Inflation: What Caused It and What to Do About It

Greater Vineland Chamber of Commerce
Vineland, NJ

October 20, 2022

Patrick T. Harker

President and Chief Executive Officer
Federal Reserve Bank of Philadelphia

FEDERAL RESERVE BANK
PHILADELPHIA

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Hello! It's great to be back in Vineland. The last time I was here three years ago, I began my talk by posing an extraordinarily controversial question: Is this the dandelion capital or egg capital of the country? Given the controversy this engendered, I think it's better if I stick to safer subjects this time: the country's economic outlook, as well as my thinking on monetary policy. Then we can get to our Q&A, but please, nothing about dandelions or eggs.

I also said something else three years ago: my standard Fed disclaimer. That, I *do* intend to repeat: The views I express today are my own and do not necessarily reflect those of anyone else on the Federal Open Market Committee or in the Federal Reserve System.

Inflation

As you all know, inflation is far too high. The Federal Reserve's long-range target is 2 percent annualized inflation — and annualized inflation came in at 8.2 percent in September. Prices were up 0.4 percent in September, from just a month before.

This is a period of tremendous hardship for Americans, particularly those with low or moderate income. We're seeing a huge demand at food banks — and it's coming, in many cases, from people who are working full-time. Our contacts in the banking industry are telling us that more families are taking on unsecured debt to meet daily expenses.

Inflation is widespread throughout the economy. While price hikes were limited initially to just a few items like used cars, we're now experiencing rapid rises in prices on everything from new vehicles and dishwashers to life's staples, like food, gasoline, and rent. Health-care inflation continues to be troublesome, too, and, unfortunately, shows no signs of abating. In fact, I expect hefty rises in health-care premiums next year as health-care systems renegotiate reimbursements with their insurers after suffering large losses this year.

Because of high inflation, household wealth is declining. That's partially because purchasing power is decreasing and Americans are spending their savings. It's also because the stock market, where tens of millions of Americans stash hefty portions of their retirement savings, is down on inflation fears and rate hikes. All of this is making it harder for Americans to save and to plan for retirement.

More broadly, we can't have a well-functioning economy with high inflation, particularly if high inflation expectations get embedded. To make the economy as efficient as we can in the long run, we have to get on top of inflation.

And that is precisely what the Federal Reserve is doing. Inflation is a problem that must be solved. We need to see continued movement toward 2 percent core inflation. We also need to pay attention to the distribution of inflation, making sure it's falling across a wide spectrum of goods and services throughout the economy.

To solve our inflation problem, we need to understand what has caused it. In this case, there is no singular cause. It has instead been a confluence of events, essentially, a "perfect storm."

A global pandemic, a war in Europe, and, yes, fiscal and monetary policy decisions have combined to limit supply and boost demand. The result has been inflation running at 40-year highs.

Let's begin with constraints on supply.

The events of the last few years have revealed the extraordinary fragility of global supply chains. If one ship, stuck in one canal, could ground global logistics to a halt for days, imagine the effect of a multiyear global pandemic.

In fact, we don't need to imagine it: COVID-19 lockdowns have badly damaged supply chains. Semiconductors, present in everything from automobiles to washing machines, have been in short supply for the better part of three years as factories have shuttered for extended periods and international ports have clogged. Issues here persist, with China — "the world's factory" — continuing to pursue a Zero-COVID policy. Even today, China continues to impose lockdowns, though there is some speculation that these policies may now begin to be relaxed with Xi Jinping having secured a third term as Chinese president.

Russia's tragic, horrific invasion of Ukraine further choked supply.

Shipments of grain and fertilizer fell, pushing up food prices. So did Russia's energy exports. Europe and the U.K. are in the middle of a full-blown energy crisis. Gasoline prices spiked here, fell a bit, and are now back up again. The Saudis have further compounded our problems by announcing they will *cut* production, even in the face of elevated prices.

Certain U.S. government policies have contributed to our supply-side issues. While I remain neutral on the overall wisdom of each of these policies, their effect on supply is undeniable. The federal government applies tariffs on everything from Chinese-made televisions to Canadian lumber, spiking prices. A more than two-year *pause* in legal immigration has contributed to labor shortages — we have about 2 ½ million fewer workers than we would have had, had we remained on trend.

And housing costs are up — though moderating slightly in recent months — not just because of pricier materials and labor, but also because we are not building enough houses to keep up with demand. This is often a result of local government policies, like restrictive zoning, that stymie construction.

All of these supply constraints have been accompanied by extraordinarily robust demand. For one, our labor market remains hot. That means Americans are earning paychecks, even if their relative value is declining because of inflation. Employment in manufacturing, financial services, and other industries has long since recovered from the pandemic-induced recession, and now pent-up demand within the leisure and hospitality industry is driving employment growth as well.

