

For release on delivery
5:45 p.m. EDT
March 31, 2023

The U.S. Economic Outlook and Monetary Policy

Remarks by

Lisa D. Cook

Member

Board of Governors of the Federal Reserve System

at the

2023 Midwest Economics Association 87th Annual Meeting

Cleveland, Ohio

March 31, 2023

Thanks to President Kasey Buckles and the program committee for affording me the opportunity to give the C. Woody Thompson Memorial Lecture. It is a pleasure to be back in the Midwest. Before joining the Federal Reserve, I taught economics at Michigan State University, which I chose for its bird's-eye view of the industrial Midwest. Big 10 rivalries aside, Ohio and Michigan share quite a lot, including many of the same economic concerns and interests.

Today I would like to outline my views on the trajectory of U.S. economic developments and what they imply for the appropriate path of monetary policy.¹

This is an especially challenging time to be an economic analyst or policymaker. Recent developments in the banking sector have added to existing uncertainties about recovery from the pandemic shock and developments abroad. In that context, the economic and policy outlook needs to balance data dependence with forward-looking analysis. Recent data show greater momentum in inflation and economic activity, but recent banking developments may suggest greater headwinds for financial conditions and the economy going forward.

The U.S. economy

Assessing the current state of the economy requires revisiting the pandemic and its economic repercussions. From the perspective of the NBER Business Cycle Dating Committee, the 2020 recession was unprecedented. Of the 35 recessions since 1858, only 8 spanned months in the single digits from peak to trough. The one in 2020 was severe, but it spanned only two months from peak to trough and was the shortest recession on record.

¹ These views are my own and do not necessarily reflect those of the Federal Reserve Board or the Federal Open Market Committee.

However, the pandemic's economic effects reverberated through 2021 and 2022. Inflation surged during the recovery amid pandemic-induced disruptions to supply, while demand for goods was boosted by a shift away from in-person services, and overall demand was supported by monetary and fiscal policy. Russia's invasion of Ukraine in February 2022 was a further supply shock to the global economy, driving up prices for energy and other commodities. Last June, U.S. inflation hit a peak of 7 percent as measured by the 12-month change in the personal consumption expenditures (PCE) index.

In response, the Federal Reserve has been using its monetary policy tools to restore price stability by bringing demand into line with still-constrained supply. Over the past year, we have raised the federal funds rate nearly 5 percentage points and have begun to reduce the size of our balance sheet.

As a result, financial conditions have tightened significantly. Borrowing costs have risen, equity prices have declined, and the dollar has appreciated on net.

Interest-sensitive sectors of the economy have slowed. Residential investment subtracted nearly 1 percentage point from gross domestic product growth last year, as housing demand was curtailed by higher mortgage rates. Business fixed investment held up last year but appears to have slowed more recently. Manufacturing activity has slowed in response to tighter financing conditions, the stronger dollar, and some retracement of the pandemic-related shift from services to goods.

As energy prices have moderated and supply disruptions have eased, inflation has started to abate. However, the process of returning inflation to 2 percent has a long way to go and is likely to be uneven and bumpy.

Indeed, the inflation picture is less favorable than it appeared earlier this year. Part of the encouraging disinflation initially observed in the fourth quarter of last year was revised away, while inflation over the first two months of this year came in high.

The inflation data show some persistence. The 3-, 6-, and 12-month changes in February prices for the core PCE index—excluding food and energy—are all around 4½ to 5 percent. Housing services inflation continues at a rapid monthly clip, contributing much more to inflation than it did before the pandemic. Inflation in non-housing core services remains sticky at elevated levels. Even core goods prices rose in January and February, after three months of declines, highlighting the uneven nature of the disinflationary process.

Even so, several factors are likely to contribute to disinflation. Long-term inflation expectations remain well anchored, and shorter-term expectations have retraced much of last year's rise.² Rent increases on new leases have slowed sharply over the past six months, which should begin to pull down measured housing-services inflation over the course of this year. Moreover, significant supply of multifamily housing is coming online, which should take further pressure off the rental market.

Core goods inflation should continue converging toward its pre-pandemic trend of slightly negative numbers, as supply chains continue to heal and demand for goods continues to slow. Rebounding automobile production should help prices for new and used cars continue to moderate as cars become more available. More broadly in the economy, profit margins may narrow as buyers become more price sensitive and pull

² As shown, for example, in surveys from the University of Michigan and the Federal Reserve Bank of New York.

back on spending. Earnings calls from nonfinancial corporations already show increasing awareness of resistance to price increases.

Non-housing core services inflation is a broad category that accounts for more than half of the core PCE index. Inflation in that category looks quite persistent amid strong post-pandemic demand for travel, dining out, and medical care. Disinflation in these services will likely require some combination of slowing demand and further recovery in supply.

One potential avenue of disinflation is that a decline in prices for some goods may help lower related services prices. For instance, an eventual retreat in car prices may feed into lower prices for car insurance, repairs, and rentals, reversing some of their increases over the past two years.

Another potential source of disinflation is that wage growth has moderated somewhat, even as the labor market remains very strong by most measures. Payroll employment growth was extraordinarily robust in January and February, unemployment remains near record lows, and job openings remain very elevated.

Nonetheless, there are some signs that the labor market is softening at the margin. The Federal Reserve Board staff's measure of private employment using data from the payroll processing firm ADP suggests that job gains slowed in January and February. Job postings from Indeed show a noticeable decline. And the quits rate has retraced more than half of its pandemic-era rise, falling steadily from a 3 percent peak in late 2021 to 2.5 percent in January. That could be significant, as much of the surge in wage growth a year ago may have been driven by outsized wage gains of those changing jobs and by employers raising wages to retain existing workers.

