The Economic Club of New York

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The Economic Club of New York

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Loretta J. Mester
President and Chief Executive Officer
Federal Reserve Bank of Cleveland

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Signature Luncheon
In Person/Hybrid Event

Moderator: Pierre Yared
MUTB Professor of International Business
Senior Vice Dean for Faculty Affairs
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Introduction

President Barbara Van Allen

Good afternoon everyone. We have a large virtual audience as well. And so I want to be sure that everybody everywhere feels like we're getting off to a timely start. Welcome to the 677th meeting of The Economic Club of New York. I'm Barbara Van Allen, President and CEO of the Club. And it's an honor to be here with all of you today. It's our 115th anniversary, and we're going to celebrate that at an anniversary dinner next month. We will have John Williams actually moderating a panel of a number of our former chairs, so that will be an exciting event. Stay tuned for details.

We, as many of you know, are the nation's leading nonpartisan forum for discussions on economic, social, and political issues. We've had more than 1,000 prominent guests appear before the Club over the last century, and we're very proud of that tradition of excellence here. A special welcome to members of the ECNY 2022 Class of Fellows – a select group of diverse, rising, next-gen business thought leaders. They number 55 this year, and the application for 2023 is now online for those members that would like to sponsor a young, upwardly mobile member of their team. We also have students joining us from the CUNY Graduate Center as well as NYU's Stern School of Business. They're with us virtually today.

I'm honored to welcome our very special guest, President and CEO of the Federal Reserve Bank of Cleveland, Loretta Mester. Loretta participates in the formulation of U.S. monetary policy and oversees more than 1,000 employees in Cleveland, Cincinnati, and Pittsburgh, who conduct economic research, supervise banking institutions, and provide payment services to commercial banks and the United States government. She assumed her role as President and CEO in 2014.

Prior to being named President and CEO, she was Executive Vice President and Director of Research at the Federal Reserve Bank of Philadelphia, where she served as Chief Policy Advisor. She joined the Federal Reserve Bank of Philadelphia in 1985 as an economist, becoming Senior Vice President and Director of Research in 2000, and Executive Vice President and Director of Research in 2010.

Loretta is an Adjunct Professor of Finance at the Wharton School of the University of Pennsylvania. She has also taught in the undergraduate Finance and MBA programs at Wharton and in the PhD program in Finance at NYU. Her areas of research expertise and interest are many but include the organizational structure and productive efficiency of financial institutions, financial intermediation and regulation, agency problems in credit markets, credit card pricing, central bank governance, and inflation. She's published numerous articles in refereed academic and professional journals on a variety of topics, including economics, central banking, and financial intermediation and

regulation.

The format today will begin with an opening speech from Loretta followed by a conversation, which we're fortunate to have Pierre Yared doing the honors of moderating. Pierre is the Mitsubishi UFJ Trust and Banking Professor of International Business, Senior Vice Dean for Faculty Affairs and Vice Dean for Executive Education at Columbia Business School. His research has been published in leading academic journals. He focuses on macroeconomic policy and political economy. As a reminder, this conversation is on the record. We do have media in the room and plenty of it online as well. Loretta, I'd like to invite you to the podium to begin.

Opening Remarks by Loretta J. Mester

Well, thank you, Barbara, for that really nice introduction. And thanks, everybody, for being here. I really appreciate the invitation to speak at The Economic Club of New York, and I'm really looking forward to the dialogue. I learn a lot by hearing what is on people's minds and it helps me think about the economy.

I guess it's no surprise I'm going to talk about inflation. And I'm going to talk about how monetary policymakers are going to persevere in fostering price stability, the return to price stability and, of course, the views I present will be my own views and not

necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.

Unacceptably high and persistent inflation remains the key challenge facing the U.S. economy. Inflation has been running well above 2% for almost a year and a half, and the risks to inflation forecasts are skewed to the upside. Everyone is feeling the brunt of high inflation. It's imposing a particularly onerous burden on those households and businesses that don't have the wherewithal to pay more for essentials like food, gasoline, and shelter. And lower-income households spend a higher proportion of their income on these essentials, and these components have had some of the strongest price increases. We have essentially moved from a situation in which households and businesses could be rationally inattentive to inflation to one in which inflation is on everyone's mind, with lower-income households having to make hard choices about how to spend their money to make ends meet.

Now, price stability is the foundation of a strong economy. It is necessary for ensuring that the U.S. can sustain healthy markets over the medium and longer run and that the economy can be productive and live up to its potential for everyone's benefit. Without price stability, businesses and households have to divert attention to trying to preserve the purchasing power of their money, and it becomes more difficult to plan for the future and to make long-term commitments and investments. Hence, high inflation can have

negative long-run implications for an economy's potential growth rate and standard of living.

The FOMC is strongly committed to using its tools to return the economy to price stability and it will persevere to make this happen. We're taking decisive action to remove monetary policy accommodation to bring demand into better balance with constrained supply in both product and labor markets. Since March, the FOMC has reduced monetary policy accommodation by raising the target range of the fed funds rate by 3 percentage points and by reducing assets the Fed is holding on its balance sheet.

