An Update on the U.S. Economy and Monetary Policy

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Introduction

It is a real pleasure to welcome you to the Federal Reserve Bank of Cleveland. I thank the National Association for Business Economics, its Cleveland Chapter, Team NEO, David Altig, and Bill Koehler for the opportunity to speak with you about the economy. Dave and I go back a long way – perhaps too long for me to admit to. We worked together when we were both research directors, Dave at the Atlanta Fed and me at the Philadelphia Fed. Dave is a first-rate economist, so I know he will keep me on my toes as he moderates this session.

Before we get into today's question and answer portion, I thought it would be helpful to frame the discussion by offering a few brief remarks about the economy and monetary policy. I will start by reminding everyone that what I say today will be my views and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee.

Economic Developments

Substantial progress has been made on the inflation front since inflation peaked in 2022, in the range of 7 to 9 percent, depending on the measure. But inflation is still above our 2 percent objective. PCE inflation is now running about 2-1/2 percent, whether it is measured year-over-year or over the past six months, annualized. And core PCE inflation is running about 2-3/4 percent, measured year-over-year, and near 3 percent, annualized, over the past six months. The monthly inflation readings in January and February came in firmer than the readings over the second half of last year and are a good reminder of what we already knew: that the disinflation process will not be a smooth path back to 2 percent.

In my view, the inflation picture has not changed very much since the start of the year, because I had already thought that the pace of disinflation would slow down this year. I continue to think that the most likely scenario is that inflation will continue on its downward trajectory to 2 percent over time. But I need to see more data to raise my confidence. Some further monthly readings will give us a better sense of whether the disinflation process is stalling out or whether the start-of-the-year readings reflect a temporary detour on the downward path back to price stability. I do not expect I will have enough information by the time of the FOMC's next meeting to make that determination.

A remarkable thing about the disinflation is that it has occurred in the midst of strong labor markets and economic growth. While the broader tightening in financial conditions over time has led to some moderation in the growth of output and employment, both have remained stronger than expected. That relatively strong demand confronts a supply side of the economy that is healing. Supply chain disruptions and bottlenecks have improved over the past three years and the labor market is normalizing. People have returned to the labor force over time, and immigration has also increased the supply of labor. With imbalances between supply and demand in both product markets and labor markets easing, inflation has been easing as well. Now that pressures on supply chains are approaching normal and the labor market is coming into better balance, we are not likely to get as much help on inflation from the supply side as we saw last year.

The Economic Outlook

I have revised up my projection of growth for the year based on the incoming economic information, including the official statistics and also the reports we receive from our directors and regional contacts, which are forward looking. In the most likely scenario, I still expect growth to moderate compared to last year's very rapid pace. But instead of the economy growing under trend this year, I now expect it will grow a bit above my 2 percent estimate of trend growth. I expect the labor market to continue to come into better balance this year, with a slight uptick in the unemployment rate from its current very low level. And I expect further progress on inflation but at a slower pace than we saw last year. If the economy evolves as expected, then in my view it will be appropriate for the FOMC to begin reducing the fed funds rate later this year, as inflation continues on its downward path toward 2 percent, and labor markets and economic growth remain solid. These reductions should be viewed as a normalization of policy back to a neutral level as the economy returns to price stability and maximum employment. But, of course, the actual path of policy will depend on how the economy actually evolves.

My forecast is similar to the median among the FOMC participants in the Summary of Economic Projections that were released after our March meeting,[1] except that I see somewhat higher inflation this year. In my projection, I have also raised my estimate of the longer-run federal funds rate to 3 percent compared with 2.5 percent, which had been my estimate for some time. I raised my estimate to reflect the continued resilience in the economy despite high nominal interest rates and higher model-based estimates of the equilibrium interest rate, *r*-star.

I have been discussing my view of the most likely scenario, but there are several risks to the forecast, including continued heightened geopolitical tensions, slow growth of the Chinese economy, potential deterioration in conditions in commercial real estate markets, renewed stresses in financial markets, and, on the upside, the possibility of stronger than expected productivity growth.

Monetary Policy

At its meeting two weeks ago, the FOMC decided to keep the target range of the fed funds rate at 5-1/4 to 5-1/2 percent and reiterated that it does not expect it will be appropriate to reduce the target range until the Committee has gained greater confidence that inflation is moving sustainably toward 2 percent.

With inflation now moving closer to our goal, the risks to achieving both parts of our dual mandate have become more balanced. When we were tightening policy, we needed to focus on the inflation part of our mandate, because inflation was so high and the labor market was strong. Now, risk management with respect to both parts of our mandate will need to be the hallmark of monetary policy decisions going

[1] See Summary of Economic Projections, March 20, 2024. (https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20240320.pdf)

forward. If year-ahead inflation expectations continue to decline, maintaining the current level of the nominal fed funds rate for too long would effectively be a tightening in our policy stance, which would pose an increasing risk to the maximum employment part of our mandate. On the other hand, moving rates down too soon or too quickly without sufficient evidence to give us confidence that inflation is on a sustainable and timely path back to 2 percent would risk undoing the progress we have made on inflation. At this point, I think the bigger risk would be to begin reducing the funds rate too early. And with labor markets and economic growth both being very solid, we do not need to take that risk.

Our current monetary policy stance puts us in a good position for managing risks that could manifest themselves on either side. If the labor market deteriorates, we can move rates down sooner and more quickly than in our baseline. Rather than view this as a normalization, the intention would be to return to an accommodative stance of monetary policy to support the economy. On the other hand, if inflation appears to be stalling at a level above our goal, we can hold our restrictive stance for longer than in the baseline.

In contrast to where we are now, our policy was not well positioned when we started our tightening cycle because the policy rate was so low and inflation was moving up persistently. We needed to raise rates fairly aggressively. At this point, we are seeking to calibrate our policy well to economic developments so we can avoid having to act in an aggressive fashion. Indeed, if the economy evolves as I expect, I anticipate that we will be able to move rates down gradually as inflation and inflation expectations move down, allowing us to continue to manage the risks to both sides of our mandate.

But let me reiterate: the actual path of policy will depend on how the economy actually evolves. The FOMC's job continues to be to assess the implications of economic and financial developments for the outlook and risks around the outlook and, given that assessment, to calibrate monetary policy so that inflation returns sustainably to our 2 percent goal and labor markets remain healthy.

This concludes my brief prepared remarks. I look forward to our discussion.