2024 College Fed Challenge Winner Presentation
Federal Reserve Board

BRACKLINN WILLIAMS. Good morning, everyone. We have a full agenda for today's discussion on the balance of risks in the economy. Since the beginning of this tightening cycle, inflation has declined substantially towards our 2 percent target, but labor conditions have softened materially. The current restrictive level of monetary policy is no longer appropriate. The question is now how fast and how far to cut to best ensure a soft landing as we normalize policy. We will begin with a survey of the growth outlook before discussing the labor market, the inflationary environment, and financial conditions before we vote and provide forward guidance.

DANIEL SOZANSKI. Real GDP growth in Quarter 2 came in hot, revised up to 3 percent. GDP was already higher than CBO estimates of potential and this growth was much higher than the Quarter 1 figure, 1.4 percent, and our Summary of Economic Projections number, 2 percent. Solid consumer spending gains, private inventor investment, and non-residential fixed investment drove this strength.

ELLIOT LEE. However, demand is weakening. Production decreased for the first time in seven months as sales continued to fall. Manufacturing output experienced its largest drop in over a year. The dual mandate does not include growth and unemployment risks are of more concern at present.

BRACKLINN WILLIAMS. Let's turn to the labor market. The unemployment rate was 4.2 percent in August, up from the historic sub 4 percent rate that held for two years before the pandemic. Job openings also continued to decrease.

ELEANOR CLEMANS-COPE. In light of Trappel's warning against further cooling in the labor market, it is especially important to take lags of policy effects on employment into account. We should pay attention to our outlook for unemployment several months from now, not just today. Continuing our cuts is necessary to respect both the duality of the mandate and our commitment to being data driven.

WILLIAM NEUMANN. The labor market has been cooling from overheated levels but remains resilient. Total non-farm employment rose by 142,000 in August, rebounding from a low in July. Initial and continuing jobless claims are declining. Unemployment sits at 4.2 percent, a decrease from July. While the unemployment rate is expected to continue to drift up with a summary of economic projects number of 4.4 percent by the end of the year, it will be slightly above our projection of long-run unemployment.

DANIEL SOZANSKI. Much of the unemployment rise we saw was due to labor force expansion. This is unlikely to continue. In August, the labor force participation rate held study at almost 63 percent, near pre-pandemic levels, while a prime age participation remained above at nearly 84 percent. With pandemic retirees unlikely to return, there's little room for further expansion. Immigration, the other source of new workers, may not be reliable going forward. As Michelle Bowman noted, the data impacts of immigration are difficult to project.

ELLIOT LEE. Even if the labor supply is expanding, household expectations about the availability of jobs are falling. And this can make the rise in unemployment self-reinforcing. When layoffs rise, households and businesses pull back spending in investment, causing a negative feedback loop. This is what the Sahm rule, which was triggered this summer, signals.

ELEANOR CLEMANS-COPE. And this may already be happening. The New York Feds SCE Labor Market Survey in July found that the share expecting to become unemployed in the next four months was the highest since 2014, at 4.4 percent. The Conference Board Consumer Confidence Index also fell in September. The quits rate has continued declining over the past two years to 1.9 percent, a bit below pre-pandemic levels.

WILLIAM NEUMANN. Well, I question the efficacy of the Sahm rule. Many of the usual coincident indicators for the rule were not correlated with it this summer. Sahm, herself, mentioned that the increase in unemployment has been mainly due to our more robust labor supply. Thus, the Sahm rule may simply be another pandemic exception.

DANIEL SOZANSKI. Given that we just cut rates, these conditions might change. The uncertain policy lag suggests we ease at a cautious pace to better respond to upside inflation risks if they occur.

ELEANOR CLEMANS-COPE. Concerning that trend, the vacancy-to-unemployment ration decreased steadily to 1.1, driven by rising unemployment and decreasing hires. This is its lowest since the start of the pandemic, another sign of a looser labor market. Benigno and Eggertsson describe a nonlinear Phillips curve with a kink to a steeper slope when the labor market crosses neutral. The easing labor market may have caused a sharp drop in inflation, but further inflation targeting, now that we're near the kink as seen on the right-hand panel, may cause higher unemployment risks. And reduce our chances of a soft landing.

BRACKLINN WILLIAMS. Inflation is slowing across the board. On a year-over-year basis, August PCE was 2.2 percent and Core was 2.7, showing signs of moderation. Also in August, the PPI cooled to 2.2 percent. Although it isn't yet at our 2 percent target, inflation is trending downward, giving us confidence in a sustainable path toward price stability.

ELLIOT LEE. The three-month Core PCE annualized is already there, at 1.7 percent, its slowest pace this year. This may indicate that given lags, the downward trend has already hit or passed the target.

DANIEL SOZANSKI. We can't yet write the inflation battle off as one. We are still above the 2 percent target and consumers are feeling the pain of high prices. Meanwhile, spending remains strong, especially in retail and auto. Even more concerning is that progress towards the goal is slowing. Cutting too fast could reverse the direction of this trend, not just hold indicators at current levels.

