

Restoring Price Stability: Monetary Policy Considerations for 2023

Remarks by
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The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers, or representatives.

Thank you for that warm introduction. We're pleased to host today's Central Exchange program. CX has been an important part of Kansas City's success as it provides support for women to develop their leadership abilities and contribute to the momentum in our community. Our partnership with CX has benefitted a number of women leaders here at the Kansas City Fed, including me. Your invitation in January 2012 was my first public speech as the new president of the Kansas City Fed, and I'm honored to continue the tradition on the eve of my retirement later this month by looking back and looking ahead at the U.S. economy.

Over the past year, the Federal Reserve has pursued its most aggressive tightening of monetary policy in decades. Interest rates rose from zero to 4¼ percent in less than a year, and within only a few months of ending its large-scale asset purchases, the process of shrinking its nearly \$9 trillion balance sheet was initiated. Financial conditions in turn have tightened considerably. Mortgage rates have roughly doubled, equity prices have fallen, and the dollar has appreciated. In the conservative world of central banking, these are sharp and dramatic moves.

What makes this tightening even more extraordinary is that little of this was expected a year ago. Going into 2022, the Federal Reserve anticipated that its policy rate would rise only modestly over the course of the year to a peak rate just above 2 percent by the end of 2024. Financial markets expected an even more gradual removal of monetary accommodation, with market participants assuming the Fed's sizeable balance sheet would begin to shrink in the middle of 2024. These forecasts generally assumed that monetary policy tightening this time would look very much like the last time the Fed tightened monetary policy when the pace was gradual and drawn-out.

That cycle started with an initial rate hike in December 2015 and ended three years later at a peak policy interest rate of 2½ percent. The process of shrinking the balance sheet did not begin until a full two years after the first interest rate increase. Throughout that period, the narrative around tightening was less clear in terms of how the Federal Reserve was reacting to the data, and the financial markets reacted poorly to what now seem like minor changes in the outlook for policy.

What made the Fed toss out its previous playbook and pivot towards much more aggressive action? The answer is, of course, inflation. Relatively early last year, it became apparent that high inflation was going to prove more persistent than anticipated. At the end of 2021, the Federal Reserve's policymaking body, the Federal Open Market Committee, expected

inflation to fall from 5¼ percent to 2½ percent in 2022, near the FOMC’s longer-run 2 percent objective. But instead of easing, inflation rose. In the latest data, inflation is running at 5½ percent, well above those 2021 projections and, more importantly, far above the Fed’s objective.

How did we get here? Shocks and shifting imbalances

Given the importance of inflation in explaining the evolution of policy over the last year, the outlook for inflation remains a central feature for any outlook of the economy overall. In my view, today’s inflation dynamics reflect both unexpected shocks, such as the war in Ukraine, and continued—though shifting—imbalances in the economy.

The war in Ukraine pushed up energy and commodity food prices through most of 2022. From February to June, the price of a gallon of gasoline increased almost 50 percent to \$5 a gallon, and energy prices contributed almost one-fourth of the increase in overall prices. Since June, weaker expectations for global demand as well as a record 200-million-barrel release from the United States’ Strategic Petroleum Reserve have returned oil prices to about where they were before the conflict. An initial spike in crop prices also has largely faded. Given that the conflict continues unabated and that the possibility that energy and crop prices might rise again remains, renewed pressure on overall inflation is certainly a very real risk.

More fundamentally, the inflation we have seen over the past 18 months has been driven by imbalances between supply and demand in the economy. Demand has been boosted by the extraordinary policy response to the pandemic, with a \$6 trillion fiscal expansion largely consisting of transfers to households and businesses. At the same time, the economy’s ability to supply goods and services has been constrained by pandemic-related disruptions to production and transportation as well as labor shortages. When demand exceeds supply, prices rise.

The initial increase in inflation was importantly driven by higher goods prices, as shifting consumption patterns and production disruptions led to large supply and demand imbalances for certain durable goods. An assumption that the supply of goods would recover was an important element behind forecasts that called for falling inflation in 2022. And indeed, over the course of 2022, supply chains recovered, shortages of key parts—including many kinds of semiconductors—were resolved, and shipping rates returned to pre-pandemic levels. The long line of ships waiting off the Port of Long Beach has disappeared. And as expected, goods prices

have started to moderate, with prices (excluding food and energy) falling over the past two months.

Even as the prices for goods have begun to decline, other prices related to services have strengthened. Underlying the strength of services prices has been an extremely tight labor market, with the demand for employees by businesses far exceeding the supply of willing workers. The unexpected degree and persistence of labor market tightness has led to a shift in price pressures from goods to labor-intensive services. In other words, ongoing inflationary pressures still reflect imbalances between supply and demand, but those imbalances have shifted as the tightness in product markets has given way to tightness in the labor market.

