Lake Effect:
Views from the Fourth District on the Economy and Monetary Policy

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The City Club of Cleveland
Friday Forum
Cleveland, OH

December 6, 2024

For release on delivery
12:00 pm EST

Introduction

Good afternoon. It's an honor to join the ranks of speakers who have engaged with the City Club of Cleveland. I'm a fan of your mission to create conversations of consequence that help democracy thrive, and I hope to contribute to that tradition today. I look forward to your questions, in particular because understanding what's on your minds is an important part of my job as Cleveland Fed president.

I've been in Cleveland for about four months, but it isn't my first time in the city. My husband grew up in Shaker Heights, and his family continues to call the region home, so I was familiar with the area and its famous lake-effect snow. But as a full-time resident, I have been moved by how welcoming the community has been. Many people have been willing to share their experiences and recommendations to make sure that I enjoy the best that Northeast Ohio has to offer. A few of my early favorites have included catching games with the Guardians and Cavaliers, sipping on a Christmas Ale, and discovering a local pinball spot. And though I've settled in Cleveland's East Side, I've been pleasantly surprised to learn that you don't actually need a passport to cross the Cuyahoga River. And that's good because so far I've found some of my favorite restaurants on the West Side.

I'm impressed with the strong spirit of collaboration among business and community leaders here. Your commitment to making this region a great place to live and work is apparent in big ways and small, from the connections between the private sector and nonprofits, to education and world-class arts. I thank you all for your hospitality in helping me get to know my wonderful new home.

So, a little about me. Before joining the Cleveland Fed, I worked in financial markets for 30 years, where, when it comes to understanding financial conditions and interest rate dynamics, the Fed is the North Star. I have also had the opportunity during my career to work directly with financial market policymakers, something I found very rewarding. It was this aspect, the Fed's public service mission, that attracted me to the job. It has been both thrilling and humbling to apply my practical experience to my new role leading the Federal Reserve Bank of Cleveland in our work on behalf of the region and the nation.

When people ask what's surprised me the most about working at the Fed, I've been struck by how little people know about the breadth of our responsibilities. In my remarks today, I will do my best to demystify the Federal Reserve, and I'll highlight the ways in which my colleagues at the Cleveland Fed play important parts in carrying out our core responsibilities. I'll also share my views on the current prospects for the Fed's highest-profile responsibility, formulating monetary policy for the nation. Before I begin, I want to note that the views I express today are my own and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.[1]

The Federal Reserve's Five Functions

One thing the City Club and the Fed have in common is that we've stood the test of time. The City Club was created in 1912, just one year before the Federal Reserve was established in 1913. The Fed's origins are tied to the wave of financial crises that swept the country in the late nineteenth and early twentieth centuries. To their credit, the framers of the Federal Reserve Act saw the need for a central banking "system" rather than a single entity. The new system created a decentralized institution with public and private characteristics, one that is uniquely capable of serving the nation's economic and financial interests free from short-term political pressures.

So what exactly does this look like? In Washington DC, the Board of Governors is a federal government agency with seven members who are appointed by the US president and confirmed by the Senate. Across the country, 12 regional Reserve Banks including Cleveland serve as the operating arms of the Federal Reserve System. Although we were created by Congress to serve the public, the Reserve Banks are not

[1] I am grateful to members of my staff in the Research and Communications Departments including Edward Knotek and Doug Campbell for assistance with these remarks.

part of the federal government. Each Reserve Bank has its own board of directors drawn from different parts of the regional community, including business, banking, and nonprofit leaders. The Cleveland Fed represents the Fourth Federal Reserve District, encompassing Ohio and parts of Pennsylvania, Kentucky, and West Virginia. The boundaries for each of the Districts were based on trade and economic considerations of the early twentieth century, when our region was primarily known as a manufacturing hub.

In 2024, the Fourth District's economy has evolved beyond its manufacturing roots, with growing education, healthcare, and technology sectors. The Fed's decentralized structure allows each Reserve Bank to bring on-the-ground insights into the process of setting policy for the entire nation. Though as a courtesy to my colleagues and with acknowledgement that DC can't really handle it, I will leave the lake-effect snow at home. I have already come to rely heavily on the perspectives of the Bank's directors, including those in our branches in Cincinnati and Pittsburgh, and on the input from our advisory council members and contacts across the District. The real-time information they provide is one crucial input into how I think about monetary policy. However, monetary policymaking is just one aspect of the job. My fellow policymakers and I gather at least eight times each year, and I spend the lion's share of the week before these meetings in intense preparation. Leaving aside these 56 days of meetings and prep, there are still 200 weekdays left in the year. I'm sure many of you, like much of my family and friends, are wondering what else we do at the Federal Reserve aside from monetary policy that makes use of that time.

