FEDERAL RESERVE BANK of ST. LOUIS

Unofficial Transcript:

St. Louis Fed President and CEO Alberto Musalem's Remarks at the Shadow Open Market Committee Meeting

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Alberto Musalem: Good afternoon, everyone. I would like to thank the Shadow Open Market Committee, and especially Jim Bullard, for the invitation to address you today. This committee has produced critical commentary on monetary policy analysis for more than 50 years, and I've been really looking forward to speaking with you. Can you hear me OK?

OK, I will begin with a few remarks on economic conditions and conclude with some comments on monetary policy. I'll then put on my catcher's mask to field some questions from Jeff Lacker. I'm hoping for softballs, but I'm expecting fastballs and some curves! Let me state at the outset that these are my remarks and my views and do not reflect or represent those my FOMC colleagues.

To get right to the point, I'll summarize my main four messages.

Persistent demand forces have kept the U.S. economy growing at or above potential despite a series of negative supply shocks. The labor market is stable and balanced around full employment. Looking ahead, I perceive risks around economic growth and the labor market to be symmetric.

Inflation is too high, exceeding the FOMC's 2% target. I perceive inflation risks as skewed towards persistent above-target inflation.

I focus on economic scenarios over an 18-month horizon, which I view as the appropriate time frame for monetary policy to have an effect. I'll discuss two plausible inflation scenarios. Under one scenario, which I view as the more likely, inflation persists meaningfully above 2% absent further removal of monetary policy accommodation. Under a second scenario, less likely but still plausible scenario, inflation recedes and converges to 2% in 18 months without any further lessening of monetary policy accommodation. Such a scenario could unfold for a variety of reasons, as I will discuss.

I judge that additional firming of monetary policy will be necessary, and soon. Incremental adjustments made earlier are usually less disruptive than larger and abrupt actions taken later. Moving sooner in smaller steps while inflation expectations are anchored has a better chance of succeeding without adverse impact on the labor market or economic growth.

I will now elaborate on these points.

The U.S. economy has been resilient. Real GDP is growing at a strong pace, close to or exceeding potential. Third-quarter data confirm the underlying strength of the U.S. economy. Consumer spending is strong and showing no signs of slowing, while the data center buildout is powering double-digit growth in nonresidential fixed investment.

Several tailwinds are supporting economic activity. I am optimistic that real GDP will continue to grow at or above potential for the foreseeable future. The AI-driven boom in capital expenditures and wealth effects-driven consumption spending might slow from their current pace but are likely to remain a tailwind for some time. Corporate earnings have been strong — unusually so for this stage in the business cycle. Fiscal policy is continuing to support economic activity, as is deregulation, most notably in energy and the financial sectors.

I believe that monetary policy and financial conditions remain accommodative. Financial conditions tightened recently, both in anticipation and as a result of our September policy action, and markets have become more selective in allocating capital. Credit spreads in cyclical sectors and for high-yield borrowers have widened, especially for those involved in the AI infrastructure build. Total net new financing of the economy by banks and capital markets has moderated but remains healthy, and bank financing has strengthened as capital markets activity has slowed.

On balance, the recent tightening of financial conditions has been less than during recent stress events, such as Liberation Day and the beginning of the Middle East conflict earlier this year. The economy remained solid after those events, so I am not overly concerned by the recent tightening of financial conditions.

The home mortgage market remains an area where financing conditions are tight. The housing market remains significantly challenged by high mortgage rates, building costs and supply shortages.

Besides the housing market, stagnant real personal disposable income growth and geopolitical tensions are potential headwinds to growth. Various financial, physical, social and political constraints could also slow the pace of investment in data centers or lower the valuation of AI-related companies. But for now, I perceive these potential headwinds as less likely or impactful than the tailwinds propelling the economy forward.

Let me now make a few observations about the labor market and inflation.

The labor market has been remarkably stable and balanced, and close to full employment for more than a year. At 4.2%, the unemployment rate lies at the median of the long-run

projections of FOMC participants, as reflected in the Summary of Economic Projections for September.

