

# **The Economic Outlook, Monetary Policy, and Getting Back to Normal**



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## **Introduction**

Good afternoon and thank you for that very kind introduction. I also thank the Cleveland Association for Business Economics, CFA Society Cleveland, and the Risk Management Association for inviting me to speak today. I am pleased to say that a number of Cleveland Fed employees are members of your fine organizations and some are here with us today.

I am now into my fourth month on the job as president and CEO of the Federal Reserve Bank of Cleveland. In that short time, in addition to getting to know Cleveland and the rest of the Fourth District, I have attended and voted at three meetings of the Federal Open Market Committee, or FOMC. As most of you know, the FOMC is the body within the Federal Reserve System responsible for setting monetary policy. Our latest meeting was just last week. In addition to our usual policy statement describing the Committee's monetary policy decision, the FOMC released its Summary of Economic Projections, or SEP, which summarizes each FOMC participant's economic projections for output growth, unemployment, and inflation based on his or her individual view of appropriate monetary policy. The FOMC also released updated information on the approach it plans to take to return monetary policy to more normal territory, in terms of both the level of interest rates and our policy tools. So there is a lot for us to talk about today, and I would like to take this opportunity to discuss my views on the economy, monetary policy, and normalization. Of course, these are my own views and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.

## **The Economic Outlook**

The economy is now in its sixth year of expansion, and while it has had its ups and downs, it has made significant progress toward fulfilling the Federal Reserve's goals of price stability and maximum employment. Real output growth rebounded sharply in the second quarter, growing at more than a 4 percent annual pace, after falling slightly more than 2 percent in the first quarter due to the harsh winter

weather. I expect real GDP to expand at about a 3 percent annual pace in the second half of this year and over 2015 and 2016. This is a moderate pace of growth, but it is somewhat above my estimate of longer-run trend growth, which I put at around 2.5 percent. I believe several factors support above-trend growth over the next couple of years. Household and business balance sheets have improved and so have consumer and business confidence, which should support spending. In addition, monetary policy remains highly accommodative. And I expect labor markets, which have shown significant progress, will continue to strengthen and help sustain consumer spending. Of course, there are risks around this forecast. These include geopolitical risks, which have escalated in recent weeks, as well as weakness in some economies abroad. Despite the risks, it's my view that our economy is on firmer ground than it has been for some time.

My output projections of 3 percent in 2015 and 2016 put me at the upper end of the central tendency of FOMC participants' new projections for 2015 and just above the upper end for 2016. The central tendency is obtained by dropping the lowest and highest three projections from among the FOMC participants. For 2015, the central tendency is 2.6 to 3.0 percent, and for 2016, it is 2.6 to 2.9 percent. I note that my 2.5 percent estimate for longer-run growth is also somewhat more optimistic than the central tendency of 2.0 to 2.3 percent. Of course, there is always a good deal of uncertainty around estimates of trend growth, perhaps even more so today in the aftermath of such a deep recession. I lowered my estimate of trend growth after the Great Recession, but perhaps not far enough given the low productivity growth we've experienced over the past couple of years. On the other hand, I think it is premature to discount the future too much. It is good to remember the experience of the 1990s when over a period of several years, many forecasters revised down trend growth estimates only to subsequently revise them up significantly in response to strong productivity growth.

As I mentioned, labor market conditions have improved significantly over the expansion. Admittedly, the recovery in jobs has been much slower than anyone would have liked, and the August payroll

employment increase was a bit of a disappointment, coming in at 142,000 jobs, after six months of increases greater than 200,000. But I think it's important not to overreact to one month's number. The monthly data can be volatile, and the payroll data get revised. Monthly payroll gains have averaged 215,000 jobs so far this year, somewhat stronger than last year's pace.

The unemployment rate currently stands at 6.1 percent, down significantly from a peak of 10 percent in October 2009, and more than a percentage point lower than a year ago. The improvement has been faster than many economists and policymakers, including some on the FOMC, had anticipated. For example, last September, according to the central tendency of their projections, FOMC participants were projecting that the unemployment rate would be 6.4 to 6.8 percent in the fourth quarter of this year. But the unemployment rate is already lower than that. Other measures of unemployment or underemployment have also improved over time. These improved measures include those that track people who are working part time but would prefer a full-time job, and those that track the long-term unemployed – people who have been out of work for more than six months. More progress needs to be made and I anticipate that it will be made. My outlook is that as the expansion continues, firms will continue to add to their payrolls and the unemployment rate will continue to decline. I expect that by the end of next year, the unemployment rate will fall to around 5.5 percent, which is my estimate of the longer-run, or natural, rate of unemployment, and remain near there in 2016. Like longer-run growth estimates, there is considerable uncertainty around estimates of the longer-run unemployment rate. These estimates depend on demographics, production technology, and other structural factors, and can vary over time. My estimate is on the upper end of the central tendency of 5.2 to 5.5 percent of the FOMC's projections of longer-run unemployment. This means that I am projecting a somewhat faster return to full employment than some of my colleagues.

