Returning to Price Stability:
An Update on the Economy and Monetary Policy

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

Briefings for Business
Wayne Economic Development Council
Wooster, OH

May 16, 2024

Introduction

I thank the Wayne Economic Development Council for inviting me to speak on the economy and monetary policy in the council's Briefings for Business series. The council's work to foster economic development in the region aligns with the Federal Reserve's mission to foster a strong economy.

Eddie Steiner is an active member of the Federal Reserve Bank of Cleveland's Board of Directors, and chairs the Board's Audit Committee, and Steve Matthew, who will be moderating the question-and-answer portion of today's session, is an active member of our Northeast Ohio Business Advisory Council. I will take this opportunity to thank them for their public service, which helps our Bank fulfill its mission. I also thank the many others in this room who regularly provide us with insights into economic conditions. These insights help to inform the Cleveland Fed's section of the Beige Book, the summary of regional economic developments published by the Federal Reserve prior to each FOMC meeting. The reconnaissance that you provide on business activity, the labor market, community conditions, and financial conditions is often more timely than the official data, and it helps us evaluate not only where the economy is but where it is going. You play a role in monetary policymaking because the information you provide informs my views of the economy and monetary policy, and it helps the FOMC make more informed monetary policy decisions in pursuit of its statutory goals of price stability and maximum employment.

I am especially looking forward to the question-and-answer portion of our session because I learn a lot from hearing what is on your mind. But before we get into today's dialogue, I thought it would be helpful to frame the discussion by offering some remarks about the economy and monetary policy. 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.

Economic Developments

At our FOMC meeting about two weeks ago, the Committee decided to maintain the target range for the federal funds rate at 5-1/4 to 5-1/2 percent and to continue to reduce the Federal Reserve's securities holdings. We have held our policy rate at this restrictive level since July of last year.

The FOMC 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 our goal of 2 percent. 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. In the second half of last year, inflation readings came in lower than expected, and PCE inflation was running at about our 2 percent goal over those six months. But the year-over-year measures of inflation remained elevated, and we knew it was too soon to declare victory over inflation. Over the first three months of this year, we have seen no further progress on PCE inflation. In fact, measured year-over-year, headline PCE inflation moved up to 2.7 percent in March and core PCE inflation remained at 2.8 percent. The three-month changes are running considerably above the levels seen over the second half of last year. Over the past three months, PCE inflation in core goods and PCE inflation in core services excluding housing have moved up, and housing services inflation has moved sideways. Yesterday's CPI inflation report is the first inflation reading for April. We saw a welcome tick down in the monthly readings for total and core CPI inflation, though those readings were higher than those we saw in the second half of last year.

I had expected the progress on inflation to slow this year compared to last year, because I didn't think we would get as much help from supply-side adjustments. Supply chain disruptions and bottlenecks have improved over the past three years and the labor market has been normalizing. People have returned to the labor force over time, and immigration has also increased the supply of labor. The healing of the supply side of the economy contributed to last year's disinflation, and we are not likely to get as much help on inflation from the supply side as we saw last year. Progress will depend more on moderating demand.

Still, the lack of progress on inflation so far this year has been disappointing. I think it is too early to conclude that progress on inflation has stalled out or that inflation is poised to reverse course: the journey back to price stability was never expected to follow a smooth path. But the recent readings have not inspired greater confidence in me, and we will need to accumulate further data over the coming months to have a clearer picture of the inflation outlook. I now believe that it will take longer to reach our 2 percent goal than I previously thought. But the Fed remains strongly committed to returning the economy to price stability.

The good news is that the economy is well positioned to allow us to accumulate those data without concern that monetary policy is overly restrictive. A remarkable thing about last year's disinflation is that it occurred in the midst of strong economic growth and labor markets. Last year, the economy grew at a pace above 3 percent, which is higher than my 2 percent estimate of trend growth. Indicators point to continued underlying momentum in the economy this year. According to the advance estimate, GDP growth did moderate to a 1.6 percent pace in the first quarter. But that step down reflected the inventory and trade components, which are often revised in subsequent releases as more data come in. Final sales to private domestic purchasers, which is a better indicator of underlying demand, continued to rise at a pace of around 3 percent. Consumer spending has remained healthy, despite rising credit card delinquency rates, and business fixed investment in equipment and software has strengthened, consistent with the anecdotal evidence from business contacts. Indeed, leading up to the FOMC meeting two weeks ago, there was a significant change in tone from the contacts in our District. Many reported that economic activity had strengthened and by more than they had anticipated.

