The Economy, Inflation, and Monetary Policy

Risk Management Association — Philadelphia Chapter
Philadelphia, PA

November 10, 2022

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President and Chief Executive Officer
Federal Reserve Bank of Philadelphia

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Good morning! It's great to see you all in person after two years of virtual meetings. While clicking a Zoom link is, admittedly, a little bit easier than fighting traffic or dealing with transit, there's something undeniably invigorating about being back together physically. So thanks so much for joining us.

I'm eager to take your questions, so please use the Slido code indicated on the screen behind me. But before we get to the open discussion, I'd like to take a few minutes to discuss the state of the national and regional economy, inflation, and path of monetary policy.

But before I do that, I need to give you the standard Fed disclaimer: The views I express today are my own and do not necessarily reflect those of anyone else on the Federal Open Market Committee (FOMC) or in the Federal Reserve System.

The Economy

Let's begin with the national economy, where there are signs that activity is decelerating. Credit card purchase data indicate that consumer spending, which comprises around 70 percent of economic activity in the United States, is slowing, with services and retail leading the decline. Investment in housing has weakened, and even the boom in manufacturing, which has buoyed the economy, is starting to wane.

After two negative quarters of GDP growth to start the year, the third quarter saw growth of 2.6 percent, and that was largely due to strong exports. In sum, the reopening boom we experienced as businesses came back to life after a pandemic-induced hibernation appears to be pretty much over.

There is one glaring exception to this rather lackluster data set: employment. The job market continues to run extremely hot. The national unemployment rate is 3.7 percent, and we still have more than 10 million unfilled jobs. All of which is to say, one economic category has certainly not suffered even as other sectors have slowed: Help Wanted signs.

Regionally, there are signs of weakness as well, though as with the national economy, employment remains robust.

The Philadelphia Fed's *Manufacturing Business Outlook Survey* is in negative territory, meaning that respondents are pessimistic regarding the economic environment six months from now. Importantly, however, shipments remain in positive territory as firms work off sizable order backlogs piled up during the pandemic. In residential real estate, activity has flattened after a huge boom, and we are seeing more prices being reduced for home listings.

It also appears that central business districts in our region are going to endure lighter foot traffic in the foreseeable future. Employers who have called their workers back to their offices are in many cases offering hybrid schedules, and the data reflect this. This trend tends to be more pronounced in our region than nationally. We can see this most clearly in mobility statistics, which indicate time in workplaces is down 20 percent nationally and 30 percent in Philadelphia. For public transit, the drop-off is even more stark, with time in transit stations down 20 percent nationally and 45 percent in Philadelphia.

Inflation

Now to inflation, which remains far, far too high.

This is a period of tremendous hardship for Americans, particularly those of low or moderate income. We're seeing 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.

The Federal Reserve's long-range target is 2 percent annualized inflation, and right now, annualized PCE inflation, including food and energy, stands at 6.2 percent. Prices were up 0.3 percent in September from just a month before. Moreover, inflation is widespread throughout the economy. While initially, price hikes were limited to just a few items like used cars, we're now seeing rapid rises in prices on everything from new vehicles and dishwashers to life's essentials, like food, health care, and rent.

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 in the long run as we can, we have to get on top of inflation.

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.

We are committed to bringing down inflation.

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. We all know about semiconductor shortages, which have limited supplies of everything from new cars to washing machines. These shortages persist, owing largely to China's Zero-COVID policy. But the pandemic has wrought shortages in more obscure items. A major auto company for instance, is having a hard time securing enough of its trademark emblems. That has slowed shipments of new vehicles.

Russia's horrific invasion of Ukraine further choked supply.

After Vladimir Putin's forces invaded Ukraine, shipments of grain and fertilizer fell, pushing up food prices. And the decline in Russia's energy exports has helped fuel the rise in energy prices causing an energy crisis in Europe and the U.K. Gasoline prices spiked here, fell a bit, and are now back up again. OPEC Plus has further compounded our problems by announcing it will *cut* production, even in the face of elevated prices. We know that gas prices are incredibly important to consumers and responsible for much of the decline in consumer sentiment.

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. Our immigration policy, such as it is, has resulted in a more than two-year *pause* in legal immigration. This has certainly contributed to labor shortages; we have about 2½ million fewer workers than we would have had, if we had remained on trend.

All of these supply constraints have been accompanied by robust demand. For one, as I indicated earlier, our labor market remains hot. That means Americans are earning paychecks, even if their relative value is declining because of inflation.

Not surprisingly, low unemployment rates have produced 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 who can't compete with larger banks for jobs like tellers. In tourist regions like the Poconos and 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 those areas that workers can't afford to live there.

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.

Government aid was dispersed in a largely untargeted fashion. For instance, mortgage forbearance and student loan forbearance were both offered to any borrowers, no questions asked, and in the case of student loans, applied automatically. Recall why these policies were enacted; we were in the middle of a full-blown panic, and the federal government needed to get money out the door. But it's clear that policies like these contributed to high levels of demand. If you don't have to pay your mortgage for a year, you have a lot more money to spend on other goods and services.

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 of 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 375 basis points since the start of the year. Granted, we started from zero, but we have raised rates significantly — and very quickly.

In the upcoming months, in light of the cumulative tightening we have achieved, I expect we will slow the pace of our rate hikes as we approach a sufficiently restrictive stance. But I want to be clear: A rate hike of 50 basis points would still be significant. Since 1983, the FOMC has increased the target a total of 88 times, and of those, 75 of the hikes were less than 50 basis points.

At some point next year, I expect we will 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 always 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.

So what does all of 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 core PCE inflation to come in around 4.8 percent in 2022, around 3.5 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. We've heard from contacts in manufacturing that, given how hard they have worked to staff up, they will be extremely reluctant to cut jobs even as the economy slows.

That gives me confidence that we can bring inflation under control without doing unnecessary damage to the labor market. Our resolve is strong, and our goal of stable prices and maximum employment is achievable.

Thanks so much for being here. I really appreciate the important work that RMA does in our region. Now let's open things up for questions.