Payroll growth has been near the breakeven rate needed to maintain a low unemployment rate; the ratio of job vacancies to unemployed persons hovers close to 1; and claims for unemployment insurance remain low. An elevated long-term unemployment rate and low job-finding expectations bear watching.

Real wages have been increasing rapidly for a few occupations, such as electricians and other skilled trades involved in the data center buildout. This is spilling over into higher real wages and labor costs in proximate construction activities. However, on average across the economy, nominal wage growth has not kept up with inflation, and many workers are falling behind in real terms.

The labor market has not been driving inflation. Nonetheless, inflation is elevated and broad-based, and I perceive a meaningful risk that above-target inflation will persist longer than consistent with price stability. Headline and core inflation continue to run at 3% or higher. September data on PCE inflation show upward momentum in goods inflation driven by higher energy prices, while services inflation remains sticky above 3%.

Inflation expectations have thus far remained mostly well anchored. Some survey measures of expected inflation have recently drifted higher, a trend mostly due to energy and other commodity prices, which bears watching. However, market-implied long-term inflation expectations remain anchored, consistent with market expectations that the FOMC will raise its real policy rate to an appropriate level within the next few months.

The increase in long-term nominal bond yields in recent months mostly reflects higher expected real policy rates. Higher real rates, in turn, have been driven by expectations of strong real economic growth and competition for financing between the public and private sectors. Nominal bond yields would likely rise further if the public comes to doubt the Fed's resolve to achieving price stability, unnecessarily increasing financing costs for borrowers.

Looking ahead, I'm focused on two plausible inflation scenarios for the next 18 months.

Under the first and more likely scenario, persistent strong demand and ongoing supply pressures keep inflation elevated absent some additional firming of monetary policy. I agree with Chairman Warsh's characterization of the recent increase in the FOMC policy rate as "removing a dose of accommodation." In my view, policy remains accommodative, and further firming will likely be necessary to ensure inflation converges to 2% in a timely manner.

However, there is a less likely but plausible scenario in which additional policy firming will not be required. Falling energy prices and lower shipping costs, or an increase in potential output

growth driven by higher productivity growth, might ease inflation pressures. Alternatively, aggregate demand might slow more than that is now expected, perhaps because spending on AI or data centers slows substantially, or financial conditions tighten abruptly and wealth effects-driven consumption spending deteriorates.

Because I view the second scenario as less likely than the first, I continue to judge that a further removal of monetary policy accommodation will be required to ensure inflation converges to 2% within 18 months.

My FOMC colleagues and I are committed to achieving price stability. Inflation is a distortionary tax, and a regressive one at that. In my meetings with business leaders, representatives of community groups, and elected officials, the conversation often turns to inflation and its adverse effects on the people we serve.

As you know, the Fed has a dual mandate — maximum employment and price stability. The Fed is sometimes accused of killing jobs or of being anti-growth when it takes action to contain inflation. In the 1970s, Allan Meltzer, Karl Brunner, Anna Schwartz and other members of the Shadow Open Market Committee argued persuasively that price stability is, in fact, a prerequisite to achieving maximum employment and sustained economic growth. History has since borne out their view.

The best that monetary policy can do now for employment and economic growth is to restore price stability in a timely manner. The short-run economic costs of reducing inflation are less when the central bank acts before inflation has become entrenched and is expected to persist. Acting sooner and incrementally now is likely to be less disruptive or costly than delaying and being forced to take large, abrupt actions later.

I am committed to achieving price stability and maximum employment for the American people and to working expeditiously with my FOMC colleagues until the job is done.

Thank you.

Jeffrey Lacker: Great. So thank you for those remarks. I thought we'd do a Q&A just Alberto and I, and then open it up to more of an audience Q&A, hear your questions. I thought I'd start by shifting away from current events and current monetary policy stance. Ask about Fed communications. Something that's been talked about a lot in the last six to nine months. You recently gave a speech at the LSE and talked about, among other things, Fed communications. So how and perhaps the most important question is what should FOMC officials say about future monetary policy when they speak? Just as a general matter.

