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2024

ECON 4011 - Monetary Economics | Professor Ilir Miteza

POLICY RECOMMENDATIO N

INTRODUCTION

ECONOMY TRENDS & NOW

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- Trend
- Components
- Gap

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- Job creation & wages

AD & AS

- Sales & Inventories
- GSCPI

$i = r + \pi$

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- Inflation expectation
- Interest rate

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- LEI & predicting economic trends
- CEI & cycles

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- Fiscal

POLICY RECOMMENDATION

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- Taylor Rule
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- Tools

ECONOMY TRENDS & NOW

Data from Q3 2024

$23T

Real GDP Growth

2.66% annual growth

Data from November 2024

4.2%

Unemployment Rate

Below NROU: ~ 0.01%

Data from October 2024

2.80%

Inflation Rate

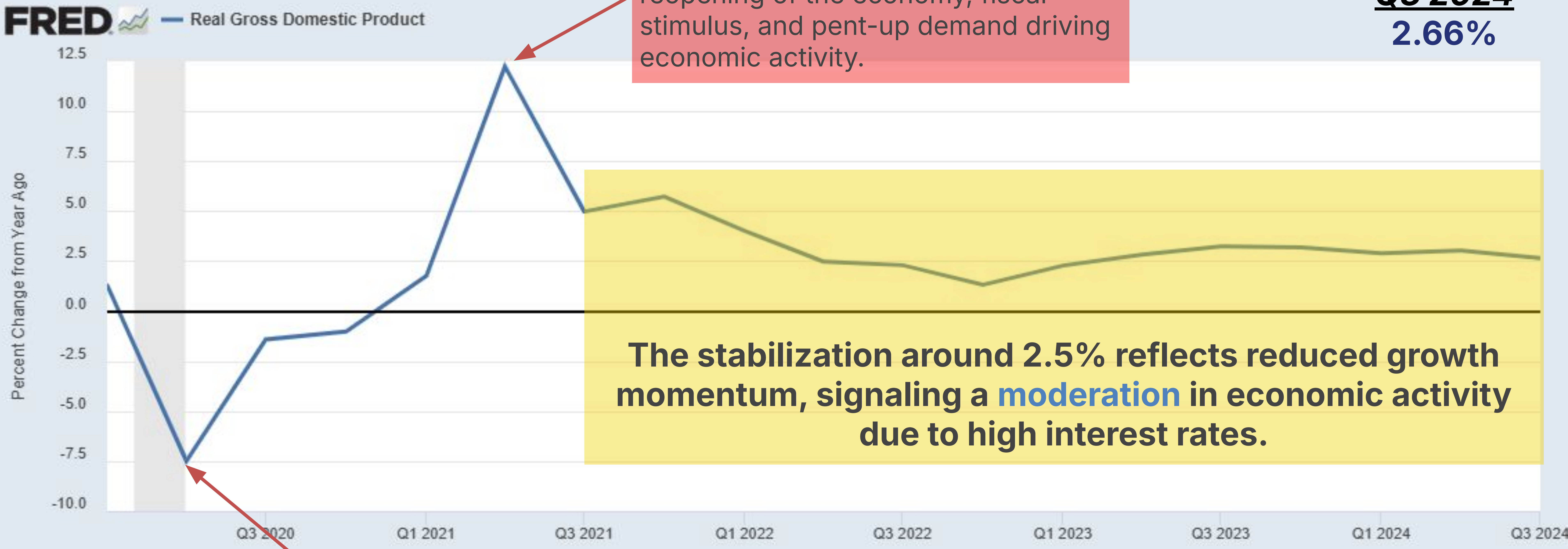
Target: 2%

GDP TRENDS

2024

Q3 2024
2.66%

Rapid rebound in 2021, peaking significantly that aligns with the reopening of the economy, fiscal stimulus, and pent-up demand driving economic activity.



The stabilization around 2.5% reflects reduced growth momentum, signaling a moderation in economic activity due to high interest rates.

Steep drop in GDP growth in 2020 The GDP fell below 0%, due to widespread economic disruptions, lockdowns, and reduced economic activity.

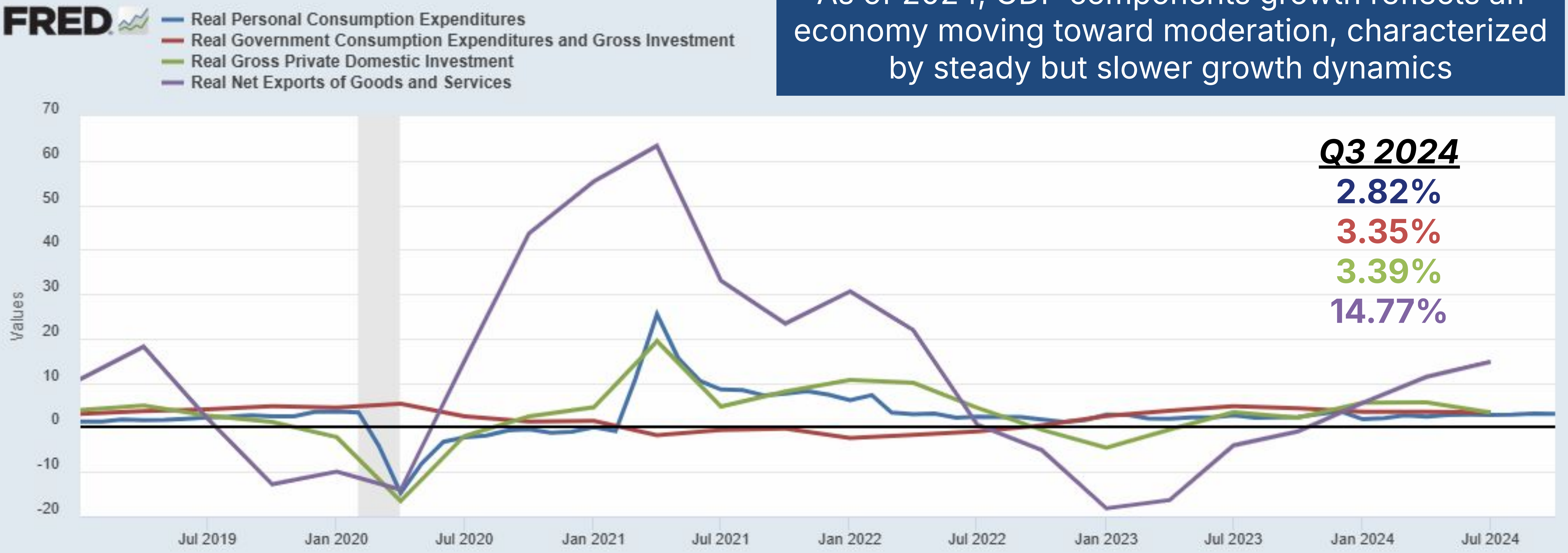
GDP COMPONENTS

Largest driver of economic activity, reflecting strong household spending despite inflationary pressures.

The contributions to GDP by its components for Q3 2024

Consumption (C): ~ 68.73%
Investment (I): ~ 16.95%
Government Spending (G): ~ 18.73%
Net Exports (X - IM): ~ -4.61%

