Monetary Policy: Progress Is Not Victory

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Good afternoon. It's terrific to be here and be speaking once again to the Economic Club of New York. So, thank you very much for the invitation, and I look forward to a great discussion.

Before we get started, I would like to take a few minutes to describe how I see the current economic environment and the uncertainties and tradeoffs we face as we calibrate policy. The key takeaway is that the moment calls for optionality. We must keep our minds open so that we can respond to conditions as they evolve. Vigilance and agility are paramount to finishing the job—the job being, of course, to restore price stability as gently as we can.

The good news is—at this point—we have time to get it right. The economy and policy are in a much better place. Growth and inflation are gradually slowing and the risks to the outlook are largely balanced. Monetary policy is restrictive and financial conditions are tight. So, we don't have to rush to any decisions.

But progress isn't victory. And we must remain resolute to finish the job. A gradual return to 2 percent inflation is in our sights, but it is not yet in our grasp. That is the final mile.

But before I go further, let me say that the views I express today are my own and do not necessarily reflect those of my colleagues or anyone else within the Federal Reserve System.

Progress to Date

I mentioned that the economy and policy are in a better place. So, let me begin by taking stock of where we have been and how far we have come.

As you may remember, in March 2022—just 18 months ago—the Federal Open Market Committee (FOMC) had a problem. Headline and core inflation had risen to multidecade highs and were projected to keep rising. Inflation expectations, especially at the short end, were close behind.[1] And there were concerns that this could generate a more worrisome increase in medium- and longer-run inflation expectations.

So, the FOMC began to rapidly adjust monetary policy.[2]

Since that time, we have raised the federal funds rate by 525 basis points to its highest level in 22 years.[3] These cumulative increases have moved policy into restrictive territory. Indeed, the real federal funds rate, as measured by the nominal funds rate less one-year-ahead inflation expectations, exceeds almost all measures of its neutral value.[4]

We are seeing the effects of this tightening on the economy. Headline and core inflation have both declined significantly, bringing us much closer to our 2 percent target.[5] As my contacts in the Twelfth District tell me, this is having an immediate positive effect on households, businesses, and communities who have been struggling on the treadmill of constantly rising prices and falling purchasing power. The relief they're seeing in their wallets is translating directly into more positive views about future inflation. We see this nationally in short-run inflation expectations, which have been falling almost one for one with the declines in inflation.[6]

Perhaps most encouragingly, the welcomed decline in inflation has come without significant deterioration in economic growth or the labor market. The economy and labor market are slowing, but not severely or abruptly. These developments have led market participants, businesses, and households to replace fears of recession with hopes for a soft landing, a sea change from earlier this year.[7]

This is unequivocally good news. But to ensure that we fully achieve the outcomes we want—sustainable price stability and a healthy and balanced labor market—we need to finish the job.

So, what will this require?

[1] Household expectations of near-term inflation began rising following a surge in commodity prices in 2021. For more information, see Glick et al. (2021).
[2] The FOMC first signaled that policy would need to be tightened in November 2021. It started the tightening cycle in its March 2022 meeting.
[3] The current range of the federal funds rate is 5.25 to 5.5 percent.
[4] A range of common measures for business and consumer inflation expectations currently puts one-year-ahead inflation expectations between 2.5 percent and 3.6 percent, leading to a real funds rate between 1.8 percent and 2.9 percent. This is notably above the median Summary of Economic Projections (SEP) estimate of the neutral rate of 0.50 percent.
[5] Federal Open Market Committee (2023) specifies the 2 percent target as measured by the personal consumption expenditures price index (PCEPI). As of August 2023, the 12-month change in overall PCEPI moderated to 3.5 percent from a high of 7.1 percent in June 2022. Similarly, core PCEPI, which excludes volatile food and energy categories, fell from a peak of 5.6 percent to 3.9 percent.
[6] Business and consumer short-term inflation expectations have fallen notably since the beginning of the current tightening cycle. For example, the Federal Reserve Bank of Atlanta's Business Inflation Expectations shows one-year-ahead expected inflation moderating from 3.8 percent in March 2022 to 2.5 percent in the latest reading. Similarly, the University of Michigan's Surveys of Consumers show a moderation in one-year-ahead expected inflation from 5.4 percent in March 2022 to 3.2 percent in the latest reading.
[7] For example, the University of Michigan's Surveys of Consumers' index for expected business conditions, which measures household sentiment for economic growth in the coming year, improved notably since earlier this year and reached its highest value since the beginning of the current tightening cycle as of September 2023. Additionally, the latest Federal Reserve Bank of Philadelphia's Survey of Professional Forecasters shows respondents placing less probability on a downturn in real GDP in the second half of 2023 relative to earlier in the year.

