Certain Uncertainty

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Introduction

Good morning, everyone. I'm so pleased to be here with you today.

As it says on my CV, monetary policy under uncertainty has been my primary area of research. And after 30 years in central banking, I can unequivocally say: Uncertainty is the *only* certainty in monetary policy.[1]

Today I will discuss the economy and monetary policy in the context of a changing and uncertain landscape. I'll talk about global inflationary trends, inflation expectations, and how the Federal Reserve is working to achieve its dual mandate of maximum employment and price stability.

Before I go further, I must give the standard Fed disclaimer that the views I express today are mine alone and do not necessarily reflect those of the Federal Open Market Committee (FOMC) or others in the Federal Reserve System.

The Economy Today

I will start with a snapshot of the U.S. economy. The economy entered the new year on firm footing. GDP and job growth have been solid, propelled by robust gains in the labor force and productivity. After a period of cooling, a wide range of labor market indicators, including the unemployment rate, have stabilized, with supply and demand broadly in balance and the labor market no longer a source of inflationary pressure.[2]

The disinflationary process has continued on a bumpy path toward the FOMC's inflation goal of 2 percent over the longer run. After reaching a 40-year high of over 7 percent in 2022, inflation—as measured by the 12-month percentage change in the personal consumption expenditures price index—has fallen to about 2-1/2 percent, still somewhat above our 2 percent target.

That's where things stand now, but the future is highly uncertain. Recent data—both hard and soft—are sending mixed signals. Measures of policy uncertainty have increased sharply in recent months. This is also seen in responses that explicitly ask about uncertainty in the New York Fed's Survey of Consumer Expectations (SCE).[3] And my business and financial market contacts highlight the role of greater uncertainty, especially around trade policy, in making it more difficult to plan investments and hiring.

Navigating uncertainty during periods of large changes will be a recurring theme in my remarks today. I will dig deeper into two topics that are important to understanding inflation in the current macroeconomic environment and that will no doubt shape the future course of our economies. And since this is the "*Macroeconometric* Caribbean Conference," I will of course bring evidence from macroeconometric models to bear on these topics.

Global Inflation Trends

It goes without saying—especially to this audience of representatives of central banks from the Caribbean region—that our economies are interconnected, and developments in one part of the world can have effects that ricochet across the globe. To be sure, a country's economy is influenced by domestic developments, but when it comes to inflation, global factors are a major driver, one that stretches across countries. This dynamic was particularly evident during the past five years, when countries around the world experienced a sharp rise and subsequent fall in inflation.[4]

Economists at the New York Fed have developed a statistical model, called Global Multivariate Core Trend Inflation (Global MCT), to measure and better understand the behavior of the persistent components of global inflation.[5] This model uses inflation data from seven economies to estimate a common global inflation trend, as well as global

sectoral inflation trends in tradable sectors, such as core goods and food and energy. It exploits the co-movement of the persistent components of inflation across both countries and sectors.

This analysis uncovers very strong common components of inflation, with global factors explaining an overwhelming share of the persistent movements in inflation rates across the economies in the sample, except for Japan's. Importantly, these results are not driven by the pandemic and post-pandemic periods, as they are evident in pre-pandemic inflation data going back to 1990.

Analysis using this model finds that supply shocks were the primary driver of the rise and subsequent decline in global inflation trends over the past several years, both at the general and sectoral levels.[6] From the beginning of 2021 to late 2022, the estimated global inflation trend soared, then reversed most of that increase over the following two years. Although supply factors were primarily responsible for these swings, demand factors also played a role in boosting the global inflation trend from late 2021 to mid-2024.

When inflation is a global phenomenon, what can individual central banks do to control it? Here again, Global MCT provides a useful lens to analyze this question. Based on an estimated vector autoregressive model that includes Global MCT, U.S. monetary policy shocks have economically and statistically significant effects on both the global inflation trend and the core goods global inflation trend. And the peak effect occurred after about 12 months. Similar results are obtained using a version of the model with European Central Bank monetary policy shocks.

