Views on the Economy and Monetary Policy:
In a Good Place and Ensuring We Reach an Even Better One

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Introduction

I thank Michael Adelman, CEO of the Ohio Bankers League, for the opportunity to speak at this year's Economic Summit. Of course, the views I present today will be my own and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee.

The last time I spoke at an OBL event was in September 2021. At that time, a strong economic recovery was underway, but it was an uneven one and there were still many challenges and risks, including the Delta variant of the coronavirus, which was emerging. People were starting to return to the workforce but only slowly. The number of payroll jobs and the labor force participation rate were still well below where they were prior to the pandemic, and the unemployment rate, while down from its peak of nearly 15 percent early in the pandemic, was still near 5 percent. Inflation had moved up to over 4 percent. It was expected to rise further and remain elevated until supply constraints and pent-up demand eased, which would take some time. Monetary policy had not yet begun to tighten.

The economy and monetary policy have certainly been on quite a journey since then. Characterizing both today, I would say that the economy and monetary policy are in a good place. Inflation is still above our goal of 2 percent, but it has moved down considerably from its high level in 2022 and labor markets and economic growth remain strong. The FOMC's job now is to ensure that the economy reaches an even better place by calibrating monetary policy to achieve our dual mandate goals of price stability and maximum employment. In order to do that calibration, we will need to continue to monitor and assess incoming economic and financial information and its implications not only for the baseline forecast but also for the risks around that forecast. Risk management will take center stage.

Bankers have played an important role in determining where the economy is today and where it is going. By providing valuable credit, risk-management, liquidity, and payments services to your customers, you support a strong economy. Ohio bankers supported families, businesses, and communities throughout the pandemic, and they continue to do so, even as the industry faces its own challenges. I want to thank you for managing through the balance-sheet impacts of the sharp rise in interest rates over the past two years and the liquidity stresses that manifested themselves last March. Just as the Fed will be carefully managing risks in determining its appropriate policy stance, banks will need to do so as well, so that they can continue to contribute to a strong economy.

I also want to thank the bankers in Ohio and throughout the Fourth District for the timely information and insights on the economy and banking conditions that they have provided to me in my role as a Federal Reserve policymaker. Several of the Cleveland Fed's current and former directors and members of our Community Depository Institutions Advisory Council are here today, and they can attest to the rich set of insights provided by our bankers. This information plays a crucial role in helping us better understand what is really happening on the ground in real time and what could be coming.

So let me now turn to my assessment of the where the economy and monetary policy are and where they are likely going.

Economic Developments

Over the past four years, the pandemic and its aftermath have been the major forces shaping economic developments and the major sources of uncertainty about the economy. When the pandemic hit, the economy shut down in March 2020, and fiscal and monetary policymakers took aggressive actions to support households and businesses, ensuring that credit continued to flow and limiting lasting damage to the economy. The economy began to reopen in May 2020 when public health statistics began to improve. But it wasn't business as usual. The pandemic had affected global supply chains, the supply of and demand for labor, and the composition of household and business spending on housing, goods, and services. Imbalances between supply and demand in both product and labor markets led to significant upward pressure on prices, and inflation began to rise in April 2021. Russia's invasion of Ukraine in

February 2022, an ongoing human tragedy, added to inflationary pressures, spurring higher prices for oil, food, and other commodities. In 2022, headline inflation reached levels not seen in 40 years, running 7 to 9 percent, depending on the measure. In response, the FOMC began raising its policy rate, the federal funds rate, in March 2022, and over the two years since, the Committee has significantly tightened the stance of monetary policy by raising the fed funds rate by a cumulative 5-1/4 percentage points. The Fed is also reducing the size of its balance sheet by allowing assets to roll off in a systematic way according to the plan announced in May 2022.

The tightening of monetary policy has led to a broader tightening in financial conditions over time and, in response, aggregate demand has begun to moderate. In addition, the supply side of the economy has been healing. Supply chain disruptions and bottlenecks have improved significantly, and firms have invested in diversifying their supply chains, making them more resilient to disruptions. Growing tensions in the Middle East might undermine supply-chain improvements, but our business contacts tell us that so far there has been minimal effect on their operations and that they expect the increase in shipping costs through the Red Sea to be temporary, but this is a risk worth watching.