Given the current level of inflation, it's broad-based nature, and its persistence, I believe monetary policy will need to become more restrictive in order to put inflation on a sustainable downward path to 2%. Given appropriately restrictive financial conditions, my modal outlook is that inflation will move down appreciably next year to about 3 ½%, and continue to decline, reaching our 2% goal in 2025. I anticipate that the return to price stability will entail a period of output growth that is well below trend over the next two years. This below-trend growth will lead to slower employment growth with the unemployment rate moving up to 4 ½% by the end of next year and a bit more in 2024.

We are likely to experience higher-than-normal levels of financial market volatility as

well. At this point, indices constructed by the St. Louis Fed and the Kansas City Fed point to low levels of financial stress, but we will need to remain particularly attentive to financial vulnerabilities. With growth well below trend over the next couple of years, it is possible that a shock could push the U.S. economy into recession for a time. None of this is painless, but the high inflation we're experiencing is already inflicting pain on many people. The necessary costs incurred now for the economy to transition back to price stability are much lower than the costs borne later were inflation to become embedded in the economy, influencing wage- and price-setting behavior, investment decisions, and longer-term productivity growth. Perhaps Paul Volcker said it best as he fought inflation in the 1980s, "failure to carry through now in the fight on inflation will only make any subsequent effort more difficult, at much greater risk to the economy."

Now, the inflation we're experiencing today stems from many factors, but fundamentally it reflects an imbalance between strong demand and constrained supply, which has led to significant upward pressures on prices. Indeed, both aggregate demand and aggregate supply were affected by the pandemic and by the responses of households, businesses, and policymakers to it. Mandated shutdowns and the voluntary pullback in demand for high-contact services led to a shift in spending early in the pandemic from services to goods. When the economy reopened, demand surged. This strong demand was supported by the extraordinary level of fiscal transfers and accommodative monetary policy applied during the height of the pandemic.

Economic growth is now slowing down from last year's robust 5-3/4% pace. Indeed, the level of real GDP decreased in the first half of this year, but current estimates suggest that it did resume rising in the second half. Activity is slowing partly in response to the monetary policy actions taken this year, which have led to tighter overall financial conditions. This is most easily seen in the housing market. Housing demand increased during the pandemic as housing preferences shifted. Housing supply, which was already somewhat constrained before the pandemic, could not keep up with increased demand and house prices rose.

This year, housing market activity has slowed appreciably as mortgage rates have risen 3½ percentage points since the start of the year. Housing starts and sales have moved down. Now, house price inflation is beginning to ease but the year-over-year increase in house prices is still in double digits and well above pre-pandemic levels. Growth in rents also remains high.

In addition to tighter financial conditions, the slowdown in economic activity more broadly reflects how households and businesses are responding to very high inflation and their concerns about the economic outlook, to the waning effects of the pandemic fiscal stimulus, and to slower growth abroad. Both consumer spending and business investment have decelerated from the robust pace seen last year, and as the effects of the pandemic have waned, consumption has begun to shift from goods to services.

The supply side of the economy remains constrained relative to demand. There are signs that supply chain bottlenecks, which have stemmed from pandemic-related shutdowns across the globe and the war in Ukraine, have begun to ease. Our business contacts tell us that supply chain disruptions remain a challenge but over time they have learned to navigate through them more effectively. They report that the larger factor holding back production now is the lack of available workers.

So we are seeing some signs of moderation in the labor market, but overall conditions remain very strong and labor demand is still outpacing labor supply. Now it is true that the number of job openings has fallen this year, but there's still 1.7 openings per unemployed person. And if you go back to 2019, another time of tight labor markets, there were about 1.2 openings per unemployed worker.

Last year, job gains averaged over 550 thousand per month. This year, through September, job gains have eased to an average of 420 thousand per month. But that's still very strong job growth by historical standards. The unemployment rate is lower now than it was at the start of the year, and at 3.5% is at a 50-year low. The participation rate of prime-age workers has returned to where would expect it to be based on demographics. Now many people chose to retire during the pandemic and left the labor force, so the overall participation rate, which includes those of retirement age, has risen only gradually. A continued rise in participation would be helpful in easing the imbalance

between labor demand and supply. But typically most people who have retired and have begun to receive Social Security payments don't return to the job market. So I don't expect to get much help from the retirees returning, and I don't expect to get much help from immigration either. Net migration has been declining since the late 1990s.

So it is unlikely, it seems likely to me that much of the rebalancing will need to come on the labor demand side. This could occur mainly through firms reducing the number of workers they are seeking rather than through layoffs. Indeed, many of the employers that we've talked to have told us that because it's been so hard to attract and retain workers over the past two years, that they're going to strive to keep them on their payrolls even if demand for their products slows down. And that would result in a smaller rise in the unemployment rate than has been seen in other economic slowdowns.

