Progress and Prudence:
An Update on the Economy and Monetary Policy

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Introduction

I thank the Akron Roundtable for inviting me to speak in the Signature Series today about the economy and monetary policy. Of course, the views I present will be my own and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee.

The Akron Roundtable's work to foster community dialog aligns very well with the Federal Reserve Bank of Cleveland's own efforts to engage with the public. I like that word "dialog." At the Cleveland Fed we strive to provide our communities with useful research, data, and analysis. For example, our Center for Inflation Research provides various resources to policymakers, researchers, and the general public on inflation and its drivers.[1] And in return, we receive economic reconnaissance from a wide variety of contacts from throughout our region. I firmly believe that the Fed's engagement with the public leads us to make better policy decisions. I also believe that the structure of the Federal Reserve System supports that engagement. So before turning to the outlook, I will give a brief overview of the Fed's structure.

The Structure of the Federal Reserve System

Congress established the Fed in 1913 after a period of financial instability as an institution to promote the health of the U.S. economy and the financial system. Congress designed the Fed to operate in the public interest as a decentralized central bank: the Fed is independent *within* the government but not independent *from* the government. At the time, there were concerns that the central bank would become dominated by financial interests in New York or political interests in Washington. So the Fed was designed to include representation from across the country and to balance public-sector and private-sector interests, and Wall Street and Main Street concerns.

[1] For more information, see the web pages of the Federal Reserve Bank of Cleveland's Center for Inflation Research at https://www.clevelandfed.org/en/our-research/center-for-inflation-research.aspx.

The Federal Reserve System has 12 regional Reserve Banks and a seven-member Board of Governors in Washington, D.C. that oversees those Banks. The governors are appointed by the president of the United States and confirmed by the Senate.[2]

The 12 Reserve Banks are distributed around the country in locations that were the centers of economic activity back when the Fed was established. Each Reserve Bank has a board of directors whose nine members are chosen in a nonpolitical process, with three representing banks and six representing business, agricultural, industrial, and public interests in the Districts they serve. One important responsibility of the nonbank directors on a Reserve Bank's board is selecting the Bank's president, who is subject to approval by the Fed's Board of Governors. Some Reserve Banks also have Branches with five- to seven-member boards. The Cleveland Fed represents the Fed's Fourth District and includes the state of Ohio and parts of Pennsylvania, Kentucky, and West Virginia; we have Branches in Cincinnati and Pittsburgh. In addition, we have a number of advisory councils that draw their membership from various sectors and geographies in our District.[3]

This regional structure of the Fed has served the country well for more than 100 years. The U.S. is very diverse, encompassing large cities, small towns and communities, and rural areas, with a mix of different industries and occupations, and some places more prosperous than others. The Fed's structure helps to ensure that a variety of information from all sectors of the economy and all parts of the country is taken

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[2] Governors serve staggered terms of up to 14 years. These terms span several terms of the president and members of Congress, a structure that is intended to insulate the governors from short-term political influence and which allows them to take a longer-run perspective when setting monetary and financial regulatory policy. The chair and vice chair of the Board of Governors, and the governor who serves as vice chair of supervision, are chosen by the president and confirmed by the Senate from among the sitting governors for four-year terms. The chair and vice chairs can be reappointed until their terms as governors expire.

[3] More information about the Cleveland Fed's board of directors and advisory councils is available on our web site at https://www.clevelandfed.org/about-us/directors and https://www.clevelandfed.org/about-us/advisory-councils, respectively.

into account in our monetary policy decisions.[4] The Cleveland Fed is continuously gathering information from a diverse group of business, consumer, community, and labor contacts throughout our District. This information helps me to formulate my views on the regional and national economies and monetary policy, and I bring this information to meetings of the Federal Open Market Committee (FOMC). The FOMC is the body within the Fed that is responsible for setting monetary policy.[5] Other Reserve Bank presidents are doing the same thing. So the discussions at FOMC meetings contain a mosaic of economic information and analysis from all parts of the country. And this regional information, along with economic and financial data and analysis, informs the FOMC's setting of national monetary policy in pursuit of its statutory goals of maximum employment and price stability.[6]

The Economic Journey So Far

So, what does the economic information we have been gathering tell us about the economy and what are the implications for monetary policy? I titled my remarks today "Progress and Prudence." It may sound like the title of a Jane Austen novel, but I think it is a good characterization of where we are and what will be needed to ensure that the economy returns to price stability. To see the progress, it will help to briefly review how the economy got to where it is today.