The pandemic had profound effects on the labor market, but the labor market is normalizing. People have returned to the labor force over time, and the labor force participation rate of people aged 25 to 54 is now slightly above its pre-pandemic level.

Over time, the imbalances between supply and demand in both product markets and labor markets, which helped fuel high inflation, have lessened, and inflation has moved down. This disinflation has happened even as the economy has remained very resilient, with both economic growth and the labor market outperforming relative to expectations. As you'll recall, many CEOs and economists thought that growth last year would be below trend. But the economy didn't agree. Real GDP growth in the fourth quarter stepped down from its very strong pace in the third quarter, but it was still a solid 3-1/4 percent annual rate. Growth last year is estimated to have been a bit over 3 percent, above my 2 percent estimate of trend growth. The change in firms' inventories was expected to subtract from growth last quarter, but instead made a slight positive contribution. Growth in final sales, which excludes the change in inventories, was quite strong.

Consumer spending makes up about 70 percent of GDP. Strong income growth and healthy balance sheets have continued to support household spending, and the savings rate has moved below its pre-pandemic level, reflecting strong spending. It is interesting that despite the economy's strong performance, including strong consumer spending, until recently surveys of consumers indicated that most people were not very happy about the economy. I believe that partly reflects the fact that even though inflation has been coming down and wage gains have been high, many people's wages haven't kept up with inflation. When inflation persists at levels above our goal of price stability, the price level is moving up faster than we would like, and households and businesses have to pay those higher-than-desired prices. With inflation moving down, wages adjusted for inflation have begun to move up, and this is helping to close the gap between the cumulative increase in inflation and the cumulative increase in wages.[1] This may be partly why consumers are feeling better about the economy.

I expect household spending to moderate somewhat this year. In the wake of high prices, many families, especially those with lower incomes, have spent the savings accumulated during the pandemic. There has been an uptick in credit card debt, suggesting that some households have exhausted their ready cash balances. Delinquencies on consumer loans have also edged up, although they are still at low levels.

[1] Since the first quarter of 2021, when inflation began to rise, PCE inflation has been running at an annualized pace of 4.8 percent. Workers' compensation (as measured by the employment cost index for civilian workers' compensation) has risen at an annualized rate of 4.5 percent. So there is still a gap, but that gap has been closing over time as inflation has moved down.

Tighter financial conditions have restrained investment in housing and business spending. Businesses slowed their spending on equipment and software last year, and it is expected to continue to moderate given restrictive credit conditions. The regional manufacturing surveys from the Federal Reserve Banks and the national ISM survey indicate weaker manufacturing activity. Fourth District manufacturers tell us that their order backlogs are diminishing. In the housing market, residential investment declined in 2022 and was flat last year. Sales of existing homes are at low levels, but sales of new single-family homes were fairly resilient given the longer-term shortage of available housing. The shortfall in housing supply has kept home prices relatively high, but rents, especially for new tenants, have moved down and that should lead to continued tempering of inflation in housing services.

Last Friday's labor market report for January shows that the labor market has been remarkably resilient. Payroll job growth rose by about 350 thousand jobs in January. Even if some of that reflects seasonal adjustment issues, it was an unexpectedly strong reading, and the job numbers for October, November, and December were revised up. The unemployment rate has been 3.7 percent over the past three months, near a 50-year low. This is very strong performance. Other indicators point to some moderation in the labor market. Our contacts tell us that, except for the healthcare sector, it is easier to hire than it was a year ago and that they are getting more applicants per job opening. The pace of job quits has also declined since peaking in 2022. Now, workers are quitting jobs at about the same pace as before the pandemic and the number of job openings has been declining. There are now about 1.5 openings per unemployed worker. This is above the level we saw in 2019, another period of strong labor market conditions, but it has come down a lot since March 2022 when we began to tighten monetary policy.[2] And on the supply side, as I mentioned, the labor force participation rate for workers aged 25 to 54 has normalized.

[2] In 2019, the ratio of openings per unemployed workers averaged 1.2 percent; in March 2022 it was 2.0.