Demand explains part of the tightness of the labor market, with employers posting 1.7 vacancies for every person reporting to be looking for work. However, surprisingly weak labor supply has also been an important factor. Workforce engagement continues to disappoint, and the labor force participation rate remains more than 1 percentage point below pre-pandemic levels. The decline in participation is now concentrated among those older than 55 and likely reflects early retirements and health concerns, decisions which can be sticky and difficult to reverse.

Policy implications for 2023

While the recent data on inflation has been encouraging, eliminating the imbalances that have been driving prices higher will be required to restore price stability. So far, the increase in interest rates has worked to slow demand growth, allowing supply to catch up, particularly for goods. Our regional contacts note that higher interest rates have slowed the housing market dramatically, both in regard to sales and new residential construction. Speculative commercial real estate projects have also largely stopped, though firms have reportedly continued with projects related to their own expansion or upgrades. The shortages of lumber that drove up construction prices in 2020 and 2021 have disappeared and prices have fallen.

But even as goods prices have started to decline, services prices continue to rise, boosted by a tight labor market. How much additional tightening will be needed to bring inflation back to 2 percent remains an essential aspect of the Federal Reserve's deliberations.

The longer inflation remains above its 2 percent objective, the greater the chance that higher inflation becomes embedded in the expectations of workers, producers, and consumers.

History has shown that once inflation becomes ingrained in public expectations, it can be very costly to combat.

Through its aggressive action over the past year, the Federal Reserve has demonstrated its commitment to restoring price stability. This may explain why measures of longer-run inflation expectations have remained relatively stable even as realized inflation has proven to be stubbornly high.

As policymakers judge the appropriate path of policy over the coming year, a number of economic uncertainties are likely to confront them. For one, the global outlook is highly unsettled. Disruptions in European energy markets threaten production and dampen consumer sentiment, with many forecasters suggesting that a recession in the euro area is unavoidable. In China, the pandemic remains a threat, both to public health and to economic activity. Overall, the global outlook does not suggest much of a buffer for the U.S. economy if growth were to slow appreciably more here.

Another source of uncertainty for policymakers is the tremendous amount of liquidity that remains in the financial system. Households for example are holding an additional \$4 trillion in currency and checking accounts relative to pre-pandemic levels.¹ This additional money coincides with a sharp increase in saving during the pandemic, as spending was curtailed, and government transfer programs attempted to preserve household incomes.

How households manage this additional excess saving over time could have important implications for the path of policy. If they decide to hang on to higher levels of liquidity, perhaps out of a renewed sense of caution given the experience of the pandemic shock, then the effect on the economy, inflation, and policy could be minimal. If instead, this higher liquidity allows households to boost spending, the outcome could be continued pressure on imbalances and inflation. Such a scenario might call for further increases in interest rates to incentivize saving rather than spending.

As policymakers consider the path of interest rates, they also will be following through on plans to significantly reduce the size of the Fed's balance sheet. Currently, up to \$95 billion of assets are rolling off the balance sheet every month as they mature. It is important that these reductions continue so that the central bank's balance sheet is no larger than needed to carry out

¹ From the Board of Governors Flow of Funds data, household holdings of checkable deposits and currency increased from \$1.2 trillion at the end of 2019 to \$5.1 trillion in the third quarter of 2022.

its operating regime in an effective and efficient manner, thereby minimizing its footprint and influence in financial markets. Based on the Federal Reserve’s previous experience, reducing the size of its balance sheet can be a slow and challenging process.²

Finally, policymakers will undoubtedly face more complicated choices and difficult communications as the tradeoffs between inflation and employment become more apparent. Uncertainty around the path of policy could rise once the public and markets start evaluating how the Federal Reserve is weighing inflation relative to a softening labor market in its policy decisions.

Longer-term, reflections on the recent surge in inflation might serve to shift the policy discussion about growth in the United States, from the demand-focused view that prevailed over the past two decades to a greater acknowledgement of the structural factors affecting and impeding growth. Prior to the pandemic, economic growth considerations had focused almost exclusively on the weakness of demand, as supposedly evidenced by low interest rates and low inflation. This narrative argued that if demand could be boosted, supply would be forthcoming, and growth would pick up. However, faced with an almost unprecedented surge in demand following the policy response to the pandemic, the supply side of the economy has revealed itself as a binding constraint. After decades of associating slow growth with insufficient demand, the current episode suggests supply side factors affecting the economy might be less nimble than thought. Future reviews of the Federal Reserve’s policy framework could offer the opportunity to explore this dynamic and consider the implications for monetary policy.

² Gulati, Chaitri, and A. Lee Smith. “[The Evolving Role of the Fed’s Balance Sheet: Effects and Challenges.](#)” Federal Reserve Bank of Kansas City. *Economic Review*. Fourth Quarter 2022.