So, let me give you a quick tour of the Fed's other major responsibilities.[2]

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[2] For a comprehensive overview of the Fed's functions, see "The Fed Explained: What the Central Bank Does," a Federal Reserve System Publication, August 2021. (https://www.federalreserve.gov/aboutthefed/files/the-fed-explained.pdf)

Financial Stability

First, the Fed has a responsibility to promote financial stability, which again was the primary reason for its founding more than 100 years ago. We had a great discussion about this role last month, when the Bank hosted its twelfth annual Financial Stability Conference in partnership with the Office of Financial Research. The Fed monitors the financial landscape for emerging risks while enforcing rules and regulations aimed at promoting financial system resilience over the longer term. We also have tools to contain damage if a shock hits the economy. You may recall the emergency liquidity and funding support the Fed issued in response to economic disruptions caused by the onset of the pandemic, including the Paycheck Protection Program Liquidity Facility, which helped banks extend credit to small businesses via low-interest Paycheck Protection Program, or PPP, loans. The Cleveland Fed played a part in that program by offering direct support to community development financial institutions.

Supervision and Regulation

Closely related to our financial stability responsibility is our supervision and regulation function. The Fed's Board of Governors controls the regulatory side and has delegated the examination authority to the 12 Reserve Banks. Our goal here is to ensure that individual banks and other financial institutions operate safely and soundly. At the Cleveland Fed, we have a team of examiners who evaluate more than 260 financial institutions across our District. When individual institutions are stable and provide valuable credit services to households and businesses, they form the foundations of a strong financial system. With examiners serving as boots on the ground, we're better able to see developments at key firms and in markets that may signal wider trends that could add risk to the financial system as a whole.

Payments

Third on the list of Fed responsibilities is our support for the nation's payments system. Most of us spend very little time thinking about the payments system—it's like plumbing—but if something goes wrong, it's a big problem. For buying groceries, paying bills, and taking care of business expenses, the Fed's job is to help ensure the whole payments system runs smoothly behind the scenes. The Cleveland Fed also supports the US government's payments services. If you've ever made a payment on a student loan or used a credit card to buy a souvenir at a national park gift shop, you've touched applications developed and managed by the Cleveland Fed's Treasury services team.

Payments also include cash transactions. Of course, cash—along with paper checks—is no longer the predominant medium of exchange, since the world has shifted toward electronic payments. As such, the Fed is constantly assessing the quantity of currency that will be needed as financial habits change. The Federal Reserve issues paper currency at its locations across the country, including here in Cleveland. If you happen to have any cash handy, take a look. On every denomination of bill, there is a letter and a number printed on the face side. The letter will be A through L, representing the 12 Reserve Banks, coupled with its corresponding number from 1 through 12. If you have a bill with a D4, congratulations! You're holding a Federal Reserve Bank of Cleveland note. On every Fourth District one and two dollar bill, there are two concentric circles around the letter D. The outermost circle says, "Federal Reserve Ohio." The innermost says, "Bank of Cleveland."

Consumer Protection and Community Development

A fourth responsibility of the Fed is to promote consumer protection and community development. This work takes several forms. In supporting consumer protection, bank examiners at the Cleveland Fed and throughout the Federal Reserve System ensure that financial institutions follow fair lending and fair housing laws and that they are meeting the credit needs of their low- and moderate-income neighborhoods, as prescribed under the Community Reinvestment Act.

In supporting community development, Reserve Banks have teams of analysts who conduct in-depth research on topics such as affordable housing and occupational mobility. You can learn more about the Fed's work in community development on fedcommunities.org, which, I should add, is a Systemwide effort the Cleveland Fed leads to highlight the research and outreach of community development teams across the 12 Reserve Banks. In addition, the Cleveland Fed leads the Federal Reserve System's annual Small Business Credit Survey, which gathers timely information on borrowing conditions for businesses with fewer than 500 employees. Finally, we employ outreach managers who share insights about the Fed's resources with community members, and, at the same time, listen and learn from the public about the challenges they face.

