent target by the end of 2025.

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 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.

In sum, 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 price

⁶ For comparison, the U.S. unemployment rate has peaked at over 6 percent either during or shortly after every recession since World War II.

stability as expeditiously as possible. Today, inflation is our primary concern. Reducing inflation is likely to require a sustained period of below-trend growth, and there will most likely be some softening of labor market conditions. But this is necessary to restore inflation to our 2 percent target. Low and stable inflation is a prerequisite for achieving the kind of sustained strong labor market outcomes that bring benefits to everyone in our society. We hope to achieve this goal as quickly and efficiently as possible.

Thank you.

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