FEDERAL RESERVE BANK *of* ST. LOUIS
CENTRAL TO AMERICA'S ECONOMY®

Remarks on the U.S. Economy and Monetary Policy

Kathleen O'Neill Paese
Interim President and CEO, Federal Reserve Bank of St. Louis

Association for Corporate Growth Kentucky, CFA Society Louisville and Financial Executives International Louisville
Jeffersonville, Ind.
Nov. 9, 2023

Good afternoon, everyone. I am very happy to be here with you today, and I look forward to sharing information on the economy and the path of monetary policy. As interim president of the Federal Reserve Bank of St. Louis, I represent the Eighth Federal Reserve District at meetings of the Federal Open Market Committee, or FOMC, where I report on economic conditions in the District, comment on the key data and analysis about the national economy and express my views on monetary policy. The Eighth District encompasses all or parts of seven states, including western Kentucky and southern Indiana, and we have a branch office in Louisville in the capable hands of our branch executive, Seema Sheth. In a few minutes, Seema will be pitching some hard questions to me, but first I will level set with a few remarks about the U.S. economy and monetary policy. At the outset, let me make clear that I'm expressing my personal views, which are not necessarily those of any other FOMC participant.

Monetary Policy Goals

The Federal Reserve has a mandate from Congress to pursue monetary policy directed toward achieving maximum sustainable employment and price stability. This is often referred to as the Fed's "dual mandate." The FOMC is the Fed's monetary policymaking committee. At its meetings, the Committee reviews current economic conditions and forecasts, discusses policy options, and decides on a course of action to achieve the dual mandate goals. Typically, the FOMC sets a target range for the federal funds rate and then adjusts the interest rate paid on bank reserve balances so that the fed funds rate stays within the target range. At times, the Fed has used other tools, such as purchases of Treasury and mortgage-backed securities, but the federal funds rate is the main tool.

The FOMC's statement on longer-run goals and monetary policy strategy is posted on the Federal Reserve Board of Governors website.[1] That statement lays out how the Committee will respond to employment shortfalls and deviations from price stability. Further, it explains that the Committee will take a balanced approach whenever the employment and price stability goals are seemingly in conflict. Notably, the statement does not specify a numerical target for the employment mandate because employment is influenced by many things besides monetary policy. However, the statement does specify a numerical target for inflation, because over the long term inflation is determined primarily by monetary policy. For several years, the FOMC has judged that 2 percent average inflation, as measured by the price index for personal consumption expenditures, or PCE, is consistent with the price stability goal. Two percent is a widely accepted international standard for inflation. It is based on experience indicating that the economy performs well with a 2 percent average inflation rate while allowing more room for the Fed to lower interest rates in response to employment shortfalls that may occur.

Responding to the COVID-19 Shock

The U.S. economy, and consequently the Fed's monetary policy, were put to the test by the COVID-19 pandemic shock and its effects on the global economy. When the pandemic began to sweep across the United States in March 2020, the FOMC cut its target for the federal funds rate to zero and began to make substantial purchases of Treasury and mortgage-backed securities.[2] These actions were taken to prevent a potential financial crisis and to insulate the economy as much as possible from the economic fallout of the shock. That "pedal to the floor" monetary policy was appropriate at the time and effective at helping to limit the economic fallout of the pandemic and in encouraging economic recovery. However, as the economy recovered, employment grew rapidly and inflation began to rise sharply. Monetary policy then had to adjust. The Fed did that first by easing up on the gas pedal and later by applying some brake pressure. The Fed did not slam the brakes on the economy, but did expeditiously firm policy to bring inflation under control with as little negative impact on the real side of the economy as possible.

Monetary policy today remains modestly restrictive but not overly tight. At its most recent meeting on November 1, the FOMC reaffirmed its commitment to achieving 2 percent inflation. Although the Committee did not increase its target for the federal funds rate at that meeting, it

[1] See the FOMC's "Statement on Longer-Run Goals and Monetary Policy Strategy," adopted effective Jan. 24, 2012, and reaffirmed effective Jan. 31, 2023.