Labor market conditions also remain strong. Payroll job growth has been remarkably resilient. Job gains averaged about 270 thousand per month in the first quarter of this year compared to around 210 thousand per month the previous quarter. Employment did moderate last month to a still healthy gain of 175 thousand. The unemployment rate remains low, at 3.9 percent in April. Still, the labor market has come into better balance over time as demand for workers has moderated while the supply has increased. The gap between the number of open jobs and the number of unemployed workers has narrowed. It is now about 1.3, only slightly above the 1.2 level seen in the strong labor market conditions in 2019. Our regional contacts report that while it remains difficult to find candidates with the skills needed for some jobs, in general, it has become easier to hire over time.

As labor demand has come into better balance with labor supply, wage pressures have eased. Firms in our District are expecting wage increases to average about 4 percent this year, down from 5 percent a year ago. And the wage premium workers can get from switching jobs compared to staying in their current jobs has moved back down to pre-pandemic levels.[1] It had shot up after the pandemic shutdown when firms were in desperate need of workers.

Whether wage growth adds to price pressures depends on whether wages adjusted for inflation are growing faster than the growth in labor productivity. Based on current estimates of trend productivity growth, which lie in the 1 to 1-1/2 percent range, wage growth is still above the level consistent with 2 percent inflation.[2] But there is the possibility that changes in technology are leading to higher trend productivity growth. The scarcity of workers during the pandemic gave firms a great incentive to invest

[1] See the Federal Reserve Bank of Atlanta's Wage Growth Tracker at https://www.atlantafed.org/chcs/wage-growth-tracker.

[2] Current estimates suggest that trend productivity growth remains relatively low, in the 1 to 1.5 percent range. See the website https://sites.google.com/view/james-a-kahn-economics/home/trend-productivity-update, which provides the latest estimates of trend productivity growth based on the model in James A. Kahn and Robert W. Rich, "Tracking the New Economy: Using Growth Theory to Detect Changes in Trend Productivity," *Journal of Monetary Economics* 54, September 2007, pp. 1670-1701. (https://doi.org/10.1016/j.jmoneco.2006.07.008)

in automation, and new technologies such as generative AI hold the promise of increasing productivity over the medium to longer run. If the higher productivity growth readings we saw last year are sustained, then current levels of wage growth could continue without adding to price pressures.

The Economy in Ohio

The current developments in activity, employment, and inflation at the national level are also reflected in Ohio's economy. As in the nation, labor market conditions in the state remain strong but show some signs of moderating. The state's unemployment rate has ticked up this year, but stood at 3.8 percent in March, which is near its historical low. Employment growth over the first three months of the year has slowed from last year's strong pace. And as I mentioned, employers in the state tell us it is easier to hire now. Immigration has likely contributed to that easing. Last year, immigration was the main driver of an increase in Ohio's population, the first yearly rise in population since the pandemic.[3] All in all, we have seen strong labor market performance in the state.

Ohio is the seventh largest economy in the nation in terms of gross state product. Manufacturing and, within manufacturing, auto and auto parts constitute an important sector of Ohio's economy, and compared to the nation, manufacturing represents a larger share of payroll jobs in Ohio. But that differential has fallen over time as the economy here has diversified from one largely dependent on manufacturing and heavy industry to one in which healthcare and education play a significant role. In the 1990s, manufacturing represented about 20 percent of Ohio's jobs and "eds and meds" represented about 12 percent. Those shares have now nearly reversed. In the past decade, the share of jobs in

[3] See William H. Frey, "Immigration is Driving the Nation's Modest Post-Pandemic Population Growth, New Census Data Shows," The Brookings Institution, January 4, 2024 (https://www.brookings.edu/articles/immigration-is-driving-the-nations-modest-post-pandemic-population-growth-new-census-data-shows/).

manufacturing has fallen to under 13 percent and the share in "eds and meds" has risen to nearly 17 percent.[4]

Regions that have diversified their industrial base have generally fared better over time and have proven to be more resilient. But the types of shocks that hit the economy can have differential effects on regions because of differences in their industrial makeup. For example, the healthcare sector was particularly hard hit by the pandemic. The labor market in healthcare remains particularly tight, with nurses expected to remain in short supply for some time to come. But, even within healthcare, our contacts report that they have seen some improvement in hiring and some normalization in wage growth.

Economic Outlook and Monetary Policy

In my view, the most likely scenario for the overall economy and that of the region is that the current restrictive stance of monetary policy will continue to help moderate growth and labor market conditions and that this moderation will contribute to the further easing of price pressures. So I expect progress on inflation over time, but at a slower pace than we saw last year. Analysis at the Cleveland Fed indicates that the past slowdown in wage growth will pass through to lower price inflation in core services and that the declines that have occurred in rents in new leases will pass through to slower inflation in housing services. Both of these effects will be needed in order to get back to 2 percent inflation, but they will take some time.

