

Lisa D Cook: Moving toward better balance and implications for monetary policy

Speech by Ms Lisa D Cook, Member of the Board of Governors of the Federal Reserve System, at the Economic Club of New York, New York City, 25 June 2024.

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Thank you, Barbara. It is a fitting time to be speaking again to the Economic Club of New York, because this month marks two years since my first Federal Open Market Committee (FOMC) meeting.¹ At that meeting, we kicked off a series of large interest-rate increases, all of which I supported, because I am fully committed to bringing inflation sustainably back to our 2 percent target. As I said when I joined the Board, I care about both sides of the dual mandate Congress gives us, maximum employment and price stability. When inflation was well above target and the unemployment rate was historically low, we prioritized restoring price stability. Over the past year, inflation has slowed, and labor market tightness has eased, such that the risks to achieving our inflation and employment goals have moved toward better balance.

I think now is a good time to assess how the economy has evolved after rates have held steady at a restrictive level for nearly a year. Today, I will provide a progress report on disinflation, give you my outlook on the economy, and share my views on how to ensure that monetary policy brings inflation fully back to 2 percent over time while being attentive to the risk of a slowing labor market. I will conclude my remarks with a few words about my role as chair of the Board's Financial Stability Committee.

Inflation

As the U.S. and global economy recovered from the pandemic, rebounding demand came up against still-constrained supply, and inflation rose to the highest level in many years. In the past two years, 12-month inflation in the PCE price index has fallen from a peak above 7 percent to 2.7 percent in April, and it likely moved a bit lower in May based on consumer and producer price data. However, after rapid disinflation in the second half of last year, progress has slowed this year. My focus remains on making sure inflation is on a path to return sustainably to 2 percent. How do I think about making that determination? To respond, I think it is helpful to look at the underlying data.

Some price components have clearly improved. Food and energy price increases moderated significantly over the past two years as global commodity supplies recovered from the shock of Russia's February 2022 invasion of Ukraine. When excluding often-volatile food and energy costs, 12-month inflation in core goods prices is down from 7.6 percent in early 2022, returning to the trend of slightly negative inflation observed before the pandemic. The increased availability of computer chips and other material inputs led to a recovery in motor vehicle production and, along with restraint in aggregate demand, likely reduced supply–demand imbalances for durable goods, more generally.

Inflation in services, a spending category that accounts for about two-thirds of household budgets, has slowed significantly, though it remains noticeably above pre-

pandemic rates. Specifically, housing services inflation has eased quite gradually, as it takes time for the moderation of increases in market rent-what a landlord charges a new tenant-to show through to broader measures of shelter costs. One possible explanation is that landlords raise rents for existing tenants only gradually over several years and are still moving those rents closer to the market rate.

Outside of housing, 12-month services inflation slowed over the course of last year from above 5 percent to below 3.5 percent but has stalled near that rate this year. That is still about 1 percentage point above the average pace during the two years before the pandemic. Some of the largest contributors to recent services inflation are imputed prices, including portfolio management fees that are affected by equity price increases. Other components of services inflation that are more reflective of supply and demand conditions in the economy have continued to ease. Prices of hotel stays, airline tickets, and restaurant meals are illustrative.

I expect that the longer-run disinflation trend will continue as interest rates weigh on demand. Anecdotal reports, including from the Fed's Beige Book, suggest consumers are pushing back on price increases. Several national retailers have announced plans to lower prices on certain items, and there is increasing evidence that higher-income shoppers are trading down to discount stores. Two other important factors supporting this trend are well-anchored long-term inflation expectations and short-term inflation expectations falling back to near pre-pandemic levels.

My forecast is that three- and six-month inflation rates will continue to move lower on a bumpy path, as consumers' resistance to price increases is reflected in the inflation data. I expect 12-month inflation will roughly move sideways for the rest of this year, with monthly data likely similar to the favorable readings during the second half of last year. Beyond that, I see inflation slowing more sharply next year, with housing-services inflation declining to reflect the past slowing in rents on new leases, core goods inflation remaining slightly negative, and inflation in core services excluding housing easing over time.

