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"Assessing the Economy as a New Year Begins"

Remarks for NAIOP Massachusetts

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Boston, Massachusetts

The views expressed today are my own, not necessarily those of my colleagues on the Federal Reserve Board of Governors or the Federal Open Market Committee.

Key Takeaways

1. As we begin the new year, "the economy is in a good place overall."
"Inflation is down significantly from its 2022 peak," and data continue to point to a gradual, if uneven, trajectory back to the Fed's 2 percent target. This has been accomplished with a labor market that has stayed healthy "as unsustainably hot job-market conditions from two years ago cooled in an orderly way."

2. By describing the economy as in a good place overall, Collins is *not* declaring victory – and in fact sees "considerable uncertainty accompanying my baseline outlook."
"While inflation is down significantly, it is still above target; and its decline has been slower and bumpier" than anticipated. Collins described multiple *types* of uncertainty – including "noisy" measurement of key economic variables, unusual features of the post-pandemic economy, and possible future policy changes and geopolitical developments.

3. Reflecting on 2024, Collins notes three takeaways that influence her thinking about 2025.
The first involves the importance of supply factors, which have been critical in economic developments since 2020 (including supply-chain disruption and then normalization, favorable labor-supply developments, and growing productivity). The second takeaway involves unusual features of the economy persisting post-pandemic. These include the longer-than-expected cushion from strong household and firm finances, which "potentially lengthened the time for higher rates to work their way through the economy," and the long catch-up process of existing rents to new market rents in keeping shelter inflation elevated. A related and the third takeaway is the importance "of distinguishing potential *new* price pressures from the dynamics of past shocks."

4. In achieving both parts of the Fed's dual mandate from Congress, Collins noted the importance of continued focus on price stability and preserving healthy job market conditions.
Appropriately restrictive monetary policy has helped to rebalance demand and supply. A cooling labor market was an important reason for beginning to normalize policy, but "my concerns about emerging labor market fragility have decreased more recently, as the unemployment rate stabilized" after rising in the first half of 2024. On the other facet of the Fed's mandate, although the *rate* of price increases has moderated notably, high price *levels* have eroded purchasing power – underlining that "not just restoring, but *maintaining*, price stability is essential."

5. Collins said she supported the rate cuts in November and December although "the most recent one was a closer call." Her current outlook is broadly in line with the median forecast in the December Summary of Economic Projections by participants in the Federal Open Market Committee.
"On balance, the December cut provided some additional insurance to preserve healthy labor market conditions while maintaining a restrictive policy stance that is still needed to sustainably restore price stability." Collins expects inflation in 2025 to run somewhat higher than she previously thought, with the risks likely having shifted to the upside.

6. A gradual, patient, and holistic approach to policymaking is appropriate.
Policy is well positioned to adjust as required to evolving conditions – holding at the current level for longer if there is little further progress on inflation, or easing sooner if the need arises – "but there is no preset path." With the economy in a good place overall but with significant risks and uncertainties, "the appropriate policy strategy is gradualism, anchored by holistic data assessment, careful analysis, and patience" – taking the time to fully assess additional information, not over-reacting to individual data readings, and calibrating policy meeting by meeting.

It is a pleasure to be with you this morning. I'd especially like to thank Tamara Small, CEO of NAIOP Massachusetts, for inviting me to join you. And Kim Sherman Stamler, president of Related Beal, for being part of this program. Kim is a member of our board of directors at the Federal Reserve Bank, providing us with terrific insights on the industry and financial conditions. I'm very grateful for her public service on the board.

I'd also like to welcome all of you to the Boston Fed. Interacting with a wide variety of stakeholders in our economy is so important to monetary policymaking. I make sure to meet, and listen to, participants in the economy from all industries and backgrounds. Certainly it is wonderful to meet with so many leaders in commercial real estate today.

Since many of you are involved in development, I'll briefly mention that we at the Boston Fed consider this place an example of the civic role of buildings, and development vision. It is one way our organization has been able to contribute to Boston's vibrancy. By all accounts the late sixties and early seventies had not been especially kind to this part of Boston, and when the Fed outgrew its Pearl Street location, and built this site, it helped expand the city's financial district.[1] Today, this tower hosts a number of tenant firms as well as the Boston Fed. This area has since been enhanced with many buildings and developments, by the restoration of Dewey Square, the creation of the Greenway, and the remarkable growth of the Seaport to the east of us.