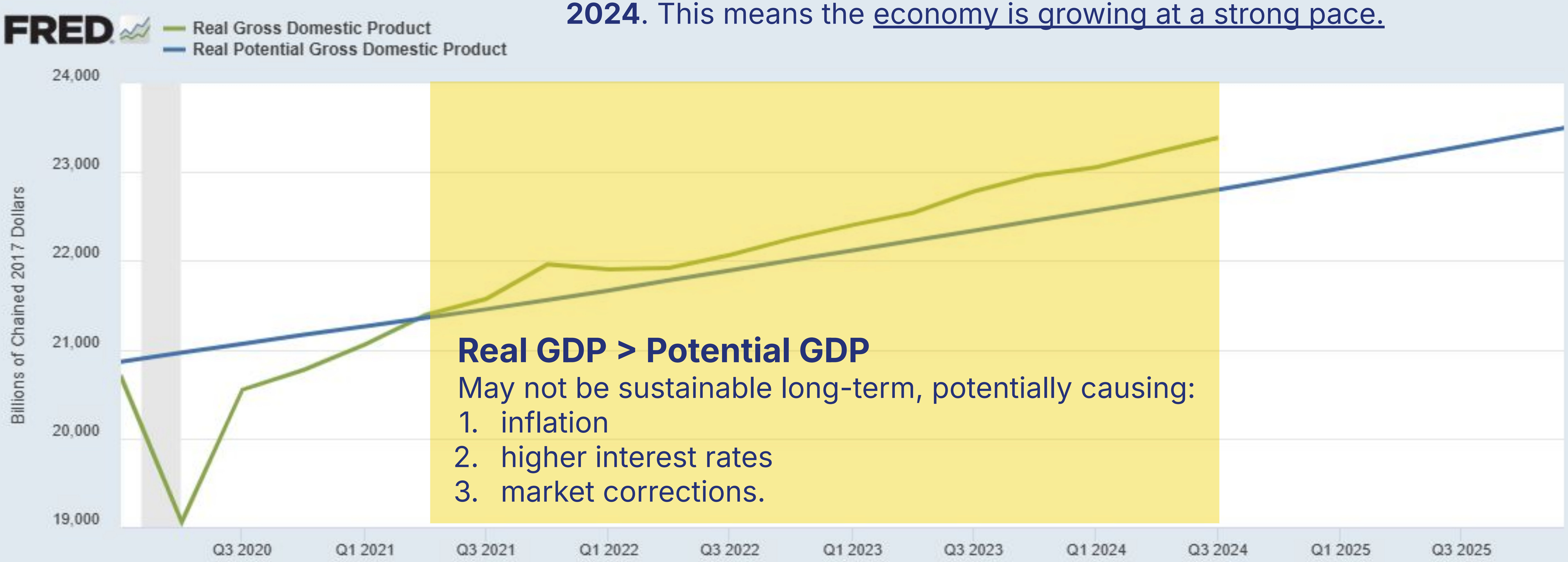
As of 2024, GDP components growth reflects an economy moving toward moderation, characterized by steady but slower growth dynamics



GDP GAP

2024

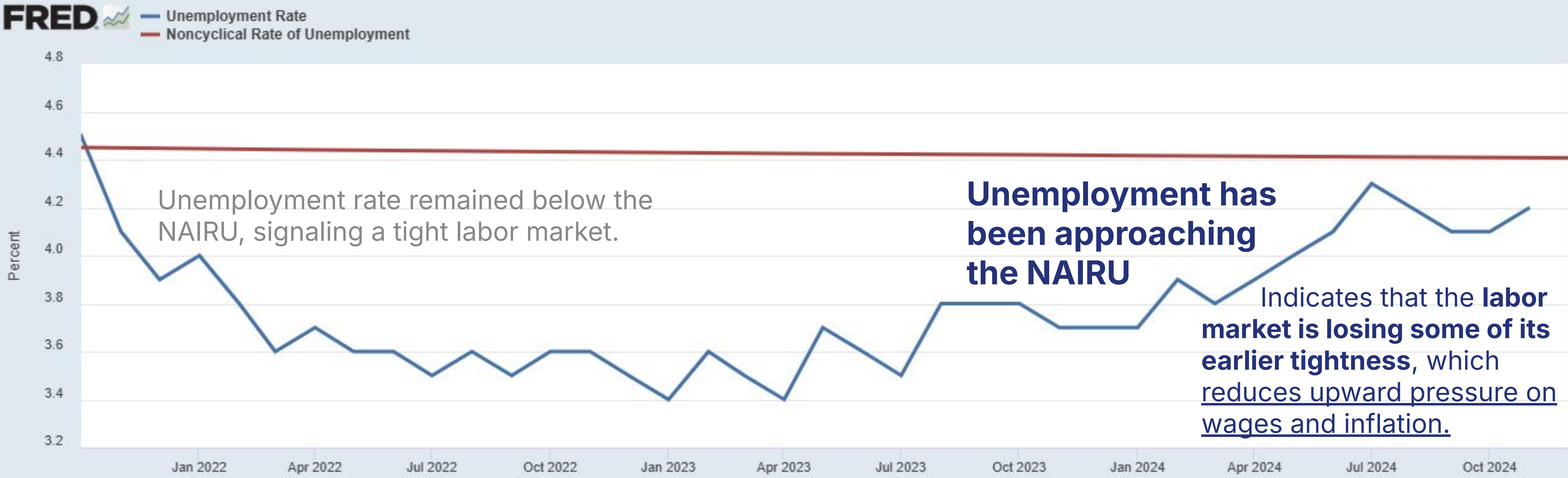
According to GDPNow, the U.S. economy is expected to grow by **3.29%** (A bit above average. 2% - 3% is consider good) in the **fourth quarter of 2024**. This means the economy is growing at a strong pace.



BUT the **interest rates cut** due to cooling inflation, a softening (yet strong) labor market, and the need to stabilize growth amidst uncertainties, ***focusing on managing risks over high GDP***

UNEMPLOYMENT GAP

2024



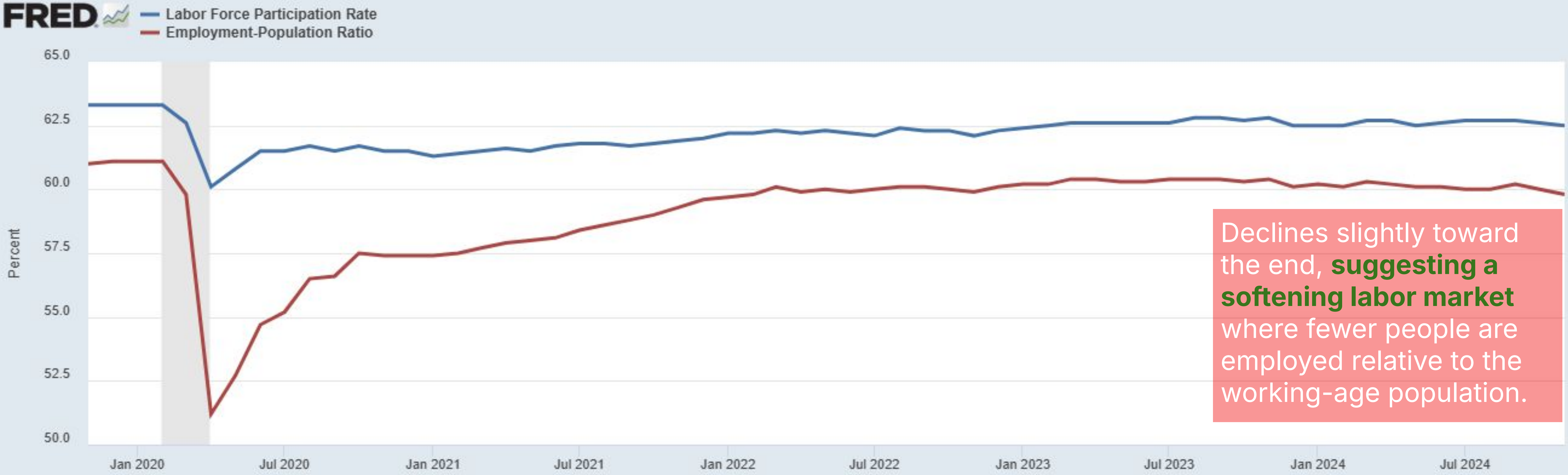
2024 Insights

While unemployment remains low, job losses are **concentrated in sectors** like **manufacturing, warehousing, and information technology**, driven by factors like reduced consumer demand, global supply chain issues, and post-pandemic adjustments like **construction and healthcare continue to show resilience** with strong growth. Temporary disruptions, such as **hurricanes and strikes**, have also influenced employment trends in certain regions .