[2] The Federal Reserve also established several temporary lending facilities to provide liquidity to specific markets and types of institutions. A summary of those facilities is available on the Board of Governors website (Funding, Credit, Liquidity, and Loan Facilities).

left the door open for further policy firming if necessary for achieving 2 percent inflation. At the meeting, I expressed support for both aspects of the decision—that is, for maintaining the target for the federal funds rate and for retaining the option of further firming if necessary for restoring price stability. Let me spend a few minutes now reviewing the events and actions of the past three years and then explain my support for the FOMC's recent decision and commitment to achieving price stability.

As Figure 1 illustrates, the unemployment rate increased sharply during the pandemic recession. From 3.5 percent in February 2020, the rate soared to 14.7 percent two months later. According to the Bureau of Labor Statistics, the true unemployment rate was even higher, as many people who should have been counted as unemployed were misclassified. At the time, economists debated how quickly the economy would recover. It turned out to be very quickly, as the figure shows. Employment growth was robust after the initial shutdown orders were lifted and people began to return to more in-person activities. Of course, the federal government provided fiscal policy support; for example, with the CARES Act and infrastructure spending bill. The Fed also provided a lot of policy support. By December 2021, the unemployment rate was back below 4 percent, and by July 2022, it was all the way down to 3.5 percent. Currently, the rate stands at 3.9 percent.

The behavior of the inflation rate was also dramatic, as Figure 2 shows. From just under 2 percent at the start of the pandemic, the headline PCE inflation rate dipped to 0.4 percent in April 2020. At the time, there was a lot of concern that had the Fed not responded aggressively, the inflation rate might have continued to decline and gone negative—a deflation scenario. However, just as the unemployment rate came down, the inflation rate began to rise as the economy recovered. The headline inflation rate ultimately reached a peak of 7.1 percent in June 2022. The so-called core inflation rate, which excludes food and energy prices, behaved similarly but somewhat less dramatically, peaking at 5.6 percent in February 2022.

As inflation rose well above 2 percent, economists debated why it had risen so much and whether it would stay high or rapidly fall back to 2 percent or below. Many blamed disruptions in supply chains associated with pandemic measures and changes in consumer behavior. The thinking was that inflation would decline quickly once supply caught up with demand. Others viewed inflation as resulting mainly from expansionary monetary and fiscal policy. The debate is yet to be resolved, and it's likely that both supply disruptions and strong demand for goods and services contributed to the inflation.

In response to higher inflation, the Fed began to ease off the gas pedal and recalibrate policy in November 2021, when it announced a slowing in the pace of its asset purchases. Then, in March 2022, the FOMC initiated a series of hikes in its federal funds rate target—11 increases so far—that raised the funds rate target to its current range of 5.25 percent to 5.50 percent. Figure 3 plots the FOMC's target rate increases across the seven tightening cycles since 1983. As shown by the green line, the tightening of 2022-23 is the quickest and steepest increase in the fed funds target in over 40 years. Shortly after the first hike, the FOMC began to reduce the size of its balance sheet by limiting the replacement of securities in its portfolio as they matured. Figure 4 illustrates the sharp increase in the Fed's holdings of Treasury and mortgage-backed securities starting in March 2020. The balance sheet size peaked in April 2022. Except for a brief increase in the spring when the Fed increased loans to depository institutions following the collapses of Silicon Valley Bank and Signature Bank, the balance sheet has continued to shrink.

Current Conditions and a Look Ahead

Inflation fell significantly in the first nine months of 2023, especially during the second quarter. As of September—the most recent month for which we have PCE inflation data—the inflation rate stood at 3.4 percent. That is still well above the Fed's 2 percent target, but a substantial improvement from the average inflation rate in 2022. Economists expect that inflation will continue to fall. However, recently, inflation has been moving more sideways than down. Measured from a year ago, headline PCE inflation was stuck at 3.4 percent from July to September, while the core measure drifted down from 4.3 percent in July to 3.7 percent in September.

