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The U.S. Economic Outlook and Considerations for Monetary Policy

Remarks by

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Good morning, everyone. Thank you for inviting me to speak. It is a pleasure to be here. I would like to use this opportunity to share with you my outlook on the U.S. economy, credit conditions, and monetary policy.

Before I start, let me remind you that the views I will express today are my own and are not necessarily those of my colleagues in the Federal Reserve System.

Aggregate Economic Activity

Despite heightened uncertainty, due to banking-sector stress, geopolitical instability, and the aftermath of the pandemic, I expect the economy to grow in the second quarter. The pace of growth, however, will be slower than what we observed in the first quarter, when real GDP increased at an annual rate of 1.1 percent. My expectation is based mainly on data that showed weakening spending in recent months, and other data that imply moderating spending, including a sizable decline in April in consumer sentiment, as measured by the initial estimate of the University of Michigan Surveys of Consumers. While my base case forecast for the U.S. economy is not a recession, I expect spending and GDP growth to remain quite slow over the rest of 2023, due to continued tight financial conditions, low consumer sentiment, and a decline in household savings that had built up after the onset of the pandemic. Furthermore, I acknowledge that there are downside risks, among them the possibility that the degree of bank lending restraint and uncertainty could weigh on economic activity more than I expect.

The Labor Market

Even as GDP growth has slowed, employment has continued to increase, and the current labor market is one of the strongest that U.S. workers have experienced in

decades. The economy created 253,000 jobs in April and the unemployment rate was 3.4 percent, the lowest since 1969. Job creation has been remarkably resilient to tighter financial conditions. Employers have added an average of 280,000 jobs a month this year. That's down from the 350,000 a month created in the second half of 2022 but still robust. The tight labor market has boosted wages and other compensation for workers. Wage growth has continued to run ahead of the pace consistent with 2 percent inflation and current trends in productivity growth. Wage gains are welcome as long as they are consistent with price stability. Over the 12 months ended in March 2023, the employment cost index (ECI) for total hourly compensation for private-sector workers rose 4.8 percent, down only a little from its peak of 5.5 percent last June.

My expectation is that the slowing economy will soon begin to reduce job growth, with labor supply and labor demand coming into better balance. The unemployment rate may rise gradually to levels still consistent with a growing economy. Data on job openings and voluntary quits by workers indicate that labor demand has eased somewhat, and this is reflected also in a modest decline in the growth of average hourly earnings, from a 12-month rate of 5 percent in November to 4.4 percent in April.

Inflation

Now let me turn to the outlook for inflation. While inflation has come down substantially since last summer, it is still too high, and by some measures progress has been slowing. After peaking at a 12-month rate of 7 percent last June, personal consumption expenditures (PCE) inflation fell to 4.2 percent in March, which is also down from 5.1 percent in February. That reflects substantial decreases in energy prices and a big slowdown in food inflation. Cheaper energy and a slowdown in food price

increases are good news for lower- and middle-income households that spend a larger share of their income for these items.

But outside of energy and food, the progress on inflation remains a challenge. Excluding these prices, which tend to be more volatile than prices of other goods and services, leaves what we call "core" inflation, and this measure is a useful guide to discern longer-lasting movements in inflation. Core PCE inflation was 4.6 percent in March, down from a peak of 5.4 percent in February 2022. While we do not have a report on PCE inflation for April yet, another inflation measure, the core component of the consumer price index (CPI), showed little further improvement in April. Looking more closely at core inflation, I like to divide it into three parts—core goods inflation; housing, which is classified as a service; and nonhousing services. Core goods inflation fell sharply over the second half of 2022 as supply-chain bottlenecks eased, but more recently it has stabilized at around 2.6 percent. Housing services inflation, which includes rent and the equivalent for owner-occupied homes, is 8.2 percent on a 12-month basis. Housing is a big part of inflation, and while rent increases on new leases have come down considerably over the past year, it will take some time for this softening in rents to show through to the 12-month changes. And, finally, inflation in nonhousing services, the largest component of services, has been stubbornly high at around 4.5 percent and shows no signs of significant decline yet.

Recent Stress in the Banking Sector

Overall, the U.S. banking system is sound and resilient, and I am confident it will be able to continue to play its important role providing credit to households and businesses. Nevertheless, it is reasonable to expect that recent stress events will lead

some banks to tighten credit standards further. The evidence is that so far there has been only a modest incremental tightening of lending conditions, which had already tightened considerably over the past year since the Federal Reserve began raising interest rates. In a survey conducted by the Federal Reserve in April, loan officers reported that 46 percent of banks had tightened credit terms in the previous three months for commercial and industrial lending to larger firms, versus 44.8 percent that had tightened in the January survey. The April survey's increase in the share of banks reporting tightening was similar, though a bit larger, for commercial and industrial lending to smaller firms. At this point, it is hard to tell how much of this tightening was in train already, after continued increases in interest rates, and it is likewise difficult to say how much the stress in midsized banks will ultimately curtail credit in the coming year. Furthermore, there is considerable uncertainty about the magnitude of the impact on household spending and business investment, and this uncertainty complicates economic outlook forecasts.

The Insurance Industry Resiliency

Given your gathering here today, I would be remiss if I did not say a word or two about the insurance industry before closing. The insurance industry has performed well through recent stresses. Although the profitability of property and casualty insurance companies in 2022 was reduced by natural catastrophes and inflation, the industry's capital appears strong when considering a range of plausible stress events. For life insurers, the recent increase in interest rates has been a mostly welcome development that has supported higher investment returns but also poses risks, such as early withdrawals by some policyholders. While the life insurance industry's capitalization remains strong,

the use of reinsurance merits continued monitoring. With that said, let me turn to monetary policy.

Considerations for Monetary Policy

So what factors will I consider in the coming weeks as I contemplate the appropriate stance of monetary policy going forward? Over the next few weeks, we will receive a considerable amount of data on economic activity for April and May, including the employment report for May and a report on May CPI inflation. Monetary policy should be forward-looking. It should be conducted so that longer-term inflation expectations are well anchored around our inflation target of 2 percent. Monetary policy should also be data dependent to allow for continuous learning about the underlying structure of the economy as new data arrive. These principles of monetary policymaking are always valuable, especially so when the level of uncertainty is high, as it is now.

I am guided by the dual mandate assigned to the Federal Reserve by the U.S. Congress: price stability and maximum employment. On the one hand, inflation is too high, and we have not yet made sufficient progress on reducing it. On the other hand, GDP has slowed considerably this year, and even though the effect has been muted in the labor market so far, demand clearly has begun to feel the effects of interest rates that are 5 percentage points higher than they were a little over a year ago. History shows that monetary policy works with long and variable lags, and that a year is not a long enough period for demand to feel the full effect of higher interest rates. Another factor weighing on my thinking is the uncertainty about tighter lending standards that I mentioned earlier. I intend to consider all these factors in the coming weeks as I contemplate the appropriate stance of monetary policy going forward.

Thank you.