We at the Boston Fed are here working on a variety of functions – all supporting the foundations of the economy and financial system. Our work includes monetary policy, economic research, bank supervision, payments and financial-infrastructure services, and community economic development.

My comments today will focus on the economy and monetary policy. As we begin this new year, the economy is in a good place overall. However, economic uncertainty is high, and additional information – about developments in inflation and the labor market, about possible fiscal and trade policy changes, and more – will be key to determining the appropriate course for monetary policy in the year ahead.

In my remarks today, I'd like to do four things. I'll start with describing what I mean when I say the economy "is in a good place" and will refer to current conditions as well as my outlook. That will lead me to a brief discussion of elevated uncertainty, and the implications for monetary policy. I'll end by offering a few reflections from 2024 that are influencing my thinking about the economy and policy for 2025. Then I look forward to taking some questions in the discussion with Kim.

But first, my standard disclaimer: these are my own perspectives, not necessarily those of my colleagues on the Fed's Board of Governors or at other Reserve Banks.

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[1] See "A Bank, A Man, A Region" - Federal Reserve Bank of Boston, pgs. 18-20.

The Economy is in a Good Place Overall

My views about the economy are based on a wide range of information – including assessments of the broad array of quantitative indicators my team and I monitor, statistical analyses, and what I learn from engagements with stakeholders across the Boston Fed's District, which is most of New England.[2] There are some mixed signals in all of this information and the data continue to be noisy (which I'll have more to say about). Still, key dimensions of the economic picture seem to me reasonably clear with respect to progress toward price stability and maximum employment – the Fed's dual mandate from Congress.

The Fed defines price stability as 2 percent inflation. I think of it more generally as inflation that is low and stable enough that most people aren't paying attention to it while they go about their activities. Clearly, that benign state has not prevailed since inflation surged in the aftermath of the pandemic, and we have all seen how difficult high inflation is for households and for firms. Maximum employment, the other leg of the Fed's dual mandate, is defined less precisely, but can be thought of as an economic environment that offers job opportunities to those who want work.

As we enter 2025, inflation is down significantly from its 2022 peak, and the data continue to point to a gradual, if uneven, trajectory back to the Fed's 2 percent target. Importantly, this progress has been accomplished with a labor market that has stayed healthy overall, as unsustainably hot job-market conditions from two years ago cooled in an orderly way. Demand and supply for workers are now in much better balance, and the unemployment rate has remained low by historical standards, amid solid economic growth. This is all good news, and central to what I mean by describing the economy as being in a good place.

Contributors to the Positive Developments So Far

I'll briefly note three sets of factors that have contributed to these positive outcomes so far.

First are developments related to the supply side of the economy. Economic growth that is demand-driven tends to be inflationary, while the combination of strong growth with limited signs of new price pressures point to *supply* improvements playing an important role. In that dimension, supply-chain

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[2] I have gained valuable insights about economic conditions by hearing on-the-ground perspectives, for example related to the pervasive challenges of housing availability and the widespread business-leader focus on enhancing productivity. More generally, given the Boston Fed's overarching mission of a vibrant economy that works for all, it is essential for our Bank to engage with stakeholders of all types across urban and rural parts of the six states in our District.

normalization has been particularly important (especially during 2022).[3] And we have seen growth in labor supply and productivity. The labor-supply expansion has come both from significant increases in immigration[4] and from a larger-than-expected rise in prime-age labor force participation (evident across gender and racial/ethnic groups).[5] These supply improvements were particularly welcome amid very tight labor markets. And last but not least, labor productivity – that is, output per hour worked – has been growing notably faster than its pre-pandemic trend. To be clear, there are many possible explanations for this rise in trend productivity growth, and it is unclear how long it will persist. However, the improvements to date have had favorable implications by supporting economic growth and the disinflation process.[6]

Second, restrictive monetary policy has been doing its job, helping to rebalance demand and supply by restraining the interest-sensitive segments of demand and thus reducing pressure on wages and prices.[7] The large, rapid increases in the Fed's policy rate in the second half of 2022, followed by more gradual hikes and then holding rates at 5.5 percent for over a year, underscored the Fed's commitment to restoring price stability and helped to keep long-term inflation expectations from rising. The fact that inflation expectations have remained well anchored reflects the Fed's earned credibility – and is something I'll continue to watch closely.

