FEDERAL RESERVE BANK *of* ST. LOUIS

Remarks on Monetary Policy and the U.S. Economic Outlook

Alberto G. Musalem
President and CEO, Federal Reserve Bank of St. Louis

Economic Club of Memphis
Memphis, Tenn.
Nov. 13, 2024

The text is as prepared for delivery.

Good afternoon. Thank you for inviting me to speak with you today.

This is my second visit to Memphis since becoming president of the St. Louis Fed. I thoroughly enjoyed my first visit in June when I had the opportunity to experience the National Civil Rights Museum. I also connected with members of the business community and other local leaders.

Today, I am grateful for the opportunity to meet with the Economic Club of Memphis to share my views on the economy and monetary policy.[1] Following my prepared remarks, I look forward to a dialogue with Douglas Scarboro. I understand he will be pitching some tough questions.

Let me begin by saying that these are my personal views and not necessarily those of my Federal Open Market Committee (FOMC) colleagues.

I would like to share three key messages. First, the FOMC's dual mandate goals of maximum employment and price stability are within sight. Second, it is appropriate for monetary policy to remain moderately restrictive while inflation remains above the FOMC's 2% target. Third, monetary policy is well positioned to return inflation to target and support maximum employment through gradual adjustments of the policy rate toward a neutral level over time, provided inflation continues to fall toward 2%.

This may well be the last mile on the journey to price stability, and I believe the economy will reach the destination with appropriate monetary policy. There is more work to do.

[1] I would like to thank Riccardo DiCecio and David Wheelock for help in preparing these remarks.

Economic Conditions

The U.S. economy is strong, and the outlook is favorable. Real GDP is estimated to be above its long-term potential in levels and growth rates. The labor market remains resilient and in the range of full employment. It has cooled and is no longer overheated, as was the case a year or two ago. While many prices remain high, the rate of inflation has declined materially from post-pandemic highs and looks to be on its way to reaching the Fed's 2% target. Getting to our inflation target while maintaining full employment is important for consumers and the entire economy.

Let's dig into a few details.

Economic Activity

The economy expanded at a strong pace through the first three quarters of 2024 and is on track for a solid fourth quarter.[2] It is being driven by robust consumption, resilient income growth, higher productivity growth, supportive financial conditions and material wealth effects from elevated asset prices.

Real personal income growth and consumer spending have remained strong throughout the expansion. Ongoing research at the St. Louis Fed suggests that growth in consumer spending has held up across the income distribution. Revised national accounts revealed that gross domestic income growth was higher in the first half of 2024 than previously thought and that "excess" household savings, associated with pandemic fiscal support, persisted well into the first half of the year. This likely contributed to strong growth in consumer spending. Current estimates suggest that excess savings have now been exhausted and that consumer spending growth should align with income growth; both grew substantially above long-run trends in the third quarter.

Labor productivity growth has improved in two post-pandemic waves, the second since early 2023. Improved labor market matching efficiency between worker skills and employer needs, new business formations, capital deepening and business investments in labor-saving technologies are possible reasons for higher productivity growth. These effects may prove durably structural, and this would be a welcome development. But it is possible that recent

[2] Real GDP grew at a 2.8% annual rate in the third quarter. Final sales to domestic purchasers grew at a 3.5% rate, and consumer spending grew at a 3.7% rate. As of Nov. 7, the Atlanta Fed's GDPNow tracking estimate for the fourth quarter was 2.5%.

productivity growth could turn out to be more temporarily cyclical. Whether the recent productivity growth is durably structural or temporarily cyclical has different implications for monetary policy, as I will discuss later.

The business sector appears generally healthy. Third-quarter earnings and revenues for large listed companies exceeded expectations, albeit by a margin slightly below the average of the last few quarters. National surveys of business expectations indicate that firms generally have a positive outlook. Fewer respondents in recent surveys said they expected a recession in the next 12 months. A majority anticipate stable or rising sales over the next few quarters. Sentiment has also recently improved among business contacts and bankers in the Eighth Federal Reserve District.

To be sure, economic conditions aren't perfect—they never are.

Low- and moderate-income consumers, along with the smallest businesses, are facing some financial and balance sheet challenges. Likely for this reason, earnings growth has been softer among firms in consumer discretionary and related sectors. Large national retailers and smaller firms in the Eighth District report that customers are price sensitive and trading down to lower-tier brands and products to maintain consumption levels.

The housing market continues to experience headwinds associated with high mortgage rates and tight supply; manufacturing activity has slowed; and the farm economy is challenged by high input costs and low commodity prices, just to name a few areas of concern.

The scope for monetary policy to directly target specific sectors of the economy or demographic groups is limited. However, by pursuing low and stable inflation, monetary policy can provide the stable price backdrop necessary for maximum employment and robust economic performance.

At the St. Louis Fed, our vision statement says: "We are committed to a strong and resilient economy for all." Our mission is broad, and one of our most critical roles is contributing to a monetary policy aimed at achieving the price stability and maximum employment objectives assigned to the Fed by Congress.

In summary, overall the U.S. economy is strong and the outlook is favorable, despite some areas of weakness. I will now turn to the labor market.