With some large employers like Comcast calling workers back into the office three days a week last month, I think we are starting to see a significant recovery in central business districts. Employment has been particularly down in those areas, as restaurants, bars, dry cleaners, and local shops have been bereft of office workers for more than two years. But I must say, Center City Philadelphia is noticeably more vibrant now than it was just a couple of months ago.

The national unemployment rate is at a very robust 3.5 percent. In New Jersey, the unemployment rate is 4 percent. The national rate is actually *lower* than what economists generally consider to be the natural unemployment rate. And indeed, there are still more job openings than there are available workers.

Not surprisingly, this has resulted in significant upward pressure on wages. In many regions, smaller employers with thin margins are having a hard time filling entry-level positions. We've heard from community bankers that they can't compete with larger banks for jobs like tellers. Near us, on the Jersey Shore, local businesses had a great summer in terms of sales, but they had a very hard time staying staffed. That's partially because of higher salary demands but also because housing has become so expensive in that area that workers can't afford to live there.

The labor force participation rate is also ticking up, a particularly welcome trend. Still, prime age women lag prime age men in workforce participation. To tackle that, we need to begin to address the cost of childcare, which has pushed far too many women out of work.

Fiscal policy has added to demand. The federal government pumped around $6 trillion into American households during the acute phase of the COVID-19 pandemic. In fact, the amount of fiscal support provided by the federal government was significantly larger than the aggregate decline in GDP triggered by the pandemic in the first place.

The government's aid was dispersed in a largely untargeted fashion. Mortgage forbearance and student loan forbearance — both offered to any borrowers, no questions asked, and, in the case of student loans, applied automatically — and direct stimulus payments to tens of millions of households were boons to Americans' bank accounts. Importantly, they were policy decisions taken during a frightening and uncertain time. But they have certainly contributed to the high levels of demand we are still seeing.

Monetary Policy

And finally, expansive monetary policy — that's us — kept the cost of capital low for long.

Throughout most of the COVID-19 pandemic, we kept rates near zero and enacted a major asset-buying program. These policies stoked demand, which they were designed to do.

As a central bank, the Federal Reserve can do little to affect the supply constraints pushing up inflation. And as I have indicated, those problems, unfortunately, will take time to resolve.

But the Federal Reserve can absolutely affect demand, and that is what we are doing. We want to see inflation coming down steadily and consistently, and we also want to see it abating across a wide array of goods and services. The goal is to adjust conditions so that demand better matches supply.

We have two primary tools for implementing monetary policy: the federal funds rate — usually just thought of as *interest rates* — and our balance sheet.

Since last fall, we have been tightening financial conditions. That process, at least as the market interpreted it, started last September, even before we began to move the federal funds rate or taper our asset purchases. Instead, simply *announcing* that we would soon begin to taper our asset purchases caused two-year Treasury yields to rise.

The taper began in earnest last November and is now complete. In fact, we are now reducing our balance sheet. We are shedding $60 billion in Treasuries and $35 billion in agency debt and mortgage-backed securities each month. Which is to say, we are removing a significant amount of financial accommodation quite rapidly.

We have also raised the federal funds rate 300 basis points since the start of 2022. That means the Fed is actively trying to slow the economy. But we are going to keep raising rates for a while. Given our frankly disappointing lack of progress on curtailing inflation, I expect we will be well above 4 percent by the end of the year.

Sometime next year, we are going to stop hiking rates. At that point, I think we should hold at a restrictive rate for a while to let monetary policy do its work. It will take a while for the higher cost of capital to work its way through the economy.

After that, if we have to, we can tighten further, based on the data. But we should let the system work itself out. And we also need to recognize that this will take time: Inflation is known to shoot up like a rocket and then come down like a feather.

Above all, I want to stress that we must remain data dependent and flexible on policy. What we really need to see is a sustained decline in a number of inflation indicators before we let up on tightening monetary policy.

And again, we need to make sure inflation expectations don't become unanchored. One hopeful sign is that our banker contacts have been telling us that many customers are opting for adjustable-rate mortgages. Another lender, who issues mortgages for properties at the Jersey Shore, told us that even wealthier buyers are starting to balk and are waiting for rates to come down before buying a new home.

That’s good news because it means borrowers expect inflation — and rates — to come down in the relatively near future.

So, what does all this mean for the economy? I expect that economic growth will moderate this year as both inflation and tightening financial conditions begin to crimp consumption. Overall, I forecast flat GDP growth for 2022, 1.5 percent growth in 2023, and around 2 percent growth in 2024.

Inflation *will* come down, but it will take some time to get to our target. I expect PCE inflation to come in at around 6 percent in 2022, around 4 percent next year, and 2.5 percent in 2024.

Turning to the job market, the unemployment rate should peak next year at 4.5 percent as financial conditions bite. It should then fall to 4 percent in 2024, which suggests that even as we tighten monetary policy, labor markets will stay quite healthy.

In sum, the Federal Reserve is taking on inflation from a position of relative economic strength. Our goal of stable prices and maximum employment is achievable, and our resolve is strong.

Thank you very much for having me. Let’s get to your questions.