While inflation was moving sideways in the third quarter, economic activity was surging ahead. Real gross domestic product (GDP) blew away economists' earlier forecasts of a slowdown with a 4.9 percent annualized growth rate—more than double the historical average. Similarly, payrolls rose sharply, averaging job gains of 233,000 per month in the quarter, capped by 297,000 jobs added in September. At the September FOMC meeting, I, along with the other participants, submitted projections for how the economy would continue to evolve over the rest of the year and for the next two years. At that time, I thought that it would likely be appropriate to raise the policy rate another time before the end of the year. The third-quarter data certainly seemed to justify that projection.

Economic data are inherently backward looking, however. For example, when the FOMC met last week, we did not know that employment growth had slowed, and that "only" 150,000 jobs had been added in October, or that the unemployment rate had risen to 3.9 percent. Some data releases provide insights about the future. But, for the most part, reports only tell us where we've been, not where we're headed. We now know what happened in the third quarter and before, but we have little data to tell us how economic conditions will evolve over the fourth quarter or next year. To get a sense of trends, we talk to many people from all types of businesses and walks of life. We have many contacts here in the Louisville area and in other parts of the Eighth District who share information that helps us discern where inflation, the labor market and economic activity might be headed.

Shown in Figure 5, as of September there were approximately 1.5 jobs available for every unemployed person. Although substantially lower than the peak of 2 jobs per unemployed person in 2022, the number of jobs per unemployed person remained well above its historical level and indicative of a tight labor market. Recent reports from our contacts suggest that labor supply and demand are continuing to become better aligned. For example, firms are telling us that it's easier to fill open positions than it was a year ago, and that wages are not rising as fast. We're also hearing from contacts that inflation pressures may be easing. That information helped convince me to support the FOMC's decision last week to hold the policy rate at its current level while leaving the option of further tightening on the table in case it is needed to finish the job of restoring price stability.

A second reason I supported the FOMC's recent decision is the tightening of financial and credit conditions that has occurred over the past two or three months. That tightening has been reflected in higher yields on long-term Treasury and corporate securities, as well as mortgage rates and other interest rates paid by households and firms. Reports from throughout the Eighth District indicate that higher interest rates are beginning to constrain economic activity, which should dampen demand and put further downward pressure on inflation. In addition, the Fed's quarterly survey of senior bank loan officers found that more banks tightened lending standards in the third quarter than eased them. Such tightening should also contribute to easing of inflation pressures. Now it remains to be seen whether the tightening of financial and credit conditions is sufficient and sufficiently persistent to bring inflation down to target. However, the tightening that had occurred by the end of October, coupled with the reports I was receiving from District contacts, convinced me to support the FOMC's decision to leave unchanged the fed funds rate target for now.

It will be important to watch closely how all facets of financial conditions evolve in the coming weeks as the FOMC weighs its policy options at its next meetings. The 10-year Treasury security yield dropped about 30 basis points late last week, which some commentators attributed to reduced prospects of further rate hikes by the Fed. I will continue to monitor the 10-year yield and other measures of financial and credit conditions and consider their implications for monetary policy. As Fed Chair Jerome Powell stressed at his post-meeting press conference last week, tighter financial conditions will need to persist for a while to bring inflation back to 2 percent. It appears clear that the road back to the 2 percent target will be bumpy, but I still believe that a soft landing for the economy is possible.

