Brief Remarks about the U.S. Economy and Monetary Policy

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

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Introduction

It is a real pleasure to speak with the European Economics and Financial Centre once again. I especially look forward to taking your questions because I learn a lot from hearing what is on your mind. Let me help frame our discussion by giving some brief remarks about the U.S. economy and monetary policy. Of course, these will be my views and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee.

The economy and monetary policy have been on quite a journey since I last spoke to you two years ago. Today, I would say that both the economy and monetary policy are in a good place. Inflation is still above our goal of 2 percent, but it has moved down a lot from its peak in 2022, when inflation hit a 40-year high, in the range of 7 to 9 percent, depending on the measure. Remarkably, this disinflation has occurred in the midst of strong labor markets and economic growth. The FOMC's job now is to ensure that the economy reaches an even better place by calibrating monetary policy so that inflation returns sustainably to our 2 percent goal and labor markets remain healthy.

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. Those forces have made it hard to track the economy because both supply and demand have been affected. Usually, it's all about demand. But the pandemic affected global supply chains, the supply of and demand for labor, and the mix 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 response to the high inflation, the FOMC began raising its policy rate, the federal funds rate, in March 2022, and over the two years since, the Committee 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. The supply side of the economy is also healing. Supply chain disruptions and bottlenecks have improved significantly, and firms have invested in diversifying their supply chains, making them more resilient to disruptions. 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. With imbalances between supply and demand in both product markets and labor markets easing, inflation has been easing, too.

I expect growth to moderate this year compared to its strong pace last year. Consumer spending has held up well, but in the wake of high prices, many families, especially those with lower incomes, are being more cautious with their spending. 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. Businesses also slowed their spending on equipment and software last year, and this spending is expected to continue to moderate given restrictive credit conditions. Tighter financial conditions have restrained investment in housing. 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 the continued tempering of inflation in housing services.

Job growth has been remarkably resilient. The unemployment rate has been 3.7 percent over the past three months and it has been within range of its 50-year low for almost two years. I expect conditions in labor markets to remain healthy but to moderate a bit. 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.

Better balance between the supply and demand for workers has meant wage growth has slowed. 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. Based on current estimates of trend productivity growth, wage growth is still a bit above the level consistent with 2 percent inflation. But it could be that trend productivity growth has moved higher than what it was before the pandemic. Workers were scarce during the pandemic, giving firms a great incentive to do more with fewer workers; many companies 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.

It is interesting that despite the labor market's strong performance, 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 relatively high, prices for many things are higher than they were before the pandemic and 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, that is, real wages, have begun to move up, and this is helping to close the gap between the cumulative increase in prices and the cumulative increase in wages. This may be partly why consumers are feeling better about the economy now.

Inflation

Inflation moved down faster than expected last year even as the economy remained strong. Measured year-over-year, as of January, total PCE inflation was 2.4 percent, core PCE inflation was 2.8 percent, and the Cleveland Fed's median PCE inflation measure was 3.5 percent.

But the January inflation report shows that we need to be cautious in assuming that inflation will continue to fall at the same pace as last year. Restrictive monetary policy has played an important role in moving inflation down, but supply-side adjustments have also been important. Now that pressures on supply chains are approaching normal and the labor market is coming into better balance, I don't think we should count on as much help from the supply side as we saw last year.

Even so, I do expect inflation to continue to move down over time to our 2 percent goal, even if it proves to be somewhat more persistent this year than last year. 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 have also moved down over time but are still above their 2019 averages. Continued progress on inflation will help ensure that these expectations move down to our goal. Progress depends on appropriate monetary policy.

Monetary Policy

At its meeting in January, the FOMC kept the target range of the fed funds rate at 5-1/4 to 5-1/2 percent, where it has been since last July. The Committee said that it 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. The Fed has a dual mandate 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.

Risk management will be the hallmark of monetary policy decisions going 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. But at this point, I think the bigger mistake would be to move rates down too soon or too quickly without sufficient evidence that inflation is 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. We don't want to find 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. And with labor markets and economic growth both being very solid, we don't need to take that risk.

My baseline forecast is that output and employment will moderate somewhat this year and inflation will continue to move closer to our 2 percent goal over time. I will gain confidence when I see inflation continuing to move down. The FOMC will then be in a position to start reducing the level of restrictiveness by moving the fed funds rate down. If the economy performs as anticipated, I expect we will find ourselves in that position sometime later this year. My base case is that when we do begin to move rates down, we will do so at a gradual pace so that we can continue to manage the risks to both sides of our mandate.

But this all depends on the economy evolving as expected. And there are a number of risks around this forecast. Heightened geopolitical tensions pose potential implications for financial markets, oil prices, and global demand and supply. Easing financial conditions could spur a resurgence in activity, leading once again to imbalances that fuel inflation. The stress generated by the bank failures last March has subsided and 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 commercial real estate assets that will need to be repriced at higher interest rates. We also know that 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. This would mean policy might be less restrictive than we think it is and that restrictive policy may be needed for longer than anticipated to achieve our goals of price stability and maximum employment.

The good news is that monetary policy is in a good place from which to assess and respond to these risks to the outlook. Because of the current strength in labor market conditions and the strong spending data, we have the luxury of keeping rates where they are as we gather more evidence that inflation truly is on a sustainable and timely path back to 2 percent. 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. On the other hand, 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 actually evolve. When our goals of price stability and maximum employment are achieved, the economy will be in an even better place than it is today.

Operating Framework

Let me conclude with some remarks about the Fed's balance sheet. At our meeting later this month, the FOMC will begin to discuss reducing the pace of the runoff in its balance-sheet assets. 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 holdings of securities total about $7 trillion and have declined by about $1.4 trillion since the runoff began.

We are implementing monetary policy via an ample reserves operating regime. In this regime, 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, rather than a reduction in reserves, runoff has resulted in a reduction in ON RRPs, with balances currently under $575 billion. 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 current level is 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. So at some point the FOMC will slow the pace of runoff and then stop the runoff when reserve balances are somewhat above the level it judges to be 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. It will also help us 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.