The third, related, point is that both household and firm balance sheets were unusually strong coming out of the pandemic, and supported economic growth even in the face of higher interest rates. While balance sheets remain in good shape, some buffers have waned over time as many households have depleted their excess savings and corporate cash balances have reverted to pre-pandemic trends. This normalization was accompanied by a slowdown in labor demand.

A cooling labor market was an important reason for beginning to reduce the degree of policy restrictiveness in September. This policy decision was reinforced by concerns about possible emerging fragilities, as slowing and more concentrated payroll growth, together with declining quit and job-finding rates, increased the risk of a more pronounced and unwanted weakening of labor market conditions. Indeed, with inflation heading back to target, a key goal for policy became preserving healthy labor

[3] The New York Fed provides a monthly index of global supply chain pressures – which surged during 2020-2022, falling back to its pre-pandemic range by the first quarter of 2023. See the Global Supply Chain Pressure Index (GSCPI) - Federal Reserve Bank of New York.
[4] On the effects of recent immigration on labor supply, see "Quantifying the Recent Immigration Surge: Evidence from Work-permit Applications" - Federal Reserve Bank of Boston
[5] See the discussion in my November 20, 2024 speech at the University of Michigan: Perspectives on the Economy and Policy - Federal Reserve Bank of Boston.
[6] Additional discussions of recent labor productivity gains include my November 20, 2024 University of Michigan speech, as well as "The Recent Rise in US Labor Productivity" by Luke Pardue, published by the Aspen Economic Strategy Group of the Aspen Institute (Labor Productivity In Brief).
[7] Demand-driven inflation has moderated notably since 2023, which coincides with my assessment of when monetary policy moved firmly into restrictive territory.

market conditions while continuing to bring inflation down. I continue to monitor a range of indicators closely, but my concerns about emerging labor market fragility have decreased more recently, as the unemployment rate stabilized after rising notably in the first half of 2024.

A Closer Look at Inflation

To be clear, by describing the economy as in a good place overall, I am *not* declaring "victory." In particular, while inflation is down significantly, it is still above target; its decline has been slower and bumpier than I anticipated; and there is considerable uncertainty accompanying my baseline outlook. It will be essential to remain data dependent going forward, with a clear commitment to restoring price stability over time, while being mindful of sustaining healthy labor market conditions.

In tracking inflation, I find it helpful to focus on core (instead of total) inflation. Although it omits the obviously vital (though volatile) components of food and energy, core is generally a better gauge of underlying inflation trends. On a 12-month basis, core PCE inflation was 2.8 percent in October and November. While this partly reflects high monthly readings in the first quarter of 2024, it is only a marginal improvement from the 3 percent rate registered at the end of 2023.

Some insight into the recent disinflation process is provided by dividing core inflation into its three components, which behave quite differently. Core *goods* inflation had declined back to its pre-pandemic range by the end of 2023, as supply-chain disruptions normalized. *Non-housing services* is a large, varied category where inflation has been highly volatile, including a big, unexpected bump at the beginning of 2024. But recent monthly inflation readings for this component have also returned to their pre-pandemic range – and I'll be watching closely to see if the decline is sustained.

Much of the continued elevation in inflation comes from the third component, *housing services*, which seemed "stuck" at the end of 2023 and well into 2024. This has likely reflected long lags for the rents charged to existing tenants to catch up to the significantly higher rent levels associated with new leases.[8] Here too, recent data are promising. If new market rent growth remains subdued, shelter price inflation should eventually normalize, though it is difficult to predict when or how quickly this will happen.

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[8] In 2022 and early 2023, rent to new lessors surged, contributing to higher inflation and pushing up the level of new market rents. This created a large gap between the rent landlords were receiving from new renters relative to those with existing leases in similar units. Over time, the gap is being narrowed as many landlords ask existing renters for larger than typical annual rent increases. This "catch-up" is a key source of the current elevation of shelter inflation, and it is difficult to tell how long it will last. But it reflects adjustment to the past surge in new rents. Although the level of new market rents remains high, they have been growing at a similar pace to growth rates pre-pandemic for many months. So, growth in new market rents does not appear to be a source of new price pressures.

