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Fed's Mester Says the Central Bank's Gradual Rate Path Is 'Appropriate'

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Federal Reserve Bank of Cleveland President Loretta Mester said Thursday she believed inflation would continue to rise and eventually hit the Fed's 2% target, making it appropriate for the central bank to continue gradually raising rates.

"I'm not as troubled by where inflation is today," she said. " I think there's good reason to think it will back up to 2%."

In a question-and-answer session following a presentation at the Cato Institute in Washington, D.C., Ms. Mester also noted the economy is growing strongly and the unemployment rate is at historic lows, she said. The Fed's gradual pace of slowly raising interest rates is an attempt to strike a balance between a strong economy and weak inflation, she said.

"To my mind the gradual path still remains the appropriate path of policy and we still want to continue to take back some of the accommodation we felt necessary to put in," she said.

In her prepared remarks, Ms. Mester said the long-term aging of the U.S. population will have a significant economic impact, including lower unemployment and growth rates, although its effect on interest rates is unclear.

Demographic changes will affect the way monetary policy is transmitted through the economy, she said. For instance, interest rate cuts could have less of an effect since there will be a smaller share of younger borrowers to take advantage of low borrowing costs. The share of older people, however, who tend to have more assets saved and who benefit from higher rates, will increase.

"Demographic change may mean that wealth effects become a more important channel through which monetary policy affects the economy," Ms. Mester said in remarks prepared for delivery at a conference at the Cato Institute in Washington, D.C.

An older population could prompt the Fed to push its benchmark interest rate down to zero more frequently, requiring more reliance on unorthodox tools such as asset purchases, she said.

On the other hand, since older people are more likely to be retired and less likely to be putting their income into savings, demographic trends could push interest rates higher, she said.

"The magnitude and even the sign of the effect of demographic change on interest rates are empirical questions," she said.

Demographic changes could also push down on productivity growth, Ms. Mester said, because older workers are more likely to stay in their current jobs, for which they may not be a perfect fit. That could reduce the economy's dynamism. On the other hand, older workers tend to be more experienced, she added, which could offset some of the dampening effect.

Ms. Mester said efforts to reduce health-care costs, boosting investments in education and research, and a more expansive immigration policy could help raise productivity and growth.