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"Perspectives on the Economy and Monetary Policy"

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The views expressed today are my own, not necessarily those of my colleagues on the Federal Reserve Board of Governors or the Federal Open Market Committee.

Key Takeaways

1. With inflation much too high, and job-availability robust, the priority is to bring inflation back to the 2 percent target, consistent with the Fed's dual mandate from Congress. It is clear there is more work to do, to get there. I expect this will require additional increases in the federal funds rate, followed by a period of holding rates at a sufficiently restrictive level for some time.

2. Both unemployment and inflation are very costly for individuals and our economy. The costs for *both* are also disproportionately borne by those who are most vulnerable in our society, like those with lower incomes. Returning to low, stable inflation will set the foundation for maximum employment that is sustainable; and for a vibrant, resilient, inclusive economy that works for all.

3. Lowering inflation requires slowing economic activity, and bringing demand and supply in the labor markets into better balance to relieve inflationary pressures. While there are risks and uncertainties, I remain optimistic about the possibility of achieving this without a significant economic slowdown.

4. The aggressive pace of interest rate increases to date has been appropriate, given rates had been near zero before March. Now that rates are in restrictive territory, the next phase of tightening should shift from a focus on *pace* to a focus on *levels* – determining the level needed to be sufficiently restrictive. I expect it will be appropriate to continue raising rates, with the size of future increases determined by a holistic assessment of incoming information.

5. As policy becomes more restrictive, the risks of overtightening rise. Increasingly, these risks must be thoughtfully weighed against the risks of moving too slowly and allowing higher inflation expectations to become entrenched.

Good morning, and thank you for having me speak with you today. It is truly a pleasure to be hosted by the Brookings Institution for this talk. My association with the Brookings Economic Studies area extends back some 30 years. I have many fond memories of my time as a senior fellow. The nonpartisanship, rigor, open-minded inquiry, and emphasis on impact at Brookings are values we share at the Federal Reserve Bank of Boston.

I also want to mention my appreciation for David Wessel, and his decades of work helping people better understand the economy and policymaking, most recently as director of the Hutchins Center. As a lifelong educator, I see this work as so important.

I joined the Boston Fed as president just a few months ago. In this role, I have the privilege and responsibility of serving on the Federal Open Market Committee (or FOMC), which sets national monetary policy – this year as a voting member.

The committee met this week. At this time of intense focus on the FOMC, I want to share my perspectives on macroeconomic conditions and discuss some key dimensions of monetary policymaking in the current context.

Before beginning, I would like to note that these views are my own, and I am not speaking for colleagues at the other Reserve Banks or the Board in Washington.

Overview

I will start by providing some historical context for current monetary policy. Then I'll turn to inflation and explore how we got to today's environment – which is important for thinking about mapping out future policy discussions. I'll then discuss the recent path of monetary policy and explore some of the challenges to determining appropriate policy going forward – and include some of my own perspectives on monetary policymaking.

After my remarks, I look forward to answering some questions.

Key Context

I'd like to start with some context.

Not long ago, the challenge facing policymakers was persistently *low* inflation, and how to increase it to the FOMC's target. Clearly, this is no longer the issue. Inflation has surged, and remains much too high, with serious repercussions for households, businesses, and the economy.

Congress has charged the U.S. central bank with a dual mandate – price stability and maximum employment. We define price stability as two percent inflation – a low level, where consumers and businesses do not have to focus on protecting themselves from eroding purchasing power. The other facet of our mandate, maximum employment, is less specifically defined. It refers to the broad, inclusive goal of job opportunities for all.

History has shown that low and predictable inflation is an important precondition for sustaining maximum employment over time. In other words, the two dimensions of the Fed's mandate are intertwined; they work together in the long run. Price stability is foundational to achieving the Fed's overarching mission, which is a vibrant, resilient, and inclusive economy.

At the moment, with inflation well above the Fed's 2 percent target, the Fed's central task must be to restore price stability. The FOMC has moved aggressively towards accomplishing this important goal, but the job is clearly not yet done. I expect more tightening will be needed.