WILLIAM NEUMANN. Wage growth has remained sticky and well above pre-pandemic levels. Services sitting at 3.7 percent year over year are also holding inflation high. This likely indicates entrenched inflation and susceptibility to a wage price spiral.

ELEANOR CLEMANS-COPE. Although it's true that wages have finally caught up with PCE inflation when indexed to 2019, this is not enough to fear a wage price spiral. Both because we broke the slowing and because the absolute increases are low. Nearly all measures of real income show a less than 1 percent annualized increase since 2019, an amount that could be accounted for by productivity gains. In fact, Steven Davis wrote that the average real wage growth has been significantly below the pre-pandemic trend.

BRACKLINN WILLIAMS. Although consumer good prices are falling at different rates, inflation is falling across all categories. Inflation remains the highest in housing at 5.4 percent year over year. Notably, PCE supercore inflation, which excludes housing, food, and energy, hit 2 percent in May and is currently at 2.1 percent.

ELLIOT LEE. I think it's also useful to look at harmonized Core PCE as a measure of inflation, which excludes owner-occupied housing. This metric has been below 2 percent since November last year and is currently hovering around 1.5 percent. For rent inflation, the Zillow Rent Index of new contracts has already returned to pre-pandemic levels. This status suggests that an unlagged measure of PCE inflation would perhaps undershoot 2 percent. There is no longer a need for restrictive policy.

DANIEL SOZANSKI. It is possible that inflation is mostly coming down for transitory reasons. Jason Furman noted this summer that Core has been higher than headline inflation for much of the past year, indicating more transitory food and energy are leading the decline. We can't guarantee such progress will continue.

WILLIAM NEUMANN. Conflict in the Middle East and Ukraine poses risks to shipping, oil, and food prices. And the nationwide port strike will wreak havoc on supply chains with disruptions at six of the ten largest U.S. ports. Cuts are appropriate but we need to proceed slowly in case inflation rebounds.

BRACKLINN WILLIAMS. Looking at the data and our decision to cut by 50 basis points in September, it is clear that we are in an easing cycle. The question now becomes how fast and to what level. In September, a majority of us projected at least 50 points of cuts between now and December.

ELEANOR CLEMANS-COPE. I suggest we cut faster with 50 points now. As labor market deterioration often occurs with a lag, we cannot risk further damage, especially considering downward revisions to non-farm payrolls over the past year. Inflation is trending downward, and expectations are well-anchored, limiting the inflationary risks to [inaudible] policy. The median five-year head CPI expectations from the New York Fed held steady in August at 2.8 percent, close to the 2 percent target for PCE on the ten-year breakeven inflation rates sits at 2.2 percent.

ELLIOT LEE. Additionally, long policy lags may still be working their way through the economy. Residential starts are falling back to pre-pandemic levels, median home sales prices are high, and existing home sales dropped over the summer to a level not seen since 2008.

DANIEL SOZANSKI. But we also haven't seen the lagged effects of our cut. Daily data for debit card transactions show consumer spending has been accelerating in recent weeks driven by spending on clothing, food services, and vehicle dealers. Total household debt continued to rise in Q2, with credit card balances reaching 1.14 trillion.

ELEANOR CLEMANS-COPE. Though recently revised upwards, both the savings rate at 4.8 percent and the savings level in GDP terms are lower than pre-pandemic. This could indicate coming economic weakness and consumers, especially those at the lower socioeconomic level, lack the financial cushion to remain resilient through a labor market downturn. Restrictive policy runs the risk of severe pain to households with low savings.

WILLIAM NEUMANN. Even if the spending is on necessities, our September cut may exacerbate the spending cycle. Faster rate cuts will only make it easier for consumers and investors to borrow and spend, which may generate a spike in GDP growth. Both the Atlanta and New York FedNow casts are estimating around 3 percent for Quarter 3. Much higher than the September Summary of Economic Projections median prediction of 2 percent, indicating a potential inflationary surge. Recent upward revisions suggest that we need to see trends, not just data points, and that individual readings argue for a more modest cut of 25 basis points.

ELLIOT LEE. However, the current pace of consumer spending is unsustainable. Credit card and consumer loan delinquencies are rising above pre-pandemic levels, reaching 3.25 and 2.74 percent, respectively. Meaning that spending may be about to decrease substantially. Additionally, the Philadelphia Fed found that the share of the credit card balances that are 60 days past due has sharply risen above pre-pandemic trends. And research by the St. Louis Fed posits that for the poorest 10 percent of zip codes, the delinquency rate has nearly doubled.

DANIEL SOZANSKI. We want to normalize rate policy to relieve these consumers, but not cause their spending to resurge. Markets are currently pricing more rate cuts than we are expecting at around 150 to 200 basis points over the next year, potentially taking us past neutral and into easy territory. This would only put upward pressure on credit-driven consumption and inflation.