Labor Market

Turning to the other side of our dual mandate, the labor market has largely returned to a better alignment between supply and demand. Many indicators suggest the job market is roughly where it was before the pandemic-tight but not overheated. The unemployment rate was a still-low 4 percent in May, but it has gradually risen over the past year since touching a more than half-century low of 3.4 percent in April 2023. Last month's rate was also modestly above readings just before the pandemic took hold.

Layoffs remain low, and payroll growth has been solid so far this year, adding an average of 248,000 jobs a month, essentially matching last year's pace. Labor supply has expanded, partly reflecting a rise in immigration. Labor force participation has broadly rebounded from pandemic lows, except for those aged 65 or older. Women between the ages of 25 and 54 led the rebound, with their participation reaching 78.1 percent in May, the highest ever recorded. With more workers entering the economy, the monthly job gains needed to keep the unemployment rate steady likely has risen from just under 100,000 to nearly 200,000. Although these estimates are uncertain, such a breakeven pace may be a bit higher than the true pace of recent job gains, when

taking into account data from the Quarterly Census for Employment and Wages. These data suggest that payroll job gains were overstated last year and may continue to be so this year. Thus, even the robust payroll numbers are consistent with a tight, but not overheating, labor market.

Signs of better balance in the labor market have come into focus. For example, the ratio of job vacancies to unemployment has fallen from a high of 2.0 in mid-2022 to 1.2 in April, in line with its pre-pandemic level. Workers are also less likely to leave their current jobs in search of new ones. The quits rate has fallen from 3.0 percent in April 2022 to 2.2 percent this April and is now below its 2019 average. This decline suggests a normalization following a period of high churn. Wage growth is outpacing inflation but is also moderating. Data from the Federal Reserve Bank of Atlanta show that the wage-growth differential between job changers and stayers has narrowed. Wage growth reflected in postings from online job boards, such as Indeed, has returned to pre-pandemic levels. These measures tend to adjust quickly to changes in labor market conditions.

Economic Activity

Turning to the broader picture, the U.S. economy has rebounded robustly since the short but deep pandemic recession. Overall, gross domestic product (GDP) growth eased in the first quarter from the rate at the end of last year. However, much of the first-quarter weakness was in net exports and inventories, noisy components from which I do not take much signal, while growth in private domestic final purchases remained solid. Going forward, I expect economic growth to remain near the rate of potential growth, somewhat above 2 percent, which is boosted by the increase in the size of the labor force.

American consumers have driven the current expansion, bolstered by strong income growth. But recent data, including first-quarter household spending and retail sales for April and May, suggest that growth is slowing. And, in April, the total amount of credit-card balances and other types of revolving consumer debt declined for the first time since 2021. Signs of strain continue to emerge among consumers with low-to-moderate incomes, as their liquid savings and access to credit have increasingly become exhausted. Credit-card delinquency is on an upward trend, and the rate at which auto loans are transitioning into delinquency is at a 13-year high. These rates are not yet concerning for the overall economy but bear watching.

Offsetting some of the slowing in consumer spending, investment spending for equipment and intangibles, such as intellectual property and software, has been strong this year. After growing at about only a 1 percent pace last year, equipment and intangibles spending grew at a more than 4 percent annual rate in the first quarter. If that strength continues, it has the potential to increase productivity over time.

Productivity growth is one factor that could change the path of both the expansion and inflation. Last year's GDP growth of 3.1 percent came alongside more moderate employment gains, implying strong growth in productivity. The economy may have benefited from investment undertaken in response to strong demand when the labor market was tight. Productivity growth is volatile and difficult to measure, but if it remains strong, then a faster pace of economic growth might not be inflationary. While the pace

of gains may have cooled from last year, I still lean toward optimism on innovation and productivity. Looking ahead, I see adoption of artificial intelligence (AI) technology as a potentially significant source of productivity growth, keeping in mind that breakthroughs, such as effective generative AI, will take time to fully reach their potential and disseminate throughout the economy and for complementary investment to bear fruit.