Musalem: Thank you, Jeff, and I'm glad you're OK. My belief is that it's really important for the public, and by that I mean households, businesses, markets, Main Street, Wall Street, to

understand how a central bank thinks and how a central bank turns incoming information into policy. I refer to that as the framework, which is a broader concept than a policy rule. I know there was a good discussion on policy rules this morning. It's really important because it leads to smoother monetary policy transmission. It leads to better economic outcomes. And it leads, in my mind, to more democratic accountability. That's very different to providing forward guidance. The best thing a central bank can do is not to tell the public what it's going to do at the next few meetings. But the best thing a central bank can do is to communicate how it's thinking about its policy as the world evolves, as the world reveals itself. Forward guidance is – my interpretation of it is you're telling the markets or the public about a path of policy. What I'm talking about is sharing with the public what your broad thinking is about for different situations in the economy how you might act. And as I said in London, it's – communicating a framework is the rare promise that is entirely within the control of a central bank.

Lacker: So, when I think economists hear about communicating a framework about future monetary policy setting, that their minds naturally go to the phrase reaction function, and as you alluded to, there was a discussion this morning of making reference to the constellation of formal algebraic policy rules as a means of conveying a reaction function. Do you see this framework idea as equivalent to conveying information about a reaction function, and do you see a role for just alluding to the predictions of policy rules?

Musalem: Yeah, I think policy rules, I think are very useful analytical tools. I use them all the time. At the FOMC, we look at many configurations of policy rules and their paths, so I think they're very useful. But what I have in mind is broader than a Taylor rule or some equivalent, because the world is complex, and no matter how well intentioned a policy rule is, it doesn't capture all the subtleties and complexities, forward-looking complexities that monetary policy faces. So, I think it's a great input into a communications, and it's well known that central banks that either don't behave according to a framework or don't communicate a framework and actually use discretion, or don't communicate what they're doing, tend to generate economic outcomes or inflation that tends to be higher and more variable. So, I think rules – and I use them all the time – are very useful inputs. But I think the communication needs to be a little broader than rules.

Lacker: So you also spoke in that LSE speech about the use of scenarios in Fed communication. You gave us an example of that, casting out two different scenarios, and even portraying what policy, how policy would differ across those. So, do policy rules have a role to play in defining what policy, how policy should differ across scenarios?

Musalem: Yeah, it's a great question. So, how I think about scenarios is, as you said, you know, I try to think of what the two or three most plausible scenarios are that are worth considering. I try to think of what the dual mandate outcomes are in those scenarios, and try to communicate what the likelihood, rough likelihood of those scenarios are, and what policy ought to be

considering in either scenario. You can think of policy rules, at least the way I think about it, two ways. You can say, given a scenario, what would the policy rule tell me to do? That's one way to do it. Or you can say, given several scenarios, what is the policy rule that is robust to those two or three or four scenarios? I prefer to do it the second way around because, you know, if you're making decisions under uncertainty, optimizing relative to an expected value is more robust than optimizing relative to a modal path.

Lacker: So the FOMC communicates as individual participants when they make public appearances like this. But they also have some joint communication mechanisms that they release to us. Can you picture a joint effort around scenario analysis? And I'll just point out that the main method of sort of collective communication about the future of monetary policy is the Summary of Economic Projections. And scenario analysis stands out as the glaring omission in that document. So, I wonder, do you have like an ideal set of revisions you'd contemplate or be attracted to to the famous Summary of Economic Projections?

Musalem: So I have three views on that. One is we already have a joint statement by the committee. It's called the statement, that comes after the press conference. On the on the SEP, I think there are two areas for improving the SEP. One is in an anonymous way connecting the economic dots or the economic scenarios of each participant with the policy dot of that participant. I think that would be a very rich – 19 scenarios would be illuminated for the public because 19 participants each has their own modal scenario, and I think that would be more knowledge, more information to the public. The other change I would advocate for the SEP is, and this is something that I think Jim Bullard advocated before me, is this rolling horizon. You know, the SEP, the further you get into the year, it collapses into December to that one meeting, and it should have a rolling forward horizon. So that's what I would say. Are there other ways to achieve the same outcome? Yes, there are. I think a monetary policy report done by the staff illuminating some potential salient scenarios and what policy might do in those scenarios is another way to achieve the same thing, and it could serve as a focal point. The difference, of course, is that would be a staff document as opposed to a decision maker committee document. So the public would have to decide how much weight to attach to each one of those. And I would not be averse to having both things out in the public. You know, the policymaker scenarios and views, and here's the staff scenarios and views. Of course, the two are correlated and related to each other because one informs the other, and vice versa. And so, I would not be averse to that.