LABOR FORCE

2024

Labor force participation is **steady** but <u>still below pre-pandemic levels.</u>

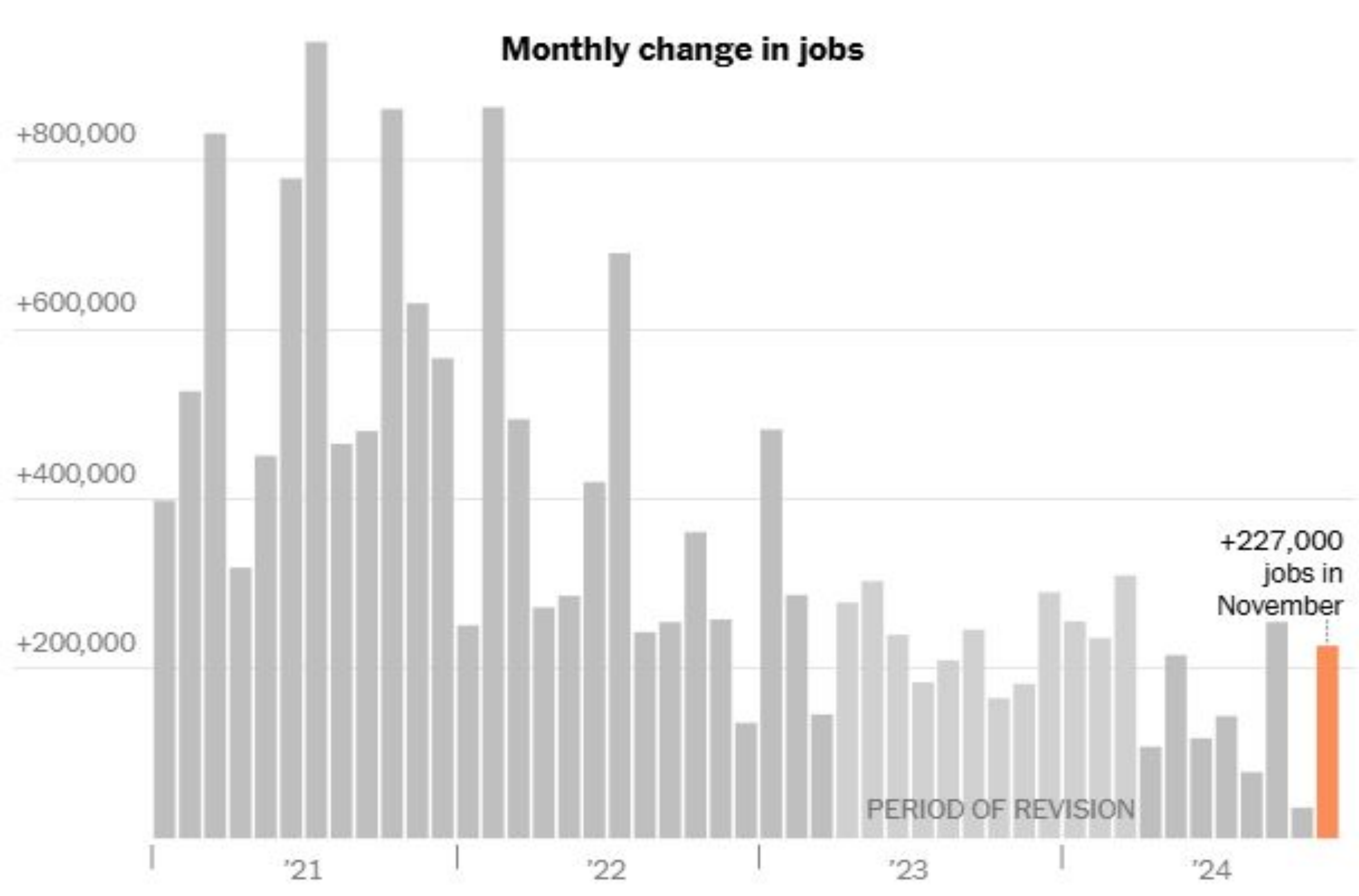


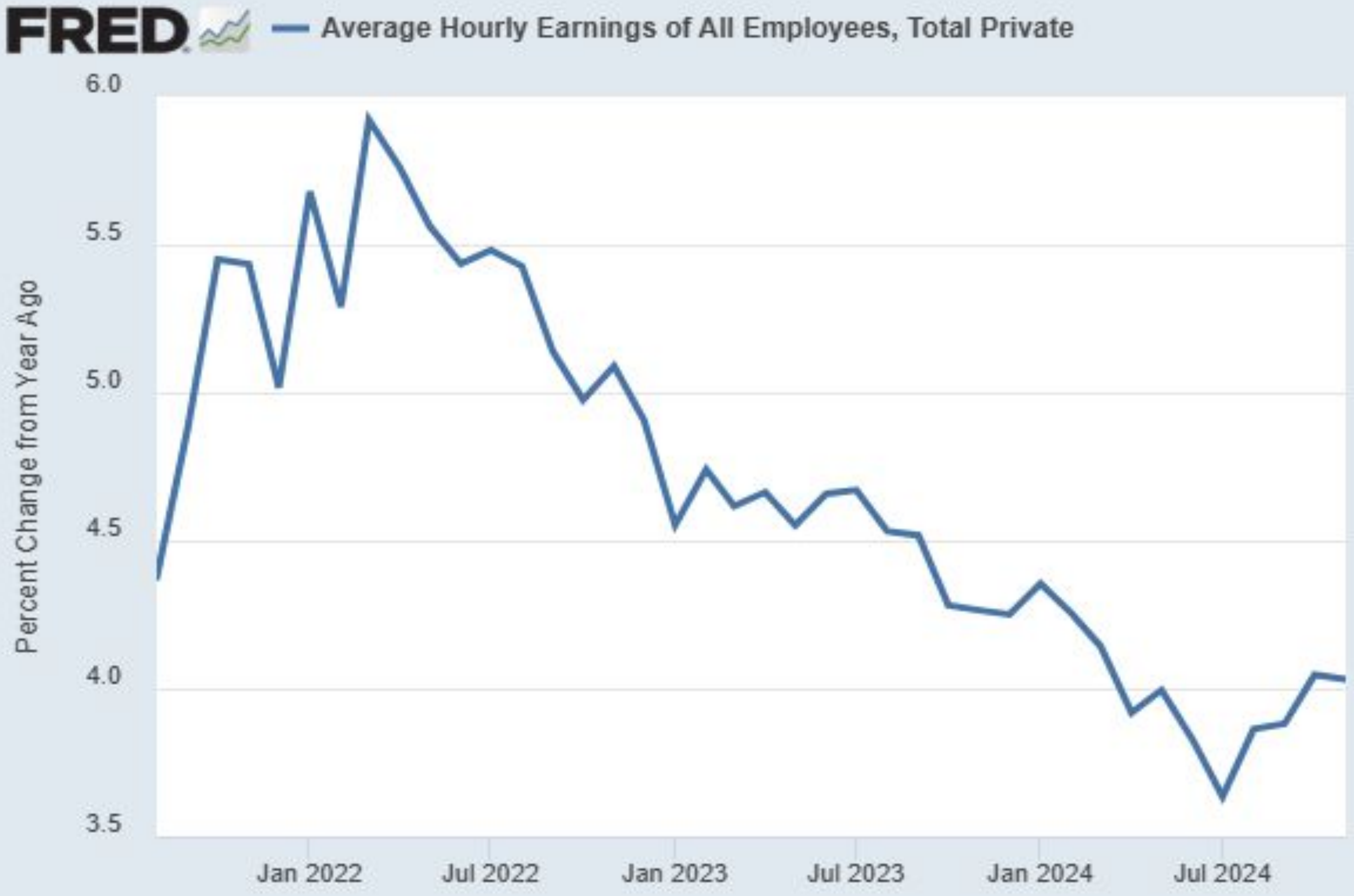
Declines slightly toward the end, **suggesting a softening labor market** where fewer people are employed relative to the working-age population.

Both indicators began to recover at different rates: LFPR has **small increased** and remained **relatively flat**, indicating **some workers left the labor force entirely** EPR **increased more quickly as people regained jobs**.