A Balanced Approach

Vigilance and agility.

Let's start with vigilance. We need to be vigilant in assessing the odds that the good data we've been seeing is a new trend, rather than just a temporary relief that will stall out too early, leaving us short of our goals. Either is possible.

I've discussed the recent positive data and the progress we've made. But why might these positive developments plateau? Put simply, the economy still has considerable momentum and a ways to go to come back into balance.

Headline data tell the story. In the labor market, even with the recent slowing, job growth remains well above what is needed to keep pace with labor force growth, and other indicators point to ongoing strength.[8] Inflation is similar. While overall inflation has fallen a lot, it continues to be almost 2 percentage points higher than our target.

Now, it's possible that the slowing we are seeing will translate into a steady march toward our goals. But in the case of inflation, there are real risks to this projection. Many components are coming down just as expected and should continue to slow. But nonhousing core services, often called supercore, has been relatively sticky and remains far above its pre-pandemic level.[9] Although it often lags other inflation, we will need to see some progress in this category to be fully confident we are on the path back to price stability. [10, 11]

What does this mean for policy? Well, this is where agility comes in. We need to be positioned and prepared for however the economy evolves. We need to have options.

If we continue to see a cooling labor market and inflation heading back to our target, we can hold interest rates steady and let the effects of policy continue to work. Importantly, even if we hold rates where they are today, policy will grow increasingly restrictive as inflation and inflation expectations fall. So, holding rates steady is an active policy action.[12]

Likewise, if financial conditions, which have tightened considerably in the past 90 days, remain tight, the need for us to take further action is diminished.

In contrast, if the deceleration of growth and inflation stalls, activity begins to reaccelerate, or financial conditions loosen too much, we can react to those data and raise rates further until we are confident that monetary policy is sufficiently restrictive to complete the job.

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[8] About 100,000 new jobs per month are needed to keep the unemployment rate at its current level of 3.8 percent over the next year, according to the Federal Reserve Bank of Atlanta's Jobs Calculator. The U.S. economy added an average of 150,000 jobs over the three months ending in August 2023.

[9] The 12-month change in the price index for core nonhousing services has been above 4 percent since April 2021.

[10] In August 2023, consumer spending on core nonhousing services was about 50 percent of total spending. Moreover, this category contributed around 2.1 percentage points, or 60 percent, to the 12-month change in overall PCEPI inflation.

[11] If the contribution of core nonhousing services to the 12-month change in overall PCEPI inflation remained at its current level and contributions from all other categories returned to their pre-pandemic (2016–2019) averages, overall inflation would only moderate to approximately 2.6 percent.

[12] The restrictiveness of policy is measured by the real interest rate, which is the nominal federal funds rate less one-year-ahead expected inflation. If the nominal funds rate is held steady while inflation and inflation expectations continue to moderate, the real interest rate will rise, making monetary policy more restrictive.

In other words, rather than a prejudged path of what policy will be, we need an open mind and optionality.

The Final Mile

When I travel around my District and across the nation, I see the progress we've made in the past year. And that is worth acknowledging.

But as I said at the start, progress alone is not victory. And it will take vigilance and agility to complete the final mile.

Thank you.

References

Federal Open Market Committee. 2023. "Statement on Longer-Run Goals and Monetary Policy Strategy." Adopted effective January 24, 2012; as reaffirmed effective January 31, 2023.

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