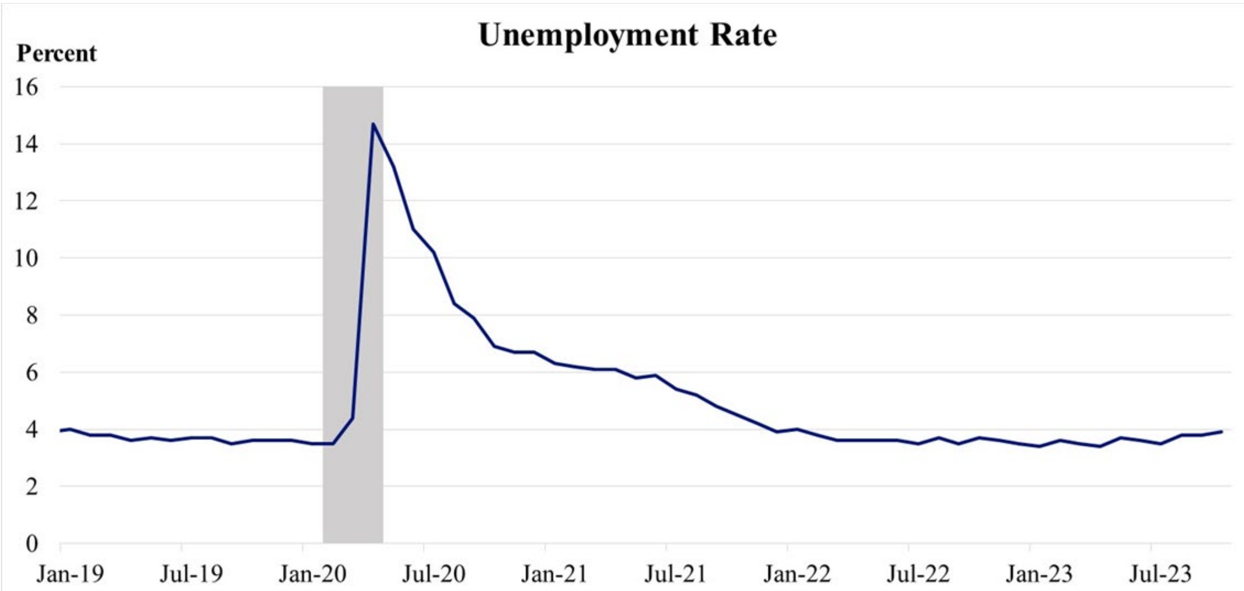
Conclusion

So, what comes next? Importantly, in its policy statement on November 1, the FOMC communicated that "additional policy firming … may be appropriate to return inflation to 2 percent over time." I expressed support for this statement because I believe that until inflation is clearly and convincingly headed to 2 percent, it would be unwise to suggest that further rate hikes are off the table. There is considerable economic uncertainty at the present time. There are reasons inflation could surprise to the upside. Labor markets remain tight and overall household liquid asset holdings remain high. A high level of household savings accumulated during the pandemic remains unspent. This suggests to me that consumer spending might continue to exceed expectations and pose upside risk to inflation. On the other hand, there are risks that could cause the economy to slow more quickly than we now expect. For example, a more abrupt or significant tightening of financial conditions than we have seen so far could dampen demand excessively. A government shutdown or an expanded war in the Middle East or other geopolitical shocks could shake business and consumer confidence and similarly depress spending, though they could possibly also increase inflation if they are associated with an increase in oil prices.

With policy currently exerting modest downward pressure on inflation, and given the balance of risks, we can afford to await further data before concluding that additional policy tightening is appropriate. However, if progress toward achieving 2 percent inflation stalls, I believe that the Committee should act promptly to ensure that high inflation does not become entrenched. If the public comes to believe that high inflation will persist indefinitely, the resulting loss of credibility would make restoring price stability harder to achieve and entail greater economic costs. I'm optimistic that we can and will achieve price stability, but we're not quite there yet and we should not declare victory and release the monetary brake prematurely. Price stability is critical for achieving maximum sustainable employment and a strong economy. Therefore, we must remain vigilant until inflation is clearly and convincingly well on its way back to target.