Importantly, current labor market conditions also appear unlikely to be a source of new price pressures – even though wages continue to grow more rapidly than their pre-pandemic trend. Indeed, analysis by Boston Fed staff show that labor remains relatively inexpensive overall, given recent productivity gains and price developments. There is likely some room for additional wage gains that would help to raise the purchasing power and economic wellbeing of workers, without fueling inflation.[9]

Although the *rate* of price increases has moderated notably since 2022, I continue to hear during my visits across New England how high price *levels* have eroded purchasing power for some households. This is a concern especially for those at the lower end of the income distribution. History has shown that periods of sustained price stability can create conditions where the benefits of economic prosperity are shared more broadly. To me, this is another reminder that not just restoring, but *maintaining*, price stability is an essential part of the Fed's mission to serve the public. I'll turn to policy and my outlook after saying a bit more about the elevated uncertainty.

Elevated Uncertainty

In a speech given at Wellesley College in the fall of 2023, I focused on monetary policy amid uncertainty.[10] Drawing on the large literature on this topic – summarized, for example, in an influential 2004 speech by then Fed Governor Ben Bernanke[11] – my remarks emphasized two points.

First, there are multiple *types* of uncertainty. All were elevated at the time, and uncertainty remains elevated. One type of uncertainty relates to data and measurement of key economic variables. For instance, monthly inflation indicators, such as the CPI and PCE, continue to exhibit more than the usual degree of volatility. There is also a wide range of views about current levels of economic fundamentals, such as the potential – or trend – growth of the economy and the neutral rate of interest.[12] A second type is uncertainty about relationships between key economic variables that influence policy decisions. For instance, as I have noted, the Fed increased rates rapidly starting in early 2022 and has maintained a restrictive policy stance for a considerable amount of time. But high interest rates appear to

[9] For recent analyses on this topic, see "Is Post-pandemic Wage Growth Fueling Inflation?" - Federal Reserve Bank of Boston (bostonfed.org), and "Productivity Improvements and Markup Normalization Can Support Further Wage Gains without Inflationary Pressures" - Federal Reserve Bank of Boston (bostonfed.org).
[10] See my 2023 Goldman Lecture in Economics at Wellesley College, "Reflections on Phasing Policy Amidst (Pandemic) Uncertainty", available at https://www.bostonfed.org/news-and-events/speeches/2023/reflections-on-phasing-policy-amidst-pandemic-uncertainty.aspx.
[11] See FRB: Speech, Bernanke--Gradualism--May 20, 2004.
[12] For instance, the FOMC participants provide a wide range of estimates in the quarterly SEP (Summary of Economic Projections) – and this range has grown recently. See The Fed - December 18, 2024: FOMC Projections materials, accessible version

have had a smaller and more delayed impact on demand than historical estimates suggest. And the third type relates to unforeseen future events, including pandemics, natural disasters, future policy changes, and geopolitical developments. Here, I'll note the sizable recent rise in indicators of U.S. trade policy uncertainty.[13]

Second, heightened uncertainty about current economic conditions and benchmarks and about the economy's response to policy changes typically calls for a *cautious, gradual* approach to monetary decision-making. The need for more aggressive policy adjustments arises when policymakers see imminent risks to the achievement of their objectives. But with an economy that is in a good place overall and policy already closer to a more neutral stance, I view the current nature of uncertainty as calling for a gradual and patient approach to policymaking.

The Outlook, and Policy

Amid this uncertainty, the Federal Open Market Committee (FOMC) began normalizing policy in late 2024, beginning with a 50 basis-point cut in September. I saw this move as fully appropriate – given the significant, if bumpy, progress on inflation. The adjustment recognized that there was no need for further cooling of the no-longer-overheated labor market; that a given nominal policy rate would become increasingly restrictive as inflation came down; and that as the pace of growth moderates, the economy can be more vulnerable to adverse shocks.

I also supported the smaller additional rate cuts in November and December – though for me, the most recent one was a closer call. On balance, the December cut provided some additional insurance to preserve healthy labor market conditions while maintaining a restrictive policy stance that is still needed to sustainably restore price stability.