Now that imbalance between labor demand and supply has put upward pressure on wages. The employment cost index for private industry workers accelerated over the six months ending in June, rising at a 6% annual pace. And if you squint, more recent reports suggest that wage pressures may be starting to stabilize. For example, average hourly earnings rose at about a 4½% annual pace in the three months ending in September, compared to a little over 4-3/4% in 2021. With trend productivity growth estimated to be around 1-1/4% to 1½%, nominal wage growth will need to moderate to

around 3-1/4% to 3 ½% to be consistent with price stability.

Even with the moderation in nominal wage growth that will occur as the economy returns to price stability, workers will be better off. In real terms, workers have been losing ground because wage increases have not kept up with inflation. Indeed, since April of last year, wages adjusted for inflation have been declining. If real wages continue to decline, it's going to be difficult to attract people back to the workforce, exacerbating the imbalance in the labor market.

Now despite some moderation on the demand side of the economy and nascent signs of improvement in supply side conditions, there's been no progress on inflation. Inflation readings have persisted at the highest levels in 40 years. Measured year-over-year, in August, PCE inflation was still running over 6% and CPI inflation was over 8%. The core measures, which omit food and energy prices, and the median and trimmed-mean measures, which exclude components with the most extreme movements each month, tell a similar story of broad-based, persistently high inflation.

Now, I want to note that we look at those measures not because food and energy prices or the prices of volatile components, such as apparel, are not important parts of a household's consumption basket. Indeed, if you look at the target of what we're trying to do in bringing back price stability, the Fed's target is in terms of total PCE inflation,

which includes all the components. But we look at those alternative measures because they can give us a better sense of where inflation is likely going. Measured year-over-year, these underlying inflation measures all moved up in August. The month-to-month changes in the inflation measures have shown no real decline, so we cannot even say inflation has peaked yet, let alone that it's on a sustainable downward path to 2%. Given developments related to the ongoing war in Ukraine, gas and energy prices may move higher again later this year. In addition, services inflation, which tends to be persistent, is at its highest level since the early 1990s, with growth in housing rent and shelter costs likely to keep inflation elevated for some time.

In my view, even with appropriate monetary policy actions, given inflation dynamics, it will take a couple of years before inflation returns to the Fed's 2% goal. But I do expect to see meaningful progress over the next year as output growth and employment growth slow and there is some improvement in supply side conditions. A key factor in this outlook is that medium- and longer-term inflation expectations remain anchored at levels consistent with our 2% goal despite current and high inflation readings. This anchoring should help to bring inflation back to our goal without as large a change in the output gap. It's the job of monetary policymakers to ensure that inflation expectations remain well anchored.

Now, in making its monetary policy decisions, the FOMC is always guided by its strong

commitment to achieving its congressionally mandated goals of price stability and maximum employment. And as always, we're calibrating our monetary policy based on the implications of incoming information for the economic outlook and on the progress toward our monetary policy goals.

Monetary policy acts with a lag on the economy so we need to be forward looking. It is unlikely that we've seen the full effects on households and businesses of the latest rate increases we have implemented and it would not be appropriate to continue moving rates up until inflation is back down to 2%. But it's also the case that based on Fed communications, financial conditions began to tighten well before our first rate increase in March and those effects have been passing through to the economy. Yet high inflation persists, an indication that we need to increase rates further.

In order to put inflation on a sustained downward trajectory to 2%, policy will need to move into a restrictive stance. That means that short-term interest rates adjusted for expected inflation, that is, real interest rates, will need to move into positive territory and remain there for some time. Although we've raised the nominal fed funds rate by 300 basis points, policy is not yet restrictive. The median projection for the longer-run nominal fed funds rate in the September Summary of Economic Projections of FOMC participants is 2.5%, which happens to be my own estimate as well.

This means that if inflation were 2%, and inflation expectations were well anchored at levels consistent with that goal, a real fed funds rate of half of a percent would be neutral in the sense of neither stimulating nor restraining economic activity. But that's an important "if." Currently, inflation and shorter-term inflation expectations are well above 2%. So if we adjust the current nominal fed funds rate by the SEP median projection for inflation next year, which is 2.8%, policy is still a tad accommodative. Further funds rate increases are needed to get policy into a restrictive stance, and the median fed funds rate path in the SEP has rates moving up to 4.4% by the end of this year and to 4.6% next year.

Now, because I see some more persistence in inflation than the median SEP projection, the funds rate path I submitted for the September SEP was a tad higher over the next year than the median path, and I don't anticipate any cuts in the funds rate target range next year. But I want to emphasize that that's based on my current reading of the economy and outlook, and I will adjust my views as warranted based on the implications of incoming economic and financial information for the outlook and risks around the outlook.

Now, while it's clear that the funds rate needs to move up from the current level, the size of rate increases at any particular FOMC meeting and the peak fed funds rate will depend on the inflation outlook, which depends on the assessment of how rapidly

aggregate demand and supply are coming back into better balance and price pressures are being reduced. Given lags in the data, the reconnaissance we receive from our contacts about what is happening on the ground in real-time will be particularly important in assessing the effects of the cumulative tightening on the economy. Now making this assessment will be challenging because both the demand side and the supply sides of the U.S. economy will continue to be affected by a variety of factors. And those include economic and policy developments in the rest of the world, which can affect the U.S. economy through trade and financial market channels.