Lacker: So, would you support releasing staff forecasts of economic and monetary policy conditions?

Musalem: Yeah, I think a monetary policy report would have, ideally would have, you know, a baseline path and an alternative path, and a discussion of likelihood and risks around them, and

a discussion of what policy ought to be in one scenario versus the other. I think that would be informative, yes.

Lacker: Let me shift gears a bit. We talked a little bit this morning about the measurement of inflation, and it's certainly been a topic of conversation since the new chairman took office. Are there particular measures of inflation that you look at? I mean, I know the Fed is sort of committed to headline PCE as its benchmark. It's what is offered up to be evaluated on, how its homework is supposed to be graded. But are there particular measures that you see as particularly useful for policy purposes?

Musalem: So, you know, the target is PCE headline inflation. At a time when we have meaningful supply shocks hitting the economy in succession, it's important to look at underlying inflation. Core inflation is a measure of underlying inflation. I'm particularly focused right now in containing further broadening of inflation or second-round effects of inflation. So I'm focused on services inflation, core services inflation, core services inflation excluding housing. So, my team and I look at several measures. Now, I'm going to say something about cherry picking here because it's very important while you are looking within the inflation metrics to figure out what underlying inflation is, not to fool yourself into cherry picking the numbers that look better to you or that support your view of the world as opposed to the truth. And so there's always a, you know, kind of a proviso there, you know, be careful with cherry picking. One of the joys of this job, and you know this well, Jeff, is that you get to interact with the public a lot, with businesses, with representatives of households, elected officials. And then in addition to the official statistics and indices that we just discussed, you get an impressionistic view of what's happening with inflation by just being in touch with the public. And so we conduct, you know, I meet, I met in the last year with something like 4,000 people, and we conduct surveys, and so you get an idea of what the underlying inflation situation actually is from all of that as well.

Lacker: So, in the broad area of indicators of inflation pressure, some people point to nominal spending, nominal GDP, and the like. There's a little discussion this morning about nominal GDP targeting. But more broadly, you know, stepping back from the idea of adopting a target or, you know, an indicator variable like that, it's somewhat surprising to some economists how little mention is made in FOMC communications about nominal spending. We're in a situation where nominal GDP growth has been pretty high. Clearly, sort of not in the short run consistent with inflation at 2%. So, do you see nominal GDP as a useful variable that maybe is underrated in policy circles?

Musalem: So, I look at it. Other colleagues look at it. It's not our target. So, our target, it's very clear that our target is PCE headline inflation. The way I think about nominal GDP – it's a different average. It's a geometric average of real activity and inflation – the same two inputs that go into a policy rule, inflation and economic activity. So weighted in an arithmetic way

instead of a geometric way. So, I use it. I look at it. Other colleagues look at it, but it's important to recognize it's not our target. And right now, it's a particularly salient moment where nominal GDP is growing at around 6% and it's an elevated level. And financial markets are certainly attuned to it. They're certainly looking at that.

Lacker: Well, that's a good segue to another kind of related area of questions. So the basic macroeconomic intuition embodied in the two most recent, the most recent Nobel Prize in economics, is that monetary policy needs to restrain or stimulate current spending to keep inflation on track. From that point of view, supply and demand shocks, the asymmetry with which a lot of FOMC officials speak of the two and how policy should react to the two, is sometimes puzzling, since you might think that it's just the gap between dollar spending and supply growth that matters. So maybe you could talk about whether the extent to which you view those two sides of the coin, demand shocks and supply shocks, as maybe different having different implications for monetary policy.

Musalem: I'm going to put the answer in the current context, if that's OK.

Lacker: Sure.