Turning to inflation, although it remains below the FOMC's goal of 2 percent, inflation measured by the year-over-year change in the price index for personal consumption expenditures has increased to 1.6

percent this year from 1.2 percent last year. Consistent with a pickup in economic growth and expectations of inflation remaining well anchored, my projection is that inflation will gradually move back toward the FOMC's 2 percent goal by the end of 2016. Of course, this projection is dependent on appropriate monetary policy. So let me turn to that now.

### **Monetary Policy**

In response to the financial crisis and deep recession, the Federal Reserve has run an extraordinarily accommodative monetary policy to promote our goals of price stability and maximum employment. The FOMC has kept its policy rate – the federal funds rate – at essentially zero since the end of 2008, and it has also used forward guidance to communicate the anticipated future path of policy. In addition, to exert downward pressure on long-term interest rates, the FOMC has purchased longer-term Treasury securities and agency mortgage-backed securities, expanding the Fed's balance sheet nearly five-fold since before the crisis.

The current program of longer-term asset purchases, commonly called quantitative easing or QE, began in September 2012. At that time, the unemployment rate was about 2 percentage points higher than it is today. Based on the cumulative progress in labor markets since that time, this year the FOMC began tapering the amount of assets it has been buying each month. Remember that tapering is not tightening. That is, the FOMC has continued to add accommodation, just at a reduced pace. Based on the realized and anticipated continued improvement in the economy, I supported the FOMC's decision last week to reduce the pace of purchases by another \$10 billion, to \$15 billion per month, and to indicate that if incoming information broadly supports the Committee's outlook, the program would end at our meeting next month.

I also supported the Committee's decision to maintain the 0-to-¼ percent target range for the federal funds rate. As the economic expansion continues, eventually monetary policy will need to return to a

more normal stance. Indeed, the September SEP shows that the Committee believes it will be appropriate for the policy rate to increase over the next several years, with most participants expecting economic progress toward our goals to warrant the first rate increase in 2015. As one can see by looking at the SEP, there is some diversity of views about the appropriate path of interest rates. That is to be expected. Monetary policy must be dependent on the realized and expected evolution of the economy, and differences in the outlook across FOMC participants can result in different views of appropriate policy. In addition, policymakers will calibrate their views on appropriate policy to changes in their outlook over time. This is what is meant by policy not being on a preset course: It should respond to changes in the realized and anticipated course of the economy.

Indeed, this is a part of the Committee's forward guidance, which remained unchanged last week. The guidance indicates that in determining how long to maintain the current target range for the fed funds rate, the FOMC will assess both realized and expected progress toward our objectives of maximum employment and 2 percent inflation, and we will look at a wide range of information in making that assessment. The guidance then indicates that, based on that assessment, the Committee continues to anticipate that it will likely be appropriate to maintain the current 0-to-1/4 percent target range for the federal funds rate for a considerable time after the asset purchase program ends.

I would prefer this second part of the forward guidance be reformulated. Even though the Committee has emphasized that policy is contingent on the state of the economy, in my view, the "considerable time" part of the guidance tends to focus the public's attention on a calendar-time for liftoff rather than on the changes in economic conditions that will help determine changes in appropriate policy. I believe the Summary of Economic Projections is a better vehicle to convey information about the anticipated timing of liftoff, as it ties policy paths to the economic outlook. But I acknowledge there is a range of views about forward guidance.

With the fed funds rate effectively at zero, forward guidance has been used as a tool of monetary policy to add policy accommodation. Indicating that the future path of short-term interest rates will be low for a long time can put downward pressure on longer-term interest rates, thereby spurring current economic activity even when the policy rate is at the zero lower bound. But in more normal times, away from the zero lower bound, I view forward guidance more as a communications device that conveys to the public how policy is likely to respond to changes in economic conditions. As such, I would like to see the forward guidance evolve over time to give more information about the conditions we systematically assess in calibrating the stance of policy to the economy's actual progress and anticipated progress toward our dual-mandate goals, and to the speed with which that progress is being achieved. A faster than expected pace of progress toward our goals would argue for a faster return to normal – that is, an earlier liftoff and more rapid funds rate increases than currently anticipated by the Committee – while a more subdued pace would argue for a slower return – a later liftoff and less rapid increases. I believe that effective communication about the contingent nature of our policy will be a key ingredient as we move back toward more normal monetary policymaking.