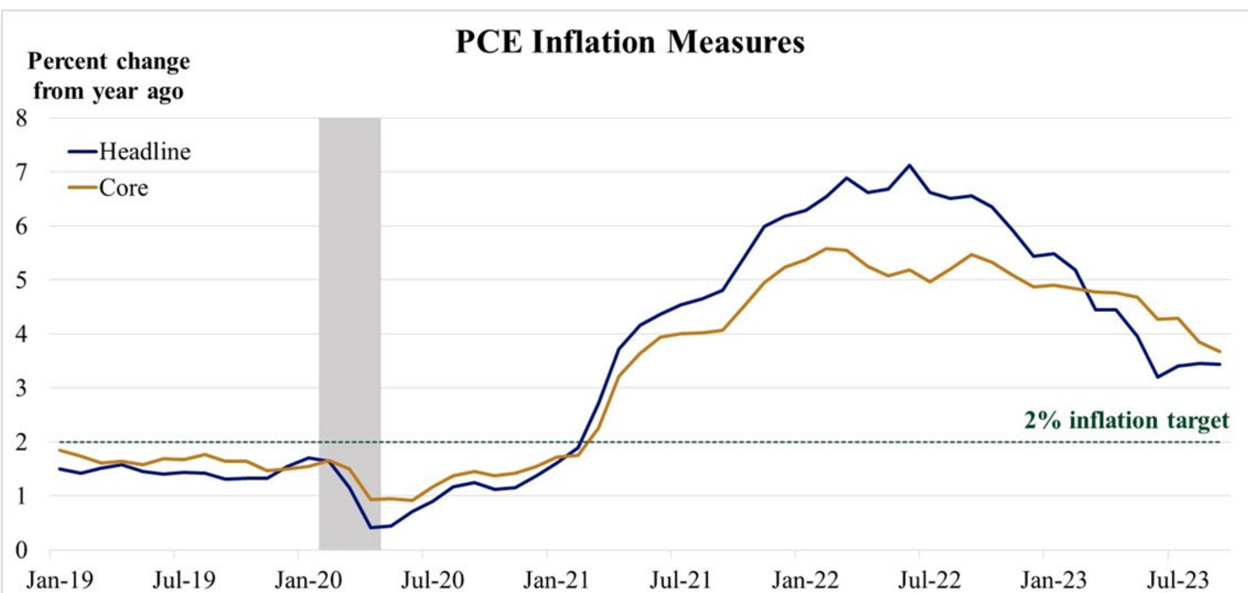
Thank you.

Figure 1: Unemployment



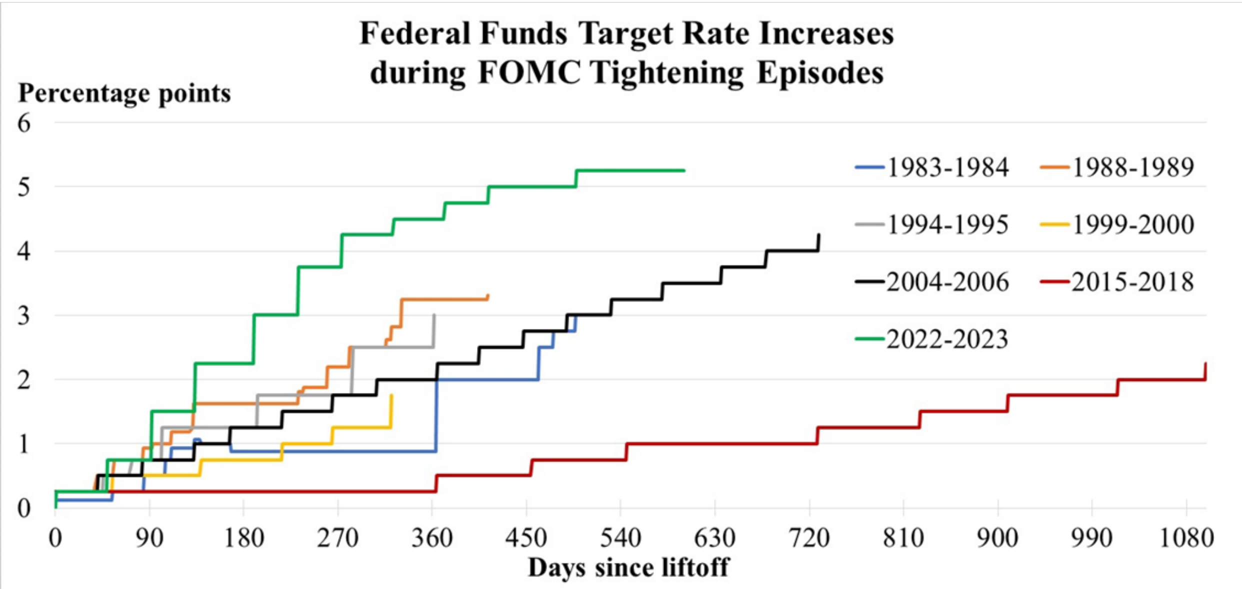
Source: Bureau of Labor Statistics. The shaded area denotes U.S. recession. Last observation: October 2023.