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[4] The regional structure also allows the Fed to carry out its other responsibilities including supervising and regulating certain banks, promoting the stability of the financial system, playing a major role in overseeing the nation's payments system, providing certain financial services to the U.S. government, and promoting economic progress and access to credit in low- and moderate-income neighborhoods and the people who live there.

[5] The FOMC holds eight regularly scheduled meetings per year in Washington, D.C. The FOMC was established by the Banking Act of 1935 and has 12 members: the seven members of the Board of Governors, the president of the New York Fed, and four other Reserve Bank presidents, who serve on a rotating basis. As president of the Cleveland Fed, I vote every other year, rotating my vote with that of the president of the Chicago Fed. Other than New York, Cleveland, and Chicago, the other presidents vote every third year. All presidents, whether voting or nonvoting, participate in FOMC meetings.

[6] The Federal Reserve Act says that the Fed should conduct monetary policy to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." When prices are stable and the economy is at maximum employment, long-term interest rates are typically at moderate levels, so it is often said that Congress has given the Fed a dual mandate.

At the start of 2020, before the pandemic, the U.S. economy was on very solid footing. It was the 11th year of the expansion, and things looked quite good from the perspective of our monetary policy goals. The unemployment rate was at historically low levels, employment growth was strong, participation in the labor force was solid, and inflation was near the FOMC's longer-run goal of 2 percent.

The pandemic changed all of that. The economy shut down in March 2020. Fiscal and monetary policymakers took aggressive actions to support households and businesses, ensuring that credit continued to flow, and to limit lasting damage to the economy. When public health statistics began to improve in May 2020, many parts of the country began to relax some of their stay-at-home restrictions, and the economy began to reopen. As the reopening progressed, it became clear that shutting down an economy can happen much more swiftly than reopening one. Spending patterns had changed, people had left the workforce, and supply chains were disrupted. And these forces are still having an effect on the economy today.

The economy expanded rapidly in 2021 as demand rebounded. But that strong demand confronted very constrained supply in both product and labor markets. The imbalances in demand and supply led to significant upward pressures on prices in an environment of very accommodative monetary and fiscal policy. A sharp rise in inflation began in the spring of 2021. Russia's war against Ukraine, which began in February of last year, led to sizable increases in food and commodity prices, also contributing to rising inflation.

High inflation makes it harder for people to make ends meet, and it also imposes longer-run costs on our economy by affecting the decisions people make about getting an education or training for a new job, and the decisions businesses make about undertaking R&D or investing in new plants and equipment. These types of investments in human and physical capital help determine our economy's pace of innovation and productivity growth and its potential growth rate, and so our longer-run standard of living.

The Fed is responsible for ensuring price stability. So in March of last year in the wake of high and stubborn inflation, the Fed began significantly increasing its policy rate, the fed funds rate. The rate has moved up a cumulative 4-3/4 percentage points and the target range of the funds rate is now 4-3/4 to 5 percent. The Fed has also been allowing assets to run off its balance sheet in a systematic way according to the plan announced last May, which is also helping to firm the stance of monetary policy. These monetary policy actions aim to tighten financial conditions to moderate demand, which will help to reduce price pressures and bring inflation down.

Progress Is Being Made

The good news is that progress is being made. Underlying demand remains resilient but economic activity has begun to slow. Real GDP grew at a below-trend pace of 1 percent last year, down from a very robust pace of about 5-3/4 percent in 2021. The slowdown in activity is seen most clearly in the housing sector, which is quite sensitive to interest rates, but also in manufacturing and business investment. Consumer spending, which makes up 70 percent of GDP, has been supported by strong household balance sheets and income growth, but it too is moderating. On the supply side of the economy, disruptions in supply chains have generally improved. Our contacts report that bottlenecks have eased, and survey data indicate that delivery times have shortened. This is welcome news because price pressures can be alleviated both through further moderation in demand and further improvement in supply.