Setting monetary policy in this environment will take careful consideration of the risks to both parts of our dual mandate as the economy evolves. Recent data showing solid growth and labor market indicators

[4] Over the past decade (2014Q2 through 2024Q1), the share of jobs in manufacturing was 8.5 percent for the U.S. and 12.5 percent for Ohio. In the 1990s (1990Q1 through 1999Q4), the share of jobs in manufacturing was 14.8 percent for the U.S. and 19.9 percent for Ohio.

suggest that risks to the employment part of our mandate have diminished. But the recent inflation readings suggest that risks to the inflation part of our mandate have risen.

I am particularly attuned to the upside risks to inflation. Geopolitical tensions have the potential to further raise oil prices and other commodity prices, or to disrupt supply chains. The shortage of housing could keep housing services inflation elevated even though rents have been falling. Medium- and longer-term inflation expectations are important determinants of actual inflation. These expectations have remained reasonably well-anchored at levels consistent with our 2 percent inflation goal throughout this high-inflation episode, and that anchoring has been an important contributor to the disinflation we have seen over time. Nonetheless, recent readings on short-term inflation expectations have moved up again. Were this increase to spread to longer-term expectations, it would be considerably harder to reach our inflation goal. So setting monetary policy to ensure that those expectations remain well-anchored will be very important.

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. The actual path monetary policy takes will depend on how the economy actually evolves; this is the data dependence policymakers often refer to. Our current monetary policy stance puts us in a good position for managing the risks that could be realized. 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. And with labor markets and economic growth both being very solid, we do not need to take that risk.

Incoming economic information indicates that it will take longer to gain that confidence; holding our restrictive stance for longer is prudent at this point as we gain clarity about the path of inflation. Once the

FOMC gains confidence that inflation is moving sustainably back to 2 percent, it will be in a position to begin to gradually normalize policy back to a neutral level as the economy returns to price stability and maximum employment. While it is not my base case, should developments in inflation and inflation expectations warrant it, policymakers will need to be open to tightening policy further. On the other hand, if the labor market unexpectedly deteriorates, policy could ease sooner and by more than currently anticipated. So monetary policy is well positioned for risk management as we gather more evidence on how the economy is evolving.

The FOMC remains fully committed to returning inflation to our 2 percent goal because price stability is critical for the long-run health of the labor market, the overall economy, and the stability of the financial system. As we have seen since the pandemic, high inflation can badly affect people's lives and their view of the country's economic well being. At a recent meeting of our Business Advisory Council, we discussed the fact that even though the labor market is strong and inflation is down from its peak, many people are not very happy about the economy. Indeed, consumer sentiment and confidence indices are well below their pre-pandemic levels. I believe dissatisfaction with the economy partly reflects the fact that even though inflation has been coming down and wage gains have been relatively high for some people, prices for many things are higher now than before the pandemic and many workers' 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. As inflation has been moving down, wages adjusted for inflation, that is, real wages, have begun to move up. As the disinflation process continues, it will help to close the gap between the cumulative increase in prices and the cumulative increase in wages, and people will then begin to feel they have made up for lost ground.[5]

[5] Since the first quarter of 2021, when inflation began to rise, PCE inflation has been running at an annualized pace of 4.7 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.

I believe another reason people are not happy with the economy is that it is much harder to purchase a house than it used to be. The median price of a home in the U.S. is now almost 50 percent higher than it was prior to the pandemic.[6] Thirty-year mortgage rates are now over 7 percent; prior to the pandemic they were under 4 percent. A recent survey of consumers by the New York Fed found that renters believe the probability of their ever owning a home has fallen to 40 percent, which is the lowest level since the question was first asked in 2015.[7] Owning a house is an important avenue for building wealth but many people feel this part of the American dream is out of reach, at least for now, and that isn't a good feeling.

I am hopeful, though, that the economy will evolve as expected and as inflation returns to our target, economic conditions continue to normalize, and labor markets remain healthy, more people will be able to enjoy the benefits of what a strong U.S. economy has to offer.

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

---

[6] According to data from the National Association of Realtors, the median price of an existing single-family home was $272,800 in February 2020 and was $397,200 in March 2024. The S&P CoreLogic Case-Shiller home price index, which is a repeat-sales index and so controls for the composition of single-family homes sold, is also up almost 50 percent over its pre-pandemic level.

[7] See the Federal Reserve Bank of New York's Survey of Consumer Expectations Housing Survey at https://www.newyorkfed.org/microeconomics/sce/housing%20.html#/.