JOB CREATION & WAGES

2024

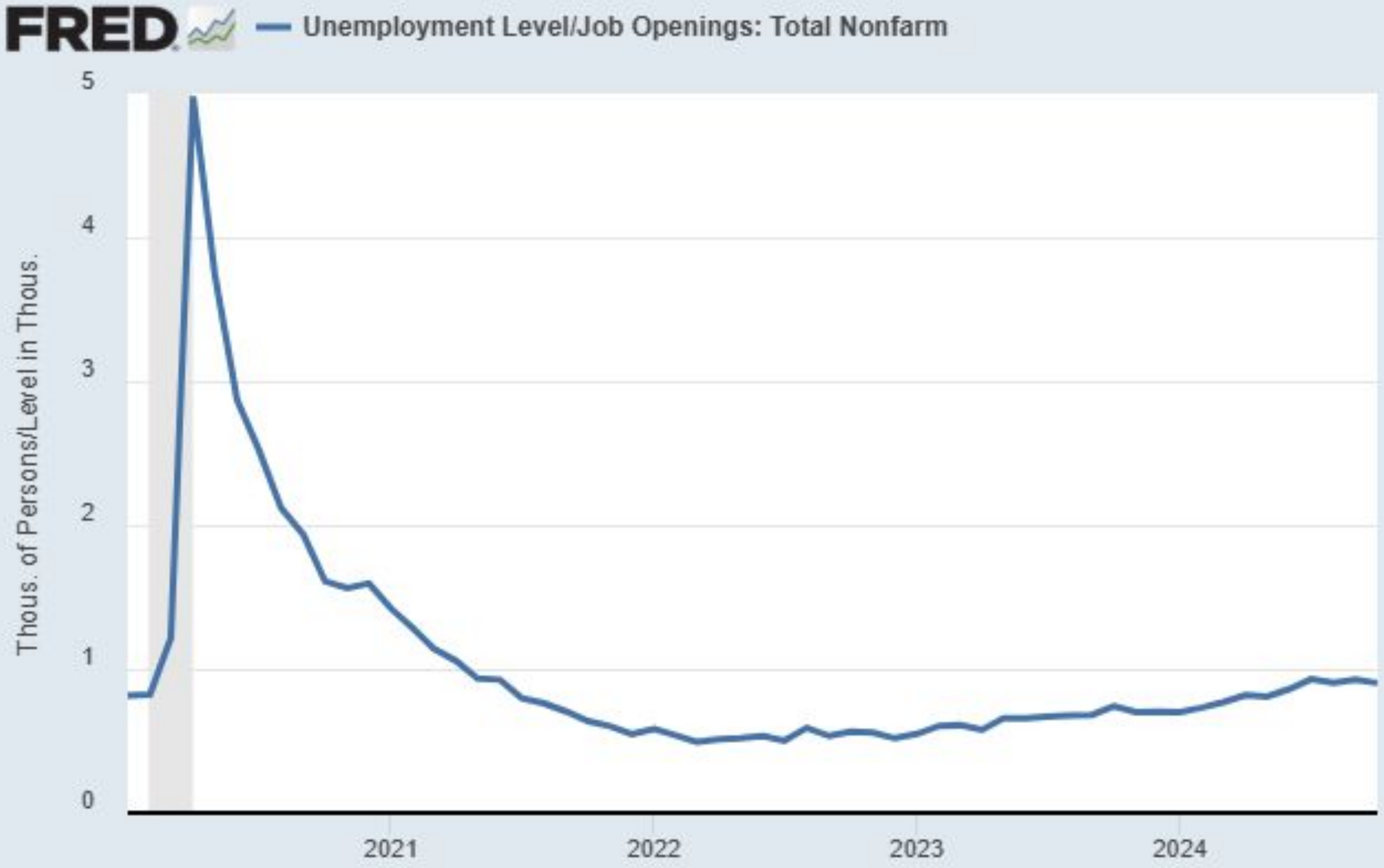




In **November 2024**, job growth remained strong with **227,000 jobs added**, but <u>still within the last year range</u>. The job creations signaling modest expansion despite disruptions like strikes and hurricanes. This continued job creation **reflects a cooling labor market** compared to the rapid growth seen in 2021.

Wage growth, driven by cost-push inflation, has **moderated** due to our <u>rate hikes but remains elevated</u>. Over the past year, it **slowed from 4.5% to 3.7% in early 2024**, <u>then rose slightly above 4%</u>. **While closer to pre-pandemic levels, wage growth is still fast**, reflecting <u>labor market tightness.</u>

LABOR MARKET



The ratio fell below 1 in 2021, **meaning job openings exceeded unemployed people**, signaling an exceptionally tight labor market. **It later rose to nearly 1**, showing a slight balance shift but still reflecting **a strong labor market**.

The ratio **rose steadily after 2021, peaking near 81%**, showing **strong labor demand**. Recently, it has slightly declined, **indicating a modest cooling in employment levels**, though the labor market remains healthy.

The labor market remains tight but shows signs of stabilizing or softening slightly. This could ease wage pressures and support efforts to bring inflation under control

SUPPLY SIDE

Compared to the last year, **the trend shows an increase in the inventories to sales ratio** after a **sharp drop** in 2020 that signals supply shortage.

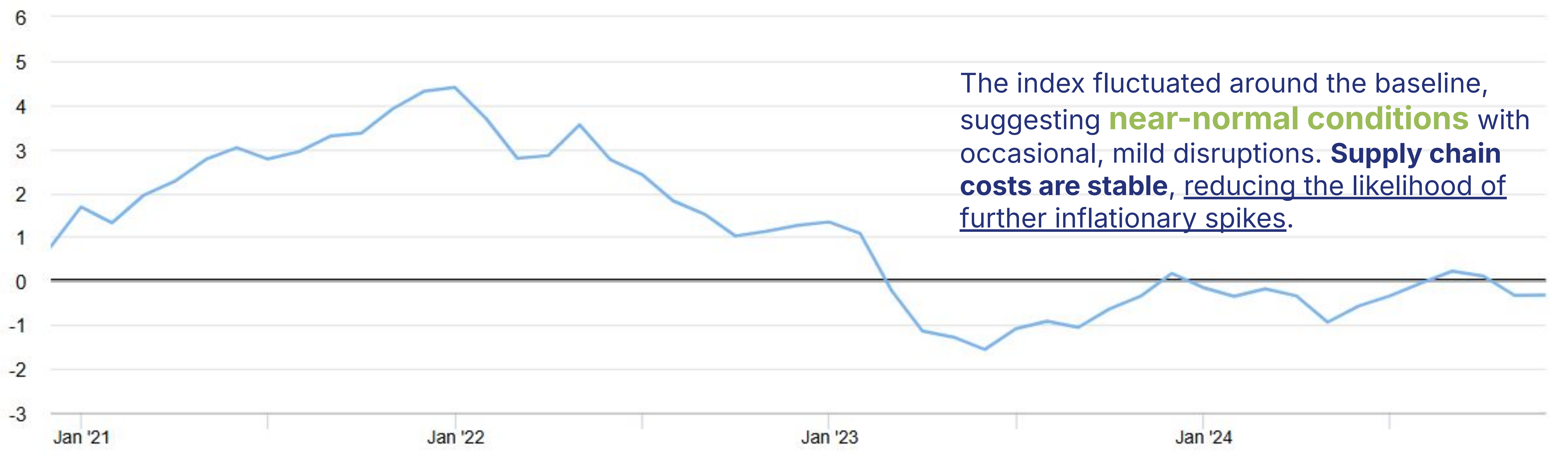
A ratio of 1.33 in September 2024 suggests retailers may be holding more inventory, potentially leading to discounting to clear excess stock, **which can help ease inflation**. We can see it showing moderate increasing trend but still within 1.3 - 1.5 typical range in US economy.

Global Supply Chain Pressure Index

2024

November this year
-0.33

Supply chain (cost-push inflationary) pressures **gradually eased** as **transportation costs declined, and production improved.**



The index fluctuated around the baseline, suggesting **near-normal conditions** with occasional, mild disruptions. **Supply chain costs are stable**, reducing the likelihood of further inflationary spikes.

The GSCPI dropped into negative territory in 2023, indicating that **global supply chain conditions became better than average, reflecting stable logistics and reduced disruptions.**