So we're going to be operating in an uncertain environment for some time. High uncertainty is usually associated with being cautious and being cautious is often associated with acting inertially. But in the current environment of high and persistent inflation, a risk management, robust control approach counsels that being cautious does not mean doing less. Instead, it means being very careful to not allow wishful thinking to substitute for compelling evidence, leading one to prematurely declare victory over inflation and pause or reverse rate increases too soon. It means not being complacent that inflation expectations will remain well anchored in this high inflation environment but taking appropriate actions to keep them anchored.

Now it's been very helpful that medium- and longer-term inflation expectations have moved up less than short-run expectations. They are below current inflation readings,

an indication that the public believes that inflation will move back down. Yet the recent declines in medium- and longer-term expectations occurred as gasoline prices declined. And I think the jury is still out about whether those readings will rise again if gasoline prices move back up. In addition, every month that inflation remains highly elevated raises the chance that inflation expectations will become unanchored and that firms and households will begin to make decisions based on persistently high inflation. If that were to happen, returning to price stability would be more difficult and much more costly in terms of lost output and higher unemployment.

So even if one doesn't think an un-anchoring of inflation expectations is the most likely scenario, the costs of being wrong are high given the current state of the economy. So the robust control approach encourages strong action to keep expectations anchored to prevent that worst-case outcome from actually occurring. In my view, in the current environment, being cautious means that the FOMC should persevere in taking policy actions to return the economy to price stability.

So, in summary, inflation remains very elevated and is placing a large burden on households and businesses. The FOMC is committed to taking appropriate action to tighten financial conditions by raising the fed funds rate and continuing to reduce the assets on the Fed's balance sheet in order to return the economy to price stability. Monetary policy is moving into restrictive territory and will need to be there for some

time in order to put inflation on a sustained downward path to our 2% goal. We're going to be looking at a variety of incoming data and collecting economic and financial information from our business, labor market, and community contacts to help guide our policy decisions.

Now, as is always the case when we're transitioning monetary policy, we will need to continue to weigh the risks of tightening too much against the risks of tightening too little. Given current economic conditions and the outlook, in my view, at this point, the larger risks come from tightening too little and allowing very high inflation to persist and become embedded in the economy. But as the effects of tighter policy work through the broader economy, I expect my view of the balance of these risks will shift, and I'm actually looking forward to that time because it will mean that we've made meaningful progress on the transition back to price stability. Thank you for listening.

Conversation with Loretta J. Mester

PIERRE YARED: Thank you very much for these very interesting comments. I wanted to ask, you spoke about tracking the economy and trying to figure out when the policies have had their impact. In thinking about that, how do you weigh inflation indicators versus employment indicators and which ones do you think come first? Could we be potentially living in a world where inflation is still very high, unemployment is rising, and we're continuing to see rates go up? How do you see that sequencing?

LORETTA J. MESTER: Well, we have a dual mandate and so inflation and maximum employment, and those are really our guiding forces here, that we're going to look at those. We've been in an environment and we continue to be in an environment where labor market conditions are strong. And so with inflation at the high level it's been, the broad-based nature of it, that it's become, that's really where the focus has been. Now eventually when we start seeing inflation moving back down, those kinds of tradeoff decisions will come into play, and we'll use a variety of information, including what we get from our business contacts and labor market contacts and community contacts to really help tell us, you know, what's happening in real-time that gives us a better view of what's happening going forward.

But at the moment, in my view, it's still the inflation as being the predominant thing that we have to get under control. And I don't really see it as a tradeoff at this moment because if we don't get back to price stability, we're not going to really have strong labor markets going forward. So that's sort of job one here at this point. But you're right, it's eventually when we start seeing inflation come back down, we'll have to use a variety of information to guide us in that, you know, making sure that we're calibrating back and meeting both parts of our mandate.

PIERRE YARED: Great. So one thing that's been on everybody's mind is what's happening in the U.K. as well as there's discussions about liquidity issues in the

Treasury market. Can you imagine a world where the Fed intervenes for liquidity purposes while continuing to increase rates? And how does that work? Does the policy remain consistent, if it's tightening on one end but then providing relief on the other end?

LORETTA J. MESTER: Well, I think the Bank of England has been very careful about explaining that what they're doing in intervening is really a financial stability issue and not a monetary policy issue. In some sense, we intervened, remember back to the beginning of the pandemic, we intervened, right? Because the financial markets and, in particular, that very important, globally important Treasury market had liquidity issues and the Fed did intervene and purchased a lot of Treasuries to make sure that the markets stayed functioning because we can't expect monetary policy to transmit through the economy if the markets aren't functioning. So you do have to take into account what's happening in the financial markets and making sure that there's orderly financial markets in order to have monetary policy transition through.