The higher interest rate environment necessary to restore price stability has challenging implications for real people. I take this, as well as the costs associated with too high inflation, very seriously. Indeed, policymakers must balance the risk that inflation remains elevated and becomes entrenched in expectations, against the risk that policy actions excessively slow down economic activity.

The economic environment is, admittedly, highly uncertain but today I will discuss why I am still optimistic about the possibility of restoring price stability while maintaining a relatively robust labor market.

More generally, I will also discuss my perspectives about monetary policy going forward. We are moving from the *initial* policy phase focused on moving rates into restrictive territory very quickly, to a *second* policy phase with a focus on determining how high rates need to go to return inflation to the Committee's 2 percent target over a reasonable horizon. This requires a careful, holistic assessment of available information and deliberate actions. I will say more about this in my remarks as well.

Inflation

I want to briefly review how inflation got to where it is, since that is important for assessing how best to go forward.

The initial rise in inflation, across many countries, resulted mostly from supply disruptions rooted in repeated waves of the COVID-19 pandemic. They caused commodity prices to jump, and the cost of transportation to rise, particularly for imported goods. Then, Russia's war in Ukraine disrupted production and trade for several key commodities, such as energy and wheat.

Over time it became apparent that problems with supply were not going to fade as quickly as expected, while demand was noticeably exceeding the economy's productive capacity. To restore price stability, monetary policy needed to respond to realign demand with supply.

As the acute phases of the pandemic eased, the strength in U.S. consumer demand led to a very hot job market, characterized by widespread job vacancies, rising quits rates, and what I'll call "hesitant" labor supply. All these factors had employers competing fiercely for workers. This led to wage increases inconsistent with a sustainable rate of overall inflation.

A number of factors have played, and are playing, a role in the shortage of workers – including a population that is aging, early retirements, lower immigration, and some potential workers remaining on the sidelines with pandemic-related concerns. So far, high wages and job availability have yet to prompt a more robust return to the labor force.

Clearly, the evolution of the labor market and jobs during and after the pandemic is a vital topic and, parenthetically, I want to mention that it is the focus of this year's Boston Fed annual economic conference, which will take place in two weeks.

Returning to inflation, there is unfortunately little the central bank can do to address supply constraints – whether related to COVID-19, Russia's war in Ukraine, or workers' decisions about labor-force participation. But monetary policy *can* influence demand, and our job right now is to slow demand, to bring it back into alignment with our economy's productive capacity and relieve pressures on inflation.

Irrespective of source, current levels of inflation are simply too high, and are taking a significant toll on households and firms. If not addressed, inflation will be increasingly damaging to the economy and its participants. I'd like to spend a bit of time discussing some of these costs, and why bringing inflation down is so important.

Of course, the Fed conducts extensive analysis of economic data. We augment this analysis by working to understand the experiences and economic realities of people and organizations in the economy. For example, an increase in inflation can reduce consumers' spending power – and that problem is more acute for lower-income individuals. I've heard about the increasing difficulties that many lower-income households are having making ends meet as costs for food, housing, and transportation rise. The rise in fuel and auto prices has also made it difficult for some low wage workers to accept jobs that require a car to get to work.

In addition, many operators of small businesses have told me about the challenges they are experiencing with inflation's effects on their raw inputs and supplies. I've also heard about firms putting their expansion plans on hold because of the uncertainty created by inflation.

Importantly, high inflation also risks upsetting the stability in inflation *expectations* seen over the past 25 years. Without well-anchored inflation expectations (that is, expectations consistent with the Fed's 2 percent target), the cost of bringing inflation down, which involves slowing economic growth and thus lost output, would be much higher.

Unfortunately, recent data on price inflation show PCE inflation only slowly drifting down from its year-over-year peak of 7 percent, reached in June. This has been disappointing, and there clearly is more work to do to bring inflation down, as I'll discuss shortly.

But I'll note that other, related price indicators are providing more encouraging signs. In particular, some global supply chain problems that have contributed to inflation since early 2021 are beginning to fade. Transportation costs and commodity prices have significantly retrenched from their peaks, and broader measures of prices paid by manufacturers have noticeably declined in recent months. In addition, recent wage data, specifically the private sector Employment Cost Index, grew more slowly than anticipated in the third quarter of 2022.