These empirical analyses illustrate how monetary policy spills over and spills back to domestic and international rates of inflation. In the United States, as in other countries, monetary policy decisions are based on domestic mandates. But as policymakers, we also understand that our decisions can affect global economic and financial conditions, and in turn can spill back onto our shores. This is one reason why it's so important that we meet in venues such as this one to share insights and analyses.

Inflation Expectations

I will now turn to the critically important role of inflation expectations and how households and businesses think about future inflation. Well-anchored inflation expectations are paramount for ensuring price stability, especially during times of turbulence and uncertainty. The experience of the past five years is a testament to this: Well-anchored expectations were key to achieving disinflation while avoiding severe economic consequences.

It is useful to distinguish between short-run expectations that tend to respond to inflation shocks and medium- and longer-run expectations that should be less responsive when expectations are well anchored.

In the past two months, we have seen clear signs of a broad-based increase in short-term inflation expectations, but most indicators point to continued well-anchored medium- and longer-term expectations. For example, market-based measures of inflation expectations have risen at shorter horizons but have been stable at longer horizons. And New York Fed business surveys from February show that businesses in the Federal Reserve's Second District expect higher cost increases, particularly among manufacturing firms and businesses with a high import share of their inputs. While year-ahead inflation expectations of firms also moved up, their longer-term expectations remained stable.[7] And the February SCE indicated that expectations are largely unchanged over the medium and longer run.[8]

The sensitivity of short-run inflation expectations to inflation shocks—while medium- and longer-run expectations are well anchored—is also seen in formal econometric analysis using data from the SCE and the University of Michigan surveys.[9]

In estimating the sensitivity of inflation expectations at different forecast horizons to "inflation surprises"—that is, the difference between what a survey respondent expected inflation to be and what it turned out to be—the analysis yields two insights. First, the estimated effects of inflation surprises to revisions in inflation expectations are considerably larger at the one-year-ahead horizon than at longer horizons. Second, the estimated effects during the past five years are similar to those during the pre-pandemic period. Broadly similar results are obtained when analyzing the co-movement of revisions in expectations across different horizons.

This analysis indicates that households expect an inflation shock will gradually decay over the ensuing years. In particular, although inflation shocks are expected to have persistent effects on inflation, these effects are anticipated

to largely dissipate after five years. Importantly, there are no signs of inflation expectations becoming unmoored relative to the pre-pandemic period.

Monetary Policy Amid High Uncertainty

As I said at the start of my remarks, the economy entered this year in a good place, but there is a high degree of uncertainty about what the future holds. So, what does this all mean for monetary policy?

At its meeting on Wednesday, the FOMC decided to leave the target range for the federal funds rate unchanged at 4-1/4 to 4-1/2 percent. In the accompanying statement, the Committee noted that uncertainty around the economic outlook has increased, and it is attentive to risks to both sides of its mandate.[10] The Committee reaffirmed its strong commitment to supporting maximum employment and returning inflation to its 2 percent objective, and its policy decisions will be based on a careful assessment of the incoming data, the evolving outlook, and the balance of risks.

In addition, the Committee decided to slow the pace of reduction in its holdings of securities. The ongoing process of balance sheet reduction follows the principles and plans laid out in 2022.[11] Last June, the Committee took a first step in slowing the pace of balance sheet reduction.[12] That process has progressed very well, resulting in a reduction of over $2 trillion in our securities holdings so far. This week's decision to slow it further is a natural next step to smooth the transition from abundant reserves to a level that is somewhat above ample. This action has no implications for our intended stance of monetary policy and should not affect the size of our balance sheet over the medium term.

The Economic Outlook

Turning to the U.S. economic outlook, I expect GDP growth this year to step down from last year's pace in part because of a slowdown in labor force growth due to lower immigration rates. But it's hard to know with any precision how the economy will evolve. Uncertainty is high, and there are many scenarios that could play out, depending on fiscal and trade policies and geopolitical and other developments. In the Summary of Economic Projections that the FOMC released this week, the central tendency of projections for GDP growth this year was between about 1-1/2 and 2 percent, and for inflation, between about 2-1/2 and 3 percent.[13] Any of these outcomes—or even some others outside these ranges—seem completely plausible to me.