Figure 2: Inflation



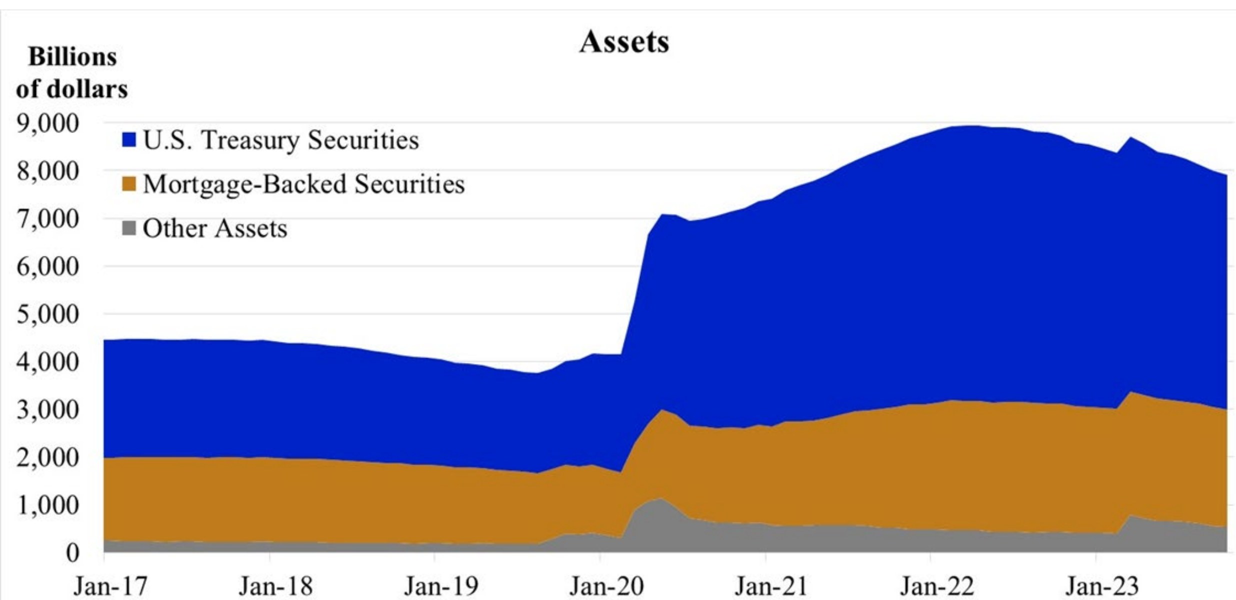
Source: Bureau of Economic Analysis. The shaded area denotes U.S. recession. Last observation: September 2023.

Figure 3: Comparing Tightening Cycles



Sources: Board of Governors of the Federal Reserve System and author's calculations. Last observation: Nov. 6, 2023.

Figure 4: The Fed's Balance Sheet



Sources: Board of Governors of the Federal Reserve System and author's calculations. Last observation: October 2023.

Figure 5: Labor Market Tightness

Sources: Bureau of Labor Statistics and author's calculations. The shaded areas denote U.S. recessions. Last observation: September 2023.