So there are some hopeful signs, although not yet clear evidence, that inflation may be beginning to moderate. It is also reassuring that long-run inflation expectations, measured in a variety of ways, remain well anchored overall.

Monetary Policy Actions to Date

Monetary policymakers reacted to this significant rise in inflation by raising interest rates rapidly. I would like to briefly discuss the recent path of monetary policy. In doing so, I will examine some factors that add challenges to determining appropriate policy going forward.

Given the uncertainty surrounding the pandemic, and concerns over additional waves of COVID-19, the federal funds rate remained near zero from the beginning of the pandemic until this spring.

Since March, the FOMC has embarked on an appropriately aggressive path of interest rate increases, moving the federal funds rate from near zero to nearly 4 percent, including this week's action. The strong pace of these increases in a short period of time has brought monetary policy from a very accommodative stance in March to restrictive territory now, with the goal of slowing demand.

Importantly, however, the work to tame inflation is not yet finished. As Wednesday's FOMC policy statement noted, "the Committee anticipates that ongoing increases in the target range will be appropriate" until the stance of policy is "sufficiently restrictive to return inflation to 2 percent over time."[1]

Various indicators *do* suggest that the policy tightening underway since March is having an effect. Raising the federal funds rate – which is a short-term rate – impacts the *longer-term* interest rates that affect people and firms' economic decisions. The runoff of assets from the Fed's balance sheet that was initiated earlier this year is also increasing interest rates at longer maturities. In all, longer-term rates have proven to be *more* responsive than in some previous economic cycles, and this amplifies the restrictiveness of the current level of the funds rate.

This has been especially notable with mortgage rates. They had risen 75 basis points at the beginning of the year, then rose from roughly 4 percent in March to around 7 percent in October. This has had a strong impact on what was an extremely hot housing market.[2] Demand is also slowing for appliances and other durable goods that go along with home purchases.

Again, the path to price stability involves bringing what has been very strong demand into better balance with supply. So I believe we need to see growth at a below trend pace in interest-sensitive sectors of the economy and more broadly — growth that is hopefully still positive but down from the rapid pace we saw last year. Indeed, there are some early signs that growth in consumer spending is slowing to a pace closer to trend. Ultimately, this broader slowdown in demand will affect the labor market. Restoring a better balance between demand and supply in the labor market will play an important role in reducing unsustainable wage inflation, and with it, price inflation.

In this context, it is notable that wage inflation is now much higher than it was pre-pandemic, despite a similar unemployment rate. A possible explanation is that demand for labor is stronger, relative to labor supply, than it was pre-pandemic. Some evidence of this can be gleaned from the fact that vacancies per unemployed worker are now considerably higher than they were in 2019. Another sign is that workers have been quitting their jobs for other opportunities at higher rates than before the pandemic.

With a very low unemployment rate, and very high vacancy and quit rates, wages were bound to increase sharply. I hope it will be possible to see a decline in wage inflation with only a relatively modest increase in the unemployment rate, as demand in the labor market cools and vacancies and quits decline.

The possibility of re-equilibrating the labor market with only a modest increase in the unemployment rate is one important reason for optimism about reducing inflation without a significant downturn.

There are also other reasons for optimism. Household balance sheets remain strong, and there do not appear to be significant imbalances in the nonfinancial business sector. So, households and businesses are fairly well positioned to support spending, and weather tighter financial conditions – which has not typically been the case in earlier cycles. In particular, households accumulated more than two trillion dollars in excess savings over the course of 2020 and 2021, and while they have started to spend out of this stock, the buffer is still large. Moreover, many firms may be reluctant to lay off workers they have had considerable difficulty hiring.

And well-anchored medium- to longer-term inflation expectations, as I have noted, will reduce the extent of the slowdown in activity needed to reduce inflation.

I recognize that this scenario might sound rosy, and acknowledge that there are a number of significant risks. The continued stresses and uncertainties of the pandemic period have been extremely challenging, taking a toll on individuals, families, and communities. Understandably, this has also dented consumer sentiment, which implies a risk that expectations of a downturn could become self-fulfilling, with a sudden curtailing of spending.