WILLIAM NEUMANN. Additionally, the level of what rate is neutral is widely debated. Given high fiscal deficits and investment demand in renewables and AI, it is possible that the neutral rate of interest, r-star, could be higher. For example, the New York Fed DSGE model projects a real neutral rate of 2.5 percent in 2025. In which case, cutting rates as fast as markets are priced could push inflation back up.

ELEANOR CLEMANS-COPE. But models for r-star have broad uncertainty. The New York Fed's Holston-Laubach-Williams model estimates a real rate of 0.7 percent, while the median rate in the September SEP was 0.9 percent. Both would imply there is a lot of room to cop before we reach neutral territory. Ultimately, the Fed should remain dependent on incoming data, not just models.

ELLIOT LEE. I would also like to touch on quantitative tightening which appears to be counter cyclical. Even if QT is part of our policy normalization, I'm concerned that the continued balance sheet selloff is still putting upward pressure on rates further along the yield curve. It may be appropriate for us to consider slowing the pace of this selloff, as well.

DANIEL SOZANSKI. I disagree. I believe QT to be of little impact presently. Banks possess abundant reserves, much more than is needed to limit volatility in money market rates. President Logan suggests we should continue QT until we reach an ample reserve environment as seen when short-term market pricing becomes more responsive to fluctuations in the supply reserves.

BRACKLINN WILLIAMS. I believe there is room to cut. However, I also want to emphasize that financial conditions are easing with buoyant market sentiment and the NFCI decreasing to its lowest point since late-2021. Since the weak July jobs report, the ten-year Treasury yield has fallen around 60 basis points, while the two-year has also fallen a similar amount over the past few months.

WILLIAM NEUMANN. The corporate bond market distress index remains healthy, just below its historic 25th percentile. Market functioning in both high yield and investment-grade sectors marginally improved over the past month and remained within historical norms. The drop in bond yields also provides stimulus. However, cutting fast and in large amounts could start panic in the markets, becoming a self-fulfilling prophesy that causes further labor market deterioration.

ELEANOR CLEMANS-COPE. Despite this, the VIX Market Volatility Index peaked on August 5th during the large stock market selloff in part due to poor jobs market data. And only recovered in response to improving labor market conditions a few days later. This suggests labor market risks could also pose financial volatility risks, adding yet another reason to cut quickly.

DANIEL SOZANSKI. I disagree. The volatility is driven by a small number of tech, and specifically AI-related firms, which are responsible for over a third of the stock market index gains over the past year. This may be a bubble, and our policy tools are not suited to address it. Easing too fast will only inflate the bubble.

WILLIAM NEUMANN. Additionally, corporate default rates have declined to 4.5 percent and the S&P 500 just hit an all-time high. There has been a lot of growth in private credit, posing future risk for the financial industry. Lower rates exacerbate this by causing private credit to chase yield. This is a matter better handled by bank regulation, but we should be mindful of the risks of easier policy.

ELEANOR CLEMANS-COPE. The softening of conditions we have observed so far has occurred with price markets pricing and cuts. If we push market expectations more hawkish, this could tighten conditions right when we need to ease them.

BRACKLINN WILLIAMS. Rather than follow markets, we need to move rates predictability and in line with incoming data. This is even more true because it is an election year. Preserving credibility requires transparency and clear communication. The size of our cut will also set market expectations for policy to come.

DANIEL SOZANSKI. If we haven't quashed inflation and the upside risks are realized, lowering rates too much could be a mistake that will come back and hurt our credibility. We should continue to emphasize that we are conducting an apolitical and data-dependent approach to policymaking.

BRACKLINN WILLIAMS. Thank you for the discussion. It seems a 25-basis point cut this time is appropriate, but we will continue to evaluate the totality of incoming data at each meeting going forward. The committee proposes to, one, cut the federal funds rate by 25 basis points to a target range of 4.5 to 4.75 percent. Two, continue to reduce the Federal Reserve holdings of Treasury securities capped at 25 billion per month and MBS at 35 billion per month. And three, provide clear and evidence-based communication that reflects our data dependent and risk management approach.

Let's now vote.

ELLIOT LEE. Aye. This cut is in line with our maximum employment mandate and will set us towards our desired soft landing.

ELEANOR CLEMANS-COPE. Aye. But the work is not over. We need more cuts to ensure compounding labor market weakness and lower expectations do not lead us towards recession.

DANIEL SOZANSKI. Aye. We need to move predictably towards more neutral policy, though we must also monitor incoming data for potential inflation risks.

WILLIAM NEUMANN. Aye. However, we should make sure to not promise future rate cuts when our policy remains data dependent. Current market pricing anticipates more cuts than data presently suggests.

BRACKLINN WILLIAMS. Aye. The aye's have it. This meeting is adjourned.