Progress is also being made in rebalancing the labor market. Overall labor market conditions remain strong. Payroll job gains averaged 345 thousand per month over the first three months of this year, a pickup from the average monthly gain in the fourth quarter of last year. The unemployment rate remains a very low 3-1/2 percent, near where it has been for much of the past year. These tight labor market conditions have made it challenging for businesses to attract and retain all the workers they need to meet

demand for their products and services. But we are beginning to see some moderation. Employment growth has slowed over the past year and firms report that it is somewhat easier to find workers now. In addition, the rate at which people are quitting their jobs is moving down, which is usually a sign of a moderating labor market. On the supply side, there have been gains in prime-age labor force participation. So progress is beginning to be made in rebalancing labor demand and supply. As this continues, it should ease wage pressures, which have contributed to high inflation.

Turning to inflation, the good news is that progress is being made here as well. In February, the year-over-year measures of both total PCE inflation and core PCE inflation were in the 4-1/2 to 5 percent range. They had peaked last year in the 5-1/4 to 7 percent range. Similarly, CPI inflation is also down. Measured year-over-year, CPI inflation was 5 percent in March, down sharply from its peak of 9 percent last summer. Core CPI inflation is now about 5-1/2 percent, down about 1 percentage point from its peak.

Despite this progress, inflation is still too high. And it is proving to be stubborn. Some measures of underlying inflation, such as the median and trimmed-mean PCE inflation rates, have shown little improvement since their peaks.[7] The disaggregated data show that the stubbornness is due mainly to the prices of services. Inflation in core PCE services excluding shelter has not improved. It tends to be sticky, is correlated with wage inflation, and is a much larger share of the overall index than goods or housing, since consumers spend a larger share of their income on these services.

[7] Median and trimmed-mean inflation measures exclude components with the most extreme movements each month. Measured year-over-year, as of February, the median and trimmed-mean PCE inflation measures are still between 4-1/2 and 6 percent, and as of March, the median CPI measure is around 7 percent. These rates are all about where they were at their recent peaks. As of March, the trimmed-mean CPI measure is now slightly above 6 percent, down about 1 percentage point from its peak. The Federal Reserve Bank of Cleveland produces the median and trimmed-mean CPI inflation rate and the median PCE inflation rate. The Federal Reserve Bank of Dallas produces the trimmed-mean PCE inflation rate. See more data and information about inflation on the web pages of the Federal Reserve Bank of Cleveland's Center for Inflation Research at https://www.clevelandfed.org/en/our-research/center-for-inflation-research.aspx.

Monetary Policy and the Outlook

So, what are the implications for monetary policy? We have moved interest rates up significantly over the past year and it is yielding progress. Yet demand is still outpacing supply in both product and labor markets and inflation remains too high. In order to put inflation on a sustained downward trajectory to 2 percent, I anticipate that monetary policy will need to move somewhat further into restrictive territory this year, with the fed funds rate moving above 5 percent and the real fed funds rate staying in positive territory for some time. Precisely how much higher the federal funds rate will need to go from here and for how long policy will need to remain restrictive will depend on economic and financial developments.

With tighter financial conditions, I expect that demand in product and labor markets will continue to moderate and inflation will continue to move down. Output growth will likely be well below trend this year and pick up a bit next year. I expect that employment growth will continue to slow and the unemployment rate, which is very low, will begin to rise, to about 4-1/2 to 4-3/4 percent by the end of the year. I expect to see meaningful improvement in inflation this year, with inflation moving down to about 3-3/4 percent this year, continuing to improve next year, and reaching our 2 percent goal in 2025.

The Economy in Ohio

In Ohio, I expect to see similar trends. Ohio is the seventh largest economy in the nation in terms of real gross state product. The path of a regional economy reflects its industrial mix and the nature of the shocks that hit the broader U.S. economy. Manufacturing and, within manufacturing, auto and auto parts still constitute an important sector of Ohio's economy. Compared to the nation, manufacturing represents a larger share of payroll jobs in Ohio, but that differential has fallen over time.[8] Ohio's economy has been transitioning from one that is largely dependent on manufacturing and heavy industry to one that is

[8] Over the past decade (2013Q1 through 2022Q4), the share of jobs in manufacturing was 8.6 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.

diversifying into health care and education. 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 manufacturing has fallen to under 13 percent and the share in "eds and meds" has risen to nearly 17 percent. Regions that have diversified their industrial base have generally fared better over time. And in general, since the pandemic, the economy in Ohio has performed similarly to the national economy. Employers have struggled to find workers throughout the post-pandemic expansion, and since workforce growth tends to be slower in Ohio than in the nation because of slower population growth, it has been a quite challenging period for our employers. Rising inflation has also plagued businesses and households here, too. But as is true in the nation, progress is being made. Employers tell us they are finding it a bit easier to hire and retain workers now and their input costs are beginning to moderate.