Musalem: Right now, my sense, my judgment from all the work we do, the outreach, the data work we do, is that core inflation, underlying core inflation, is being driven both by supply and by demand. So excess core inflation is driven by both sides of the question that you pose. My sense is that underlying core inflation is running somewhere between two and a half and 3%. When I visit with folks around my district, I hear demand and supply anecdotes. So, of course, you hear all the input costs from higher energy and higher fertilizer prices affecting transportation costs, diesel, etc. That's the supply side. But then you also hear on the demand side, very strong demand for skilled labor, for copper, for steel, for computer equipment and software associated with the AI capex build. So even in the anecdotes, you see supply and demand. I'm pretty focused now, I'm very focused on containing any further broadening of inflation from the demand side or from the supply side. Any second-round effects, particularly onto services. It's really important that we keep inflation expectations anchored here. After five years, almost six years of inflation above target, it's more likely that things could become entrenched.

Lacker: So enough about my leading questions. Now let's open it up to the audience. So, Philip, and then Mickey, and wait for a microphone.

Audience: Thank you very much. Two brief questions. Questions may be brief. Your answers may not be. But anyways, the first question is really about, go back to communication, and U.S. dollar, U.S. Treasury, all the stuff that U.S. does is more than just limited to the 50 states of the United States. It's very much global because of the status of who we are, and so the impact of it is a lot more than just here. When we become less transparent, it can, the tail can still come

back to hit us from the amount of purchase of U.S. Treasuries or the FX component and so on. By not being transparent or being more opaque, we are also adding more of a risk factor into how one, the market will consider where the interest is going. So I'd like to hear your thoughts. I don't know if it's your line or your party line that, so far your explanation. I'd like to hear how you feel personally, without putting FOMC on the line, about opacity and why that isn't, seems like, OK. That's one. Two. So far, no one has spoken about the five wonderful working groups. I like to understand how these five working groups really work with this and other 19 members or 18 members, and how by inserting additional variables are helping to make decisions that are already, in your words, a complex situation. So I'd love to hear your thoughts, personal view on both. Thank you.

Musalem: Do you want to collect some more questions, and I can answer from there?

Lacker: Why don't we take them one at a time.

Musalem: OK. So, on the question of communications, what I said during my remarks, and I said it here as well, is that I believe that communicating a framework as to how you're behaving. By a framework, I mean a target or set of targets, an instrument or set of instruments, a time frame, and how the central bank would behave under certain circumstances leads to three benefits. One of which is a smoother monetary policy transmission. What I had in mind there is what you said that that tends to lead to less risk premium being in asset prices, whether fixed-income asset prices or foreign exchange or equities, and that makes a smoother transmission of policy. On the working groups, on the task forces, they're ongoing. I think the chairman talked about them at the press conference. Excuse me. I expect the FOMC will get their output from their deliberations over the next six months or so, and I'm really looking forward to consuming that output. These are very serious people. I know a lot of them. I've learned a lot from them over the years, and I look forward to hearing their recommendations. But what I look most forward to is to consuming that output and deliberating on the merits of the recommendations, or coming up with other recommendations together with my FOMC colleagues. We are the ultimate decision makers, and that's what I'm most looking forward to.

Audience: First, Alberto, it's great to have you here. It's great. So, thank you very much. So, up until Chair Powell's last meeting in April, he/the Fed characterized monetary policy as mildly restrictive. Beginning with Chair Warsh, the Fed characterizes monetary policy as accommodative, and conditions haven't seemed to change that much. So, let me ask this question in two different ways: How does the Fed determine, or does it come to a determination of how monetary policy conditions are restrictive or accommodative, or stated differently, would you go along with putting together a checklist of different criteria that would put you in one camp or the other and evaluate that at every meeting?