Monetary Policy

That brings me back to the Fed's responsibility to conduct monetary policy. Monetary policy actions are undertaken by the Federal Open Market Committee, or FOMC, which comprises all 12 presidents of the Reserve Banks and the seven governors I mentioned earlier at the Board of Governors in Washington DC. The 12 Reserve Bank presidents rotate their voting years, with the exception of the president of the New York Fed, who is a permanent voting member and vice chair of the committee. The Cleveland Fed president votes in even-numbered years, alternating with the Chicago Fed president, who votes in odd years, while most other Reserve Bank presidents vote every three years. Importantly, whether voting that year or not, all of us speak at every meeting, and listen keenly to learn from one another.

Congress has given the FOMC a dual mandate to achieve maximum employment and stable prices. This dual mandate may sound straightforward, but the reality is that the FOMC takes a wide range of information into account in assessing how close or how far we are from these goals and how likely the economy is to reach them both today and over time.

One of the advantages of the decentralized structure is the diversity of views it brings to the conversation. My FOMC colleagues and I come from many different backgrounds. To name a few, we have former academic economists, bankers, regulators, and business consultants on the committee. I view this diversity of experience as an asset because it allows for a robust discussion from many viewpoints and allows us to address a wide range of issues from positions of deep knowledge. My background is in financial markets and business. As such, I rely on the Bank's team of research economists to provide a framework for understanding what the theoretical models or empirical data might suggest about the impact of various policy approaches. My pragmatic approach to monetary policy pairs this analysis of models and data with my reading of the signals that businesses and markets are sending.

Now, with that as a backdrop, let me lay out how I see the current economic landscape, which informs my view on the appropriate stance for monetary policy.

Economic Activity

The pandemic and the subsequent closing and reopening of the economy resulted in tremendous swings in activity. Fortunately, many of these extreme fluctuations are now behind us. But their impacts continue to linger along several dimensions.

Overall, the economy is strong, and the labor market is healthy. Inflation has eased considerably over the last two years, but it remains above the FOMC's objective.

While not a part of our mandate, the broadest measure of economic activity is gross domestic product, GDP, which captures spending by consumers, businesses, and governments on a wide range of goods and services.

Real GDP, which abstracts from changes in prices, grew nearly 2-3/4 percent over the last year. This pace of growth is a little above the average rate experienced during the 10 years before the pandemic-induced recession, and it's higher than most estimates of the economy's longer-run growth rate. Consumer spending accounts for more than two-thirds of GDP. In the national data, consumer spending remains strong, supported by the healthy labor market, rising real wages, and elevated household wealth.

As I mentioned, an important role for the Reserve Banks is collecting data and anecdotes from their Districts to complement official statistics. Information that the Cleveland Fed's research and community development teams collect from our regional contacts sheds light on changes in customer demand, hiring, pricing, and so on. The conversations with our contacts provide our most timely information on the state of the economy. This information is usually available before the official economic statistics, which can take time to compile and produce. A summary of this qualitative information from the Cleveland Fed and other Reserve Banks is released to the public two weeks before every FOMC meeting in a publication commonly known as the Beige Book.[3] The most recent version came out just two days ago. I also make it a point to talk directly to stakeholders throughout the region about how they and their organizations' clients are experiencing the economy. I find this information highly valuable to provide additional context and nuance behind the national numbers.

In a bit of a contrast to the national data, contacts in the Bank's District reported more modest growth in recent weeks, although they generally expect activity to increase further in the months ahead. Car dealers in our District have been downbeat, but other retailers pointed to stronger spending. That said, a common theme among contacts is the notion of a two-speed economic expansion. More affluent consumers are spending readily. Meanwhile, lower-income consumers are more price conscious and are often experiencing difficulties finding affordable housing, struggling to feed their families, and needing to cut discretionary spending in the face of higher prices. These reports serve as a reminder that aggregate numbers can mask significant differences across households.

Labor Market

Now let me turn to the labor market. National data and anecdotes from our District point to healthy labor market conditions. Today is a big day among market participants and economists because the Bureau of

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[3] The Cleveland Fed's most recent Beige Book entry is available via https://www.clevelandfed.org/publications/beige-book.

Labor Statistics issued its monthly Employment Situation report at 8:30 this morning. It showed that the unemployment rate was 4.2 percent and that total nonfarm payroll employment increased by 227,000 in November.

