Economic Outlook: We Are in the Final Mile of the Marathon

2024 Lyons Center for Economic Education and Entrepreneurship
University of Delaware
Newark, DE

February 22, 2024

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President and Chief Executive Officer
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Good afternoon!

It is a pleasure to be back with you once again, and I thank today's organizers and sponsors for making it all possible.

It is also a pleasure to return to the University of Delaware, which you all know holds a very special place in my heart. This university continues to live up to its motto, "Knowledge is the light of the mind," in everything it does, including opening its doors for forums such as this.

I do not wish to take away from the conversation that will follow, so with your approval, I will start right into my economic outlook.

But obviously, before I can do that, I must first provide the standard Fed disclaimer: The views I express this afternoon are my own and do not necessarily represent those of anyone else in the Federal Reserve System or my colleagues on the Federal Open Market Committee (FOMC).

A lot has certainly changed since I joined you for this event last January.

At that time, we were in the midst of a program of fed funds rate increases to get a handle on inflation. When I spoke to you last time, the rate had just been increased to a range of 4¼-to-4½ percent. Today, as I stand here, it is 100 basis points higher — a full percentage point.

Yet, while the policy interest rate is indeed 1 point higher, the inflation rate is down by a much greater amount. When we met in January 2023, core PCE inflation stood at 4.9 percent year over year. Now, we won't receive the January 2024 core PCE number until next week, but just looking at December's year-over-year rate of 2.9 percent, well, that is significant improvement. Moreover, for the last six or seven months, core PCE inflation has been running essentially at a rate of 2 percent, the FOMC's inflation target.

Last week, the Consumer Price Index (CPI) came in with headline inflation at 3.1 percent year over year in January — a 0.3 percent dip from December — and core CPI inflation at 3.9 percent annually, holding steady from the prior month. Now, comparing that to the prior year, in January 2023, headline CPI was at 6.4 percent year over year, and core CPI was at 5.6 percent. So, again, there's measured progress.

But we are bound to have bumps along the road to disinflation. Indeed, the latest CPI data mildly surprised analysts on the upside, as the drop in rents we see is only slowly passing through into the inflation numbers. And as progress can be bumpy — and uneven at times — it is important that we see more evidence, allowing us to look past the vagaries of monthly data and ensure we continue on the right path.

Regardless, the data overall suggest that we are in the final mile of the marathon of getting PCE inflation back down to our target annual rate of 2 percent. However, as anyone who has ever run a marathon can tell you, the final mile is often the hardest.

"So, Pat," I hear you asking, "where do we go from here?" Well, let me get the headline statement out of the way right now.

Yes, I believe that we may be in the position to see the rate decrease this year. But I would caution anyone from looking for it right now and right away. We have time to get this right, as we must. And to be sure, next month's meeting and FOMC vote will mark the second of eight scheduled meetings for 2024.

I would characterize my stance at the moment as the old, oft-used adage: "Trust but verify." I certainly have confidence that monetary policy is working as it should — and the trend lines on disinflation only add to that — but I'm not quite yet at the "verified" moment. And what I am doing in verifying is compiling more evidence.

What I will be looking for in the hard data will be the distribution of disinflation among goods and services. As I think back to 2021, when we saw the prices of used cars jump, the predominant thinking was that the inflation spike mostly reflected transitory factors. But then other goods and services experienced rapid inflation, and we realized that inflation was becoming more entrenched across the economy.

Today, I'm looking at the same things, but rather in reverse. Yes, the disinflation trend has picked up the pace — as I noted, the six-month core PCE is now consistent with inflation under 2 percent — but I again want to make sure that we are seeing disinflation across goods and services.

I have said before that there are three things that I look at most closely in inflation reports: transportation, food, and shelter. These are the three things that matter the most directly to the overwhelming majority of American families. Well, transportation inflation is down from its peak, though it remains elevated. Food inflation, while certainly prone to fluctuations because of a host of factors, is generally down and back to normal levels on a year-over-year basis. Shelter inflation remains elevated, though I do recognize the lags inherent in the way it is calculated.

So, in a nutshell, I find our greatest economic risk comes from acting to lower the rate too early, lest we reignite inflation and see the work of the past two years unwind before our eyes.

Along with our work on the policy rate, we have also been reducing the size of the Fed's balance sheet — what is known as *quantitative tightening*. That may describe *what* it is, but not its purpose. I prefer to use the term *balance sheet normalization*.