And, unfortunately, we cannot rule out additional supply or demand shocks, whether from a resurgence of COVID-19 or from food and energy supply disruptions due to other factors. We have also seen a sharp appreciation of the dollar, interest rate hikes around the globe, and growth slowdowns in many nations. These factors increase the risks of a more rapid decline in global and domestic demand.

But overall, while a realist and attuned to the significant risks, I am optimistic about the path for our economy, as we do the essential work to restore price stability – which is foundational to an economy that works well for everyone.

Monetary Policy Going Forward

Given all the imperatives and uncertainties I have mentioned, what is the way forward for monetary policymaking?

The FOMC's goal is to bring inflation back down to the Committee's 2 percent target over time, and as Wednesday's FOMC statement and communications stressed, this will likely entail raising rates to a sufficiently restrictive level and then holding there for some time.

Back in March, rates were far from being restrictive – they were near zero. Since then, the FOMC has tightened policy at a very fast pace to reach a level of the federal funds rate near 4 percent. The swiftness of these actions was appropriate, and reflected the FOMC's commitment to price stability.

With rates now in restrictive territory, I believe it is time to shift focus from *how rapidly* to raise rates, or the pace, to *how high* – in other words, to determining what is sufficiently restrictive. And down the road, when we get there, in my view we'll need to shift again to focus on *how long* to hold rates at that level.

In thinking about how to reach the level of the funds rate at which the Committee will deem appropriate to hold policy, I believe it is important for us to consider the various options for policy moves. This will include 75 basis points, as well as smaller increments. I note that a 50 basis-point move was considered a large move in the past.

In my view, smaller increments will often be appropriate as we work to determine how much tightening is needed to reach a level of the funds rate that is sufficiently restrictive. A focus on the level (not the pace) is what "resolve" looks like in this second policy phase.

Importantly, as policy tightens further, the risks of overtightening increase. As I've discussed, I do not believe a significant slowdown is required to accomplish our goal of restoring price stability. Therefore, it will increasingly be important to balance the risk of possibly slowing demand in the economy too much, with the risk of allowing inflation to persist too long and possibly de-anchoring inflation expectations.

Making policy decisions going forward will not be easy – it never is at this stage in the economic cycle. There is no one single indicator that will be sufficient by itself to guide policy. Decisions, even more than usual, will require a careful, holistic assessment of the range of information available. Our task is further complicated by some unusual challenges of extracting the signal from what can be very noisy data. For example, demand indicators and the labor market may send somewhat different signals as the need by businesses to fill vacant positions may persist even with some slowing of demand. The continued above-trend growth in payrolls in this morning's October employment report is consistent with this view.

It is premature to signal how high rates should go. However, I will say that the median path in September's Summary of Economic Projections can be taken as a starting point of my current thinking, with the possibility of a higher path depending on incoming information.

In determining appropriate policy, I will assess how much financial conditions have tightened and look for evidence that our cumulative policy actions are slowing demand, cooling labor markets, and having the desired effects on wages and prices. Indeed, as noted in this week's FOMC statement, the Committee "will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments."

Concluding Observations

To conclude, let me reiterate my commitment to the Fed's dual mandate – price stability and maximum employment – and specifically, my resolve to restore price stability. Policy has moved expeditiously into restrictive territory, but there is more work to do. In this next phase for policymaking, my focus is shifting from raising rates rapidly to determining the level that the funds rate must reach to be sufficiently restrictive to achieve the desired outcomes. This recognizes that the risks of inflation falling too slowly and of the economy weakening too quickly are becoming more balanced.

Returning to price stability will set the foundation for sustainable maximum employment – and for achieving the mission of a vibrant, inclusive economy that works best for all in the long run.

Thank you again for hosting me today, to discuss my perspectives on the economy and monetary policy. David, I look forward to your questions.

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[1] To view the full statement, see Nov. 4, 2022 Federal Reserve Board - Federal Reserve issues FOMC statement.

[2] Home buying has been slowing, house price increases have been decelerating (if not declining in some areas), and residential investment has been contracting quite sharply.