This wage moderation may partly reflect some improvement in labor supply. Labor force participation edged up to 62.5 percent in the most recent data. Prime-age participation is now back to pre-pandemic levels. In addition, new estimates show higher population growth over the past year amid a rebound in immigration.

Over time, there is reason to believe that rising productivity also may aid supply. I see three potential sources of rising productivity growth.

First, increased innovation associated with the spurt of new businesses since the onset of the pandemic may raise productivity. Second, current labor shortages are spurring increased investment in automation that should boost labor productivity over time. Finally, a recent paper by David Autor, Arin Dube, and Annie McGrew suggests another way that the strong labor market could boost productivity.³ They find that faster wage gains for lower-paid workers have come from job-switching to higher-wage firms, which may also be more-productive firms.

Currently, however, supply in the economy continues to be insufficient to meet still-robust demand. Importantly, consumer spending has gained steam this year after slowing late last year. Consumer spending is being supported by robust growth in households' real disposable income amid strong employment growth. Strong household balance sheets have also supported spending, although lower-income consumers appear to have mostly exhausted their excess savings.

Altogether, the incoming data would suggest a somewhat higher inflation rate for this year and stronger economic growth. However, I am closely watching developments

³ See David Autor, Arindrajit Dube, and Annie McGrew (2023), "The Unexpected Compression: Competition at Work in the Low Wage Labor Market," NBER Working Paper Series 31010 (Cambridge, Mass.: National Bureau of Economic Research, March), <http://www.nber.org/papers/w31010>.

in the banking sector, which have the potential to tighten credit conditions and counteract some of that momentum.

The U.S. banking system is sound and resilient. The Federal Reserve, working with other agencies, has taken decisive actions to protect the U.S. economy and to strengthen public confidence in our banking system. We will continue to closely monitor conditions in the banking system and are prepared to use all our tools, as needed, to keep the system safe and sound.

At the same time, I am monitoring overall financial conditions in the U.S. economy, including indicators of credit availability. I am well aware of the extensive literature linking monetary policy, credit conditions, economic activity, and inflation. Over the past 15 years, that literature came to be roughly a quarter of the syllabus in the macroeconomics class that I taught.

A particular focus over my career, including in my December NBER paper with Matt Marx and Emmanuel Yimfor, is the importance of smaller financial institutions in lending to small and medium-sized firms.⁴ Those smaller banks over time have developed relevant expertise in small-business lending and have worked to maintain relationships with small firms. Thus, I am attentive to whether recent banking developments will restrain credit to small businesses, which could slow innovation and growth in potential output over time.

⁴ See Lisa D. Cook, Matt Marx, and Emmanuel Yimfor (2022), “Funding Black High-Growth Startups,” NBER Working Paper Series 30682 (Cambridge, Mass.: National Bureau of Economic Research, November), <https://www.nber.org/papers/w30682>.

Data dependence and monetary policy

Turning to monetary policy, I have said frequently that my approach to policymaking in uncertain times is to be data dependent. And, like everyone, my own research and experiences shape my views on setting that policy. I was at the Council of Economic Advisers during the euro-area crisis, and my work on emerging economies—particularly Russia and some African economies—has taught me how difficult it can be to forecast in highly uncertain environments.

Taking all these lessons into account, I approach all our monetary policy discussions with the same mindset:

- Be prepared to adjust the outlook based on incoming data while being humble about our ability to draw firm conclusions and thus not overreacting to a few data points.
- Seek out useful data sources, including high-frequency data that may better capture evolving economic developments.
- And follow a risk-management approach that considers not only the expected outcomes, but also various risks to the outlook.

Of course, it is tempting to follow the old adage of “never make predictions, especially about the future.” But ultimately, policymaking must be forward-looking, which means relying, at least in part, on forecasts. The challenge is to figure out which models apply. For example, when I began studying banks in the post-Soviet era for my dissertation, I found that the standard models used in normal times and for mature, industrialized economies are less useful in highly uncertain environments.

Since my first FOMC meeting last June, my data-dependent, risk-management approach has led me to support the Fed’s response of frontloading monetary policy tightening to bring inflation under control.

After the swift policy response of the past year, monetary policy is now in restrictive territory. For instance, real interest rates are positive across the yield curve.⁵

Going forward, I am weighing the implications of stronger momentum in the economy against potential headwinds from recent developments. On the one hand, if tighter financing conditions restrain the economy, the appropriate path of the federal funds rate may be lower than it would be in their absence. On the other hand, if data show continued strength in the economy and slower disinflation, we may have more work to do.

The FOMC has been raising rates in smaller increments as we seek a sufficiently restrictive monetary policy stance to return inflation to 2 percent over time. By taking smaller steps, we can observe economic and financial conditions and consider the cumulative effects of our policy actions.

For the econometricians, this approach is similar to the iterative procedure in maximum likelihood estimation, where large early steps are followed by smaller steps as you approach the local optimum.

In its March policy statement, the FOMC dialed back its forward guidance on the path of the policy rate.⁶ We shifted from anticipating “ongoing increases” to saying that

⁵ These real interest rates are based on prices from Treasury Inflation-Protected Securities (TIPS) and inflation swap markets, as well as survey expectations.

⁶ See Board of Governors of the Federal Reserve System (2023), “Federal Reserve Issues FOMC Statement,” press release, March 22, <https://www.federalreserve.gov/newsevents/pressreleases/monetary20230322a.htm>.

“some additional policy firming may be appropriate.” I think this communication is appropriate as we seek to calibrate monetary policy to be sufficiently restrictive amid uncertainty about the economic outlook.

Yet what should not be uncertain is our commitment to our dual-mandate goals of maximum employment and price stability. We will do what it takes to bring inflation back to our 2 percent target over time, which will lay the foundation for sustainable strength in the labor market and the U.S. economy.