Of course, at the time, at the beginning of the pandemic, we didn't have the tradeoff that you're pointing to now, right? We bought a lot of assets first because of financial stability issues and market functioning issues. And then because we needed to really bring down and add a lot of accommodation from the monetary policy point of view, because remember back at the beginning of the pandemic, there were very dire scenarios. We

bought assets and continued to buy assets, both MBS and Treasuries, because of the monetary policy. So we didn't face the conflict between the two that you pointed out that is now in the U.K. And that's a case where communications are going to have to be clear about why we're doing, why they're doing what they're doing. I think they've been very clear so far. But I think it is hard to, you know, that's going to just have to be a focus, just making sure there's clear communications around it.

PIERRE YARED: So relatedly, how concerned are you about the dollar? And could you imagine a dollar shortage globally and restarting some of those swap lines while the rates are also rising? So it's related to liquidity provision while in a rising interest rate world.

LORETTA J. MESTER: Well, again, you know, we, at the Fed, monitor financial conditions broadly. And there's a number of, you know, when we're focusing, we're focused on the domestic economy in terms of our monetary policy. But again, the financial markets have to be orderly functioning, well-functioning markets in order to have monetary policy transition through.

So we certainly are aware of and monitor what's happening in terms of the financial markets around the world, and we monitor conditions like the value of the dollar because it has implications for the U.S. economy, right? Through trade channels and

then there's financial market channels. In terms of what we focus on, though, it's the domestic economy and so we monitor those because there are linkages between the U.S. economy and the global economy. Just think about the supply chain issues, right? You know, the lockdowns in China affected our economy because China is such a major supplier of goods to the U.S. economy, in parts and all that. So again, we have to be very aware of what's happening in the global economy because it has effects and spillovers to the U.S. economy.

PIERRE YARED: Great. Thank you. You mentioned your long-term forecast for the eventual place for the fed funds rate, and I was wondering what you think about R-star, you know, the neutral rate, and do you see that potentially rising given the globalization and other longer-term trends?

LORETTA J. MESTER: I mean that's a great question and that was certainly one of the presentations at Jackson Hole about, you know, will we go back to the lower R-star world, pre-pandemic, or will there be some permanent shift up? And, of course, a number of factors affect R-star. I think the biggest uncertainty right now, given the pandemic, is what's going to happen to productivity growth, which will have an implication for R-star? And perhaps there's a little more willingness for debt levels and fiscal policy levels to be higher than they were before, which would be upward. But then all the other factors that were affecting pre-pandemic that were keeping R-star low are

going to probably be back in place. Demographics, we're still aging in terms of many countries in the world have aging populations and that will be a downward pressure.

So I don't think we know yet. I have not changed my long-run fed funds rate, and if you look at the SEP, you know, that's been basically at 2 ½%. But I do think that's an interesting question about where things will settle down. But in the time frame that we're talking about now, I don't think those issues are going to be paramount. I think we've just got to keep going where we're going and get inflation back down.

PIERRE YARED: Great. Maybe one more question and then we'll open it up. So I've been curious about what you think about the role of forward guidance in this rising rate environment. It sort of makes sense in that when interest rates are stuck at zero, use forward guidance to let everybody know how long they're going to be stuck at zero. How do you see the role of forward guidance when you're increasing rates?

LORETTA J. MESTER: So that's a great question, and I care a lot about Fed communications, and I think of forward guidance in two ways. Sometimes it's a tool of policy. So you're exactly right. If you brought interest rates down to zero and you want to be more accommodative, forward guidance can be a very good help, right, to try to add more accommodation.

When you're in a different environment, not at the zero bound or when you're increasing, I think of the communications as being not necessarily just what I call forward guidance as a policy tool. It's really trying to explain the rationale for your policy decisions and so that people understand how are you thinking about the economy. What's your outlook? And what does that imply about monetary policy? And I think it's particularly important that we explain what our reaction function is.

So I'm going to say something that may be controversial, but the Fed, and certainly I, am not prescient. I can't see everything, everything into the future. Right? But what I hope I can do is explain if the economy turns out this way, this is how I see policy moving. And if the economy, you know, these kinds of factors happen, this is how I see policy being calibrated to those events so that people kind of have a sense of where policy is going.

I think the Summary of Economic Projections does a pretty good job of explaining where people on the FOMC are thinking about where the economy is and where it's going. But the trick is, is that people sometimes focus in on that as being a commitment. We're committed to doing that. And that's not what it is. It's really an explanation of this is the way we see the economy right now. This would be the policy path consistent with this set of forecasts and, you know, if things change and the economy turns out to be different than we anticipated, we're going to have to re-calibrate policy if we're going to

hit our goals. And so it's always driven by that. What are the goals that you're trying to achieve? Where is the economy now? Where do you think it's going? What policy is the right policy in that environment? So it's a little tricky. Communications are not always easy.

PIERRE YARED: I know I said last question, but actually I have one more. As we were speaking earlier about the fact that you're looking at different indicators for expectations of inflation and we talked about variation across households, maybe you could give us your insights in terms of what are you tracking and thinking about whether inflation is anchored? What are some potential concerns for you in thinking about that issue?