Musalem: So, I'll tell you how I come up with that assessment, and I try to separate it into buckets. I try to determine where I think the policy rate is relative to some notion of restrictiveness or accommodation. And I can talk about that in a minute. And then I then look at financial conditions and divide those into two buckets. What are prices of assets telling me, or prices of the cost of capital, whether debt or equity, is telling me about financial conditions? I try to do all this in real terms, and then I also for financial conditions. I don't know if you heard me say in the speech. I said financial and financing conditions. Then I go over the quantities of financing, availability of financing in different, for different parts of the economy. Then I put it all together, so there's an element of analytical rigor, and then there's an element of, as I've been saying for a long time, and the chairman now has become fond of saying, looking out the window and just observing what is happening in markets and the economy. I try and judge monetary policy in real terms, particularly important to do that now with inflation elevated. And I try to judge where the real interest rate is today relative to some notion of long-term neutral, which is a, it's a nebulous concept at best. But, you know, there are ways to try and figure out ranges, and then I ask myself the question: How are we relative to that long-run neutral? And very importantly, if you take one thing away from what I just said, is: What should the short-run real rate be for the economy today, depending on how you see deviations of inflation from target and the level of activity. So there are many judgments that go into the, in my case, an evaluation of whether conditions are accommodative or neutral or restrictive.

Lacker: Larry?

Audience: Thank you for your perspective on scenario analysis. In addition to having participants labeling the dots, how would you think about implementing scenario analysis into monetary policy and then operationalizing it?

Musalem: I'll say two things about that. In FOMC meetings, we already consider a variety of scenarios, so we're already doing scenario analysis. The staff presents the committee with a set of plausible scenarios and a set of economic outcomes and a set of policy outcomes around those scenarios. So, there's already an exploration of the potential outcomes, policy and for the economy. How could we communicate that to markets and the public and Main Street and Wall Street? As I said in response to one of Jeff's questions, a monetary policy report that laid out a baseline and one alternative scenario or two alternative scenarios that the committee feels are most salient or that the staff feels are most salient would be a way to achieve that.

Lacker: Gene?

Audience: In your description of the headwind, possible headwinds, I didn't hear a lot about the growing federal debt and the pressure on interest rates there.

Musalem: I did mention a competition for financing between the public and private sectors.

Lacker: That was your allusion to debt. [Laughter.] OK, I get it. Speaking of debt, there's a lot of it on the Fed's balance sheet. There's been a lot of discussion lately about the size of the Federal Reserve's balance sheet. Do you have a view about where you'd like to see the balance sheet go?

Musalem: I thought you were going to skip that. [Laughter.] I think, in all seriousness, I think the Fed ought to operate with the smallest balance sheet possible that, such that we can continue to do effective monetary policy implementation, that is, without money market volatility, and that continues to provide a source of financial stability. So I don't know where that level is. There's a task force that's doing some work on it. We're going to deliberate on it and we're trying to come up with some sort of path. I will say that if we decided that a lower balance sheet, a lower size of the balance sheet – there's, of course, the composition of the balance sheet and the duration of the balance sheet are other important variables. But if we decided the size needed to be smaller, it would be less disruptive to the economy to reduce the demand for reserves – take measures to reduce the demand for reserves before reducing the supply. Doing it the other way around, reducing the supply for reserves, without taking measures to reduce the demand for reserves would add unnecessary volatility to money markets, which would violate my first condition.

Lacker: So moving from the Fed's liabilities to assets, one last question: What's the optimal amount of agency mortgage-backed securities the Fed should hold?

Musalem: I mean, ideally, we should have, you know, if there was no legacy from history, and if there are no future shocks to the housing market like 2008, ideally, we should have a, my view is we should have an all-Treasuries portfolio. As you know, we're in the process of running down the MBS holdings. We're doing so by letting them roll off so that it doesn't disturb the housing market or the or the MBS spreads relative to the Treasury curve.

Lacker: One more question. We have time for one more, and then we have to make room for our next session. There's a woman back there. Oh, there's a woman back there. Second table. She got. She won the prize.

Audience: Alberto, can you talk about how you would view the trade-off between short rates and the balance sheet if the Fed were to pursue whatever measures it decides in the future to shrink the balance sheet. How should we think about that trade-off, versus short rates?

Musalem: Let me start by saying that we have one primary tool, and that's the interest rate. The balance sheet is useful at times, particularly when that primary tool becomes ineffective at the zero lower bound. The way the balance sheet works, for me, is mostly through affecting asset prices. The interest rate works through many channels, including by affecting asset prices. That's a very simple kind of distinction that I'm drawing. But I think the message I want to convey is that the federal funds rate is our primary tool.

Lacker: Join me in thanking him.