When we announced this plan in May 2022, we stated an intention to significantly reduce the balance sheet until reserve balances were "ample," or, simply, when the balance sheet size returned to "normal." Well, we're nearly two years in, so, how is it going?

There is no question that we have already achieved a significant reduction in the balance sheet of nearly $1.5 trillion. And we are not done yet, as reserves remain very abundant, albeit less so than in 2022.

When we announced this program, we also said that normalization would proceed in “a predictable manner.” And to make good on that count, we must slow as we approach normal. For this reason, and to make good on my promise of making normalization as boring as watching paint dry, my colleagues and I will start our discussions on how to slow the balance sheet reduction at the March FOMC meeting.

Whether it be with the balance sheet or the policy rate, the overriding concern is to get everything right at the right time because the economy continues to hum along.

GDP growth continues to be strong.

While the labor market continues to post strong monthly gains and unemployment remains near historic lows, we are also seeing multiple signs that the labor market is coming into better balance, and the very tight conditions that characterized the immediate post-pandemic period are easing. The latest data show that the ratio of openings to unemployment continues to back down closer to its pre-pandemic readings. Labor force participation improved in the last year — and this is especially important since the linchpin to any growing economy is an active labor force. Wage inflation has also moderated substantially.

But at the same time, we are not experiencing widespread layoffs. Yes, certain sectors are readjusting their workforces, most notably the tech sector, but there are not economy-wide layoffs that would suggest some recessionary forces are fighting their way to the forefront. Again, this is a good thing.

Consumer spending also continues to remain strong. Moreover, the University of Michigan’s Index of Consumer Sentiment reported its highest level in two-and-a-half years — and consumer expectations for future inflation have come down.

This is a promising signal and one that we will be looking at closely in other areas of the economy as it has largely been the American consumer who has kept on the path of achieving an economic soft landing. But on the flip side of this, I am somewhat concerned about the increase of delinquencies in credit card and other loan repayments, especially among younger borrowers and families on the lower end of the income ladder.

This picture being painted by the hard data is also backed up by what I am hearing from contacts throughout the Third District; this is the soft data upon which I place a great amount of importance because it's the real-time check that I need in my own decision-making.

When it comes to consumers, I heard months ago that they continued to spend, though they have been switching to other brands to find better deals and putting more on their credit cards, rather than just closing their wallets.

And from employers, I've been hearing that while they are still hiring, they are now looking for workers with more specific and necessary skill sets. As for the workers they've already hired, well, they're going to do what they can to hold on to them.

This sentiment is backed by the survey data in the latest *Manufacturing Business Outlook Survey*, or *MBOS*, conducted by the Philadelphia Fed in which firms in the Third District reported a six-month expectation for steady employment. Employers may be looking to alter hours or making other arrangements so that things work for their operations, but the hiring free-for-all that we experienced in the inflationary run-up is over while we do not see any drastic adjustments to payrolls.

Another *MBOS* data point that gives me confidence is the trend of the index for prices paid for inputs, which, though it has jumped a little from time to time, has been on a marked downward trend since late 2021. Moreover, in a specific special question asked for the January survey regarding price expectations for the upcoming year, the average expected change in costs was below the rate that they reported experiencing in 2023.

So, where does all this leave us? I'll go back to my initial statement. I do believe we may be near the point where we can adjust the policy rate downward. But when we will actually arrive at that point, I cannot yet say.

And just to note, I don’t have a vote on the FOMC this year, but I still have a voice in our policy discussions and intend to use it.

Just like last summer, when I was a voting member of the FOMC and I signaled my belief early that it was time to hold rates steady, I will signal my belief that we’re ready for a rate decrease when all the data — both the hard and the soft — give me that signal.

The American economy is, to put it mildly, a dynamic engine. And right now, this engine is the strongest of any in the entire world. And though we’ve been bounced around by inflation’s potholes, our careful and steady approach to monetary policy has kept the engine running smoothly and the tires of our economy on the ground. Our actions thus far have seen us progress to our destination without the broader economy sliding into a roadside ditch.

But obviously, we can’t take our eyes off the road. We want to get to our destination without any warning lights going off or tires going flat. And at this moment, the indications are that we can do that — but only if we stay focused and controlled with our hands on the wheel. We can’t go too heavy on the gas too soon, lest we lose control or pass our exit completely and have to reroute.

So, to end where I began, what a difference a year makes. It has been a year of progress. And as we continue moving deeper into 2024, the Federal Reserve Bank of Philadelphia will remain a partner in the continued economic progress of our region and our nation.

Thank you very much.