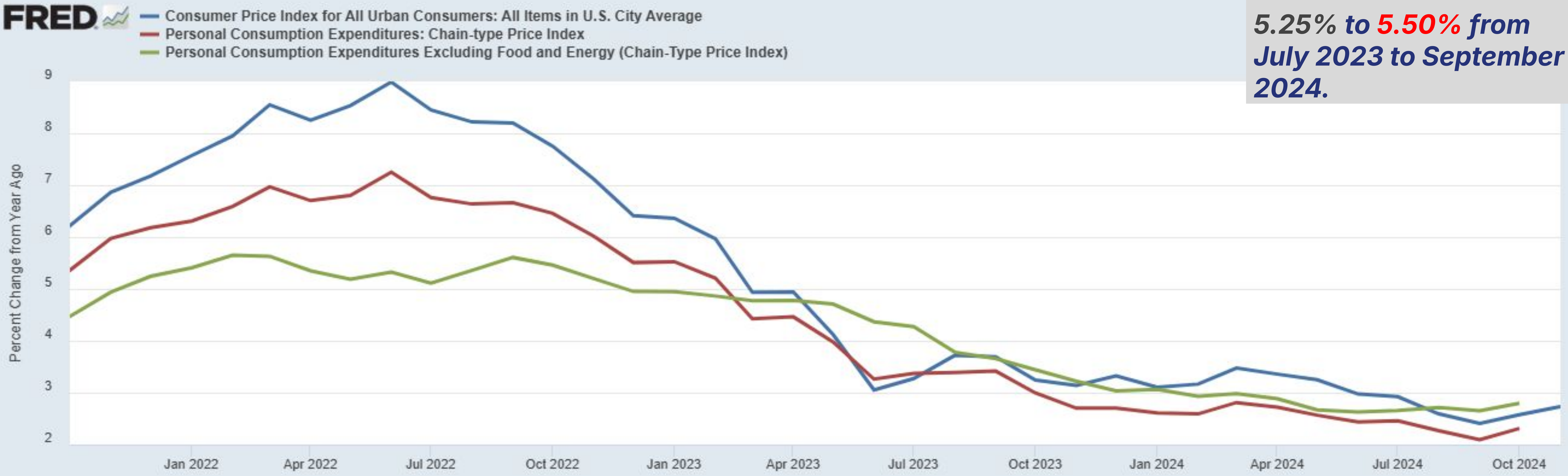
INFLATION

September this year	October this year
2.41%	2.58%
2.10%	2.31%
2.65%	2.80%

2024

$$i = r + \pi$$

 # *Interest rates at 5.25% to 5.50% from July 2023 to September 2024.*



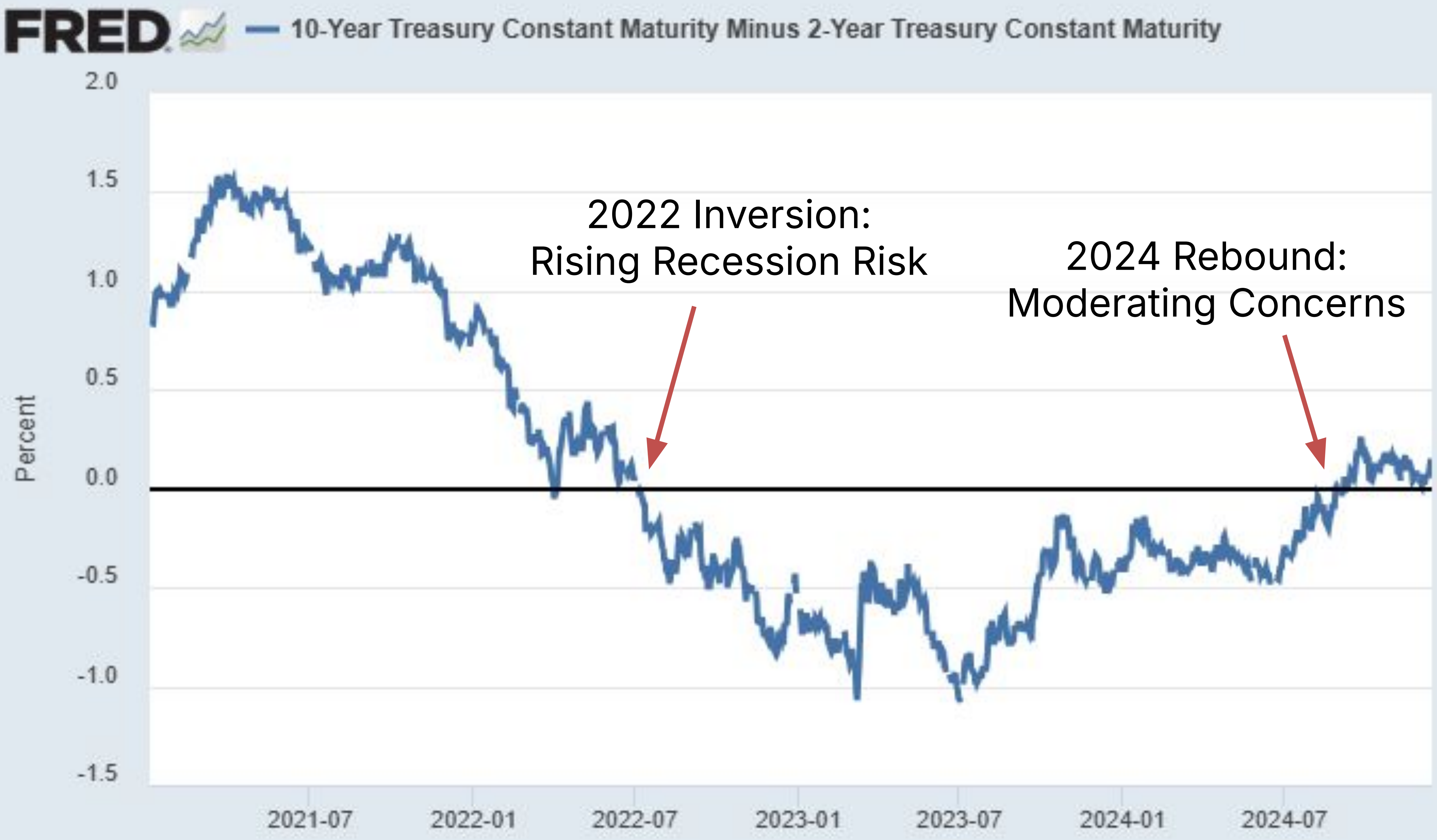
INFLATION

In 2022, **CPI** surged to a multi-decade high, **exceeding 8% year-over-year**, driven by supply chain disruptions, energy price spikes, and stimulus-fueled demand.
Inflation began easing in 2023 due to our interest rate hikes, improved supply chains, and cooling energy prices. By late 2023 and 2024, CPI inflation fell closer to 3%.

The **PCE** closely mirrored CPI trends but generally reported slightly lower inflation rates, reflecting its broader scope and methodology.
Like CPI, the **PCE peaked in 2022 but started declining steadily in 2023** as the economy responded to tightening monetary policy.

Core PCE rose less sharply than headline CPI or PCE during the inflation spike, as it excludes volatile energy and food prices.
It remained more stable but still elevated above the **2% target**. By 2024, Core PCE moderated gradually, indicating a slowdown in structural inflationary pressures. Despite headline improvements, inflation in services and housing continues to lag behind for October .

INTEREST RATE $i = r + \pi$



It highlights significant changes in market sentiment. As we rapidly **hiked short-term rates to fight** inflation in **2022**, the spread became dramatically negative, indicating an inverted yield curve, a well-known indicator of recessions. The flatness of the curve still indicates economic uncertainty and cautious market expectations about future growth, even though the recent rebound towards zero implies that recession concerns are abating.

It's important to continue monitoring the yield curve closely.

A sustained steepening would indicate improving economic confidence and growth expectations that could overheating the economy. However, a prolonged flat or reinverted curve would reinforce caution regarding potential slowdown.