Labor Market

The labor market is close to full employment. At 4.1%, the unemployment rate is below its historical median during expansions and close to the median longer-run projection of FOMC participants.[3] Layoffs remain low in the data, in reports from business contacts in the Eighth District, and in what CEOs nationally say they intend to do. Initial claims for unemployment insurance remain at low levels historically associated with ongoing growth in payroll employment.

Other measures of labor market conditions reveal a labor market that has cooled but has few signs of outright deterioration. Gross worker flows, including quits, hires and job-to-job transition rates, have all slowed. The health of the business sector, in terms of revenues, profitability, financing and balance sheets, provides some confidence that a disorderly labor market deterioration is unlikely. Nonetheless, some indicators, such as the job separation rate, have weakened modestly, and I remain attuned to the possibility of rising layoffs going forward.

With the cooling that has occurred over the past year, the labor market now seems to pose less inflationary pressure than it did a year ago. Employment cost growth has recently fallen to a rate that I estimate to be consistent with 2% inflation, especially considering the current elevated rate of productivity growth. However, though moving lower, average hourly earnings growth continues to run above trend—driven mostly by lingering demand pressures.

I will now turn to the other part of our dual mandate—inflation.

Inflation

Inflation is a tax that falls especially hard on low- and moderate-income households. Not only does it mean higher prices for goods and services, but it also leads to higher interest rates on home mortgages, credit cards and other consumer interest rates. Getting interest rates lower requires getting inflation sustainably back to 2%.

The good news is that inflation has been falling, though it remains above 2%. Thanks to lower goods and energy inflation, the latest reading on headline personal consumption expenditure (PCE) inflation was 2.1%. This is very close to the FOMC's 2% target. However, because energy prices can be highly volatile, I usually look to measures of core inflation, which exclude energy

[3] The median projection of FOMC participants in the September 2024 Summary of Economic Projections was 4.2%.

and food prices, for underlying trends. Core PCE inflation remains elevated, at 2.3% and 2.7% on a three- and 12-month basis through September, respectively. Today's release indicates that core consumer price index (CPI) inflation, at 3.6% and 3.3% on a three- and 12-month basis through October, also remains elevated.

Falling core goods price inflation, driven by lower demand pressures associated with price-sensitive consumers, has been helping with inflation convergence. By contrast, core services inflation has been running above its long-term average, driven mostly by lingering demand pressures. These pressures appear to be slowly abating, likely owing to moderately restrictive monetary policy.

Looking Ahead and Monetary Policy Implications

I have painted a portrait of an economy that has been stronger than long-term potential in growth and level terms, a full-employment labor market, and inflation currently above the 2% target but expected to converge toward it.

In my baseline scenario, based on current information, I expect inflation to converge toward 2% over the medium term, with convergence shifting toward lower services inflation from a reliance on lower goods and energy inflation. I expect economic activity to moderate toward its long-term potential in level and growth terms, with a labor market that cools further and remains in the range of full employment, accompanied by moderating compensation growth.

My baseline scenario reflects an expectation that monetary policy remains appropriately restrictive while inflation remains above 2%. The recent reductions in the FOMC's target range for the federal funds rate lessened but did not eliminate policy restraint. Further easing toward a neutral policy stance will be appropriate to support employment if inflation continues to converge toward 2%.

Shifting from my baseline to alternative scenarios, recent information suggests to me that the risk of inflation ceasing to converge toward 2%, or moving higher, has risen, while the risk of an unwelcome deterioration in the labor market has remained unchanged or possibly fallen.

Monetary policy is well positioned. Given current economic conditions and the balance of risks, I believe the FOMC can judiciously and patiently evaluate incoming information in considering further lowering of the policy rate. Future adjustments to the policy rate can be accelerated, slowed or paused as appropriate in response to new information about the outlook and risks for the price stability and employment objectives.

There are undesired outcomes that need to be avoided. Because the economy remains strong and inflation is above target, easing too much too soon could prompt an increase in demand that initially outpaces supply, further delaying inflation convergence. It could also be counterproductive for maintaining full employment. A rapidly declining federal funds rate could increase real or inflation risk premia along the yield curve, thereby adversely impacting the housing market and other interest-sensitive sectors that depend on capital market financing. Of course, easing too little too late could be associated with an unwelcome deterioration in the labor market, even as inflation remains on a course toward 2%.

Some reflection is prudent when it comes to relying on the recent elevated productivity growth to reconcile strong economic activity, a cooling labor market, and inflation that is above target but expected to fall. If recent productivity growth turns out to be durably structural, then inflation may continue to decline. However, if recent productivity growth turns out to be temporarily cyclical, then inflation convergence may be challenged, particularly if recent positive supply-side factors were to fade.

A structural assessment of recent productivity growth could lead to a faster pace of interest rate reductions, possibly with a higher neutral rate reached earlier. A cyclical assessment could lead to a slower pace of rate reductions, possibly with a lower neutral rate reached later.

A credible commitment to returning inflation to target will help preserve the economic expansion. Going the last mile to return inflation sustainably to 2% will help keep inflation expectations anchored and provide the price stability underpinning for maximum employment and sustained economic growth.

Thank you. I look forward to our conversation.