LORETTA J. MESTER: So I like to look at a variety of different measures of inflation. There's measures that we do at the Cleveland Fed. We have a new measure called the indirect consumer inflation expectations, which frames the question not asking a consumer where do you think inflation is, but really says how much would your income have to go up so that you can afford the same basket of goods that you usually buy? And that kind of is the question that most people can answer. So there's various measures that I look at. I like the survey measures. In particular when financial markets are volatile, it's harder to extract inflation expectations out of the financial market data because there's differences in risk premium and term premium that move around quite a bit, so that extraction, but I like to look at those as well.

So right now my concern, I mean we are in an environment where longer-term and medium-term inflation expectations appear to be anchored. And that's a great thing. That's going to help us get back to 2% inflation. However, I don't think we can be sanguine about that. I think we have to be very much looking at, you know, how they moved around, and we did see them move up earlier. They've moved down in recent readings, which is great, except that they also moved down when gasoline prices moved down. So in theory, they're not supposed to be related to gasoline prices. Only the short-run expectations are, but, you know, that coincident gives me pause. It makes me want to look at it.

We've seen the disparity across survey participants grow. So there's a weight of the distribution. There are some people who think that inflation is going to be much higher than the median or consistent with 2%. And most recently, there's been a large cohort, or a larger cohort at the bottom that thinks that inflation could be much lower than consistent with 2%. My read of that is there's a group of people answering the survey who think that the economy is going to really be in bad shape and that we may get into a very disinflationary environment because everything is going to slow down. So when you see those kinds of differences across survey participants, I think it does behoove you to not take for granted that inflation expectations will necessarily stay anchored. And it's our job as policymakers to make sure that we set policy to keep them well anchored.

PIERRE YARED: Great. Thank you. I think we can open it up to questions. Yes...

QUESTION: Krishna Guha from Evercore Partners. Loretta, it's great to see you. Thanks so much for your discussion. I wanted to zero in on the distinction between the peak rate that we're heading towards, the sufficiently restrictive rates to bring inflation down, and the speed with which we try to get there, the pace of rate increases. So to this point, the Committee has moved very rapidly and there's an expectation, as you know, in markets that there'll be another super-sized rate increase at the next meeting. Moving very rapidly potentially has a couple of drawbacks once you move into restrictive terrain. The first is that you can outrun your ability to learn from the data given the time lags you talked about. The second is that the speed of tightening as well as the level of rates can stress the system, including internationally, increasing the risk of blowups elsewhere in the world as well as in the U.K. So why not head for the same rate but move a little bit more slowly?

LORETTA J. MESTER: I mean that's a tradeoff that you have to make. I look at the inflation data and its persistence and it concerns me. And my concerns are that if we delay we will have the inflation become embedded in the economy. We also, you know, we talked to a lot of people in the district, and inflation is just, it's on everyone's mind now. Businesses are having to make choices about how they're setting wages, how they're setting their prices because of the inflation that we're seeing.

So eventually we'll get to the point where I think you're suggesting, which is, okay, we're going to need to now let's pause, let's maybe go slower, whatever, however it plays out, so that we can see that cumulative impact of what we've done so far. But right now, my view is that inflation is way too high. The risks of it becoming embedded are still quite high and therefore I'd rather get farther along on this journey that we're taking with the funds rate to get it into restrictive territory. Right now, because of the level of inflation and even if you think forward looking, so take a one-year out inflation rate, we're just barely at neutral. I think, you know, my calculation, we're a little bit still, a little accommodative.

So in that sense, even though we've raised the funds rate pretty aggressively, I don't think it's aggressive relative to where inflation is and how fast inflation has moved up and its persistence. But eventually we will get to the point where, okay, now we're starting to see inflation move down a little bit, we think it's peaked and it's moving back down, we will get to that point where we can go slower to the peak or, you know, take some time to look at the effects of that cumulative tightening on demand. And then hopefully supply will adjust in a good way as well and that will help us get back to 2%. So it's a discussion we will have. I just don't think this is the moment.

QUESTION: Anita Wein, Observatory Group. One area that was immediately impacted by the higher rates was the housing area. Mortgage rates shot up to a point where it's

prohibitive for many people to go forward. I wonder if you could assess the impact on the industry of the increase in rates and the probability of higher mortgage rates.

LORETTA J. MESTER: Well, I mean you're right. The initial impact of the rate increases that we put in place are seen in interest rate-sensitive sectors and, of course, the mortgage housing market is where that impact is being felt most obviously. And we've seen a trend down in terms of both housing starts and the activity in the housing market, in sales. So you're exactly right that we have seen some contracts not go through because of the increase in interest rates. And I think that, you know, as we get closer to, as interest rates keep moving up, we will see some further impact on the housing market. That said, broadly defined, the banking system is in pretty good health. We have to be concerned about community banks and other banks that have mortgage assets on their balance sheets in terms of financial stability but right now I don't see that as an issue.

Again, these are the tradeoffs you have to make, right? Yes, the people who are not able to afford, go in and buy a house also are being affected by the high rent rates that we're seeing. So again, there are tradeoffs. Different people are going to be affected differently. But right now there are a lot of people being adversely affected by the high inflation rates, which is, you know, part of why it's very important that we get back to price stability.