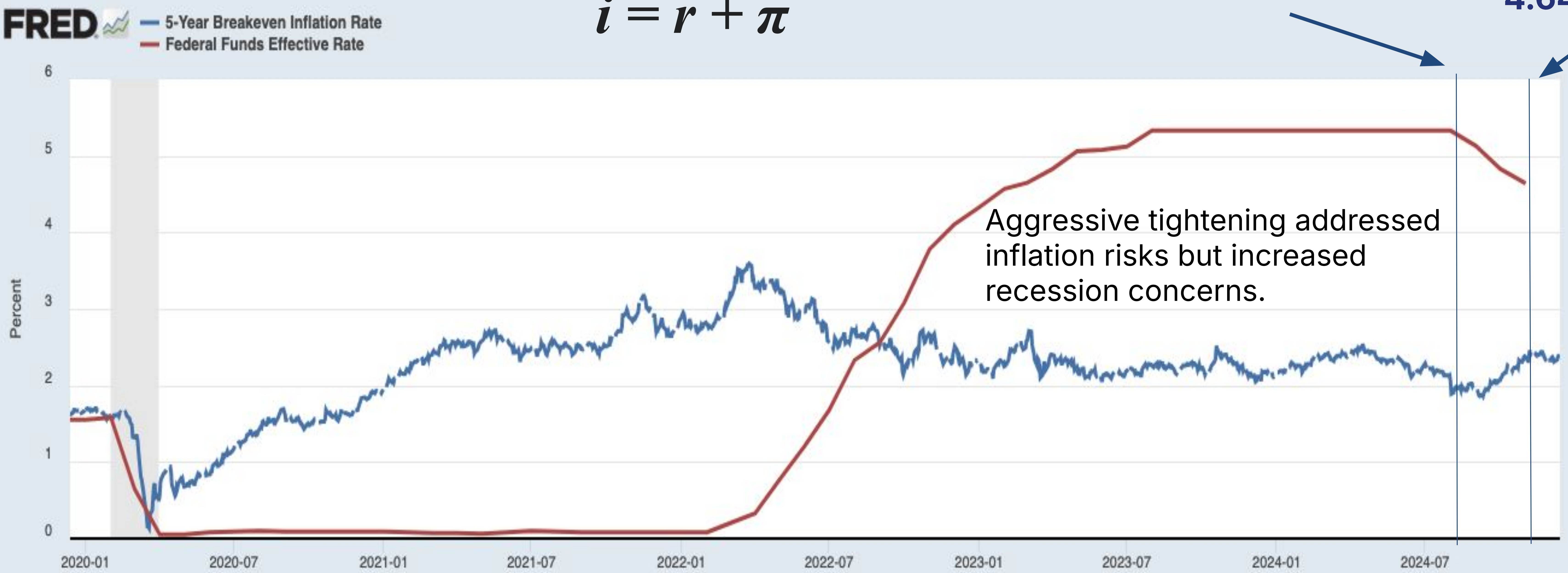
INTEREST RATE & INFLATION EXPECTATIONS

$$i = r + \pi$$

2024

Suggests a shift to easing monetary policy

5.33% FFR VS **4.64% FFR**



Rate cuts amid an economic slowdown, despite ongoing inflation, aim to **stimulate growth** and <u>avoid a recession</u>. A softening economy may **prioritize economic activity over controlling inflation**, hoping that <u>lower interest rates will encourage investment and spending.</u>

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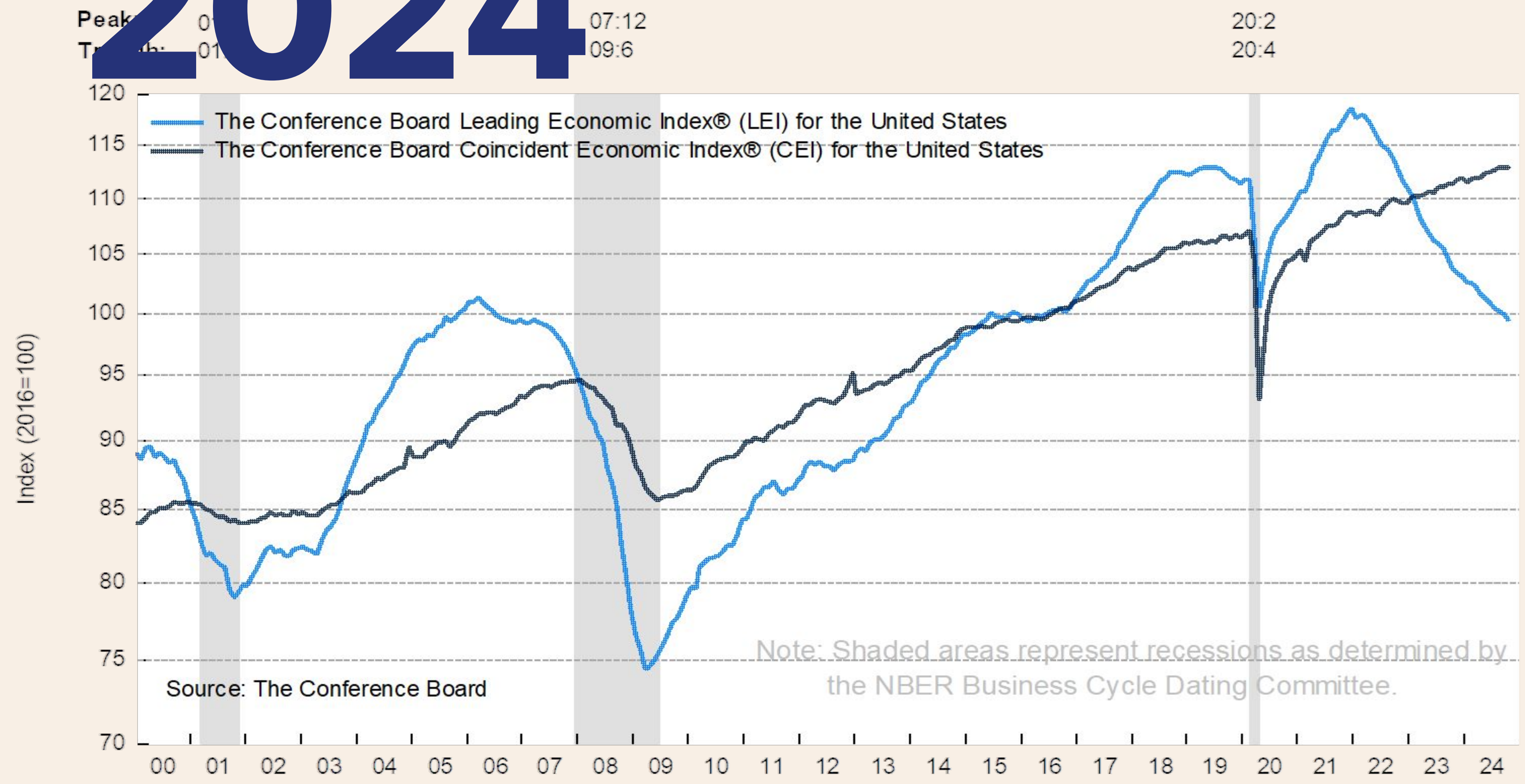
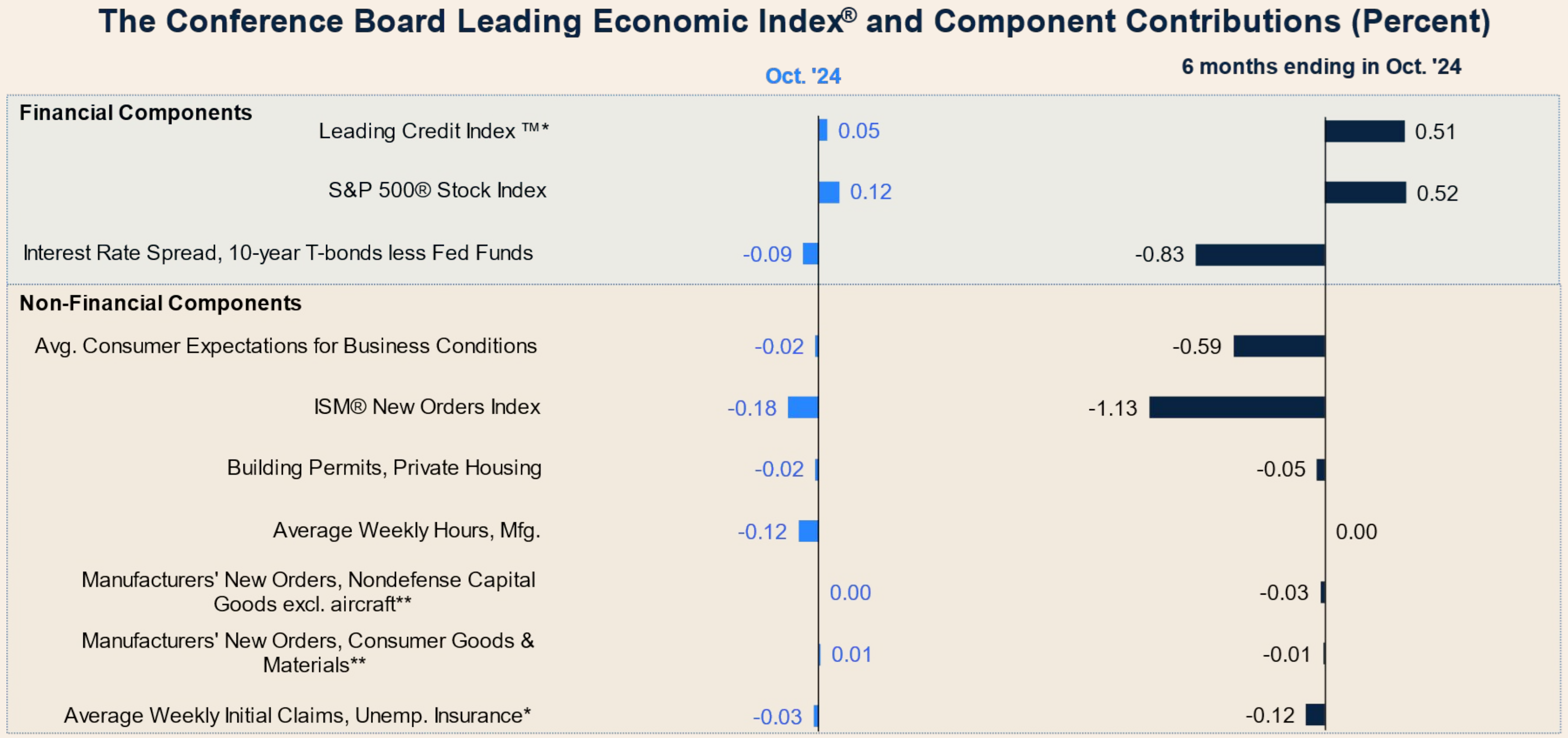
2024