Monetary Policy

Considering the full view of economic data available at the time, my colleagues on the FOMC and I decided to maintain the target range for the federal funds rate at 5-1/4 to 5-1/2 percent when we met earlier this month. I believe our current monetary policy stance is restrictive, putting downward pressure on aggregate demand in the economy. With disinflation continuing, albeit at a slower pace this year, and the labor market having largely normalized, I see the risks to achieving our employment and inflation goals as having moved toward better balance. Given our data dependence, we will closely monitor incoming information to determine the future path of policy.

Returning inflation sustainably to our 2 percent target is an ongoing process and not a *fait accompli*. In considering how restrictive policy is, I look at a broad range of indicators from financial and credit markets. For instance, the two-year real rate, derived from Treasury Inflation-Protected Securities, or TIPS, remains around 2.7 percent, up from an average of about 1/2 percent in the couple of years before the pandemic, while the 30-year mortgage rate is around 7 percent. Meanwhile, banks have significantly tightened credit standards over the past two years. In particular, small businesses and some small banks and community development financial institutions are experiencing diminished access to credit. Many of these businesses also face short-duration loans that need to be refinanced at higher interest rates. With rising delinquencies, a number of low-to-moderate-income households are also likely experiencing diminished access to credit. On the other hand, the largest firms and the largest banks do not report a lack of access to funding. Larger firms, like many homeowners, were able to lock in low interest rates for longer terms a few years ago, before rates rose.

Of course, the economic outlook is always uncertain. One way to address such uncertainty is to consider a range of scenarios and not just the baseline forecast. One scenario is the possibility that persistently high inflation durably increases inflation expectations. While this appears less likely than a year or two ago, I am very attentive to the evolution of inflation expectations. Such a risk would imply keeping monetary policy restrictive for longer. Another scenario would be that the economy and labor market weaken more sharply than expected in my baseline forecast. In that case, monetary policy would need to respond to such a threat to the employment side of the dual mandate.

Considering the balance of risks related to these scenarios, I believe that our current policy is well positioned to respond as needed to any changes in the economic outlook. With significant progress on inflation and the labor market cooling gradually, at some point it will be appropriate to reduce the level of policy restriction to maintain a healthy balance in the economy. The timing of any such adjustment will depend on how economic data evolve and what they imply for the economic outlook and balance of risks.

Financial Stability

Before I conclude, I would like to say a few words about the financial system's resilience. Following the 2007–09 financial crisis, a broad set of reforms was put in place to bolster financial stability. To ensure an ongoing focus on that area, the Board established its Committee on Financial Stability as a venue to discuss related developments and policy issues. Earlier this year, I became the chair of this committee.

Consistent with some easing of financial conditions since late last year, valuations for some asset categories have risen. Home prices, for example, have outstripped rent gains for several years. That leaves measures such as the price-to-rent ratio high relative to historical averages. Yet, these valuations have not led to an appreciable increase in risk-taking. While house prices have been growing rapidly, mortgage debt has not, and most households have ample equity cushions. As I said earlier, some households are experiencing financial strain, and rising delinquency rates suggest some caution. Borrowing by businesses and households has been expanding at rates below GDP growth for several years. I use the ratios of their debt levels to GDP as a rough proxy of whether the sectors are overleveraged, and those stand well below pre-pandemic levels.

Financial institutions and markets also appear broadly robust, with high capital and liquidity levels at the largest and most interconnected banks. While there is less visibility into nonbank financial institutions, this tightening cycle has seen markets absorb a number of risk events, suggesting that leverage does not appear too great. A subset of banks has a high concentration of commercial real estate (CRE) loans, and supervisors are working closely with those banks. As the CRE market adapts to the shifting preference for downtown office space, prices for some buildings will likely continue to fall, and more loans will need to be worked out as they come due. However, markets have broadly taken the bumps in stride so far, without notable spillovers.

In sum, I see a system that has some vulnerabilities but also important sources of resilience and, on balance, is not currently positioned to unusually amplify any future shock. A stable and resilient financial system is critical to the well-being of households and firms, allowing them to access credit, and it is essential for the Federal Reserve to achieve its dual mandate of maximum employment and price stability.

Thank you. It is a pleasure to be back at the Economic Club of New York. I look forward to continuing our conversation.

¹ The views expressed here are my own and not necessarily those of my colleagues on the Federal Open Market Committee.