Looking ahead, my current outlook is broadly in line with the median forecast in the December FOMC Summary of Economic Projections (SEP).[14] In particular, I expect inflation in 2025 to run somewhat higher than I previously thought, with the risks likely having shifted to the upside. As I've discussed, inflation, while notably closer to the 2 percent target, has proved "stickier" than anticipated. However, it is too early to tell how future policy changes by the new administration and Congress might influence the trajectories of inflation and economic activity. Separately, I will also note that it will take some time for the effects of our monetary policy actions to filter through to the economy (often referred to

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[13] See the Trade Policy Uncertainty Index at https://www.matteoiacoviello.com/tpu.htm, which is based on the work by Caldara, Iacoviello, Molligo, Prestipino, and Raffo (2020), "The Economic Effects of Trade Policy Uncertainty," *Journal of Monetary Economics*, 109, pp.38-59.
[14] Summary of Economic Projections, December 18, 2024

as “long and variable lags”). And while the labor market remains healthy, I will continue to watch for possible fragilities, remaining attentive to both sides of our dual mandate, and recognizing risks to both inflation and employment.

This context calls for a patient approach to policy – taking the time to fully assess available information and not over-reacting to individual data readings, as we calibrate policy meeting by meeting. As in the median SEP projection, this likely implies a more gradual approach to policy normalization. But there is no preset path, and a projection is certainly not a promise. In my view, policy is well positioned to adjust as required to evolving conditions – holding at the current level for longer if there is little further progress on inflation, or easing sooner if the need arises.

Some Lessons from 2024, for 2025

As I reflect on economic developments from the past year (and more generally, from the two and a half years I have served as Boston Fed president), three things stand out that influence my thinking about the year ahead. While each has been included in my remarks today, I’ll pull these lessons together here, and then wrap up by connecting them to policy:

The first lesson: don’t forget about the supply-side of the economy. Supply factors have played a critical role in economic developments since 2020. Arguably, the severity and persistence of supply-chain disruptions were underappreciated as inflation surged in 2022. And as noted above, favorable productivity and labor supply developments have been key, both to disinflation amid strong economic growth, and to solid wage growth that is increasing purchasing power without fueling price pressures. These linkages may seem evident in hindsight but were not fully anticipated. Of course, we cannot count on such favorable supply developments persisting – and the supply side of the economy will continue to warrant careful attention.

Second, recognize that unusual features of the economy are persisting post-pandemic. My remarks highlighted two examples. One is the longer-than-expected “cushion” from strong household balance sheets. In the aftermath of the pandemic, this has contributed to resilient household spending and potentially lengthened the time for higher rates to work their way through the economy. A second is the longer-than-expected catch-up process of existing rents to new market rents, and the associated difficulties in predicting the evolution of shelter inflation in the post-pandemic housing market.

Third, focus on distinguishing potential new price pressures from the dynamics of past shocks. This point connects closely to the prior one. In particular, my confidence that shelter inflation is on a downward (if slow and bumpy) path relates directly to the evidence that new market rent growth has stabilized at its average pre-pandemic rate. Provided that this pattern continues, there is much less

reason for concern about the longer-than-expected “catch-up” period to narrow the gap between rent levels on existing and new leases. Similarly, the likelihood that recent solid wage growth will generate new price pressures must be assessed in the context of productivity developments and past inflation – and there is little evidence of this so far. I’ll be looking carefully to see if new price pressures emerge in the months ahead.

Importantly, as I have noted, uncertainty remains elevated. This includes volatile (or “noisy”) monthly data, uncertainties related to unusual features of the post-pandemic economy such as those noted above, uncertainty about possible future policy, and uncertainty about fundamentals such as the level of the neutral rate of interest.

With noisy data providing some mixed signals, focusing on only a few indicators can paint a misleading picture. It is essential to assess a broad range of information over time to gain a clearer picture of current economic conditions and, importantly, their likely evolution. Furthermore, as I have emphasized, in this context, with the economy in a good place overall but with significant risks and uncertainties, the appropriate policy strategy is gradualism, anchored by holistic data assessment, careful analysis and patience.

With that, I’ll again say thank you to NAIOP, Tamara Small, and all of you for being here today. Very best wishes for a wonderful 2025. I look forward to sitting down with Kim Sherman Stamler for some questions.