### **Normalization Principles and Plans**

In that vein, I was very supportive of the FOMC's release of updated information about its plans for the eventual normalization process. The release of this information was certainly not a signal of a change in the stance of policy. Rather, it was intended to provide the public with the FOMC's current thinking on how the process is expected to go. Some of the elements are the same as the broad exit strategy principles first laid out by the Committee in June 2011. Others are necessarily new because the size and composition of the Fed's balance sheet are quite a bit different than they were in 2011. Of course, there is likely to be some learning-by-doing as normalization proceeds, and the FOMC is prepared to adjust details of the plans if warranted by economic and financial developments. Nonetheless, the FOMC has reached a general consensus on several aspects of the process.

Just as it did before the Great Recession, the FOMC will communicate the stance of monetary policy using the federal funds rate – the market rate at which banks borrow and lend reserve balances overnight to one another. We will set a target range for the funds rate, as we are doing now, and when economic conditions and the economic outlook warrant less accommodative monetary policy, we will raise the target range. But the tools the FOMC will use to bring the funds rate up to the target range will have to be different than before the crisis because the level of excess reserves held by banks is now much larger. The extraordinary accommodation and nontraditional policy tools the Fed used to address the financial crisis and deep recession have left the Fed holding nearly \$4.5 trillion in assets, compared to about \$900 billion before the crisis. Banks have on deposit at the Fed more than \$2.7 trillion in reserves over and above what they need to meet regulatory requirements. Before the financial crisis, the level of excess reserves was less than \$2 billion. With this many reserves in the system, the Fed will use the interest rate it pays on excess reserves as the main tool for moving the funds rate into the target range. When the Fed raises the rate it pays on excess reserves, this will put upward pressure on the federal funds rate since banks will be unlikely to accept a lower rate in the market than they could get by depositing their funds at the Fed. We expect that while reserves are so plentiful, the fed funds rate will trade somewhat below the interest rate on excess reserves. So we could set the excess reserves rate at the upper end of the fed funds target range.

In addition, the Fed will use other tools as needed to ensure adequate control of the policy rate. One of these tools is an overnight reverse repurchase agreement facility. Basically, with overnight reverse repos, the Fed lends securities from its large portfolio overnight in return for liquidity from eligible counterparties. Offering this alternative investment should help put a floor on the fed funds rate. But there is the potential that in times of market stress too much liquidity could be drawn from the private market to the Fed's facility, thereby exacerbating financial market stress. To limit this possibility, the FOMC has been considering and testing different design features, and as the FOMC indicated, the



overnight reverse repo facility will be used only to the extent necessary and will be phased out when it is no longer needed to help control the fed funds rate. The Fed might also use other supplementary tools like term deposits to absorb some of the excess reserves in the banking system. The Fed's ability to pay interest on excess reserves, with these supplementary tools providing backup if needed, will allow the Fed to move interest rates up to target when it is appropriate to do so, despite the large size of our balance sheet.

But over the longer run, the Fed's balance sheet will return to a more normal size and composition. The Fed will hold no more securities than necessary to implement monetary policy efficiently and effectively and the securities it does hold will primarily be Treasury securities. Holding a broad asset class like Treasuries minimizes the effect of the Fed's asset holdings on the allocation of credit to particular sectors of the economy or classes of borrowers.

To return to a more normal balance sheet, the FOMC intends to reduce security holdings in a gradual and predictable way, primarily by not reinvesting repayments of principle on securities it holds and letting the securities mature and run off the balance sheet. The FOMC expects to stop the reinvestments only after it begins to increase the fed funds rate. I support that ordering because I would rather the first signal of a change in the stance of monetary policy be conveyed by a change in the fed funds rate target range – our key way of communicating changes in policy – rather than by a change in reinvestment strategy.

At this point the FOMC doesn't anticipate selling the agency mortgage-backed securities on its balance sheet as part of the normalization process, although it might engage in limited sales in the longer run to reduce or eliminate residual holdings. If so, the timing and pace of any sales would be communicated to the public in advance. At this point, I do not view asset sales as a necessary tool for controlling interest rates. But once normalization is underway, I would be open to considering a gradual path of asset sales

over time as a way to return the balance sheet more quickly to the more normal size and composition we anticipate it to have over the longer run.

### **Conclusion**

In summary, the economy has made substantial progress toward the Fed's goals of maximum employment and price stability. As the economy returns to more normal territory, monetary policymakers are prudently planning for the eventual normalization of the stance and framework for conducting monetary policy. Last week the FOMC provided its post-meeting policy statement, new economic projections, and updated information on the process it anticipates using to normalize policy. I believe such communications can play an important part in how well the trip back to normal goes by increasing the public's understanding of the anticipated evolution of the economy and the process of returning to normal. In the end, a return to normal policy means the economic expansion with stable prices is sustainable without the support of extraordinary monetary policy – and that is a very good place to be.