As the demand for and the supply of workers have started to come into better balance, wage growth has moderated. Firms in our District are expecting wage increases to average about 4 percent this year, down from 5 percent a year ago, but still above pre-pandemic levels. The employment cost index rose at an annualized rate of 3-1/2 percent over the last three months of 2023, down from about 4-3/4 percent in the first quarter of last year. And the gap between the wages of job switchers and job stayers in the Atlanta Fed's Wage Growth Tracker narrowed last year to about its average over 2015 to 2019, another sign that the labor market is coming into better balance.[3]

Current estimates of trend productivity growth suggest that the current level of wage growth is still a bit above the level consistent with 2 percent inflation. But the strong recent readings on productivity raise the possibility that trend productivity growth has moved higher than it was before the pandemic. The scarcity of workers during the pandemic gave firms a great incentive to do more with fewer workers and many invested in automation. New technologies such as generative AI hold the promise of increasing productivity over the medium to longer run. If so, then wages would be able to rise at a faster rate and still be consistent with price stability. At this point, though, I suspect we will see further moderation of wage growth, with a gradual slowing in job growth and an uptick in the unemployment rate over the year from its very low level.

Inflation

While inflation is still above the Fed's goal of 2 percent, the news on inflation is encouraging. Inflation moved down faster than expected last year even as the economy remained strong. Measured year-over-year, as of December, total PCE inflation is 2.6 percent and core PCE inflation is 2.9 percent. Over the past six months, the levels are even lower. Other measures of inflation, including the median and

[3] The gap between the 12-month moving average wage growth of job switchers and job stayers in the Atlanta Fed's Wage Growth Tracker was 2.2 percentage points at the start of last year and 0.9 percentage point by the end of last year. These data are available at https://www.atlantafed.org/chcs/wage-growth-tracker.

trimmed-mean measures, have also moved down from their peaks. Retailers in the Fourth District say that consumers are more price-sensitive than they have been. Many of our contacts across sectors have noted that after making frequent price adjustments over the past two years, they have reverted to their usual pre-pandemic practice of setting prices once a year, a sign of easing price pressures.

The largest declines in inflation have come in goods prices. In fact, core goods prices have been declining, as they were before the pandemic. Inflation in housing services, measured by rents and the imputed rents for owner-occupied housing, and inflation in core services excluding housing, which makes up about half of the consumption basket, have eased less but have improved over time.

There are reasons to be cautious in assuming that last year's rapid pace of disinflation will be maintained as inflation gets closer to the 2 percent goal. While restrictive monetary policy has played an important role in moving inflation down, supply-side adjustments were also important. Now that pressures on supply chains are approaching normal and the labor market is coming into better balance, we should not count on as much help from the supply side as we saw last year.

While inflation may prove to be more persistent this year, my baseline forecast is that under appropriate monetary policy, inflation will continue to move down over time to our 2 percent goal. Anchored inflation expectations are an important component of that forecast. Medium- and longer-term inflation expectations remain reasonably well-anchored in a range consistent with the Fed's goal of 2 percent inflation. One-year-ahead inflation expectations from the University of Michigan and New York Fed surveys have also moved down, although they are still about a quarter to a half percentage point, respectively, above their 2019 averages. Continued progress on inflation will help ensure that these expectations move down to our goal. And that progress depends on appropriate monetary policy.

Monetary Policy

At its meeting last week, the FOMC decided to maintain the target range of the fed funds rate at 5-1/4 to 5-1/2 percent and to continue running off the Fed's securities holdings. The FOMC judges that the risks to achieving its employment and inflation goals are moving into better balance, but it remains highly attentive to inflation risks. The FOMC does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2 percent.

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. When we began this tightening cycle, inflation was far above our goal and labor markets were strong. So it was clear we needed to focus on the price stability part of our mandate. Now, with inflation moving closer to our goal, we need to balance the risks to achieving both sides of our dual mandate when determining the appropriate stance of policy.

It would be a mistake to move rates down too soon or too quickly without sufficient evidence that inflation was on a sustainable and timely path back to 2 percent. Doing so would undermine all of the good work that has gone into getting inflation to this point. On the other hand, 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.

Risk management will be the hallmark of monetary policy decisions going forward. Our job is to calibrate monetary policy to the evolving outlook and risks around the outlook so that inflation returns sustainably to our 2 percent goal and labor markets remain healthy. My baseline forecast is that output and employment will moderate this year and inflation will continue to move closer to our 2 percent goal over time. But there are a number of risks around this forecast. Heightened geopolitical tensions have potential implications for financial markets, oil prices, and global demand and supply. A continued easing in financial conditions could spur activity, leading once again to imbalances that fuel inflation. The stress generated by the bank failures last March has subsided. Many banks have diversified their sources of liquidity, making them less vulnerable. But stress could come again to banks that continue to rely on uninsured deposits for their funding while having sizable exposures to CRE assets that will need to be repriced at higher interest rates.