QUESTION: ____. With the benefit of hindsight, do you believe that quantitative easing is an aggressive policy to the extent to which it benefits the wealthy more than the average person? And if so, do you think it's had anything to do with some of the political changes that we've seen in the country?

LORETTA J. MESTER: Well, that's a broad question, isn't it? So if you step back and just ask does monetary policy affect different parts of the economy differently, you'd have to say yes. Right? And I think that's true of the QE part of policy, but it's always been true with traditional monetary policy. Interest rates, right? It affects borrowers and savers differently. And that's just the mechanism through which it gets through to the main economy.

But you have to look at yourself and say, well, would it be better not to do those things and have the economy go into a deep recession? I mean the QE was necessary at the time when you think back, the first QE programs. We were going to be in a very bad situation if we didn't make things more accommodative. And that was the mechanism through which we did it. So that doesn't trouble me. I think the lessons are that you have to be very attuned to what impacts does it have on the broader financial markets if you don't have a plan to exit QE. I think that's been the struggle on both cases is sort of how you're exiting to make sure you're doing it.

I think we learned a lot from the first time and this time we were very, I think, very communicative early on about what the plan was for the balance sheet. But yet, maybe we held too long to the old plan and said we're going to only start exiting QE when interest rates go up first. Maybe it would have been better not to do that. Maybe it would have been better to stop the asset purchases sooner and before we rose rates. But again, every situation we learned from. And that's just me in thinking about sort of what could we have done differently in this. So I think about it that way and those are the lessons that we take forward with us.

QUESTION: Where do you see the long-term size of the balance sheet?

LORETTA J. MESTER: Well, we're way above where it needs to go to long term. But I can't really give you an answer in terms of exactly where it will be because it's really going to depend on the demand for reserves. Right? I mean we know that if you go look at the New York Fed and the Board of Governors, we have some papers that actually show sort of some simulations on where it probably will get to. And it's like, if we stick to the plan that we're doing and there's no reason to think we won't, it'll take a couple of years to get down there. But it'll be much lower than it was before. But remember, it's going to start rising again just because demand for assets goes up. Cash goes up, etc. So we're way above it. We're going to do the plan. In a couple of years, we'll get it down and then the balance sheet will be able to rise again.

QUESTION: Colin Teichholtz from Element Capital. Earlier you said something that you described as controversial, I think, that you can't predict the future, or it's hard to predict the future. When I think back to some prior policy regimes, I think there was, if not predicting the future, a lot of modeling of the future and modeling of where inflation was likely to go. And then as we moved, even prior to this inflationary period, moved into the FAIT regime, it seemed like the Fed was beginning to move away from that. And, you know, there's obviously been a lot of challenges, I think, both on the public and private side in trying to model the inflation that's occurred over the last 18 months.

I'm curious how you take all of that into account when you're thinking about policy on a forward basis and trying to make that judgment about having maybe, you know, looking at your own forecast and the SEP and inflation, you know, ideally at least drifting down for a few months? And depending on where rates are, that could be an appropriate time to stop. To what extent are you making some leap of faith or modeling or predicting of the future to do that?

LORETTA J. MESTER: So I am a fan of models. I didn't mean to mean that I'm not a fan of models, but I'm a fan of looking at multiple models. I think sometimes people have a model in their head and that's the model they use and they base everything on that. And what we've seen is, of course, that sometimes the model is wrong. It doesn't conform with the reality. So I like model averaging, so I look at a variety of models. My

staff maintains models, nowcasts of inflation which are informative, but we also have structural models that help us model out what's going on. But I also like doing scenario analyses, you know, like okay if you're model is wrong, what are some other scenarios that can happen? And what would that imply about where your policy path will be?

And that was particularly important, I think, during the pandemic, early parts of the pandemic because for one thing our models were trained on data from very different circumstances, right? We hadn't seen the pandemic, right? So you had to realize that you might have a good model that works in other times but it wasn't trained on data that was anything consistent with what we were going through.

And the second important thing was there were a lot of different ways that the pandemic, that epidemiologists had for how the pandemic could play out. Well, I'm not an epidemiologist. I don't play one on TV. I have to take as given sort of scenarios, right? Well, if it played out this way, what did that mean for the economy? And then what would that mean for policy? And so it was particularly relevant there to look at varieties of scenarios for the health part of the economy and then think about, okay, what's its implications for economics, right?, the macroeconomy, and then inform your policy decisions.

So I think models can be really helpful but you have to expand your horizon and look at

varieties of different kinds of models that might give you similar answers or might give you sort of different answers. And just be prepared as the data comes in to always be checking the assumptions that your models are based on to see, okay, maybe this model isn't very good anymore for these circumstances. I'm going to shift a little more weight to that model.

QUESTION: Maybe I can ask a follow up on that relating to the question. How do you think average inflation targeting, the new framework, has impacted the Fed in the sense that it's done something different over the last year and a half than it would have without that framework?