MOMENTUM AND INDICATORS

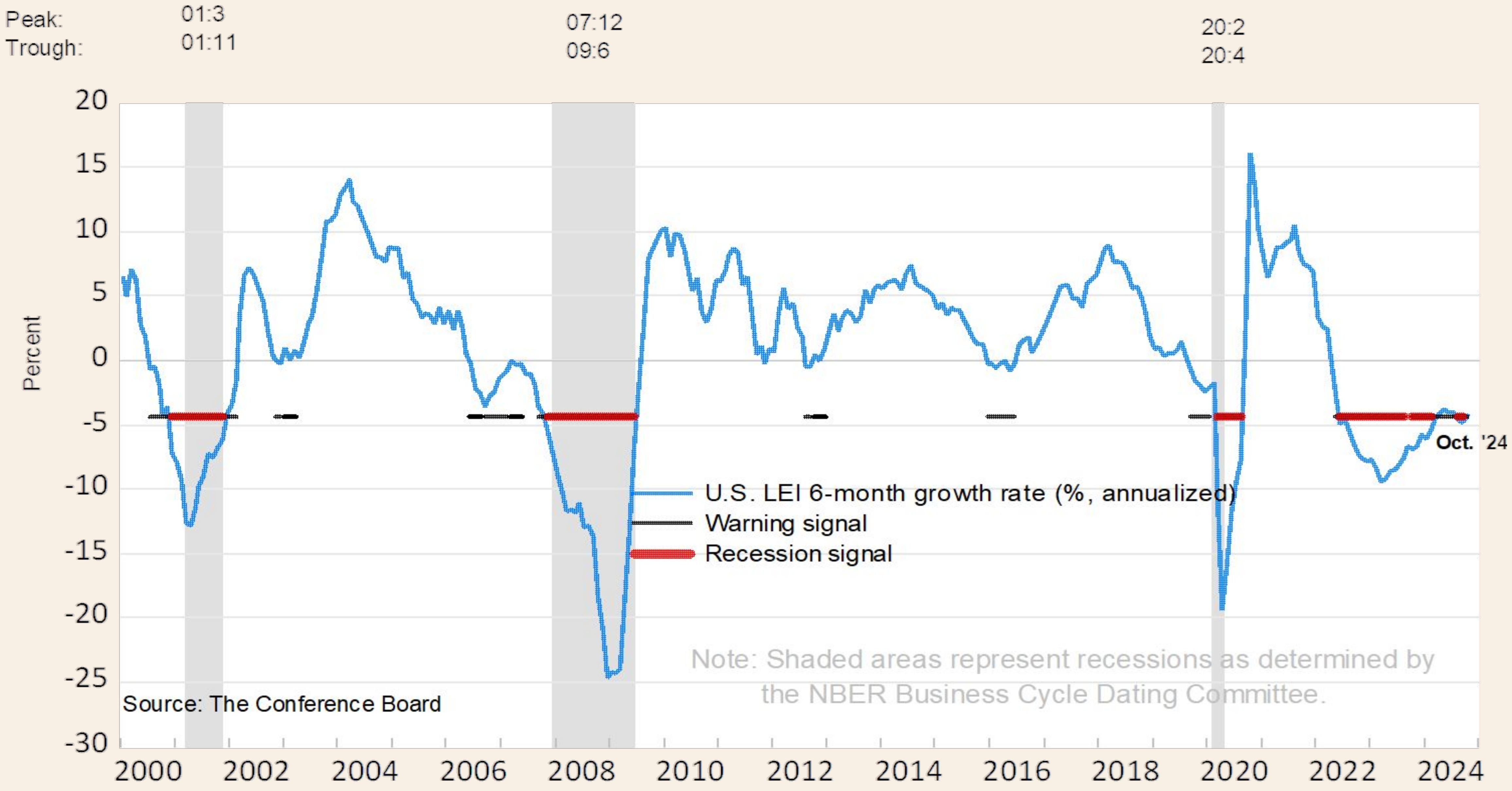
Recent: As of October 2024





During the past six months, the **Leading Economic Index** has **fallen by 2.2%**, the leading negative contributor to this decrease being a lack of orders for nondefense capital goods. (excluding aircraft) **The orders were weak in 11/14 industries**. Further factors have also seen negative impacts, likely **due to the hurricanes affecting the SouthEastern U.S.**. The LEI overall is suggesting **future hardship** for the US economy.

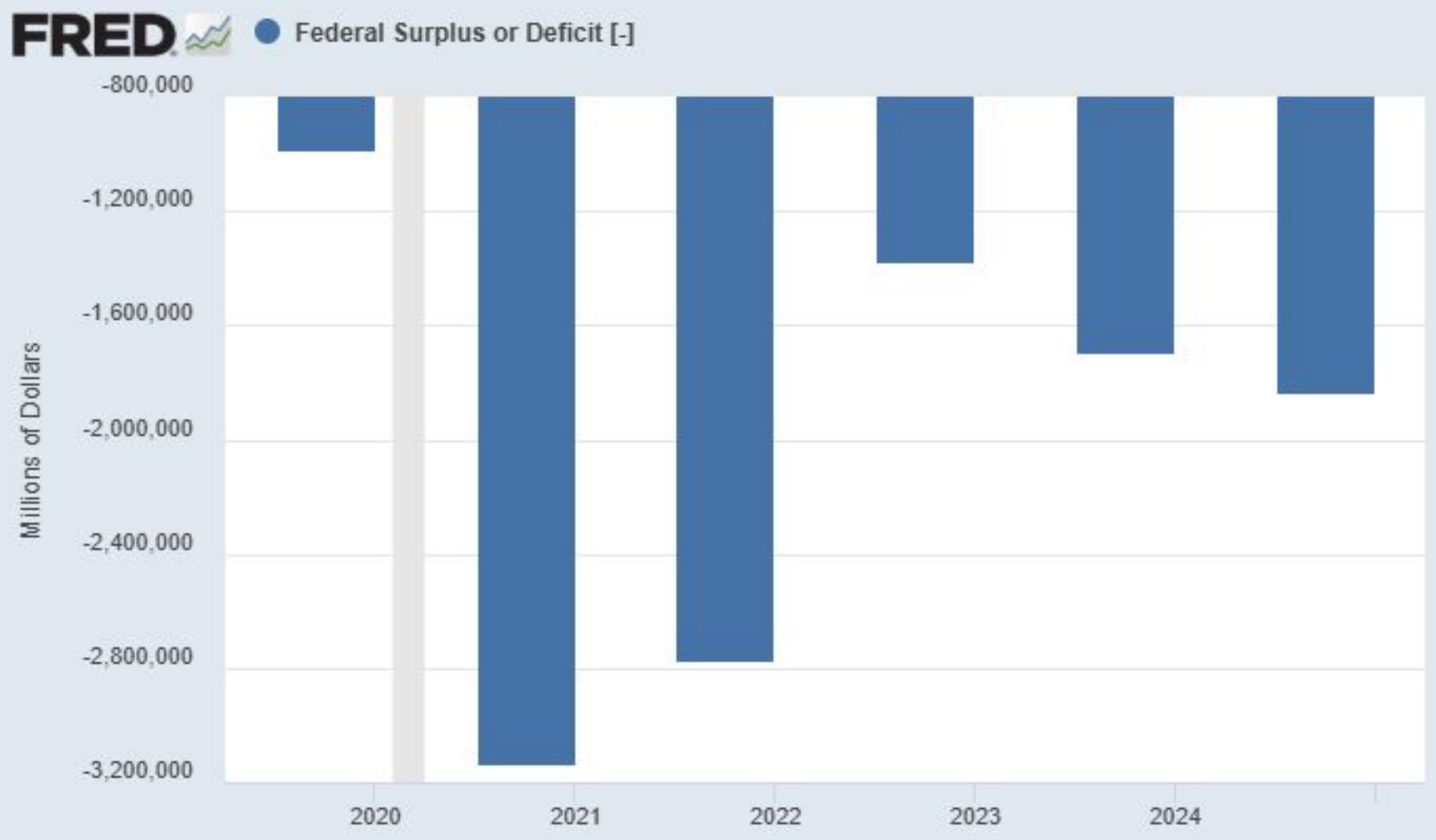
Recent: As of October 2024



The **Coincident Economic Index grew by .8%** over the last six months. The components of the CEI are used to indicate recessions. This previous month yielded **no change in the CEI**, with **positive factors being offset by negative industrial production**.