Monetary policy transmits to the broader economy by affecting overall financial conditions, but the magnitude, speed, and duration with which it affects the economy vary with the nature of the shocks that have hit the economy and other aspects of the economic environment. So while labor markets are currently strong and are expected to only gradually moderate, we need to remain attentive to the possibility that conditions could deteriorate faster than expected. On the other hand, the strong output and employment growth could be an indication that the neutral rate of interest, which rose during the pandemic, might remain high, which would mean restrictive policy may be needed for longer to achieve our goals of price stability and maximum employment.

Monetary policy is in a good place from which to assess and respond to these risks to the outlook. The current strength in labor market conditions and the strong spending data give us the opportunity to keep the nominal funds rate at its current level while we gather more evidence that inflation truly is on a sustainable and timely path back to 2 percent. This is better than finding ourselves in a situation where we begin easing too soon, undo some of the progress we have made on inflation, potentially destabilize inflation expectations, and then have to reverse course. If the economy evolves as expected, I think we will gain that confidence later this year, and then we can begin moving rates down. My base case is that we will do so at a gradual pace so that we can continue to manage the risks to both sides of our mandate. Of course, if downside risks materialize, we would have the opportunity to move rates down more quickly, just as we raised rates more aggressively than usual to combat rising inflation. Or if inflation appears to be stalling at a level above our goal, we would have the opportunity to maintain a restrictive stance for longer. Our policy actions will depend on how the economy and the risks evolve. When our goals of price stability and maximum employment are achieved, the economy will be in an even better place than where it is today.

Operating Framework

Let me conclude with some remarks about the Fed's balance sheet. As Chair Jay Powell indicated at his press briefing last week, the FOMC will be discussing reducing the pace of the runoff in its balance-sheet assets at its next meeting in March. Since June 2022, the Fed has been allowing maturing Treasuries and agency mortgage-backed securities to run off its balance sheet at a fairly good clip according to the plan announced in May 2022. The Fed's security holdings total about $7 trillion and have declined by about $1.3 trillion since the runoff began.

We are implementing monetary policy via an ample reserves operating regime in which reserve levels are ample enough that control over the federal funds rate and other short-term interest rates is executed primarily through setting the Fed's administered rates: the interest rate paid on bank reserves, the interest rate offered on overnight reverse repurchase agreements (ON RRPs), and the primary credit rate on discount window loans. Under this framework, active management of the supply of reserves is not needed. As assets run off our balance sheet, Fed liabilities move down. So far, the balance-sheet runoff has resulted in a reduction in ON RRPs, with balances currently under $575 billion, rather than a reduction in reserves. In aggregate, reserve balances are about $3.5 trillion, which is about 15 percent of banking system assets.

What constitutes an ample level of reserves is uncertain. It depends on the banking sector's demand for reserves, as well as the distribution of that demand across institutions, which will evolve over time. The

September Senior Financial Officer Survey[4] indicated that for most banks, their reserve levels are above their preferred level of reserves, and money market rates and spreads suggest little in the way of funding pressures. And the Fed's Standing Repo Facility provides a backstop against such pressures. So the current level and distribution of reserves are more than ample. But as balance-sheet runoff continues and ON RRP volume reaches a minimum level, reserves will begin declining, too, and more redistribution of reserves will need to occur across institutions. As our balance-sheet reduction plan noted, the FOMC will slow and then stop the runoff when reserve balances are somewhat above the level it judges is consistent with ample. This will help ensure that we can continue to reduce our balance sheet to its efficient size for effectively implementing monetary policy and move toward our longer-run goal of holding primarily Treasury securities, thereby minimizing the allocation of credit across sectors of the economy. I note that the runoff pace pertains to how we implement monetary policy and not to the stance of monetary policy. Our main tool of monetary policy is the fed funds rate target, and balance-sheet runoff can continue even after we begin to lower the funds rate.

This concludes my prepared remarks. Thank you for your attention. I look forward to our discussion.

[4] See Board of Governors of the Federal Reserve System, "Senior Financial Officer Survey Results," September 2023. (https://www.federalreserve.gov/data/sfos/files/senior-financial-officer-survey-202309.pdf)