In addition, it is hard currently to assign probabilities to these scenarios. This is something economists refer to as Knightian uncertainty. In these circumstances, it will be important to take a holistic view in monitoring and assessing all available information. It is also fitting to take a risk management perspective in assessing the economic outlook, in evaluating the appropriate stance of monetary policy, and in making policy decisions.

Conclusion

There is certain uncertainty in monetary policy. The current modestly restrictive stance of monetary policy is entirely appropriate given the solid labor market and inflation still running somewhat above our 2 percent goal. It also positions us well to adjust to changing circumstances that affect the achievement of our dual mandate goals.

Whatever the economy has in store for us, I am committed to supporting maximum employment and returning inflation to our 2 percent objective.

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[1] Hat tip to Alan Greenspan, who famously said "Uncertainty is not just an important feature of the monetary policy landscape; it is the defining characteristic of that landscape." Alan Greenspan, "Monetary Policy under Uncertainty," at a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August 29, 2003.

[2] Based on the latest reading of the New York Fed's Heise-Pearce-Weber Tightness Index, the labor market is now about as tight as it was in in the first half of 2017, a period when wage growth and price inflation were low. Sebastian Heise, Jeremy Pearce, and Jacob P. Weber, "A New Indicator of Labor Market Tightness for Predicting Wage Inflation," Federal Reserve Bank of New York *Liberty Street Economics*, October 9, 2024; and Sebastian Heise, Jeremy Pearce, and Jacob P. Weber, "Wage Growth and Labor Market Tightness," Federal Reserve Bank of New York Staff Report Number 1128, October 2024.

[3] Federal Reserve Bank of New York, "Medium- and Longer-Term Inflation Expectations Unchanged; Consumers' Pessimism About Their Future Financial Situations Increases," March 10, 2025.

[4] Martín Almuzara, Babur Kocaoglu, and Argia Sbordone, "Is the Recent Inflationary Spike a Global Phenomenon?," Federal Reserve Bank of New York *Liberty Street Economics*, May 16, 2024.

[5] Ozge Akinci, Martin Almuzara, Silvia Miranda-Agrippino, Ramya Nallamotu, Argia Sbordone, Greg Simitian, and William Zeng, "Global Trends in U.S. Inflation Dynamics," Federal Reserve Bank of New York *Liberty Street Economics*, February 27, 2025.

[6] Ozge Akinci, Martin Almuzara, Silvia Miranda-Agrippino, Ramya Nallamotu, Argia Sbordone, Greg Simitian, and William Zeng, "Supply and Demand Drivers of Global Inflation Trends," Federal Reserve Bank of New York *Liberty Street Economics*, February 27, 2025.

[7] Jaison R. Abel, Richard Deitz, and Ben Hyman, "Firms' Inflation Expectations Have Picked Up," Federal Reserve Bank of New York *Liberty Street Economics*, March 5, 2025.

[8] Federal Reserve Bank of New York, Survey of Consumer Expectations (February 2025).

[9] John C. Williams, "Discussion of 'Monetary Policy Transmission to Real Activity'", remarks at the 2025 U.S. Monetary Policy Forum, New York City, March 7, 2025.

[10] Board of Governors of the Federal Reserve System, Federal Reserve issues FOMC statement, March 19, 2025.

[11] Board of Governors of the Federal Reserve System, Principles for Reducing the Size of the Federal Reserve's Balance Sheet, January 26, 2022; and Board of Governors of the Federal Reserve System, Plans for Reducing the Size of the Federal Reserve's Balance Sheet, May 4, 2022.

[12] Board of Governors of the Federal Reserve System, Federal Reserve issues FOMC statement, May 1, 2024.

[13] Board of Governors of the Federal Reserve System, Summary of Economic Projections, March 19, 2025.