Prudence

Of course, I think we all recognize that there is heightened uncertainty around the economic outlook. We have come a long way in tightening monetary policy, and some of those effects are yet to be felt in the economy. In such an environment a policymaker has to be very prudent in collecting and assessing the whole panoply of incoming information, not only official government statistics but also regional information gathered from our business, labor market, and community contacts; a variety of surveys on economic and banking conditions; and higher-frequency data such as credit card spending. All of this information helps to determine not only where the economy has been but also where it is going, which is important since monetary policy affects the economy with a lag. As we gather and assess this information, I am prepared to change my views on the economy and appropriate monetary policy as changes in conditions warrant.

One of the developments I will be particularly looking at is lending conditions. The U.S. banking system is sound and resilient. But in March, stresses emerged in a small number of banks, and Silicon Valley

Bank and Signature Bank failed. The Fed, the Treasury, and the FDIC took swift action to ensure that these stresses did not spill over to the rest of the U.S. banking and financial system.[9] Had such contagion occurred, it could have undermined the public's confidence in healthy banks and prevented them from doing their important work to support the savings and credit needs of households and businesses. Banks now have access to liquidity through a new Fed lending facility, as well as the traditional discount window, where they can borrow against sound collateral to ensure that they have sufficient liquidity to serve their customers.[10] The stresses experienced in the banking system in March have eased, but the Fed is prepared to take further steps as necessary to ensure financial stability. In addition, Chair Powell has directed the Federal Reserve Board's vice chair of supervision, Michael Barr, to conduct an internal review and to report by May 1 on Silicon Valley Bank's failure, including the Federal Reserve's supervision and regulation of the bank.

Even before the recent stresses, as interest rates moved up, banks had begun to tighten their credit standards, making credit less available. This is the typical way in which monetary policy tightening transmits to the broader economy. The recent tensions in the banking system could well result in banks tightening their credit standards even more, which could result in slower spending by households and businesses and a pullback in hiring. This would work in the same direction as tighter monetary policy. So we will need to continue to assess the magnitude and duration of these effects on credit conditions to help us calibrate the appropriate path of monetary policy going forward. This is the prudent thing to do.

[9] See the "Joint Statement by Treasury, Federal Reserve, and FDIC," March 12, 2023. (https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312b.htm)

[10] More information on the Bank Term Funding Program is available at https://www.federalreserve.gov/monetarypolicy/bank-term-funding-program.htm. More information on the discount window is available at https://www.federalreserve.gov/monetarypolicy/discountrate.htm.

Conclusion

In conclusion, there has been significant tightening of monetary policy over the last year, and as a result, welcome progress is being made in bringing demand into better balance with supply in product and labor markets and reducing inflation. This is good news. But inflation remains too high.

Given that some of the increases in rates and tightening in financial conditions have yet to be felt in the economy, we need to be prudent in assessing all of the incoming economic and financial information when determining the appropriate path of monetary policy going forward. We are much closer to the end of the tightening journey than the beginning, and how much further tightening is needed will depend on economic and financial developments and progress on our monetary policy goals.

That said, price stability is critical for the long-run health of the labor market, the overall economy, and the stability of the financial system. So it would be a mistake to declare victory before the job is done. Here, I am reminded of the words of former Fed Chair Paul Volcker when he fought inflation in the 1980s: "…failure to carry through now in the fight on inflation will only make any subsequent effort more difficult, at much greater risk to the economy."[11]

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[11] Paul A Volcker, "No Time for Backsliding," remarks at the National Press Club, Washington, D.C., September 25, 1981, p. 2.
(https://fraser.stlouisfed.org/title/statements-speeches-paul-a-volcker-451/time-backsliding-8243)