LORETTA J. MESTER: Yes, that's a great question. I'm sure there's going to be PhD students writing, your students are going to be writing dissertations about this. So honestly I thought of a lot of what new framework is basically codifying the way the Fed was actually behaving in sort of post-financial crisis honestly. I didn't see it as a major change. What I do think, though, is our forward guidance that we had after we put out, was affected by, and I'm not sure that that was, the forward guidance was that helpful at that point. That forward guidance might have been something that we should have done a little bit differently. So in that sense, it affected things. But I don't think the actual actions that we took were affected by that.

QUESTION: William Shikani, Squarepoint Capital. So one of the things that I would say is that we've been the beneficiary for some time, over the past decade, of substantial investments, especially domestically, in energy production, but also globally in metals as well. Moving more forward, there's substantial concerns on ESG, investment in this space, the capital markets treating these terminal assets as near zero value and wanting cash flow today. How do you see everything moving forward in terms of if we have structurally higher energy and metals prices going into all these baskets of everything that we consume?

LORETTA J. MESTER: Well, I mean that's a big "if", right? We don't know what the path forward is going to be. I'm hoping that we get a good transition path to an energy world where we can do both things. We can have a path that gets us to a climate-responsible energy policy. But what you're talking about, I think, is a level change, right? It's basically a shift up in the prices, right? So from the point of view of an inflation shock, that wouldn't be an inflation shock. That would be a relative price shock. So I would think about that differently.

PIERRE YARED: I think this will be the last question.

QUESTION: Joe McLaughlin from the Haverford Trust Company. If higher rates push us into a recession, I think I heard you say that that would be short-lived. And I'm

wondering what are the ingredients that make you feel that way?

LORETTA J. MESTER: So my modal forecast is that we aren't going to get into a recession, but I do have a low sub-trend growth rate. And so external shocks could push us into a recession. We have strong labor markets and we have, actually if you step back and look at the economy, it's doing okay. I mean, you know, we have seen a shift down from that 5-3/4% growth rate from last year and now, we're, you know, we had a reduction, negative growth in the first half. That feels bad. Like there's no doubt about it. But if you actually go under the hood, 5-3/4% is not anywhere near trend. It's well above trend, right? So that's not sustainable. So the underlying pinnings of the economy are actually still good. The transition is painful.

And so I don't think that we're going to get into a deep recession from this but we have to be cognizant of the fact that with growth as low as it's probably going to be, we are going to see some possibility of a recession. We have to take into account there are recession risks. But again, if you talk to businesses, and this is the thing that's been striking the whole time, so we talk to a lot of different kinds of businesses in all different sectors. And, you know, when people started becoming more pessimistic about the economy, they would say, oh, I'm getting a little more nervous about the outlook for next year. You would say, well, what are you seeing in your business? Oh, our business is great. Our book of business is great. No problem. I have a struggle; I could hire more

people if I could just find them.

So there's this disconnect between the sentiment part and actually if you talk to businesses what they're saying. I'm not trying to undermine the struggles they've had. It's been incredibly difficult; the supply chain issues and the labor market issues have been. But I think sometimes we underestimate the resiliency of the U.S. economy. And so, you know, if you think back to the beginning of the pandemic, there were some very, very, very dire forecasts out there of what could happen. And yet, right, we did get through this. And so I'm kind of optimistic that there is still a lot of momentum in the economy and strength in the economy. We see it certainly in the labor market still. And then that basically limits some of the downside.

PRESIDENT BARBARA VAN ALLEN: Thank you both. That was really fantastic. I'm going to just quickly run through some of the upcoming events. And we do have Ruth Browne, the President and CEO of the Ronald McDonald House, joining us virtually for our DEI Series, October 13th. Charlie Cook is going to come up from Washington and do an interview again with Bob Rubin, the Former Secretary of the Treasury, for us in person, October 18th. Lee Zeldin, Congressman Zeldin, who is also a candidate for Governor of New York, is going to join us for our New York City Series on the 26th. That will be a webinar. And we hope to announce a date for Governor Hochul to join us as well in the coming weeks. Sebastian Mallaby, the author of *The Power Law: Venture*

Capital and the Making of the New Future, and a Paul Volcker Senior Fellow for International Economics, is going to join us virtually October 27th. His new book, by the way, is a finalist for the *Financial Times* series. And General Mark Milley will be joining us, the U.S. Chair of the Joint Chiefs, for a luncheon on November 9th. On November 10th, we have a webinar with James Runcie, the CEO of the Partnership for Economic Education. We also have a date change for Steve Squeri, the CEO of American Express. He's going to join us November 10th as well. We have our 115th Anniversary, November 14th. I already talked about that a little bit. Later in November, actually on the 17th, we're going to host Arvind Krishna, the CEO of IBM. And then our very own Club Chair, John Williams, is going to join us for a webinar on November 28th followed by Mike Wirth, the CEO of Chevron, for a luncheon December 1st. And then we have The Honorable Marcia Fudge for a luncheon December 7th. And then we wrap up with an end-of-the-year dinner with Senator Joe Manchin on December 8th. So, as always, please keep track of our website as we do add to our calendar regularly.

Thank you all for attending today. Thank you, Loretta. Thank you, Pierre. That was just a great conversation. For those that are joining us virtually, we'll see you later. And for those here in the room, please enjoy your lunch. Thank you.