POLICY: Fiscal

Why deficit growing from 2022 - 2024?
$1.8Trillion in 2024



The decision to **lower interest rates** will help reduce debt costs, easing some pressure on the budget.

Revenue Growth Offset by Structural Spending
Tax revenues hit a record $4.9 trillion (+11%), boosted by corporate taxes (+26%) and postponed deadlines. However, spending growth, especially on interest and programs, continues to outpace revenue gains.

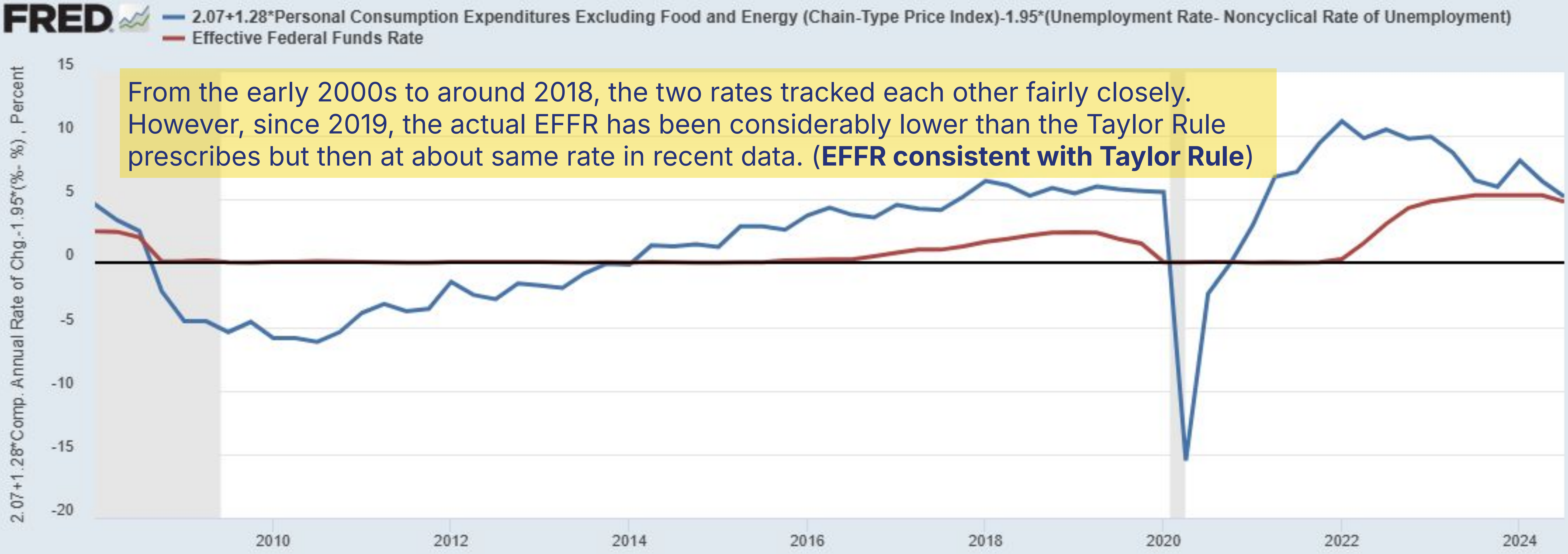
Rising Interest Payments and Debt Burden
Interest payments grew 34% to $950 billion in FY24 due to high interest rates and rising national debt. Now the 2nd largest expense after Social Security.

Increased Government Spending on Programs and Policies
Spending grew 10% to $6.8 trillion, driven by Social Security, Medicare, and tax credits. Potential student loan forgiveness could add $100+ billion to the deficit.

POLICY RECOMMENDATIO N

TAYLOR RULE INSIGHTS

2024



From the early 2000s to around 2018, the two rates tracked each other fairly closely. However, since 2019, the actual EFFR has been considerably lower than the Taylor Rule prescribes but then at about same rate in recent data. (**EFFR consistent with Taylor Rule**)

The gap between the Taylor Rule FFR and the actual EFFR suggests monetary policy is less restrictive than prescribed. This reflects the focus on supporting the economy post-COVID-19 and aiding labor market recovery.

Latest: Our policy is closely aligned with the rule. It suggests a neutral stance, balancing inflation control and economic growth.

SUMMARY

Where is the economy now?

- Real GDP > Real Potential GDP
- Unemployment < Natural Rate of Unemployment
- Inflation above target
- Debt is increasing
- Interest Rate is decreasing
- Global supply chain disruptions and geopolitical tensions are impacting the broader economy.

Where is it going?

- Slower growth in 2025: High interest rates will likely lead to reduced consumer spending and slower business investment.
- Inflation expected to decline gradually: While inflation is easing, it may take time to return to our 2% target.

What would happen if we did nothing?

- Persistent inflation: If we doesn't act, inflation could stay high, eroding purchasing power.
- Risk of stagnation or recession: Without action, inflation could escalate, potentially leading to a more severe economic downturn.
- Long-term imbalances: Unchecked inflation could lead to asset bubbles and reduced investment, affecting long-term growth.

WHAT WE WILL DO

Strategy : keep it tight but slowly easing monetary policy with gradual approach

Maintaining the FFR

Keeping the federal funds rate around 4.5% - 4.75% or take time to go back to normal rate allows the us to manage inflation without making abrupt changes to the economy. The rate affects borrowing costs for loans, mortgages, and savings. By maintaining the rate,we **gives previous rate hikes time to work and help avoid overheating the economy.** This strategy can help control inflation while preventing a sharp slowdown in growth. We can adjust its approach later based on inflation trends, ensuring it balances controlling inflation with supporting economic stability.

FORWARD GUIDANCE

Given inflation and economic uncertainty, we will avoid overly specific forward guidance. We will **base decisions on the latest data, providing clarity on our policy direction without committing to specific outcomes.** This flexible approach allows us to adapt to changing conditions, such as potential fiscal policies like import tariffs, which may impact GDP. Our focus is on the rationale behind our actions to **maintain credibility and manage expectations.**

WHAT WE WILL DO

TOOLS

Interest on Reserve Balances

Action: Lower the interest rate on reserve balances to align with a broader strategy of easing monetary conditions to support economic growth.

Rationale: Lowering the rate on reserves encourages banks to lend more, helping stimulate economic activity and boosting liquidity in the economy. It also aligns with the Fed's goals of supporting spending and investment while gradually reducing inflation.

Overnight Reverse Repurchase Agreement Facility

Action: Continue to manage the ON RRP rate carefully, potentially lowering it in line with its general interest rate cuts.

Rationale: Lowering the ON RRP rate helps absorb excess reserves from the financial system while maintaining the target range for short-term rates. This facilitates smoother liquidity management and supports broader monetary policy objectives to promote credit flow and stabilize markets.

In conclusion, our analysis of the economy's past, present, and projected future highlights key trends and the necessity for proactive action. The data and graphs presented illustrate a clear economic narrative: **GDP** is currently stabilizing at a moderate **growth rate of 2.66%** in Q3 2024. Despite a **tight labor market**, reflected in **unemployment rates below the NAIRU** and **moderate wage growth**, signs of softening have emerged. **Inflation** has cooled to **2.8% but remains above the 2% target**, and **high interest rates** have successfully curbed its trajectory while creating recessionary risks.

Looking ahead, slower growth, lingering inflation, and rising debt necessitate careful policy implementation.

By adopting our proposed strategy of gradual monetary easing—balancing inflation control with economic stability—**we can avoid stagnation while fostering sustainable growth.** Lowering interest on reserve balances and maintaining forward guidance flexibility ensures liquidity, promotes investment, and avoids abrupt economic shocks. Our approach reflects lessons from past trends, aligns with current indicators, and proactively prepares for future challenges. Implementing this method is critical for steering the economy toward long-term stability and prosperity while mitigating risks of inaction.