It can be dangerous to focus too much on one release because it may be subject to revisions and reflect idiosyncratic factors like the impact of hurricanes and strikes. Looking instead at broader trends, labor market conditions have eased from where they were in 2022 and 2023. During much of that time, the labor market was unsustainably tight: constrained labor supply and robust labor demand contributed to quickly rising wages and prices.

Today, the unemployment rate is a little higher than it was two years ago, but it's still historically low. In fact, it's near many estimates of its longer-run level. Job growth has slowed, the ratio of job vacancies to unemployed workers has declined to levels more in line with the prepandemic norm, and wage growth has shown signs of moderating. Slowing in the labor market has largely happened because of reductions in the number of vacancies and slower hiring. Reports of layoffs remain limited, both in the national data and regionally. Business contacts report that there are more candidates available for jobs than had been the case even one year ago, a situation which is reducing upward pressure on wages.

Inflation

Finding a better balance between supply and demand in general has been necessary to tackle elevated inflation. The good news is that inflation, which is the rate of change of prices, has come down considerably from where it had been. The not-quite-as-good news is that it's still not back to where we want it to be. And it's important to acknowledge that a period of elevated inflation leads to a large increase in the price *level*, one which is unlikely to be undone.

The FOMC's preferred measure of inflation is based on the price index for personal consumption expenditures, what you might know as "PCE inflation." Inflation as measured by the consumer price index, or CPI, generally runs a little higher but has followed a similar pattern. PCE inflation peaked at 7.2 percent in June 2022. As of this October, it had fallen to 2.3 percent, helped recently by declines in energy prices. Economists and policymakers also consider a variety of other inflation measures to assess the role of outliers and to extract the trend in prices. These measures are generally higher than the most recent PCE inflation reading, suggesting that a portion of the decline in headline PCE inflation may not be sustained. The Cleveland Fed has long been a leader in studying inflation, and the Bank's Center for Inflation Research produces and displays a number of useful inflation measures and other resources for economists, policymakers, and the interested public.[4]

The FOMC judges that a PCE inflation rate of 2 percent over the longer run is most consistent with our mandate for price stability.[5] The economy has made it most of the way to this objective, but there is further to go, and success is not assured. The monthly inflation readings in the last two months moved up from where they had been this summer, indicating that the disinflation process has slowed. While some components' inflation rates have returned to where they were before the pandemic, when inflation was running at or below 2 percent, other components' inflation rates have not.[6] One indicator we are watching closely is the ability of our business contacts to raise prices. Currently, our contacts are reporting that it has become more challenging to raise their prices, something which may foreshadow further easing of price pressures ahead.

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[4] The Center for Inflation Research's homepage is available via https://www.clevelandfed.org/center-for-inflation-research.

[5] See the FOMC's Statement on Longer-Run Goals and Monetary Policy Strategy, as reaffirmed effective January 30, 2024, available via https://www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf.

[6] For example, housing-services inflation remains higher than its prepandemic inflation rate, reflecting catchup of existing tenant rents to the dynamics of new-tenant rents, as described in Loewenstein, Lara, Jason Meyer, and Randal J. Verbrugge. 2024. "New-Tenant Rent Passthrough and the Future of Rent Inflation." Federal Reserve Bank of Cleveland, *Economic Commentary* 2024-17. https://doi.org/10.26509/frbc-ec-202417. Other elements of service sector inflation also remain elevated; see Hajdini, Ina. 2024. "Wage Growth, Labor Market Tightness, and Inflation: A Service Sector Analysis." Federal Reserve Bank of Cleveland, *Economic Commentary* 2024-15. https://doi.org/10.26509/frbc-ec-202415.

The experience of the last few years has reinforced that elevated inflation imposes both real and perceived costs.[7] The challenge for monetary policy is to sustain the healthy labor market conditions we have been experiencing while finishing the job of bringing inflation back to 2 percent on a sustained basis. There is more work to do.

Policy Implications

The US economy at this time has a good amount of momentum and a history of surprising resilience. For example, in the first half of 2023, the Survey of Professional Forecasters captured the expectation that GDP growth would be low, ostensibly reflecting rising interest rates to combat inflation.[8] Instead, the economy grew at an above-trend pace that year. Resilient growth, a healthy labor market, and still-elevated inflation suggest to me that it remains appropriate to maintain a modestly restrictive stance for monetary policy for some time. Such a policy stance will help to sustainably return inflation all the way back to 2 percent in a timely fashion.

It is difficult to know precisely how restrictive our current policy setting is. Large fiscal deficits, elevated productivity growth, and the Fed's ample reserves framework with many long-duration securities on the balance sheet are just some of the challenges we face in assessing what constitutes a neutral stance of policy, one which neither stimulates nor restricts economic activity. Some of the forces that appeared to be holding down the neutral rate following the Global Financial Crisis may have finally run their course or reversed. In addition, even estimates from the most sophisticated models of neutral rates tend to have a great deal of uncertainty around them. As I take into account strong economic growth, the low unemployment rate, still-elevated inflation, and signals from financial markets, among other factors, my

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[7] See L'Huillier, Jean-Paul, and Martin DeLuca. 2023. "The Long-Run Costs of Higher Inflation." Federal Reserve Bank of Cleveland, *Economic Commentary* 2023-17. https://doi.org/10.26509/frbc-ec-202317.

[8] The Federal Reserve Bank of Philadelphia conducts the Survey of Professional Forecasters each quarter. Results are available via https://www.philadelphiafed.org/surveys-and-data/real-time-data-research/survey-of-professional-forecasters.

overall view is that monetary policy is only somewhat restrictive today. In economist-speak, given our sustained robust GDP growth, with U close to U-star and pi close to pi-star, perhaps r is already close to r-star as well. Or, to put it in plain English, we may not be too far from a neutral setting today.

The target range for the federal funds rate is the FOMC's primary tool for communicating and implementing monetary policy. At our last two meetings in September and November, the FOMC reduced the fed funds target, which is now in a range of 4-1/2 to 4-3/4 percent. I supported these actions to recalibrate the stance of policy, reflecting the improvements seen thus far in reducing inflation.

To balance the need to maintain a modestly restrictive stance for monetary policy with the possibility that policy may not be far from neutral, I believe we are at or near the point where it makes sense to slow the pace of rate reductions. Moving slowly will allow us to calibrate policy to the appropriately restrictive level over time given the underlying strength in the economy. Indeed, since my initial foray into forecasting in the September Summary of Economic Projections, inflation, growth, and the labor market have all been stronger than I and the SEP median had expected. To me, this situation calls for a slower pace of rate cuts relative to my September forecast. Achieving our goals means seeing further convincing evidence that inflation is indeed continuing to decline to 2 percent while sustaining a healthy labor market.

The 1990s provide two separate episodes in which the FOMC reduced the federal funds rate by 75 basis points and then held it there for a time. While today's economy has both parallels to and differences from that era, I see those shallow midcycle rate cuts as a relatively successful precedent for helping to sustain a long expansion, though I hope not to experience another bubble in equity prices along the way. It will be necessary to monitor financial conditions alongside a broad range of economic data and anecdotes from the business community to guide our decisions.

As of yesterday, financial markets appear to be pricing in about one reduction in the fed funds target range between now and the end of January and only a few cumulative reductions by the end of 2025. This path is consistent with my current expectation for the funds rate, based on my forecast that features solid economic growth, a low unemployment rate, and gradual improvements in inflation. However, the incoming data, the outlook, and the balance of risks will ultimately determine the future path of interest rates. As with any forecast, there are risks on both sides of my expected policy path. Keeping interest rates higher than needed could unnecessarily harm the health of the labor market. But easing interest rates too much or too quickly could slow the return of inflation to 2 percent and contribute to froth in financial markets, a situation that could undermine financial stability and impede progress on our monetary policy goals. As long as inflation is above our objective and the labor market remains strong, my focus remains on finishing the task at hand. Admittedly, it's a careful balancing act.

There are more data releases between now and the next FOMC meeting that will help to shape the outlook. I look forward to discussing my observations with my colleagues at the FOMC table and will maintain an open mind about the decision that will best position monetary policy to achieve our maximum employment and price stability objectives.

Conclusion

Let me leave this where I began. I'm really excited to be in Cleveland, despite the lake-effect snow. To best represent the Fourth Federal Reserve District, I need to hear from you about what you're seeing in your businesses and communities. I encourage you to get involved. We need people in our business community to serve as Beige Book contacts and advisory council members. Our Small Business Credit Survey benefits when more small-business owners participate. Our community development teams are ready to engage with you on the hard problems facing low- and moderate-income people and neighborhoods. You can find more information and ways to work with us on clevelandfed.org.

I hope all of you take away from my remarks that the Cleveland Fed is a resource for the communities we serve and that our employees are **of** these communities. I'm proud to call Cleveland home. I very much appreciate the opportunity to talk with you today, and I look forward to your questions.