The Economic Outlook and Monetary Policy: Timing Isn't Everything

Loretta J. Mester
President and Chief Executive Officer
Federal Reserve Bank of Cleveland

The Columbus Metropolitan Club
Columbus, OH

July 15, 2015

Introduction

Good afternoon. I thank the Columbus Metropolitan Club for the opportunity to speak with so many of Ohio's business leaders. I see several Cleveland Fed directors in the audience. I want to thank them and all the attendees for taking time out of your busy schedules to be here today. As the president of the Federal Reserve Bank of Cleveland, I place a high premium on the information I gather from business people like you who are willing to share what you are seeing as you navigate through the ebbs and flows of economic waters. Your insights are enormously helpful to me as I formulate my views on the economy, views that I express when I go to Washington to participate in meetings of the Federal Open Market Committee (FOMC), the body within the Fed that sets monetary policy for the nation. More than 100 years ago, Congress designed the Federal Reserve as a decentralized central bank, with 12 Reserve Banks across the country, overseen by the Board of Governors in Washington. The Federal Reserve System's structure helps ensure that Main Street perspectives are considered around the FOMC table. It is a true strength of the System, and one worth preserving.

Before we move on to the question and answer part of today's program, I would like to open with a brief discussion of my economic outlook and monetary policy. As always, the views I'll present are my own and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.

The Economic Outlook

It has now been over six years since the official start of the economic expansion. Supported by extraordinary monetary policy accommodation, the U.S. economy has made significant progress since the darkest days of the global financial crisis and Great Recession. Underlying economic fundamentals have strengthened, resulting in an economy that has been able to sustain growth at a moderate pace over the past five years.

We began 2015 with a slowdown in output growth. Much of this year's slowdown reflected temporary factors, including the harsh winter weather and the labor disputes at ports on the West Coast. Measurement issues also likely played a role. For the past six years or so, output has tended to grow less in the first quarter than in other quarters, and government statisticians are taking steps to improve the methods used to seasonally adjust the numbers.

The recent monthly economic data, as well as information gleaned from my business contacts, suggest we are seeing a rebound in spending in the second quarter. Although yesterday's report on retail sales in June was weaker than analysts expected, it came after strong May sales. Consumer spending, which represents about two-thirds of output, picked up in the second quarter, supported by growth in personal income and continued improvement in household balance sheets. Based on projections from the U.S. Energy Information Administration, the drop in gasoline prices is estimated to be saving the average household about $700 this year. Perhaps not surprisingly, consumer sentiment is very good, at levels not seen since before the financial crisis and Great Recession.

Business sentiment also remains solid, but industrial activity has been weak in recent months. The drop in oil prices compared to a year ago has led to reduced investment and some dislocation in parts of the domestic energy sector, and this is affecting growth in certain regions of the country, including parts of eastern Ohio. But the U.S. is still a net importer of oil, and so the benefits of lower energy prices in terms of consumer, business, and local government spending will ultimately result in a net positive for the U.S. economy.

Another factor weighing on firms exposed to international trade is the appreciation in the value of the U.S. dollar since last summer. A stronger dollar means better terms of trade for U.S. consumers and businesses, which is a positive for a growing economy in the longer run. But in the near term, dollar appreciation is putting a drag on U.S. export growth. The recent stabilization in energy prices and slowdown in dollar appreciation mean that both drags should lessen over time.

On balance, I expect that after a weak first quarter, growth will pick up to an above-trend pace over the rest of this year and next, in the 2.75 to 3 percent range. I want to acknowledge there are risks around this forecast. I've incorporated a slowing in the pace of growth abroad, including China, but the magnitude of the slowdown remains uncertain. I'm also assuming that the situation in Greece will have a limited impact on the U.S. economy because our direct exposure via trade and banking is limited, Greek debt is held mainly by the public sector rather than private-sector investors, and the European Central Bank has tools to contain spillovers to broader financial markets. The Greek situation remains unresolved, but we had some positive news earlier this week and the risk of a very bad outcome with sizable effects on the global economy is not high enough to change my modal outlook for the U.S. economy of moderate above-trend growth, which will support continued positive developments in labor markets.

Over the past year, the economy has created an average of 245,000 jobs per month, and nonfarm payrolls are now 3-1/2 million above their previous peak before the recession. The unemployment rate is 5.3 percent, down sharply from its peak of 10 percent in 2009, and down three-quarters of a percentage point over the past year. A broad array of other labor market indicators have improved significantly over the past few years, including the long-term unemployment rate and the unemployment rate that includes discouraged workers and part-time workers who would rather work full-time. In addition, we are now beginning to see signs that wage growth is picking up. Year-over-year gains in the Employment Cost Index, a comprehensive measure of wages and benefits, rose from under 2 percent in the first quarter of last year to over 2-1/2 percent in the first quarter of this year. The delay in wage growth shouldn't be a surprise. Typically, wages tend to accelerate only after we've seen sustained improvements in the labor market. Some analysis we've done at the Cleveland Fed shows that in the last three expansions, job gains in industries that pay above-average hourly earnings contributed more to total private-sector job gains as the expansions continued on.[1]

In my view, the totality of evidence suggests that the economy is at or nearly at the Fed's mandated monetary policy goal of maximum employment. This isn't to say that there aren't longer-term challenges facing the labor market. Workforce development is a key issue. As a country, we want to ensure that people can enter and remain productive members of the labor force, to raise our standards of living and to make us more competitive in the global economy. However, monetary policy is not the tool for addressing this important issue. It is better served by policies focused on strengthening and increasing access to education and training.

Here in Ohio, we have also seen improvements in labor markets since the recession, but there are longer-run challenges as well. The state's unemployment rate has fallen sharply, from a peak of 11 percent in December 2009 to 5.2 percent in May, which is half of a percentage point lower than a year ago. Firms have been adding jobs. It is true that the pace of job growth in Ohio is slower than in the nation. Over the past year, jobs have been growing somewhat less than 1-1/2 percent in Ohio, compared to over 2 percent in the U.S. as a whole. And while U.S. employment is now 2-1/2 percent higher than its pre-recession peak, employment in Ohio has not quite reached that milestone.

How should we interpret this performance? It helps to put this into context. First, the pace of job growth in the state is now well above the pace we saw during the last expansion, when employment in Ohio was flat. Second, job growth in the state has been slower than the national pace since the mid-1990s – this is not a new phenomenon related to the Great Recession. It partly reflects slower population growth in Ohio and Ohio's higher share of jobs in manufacturing, a sector that has been experiencing a long-run decline

[1] See Loretta J. Mester and Guhan Venkatu, "Job Quality During the Expansion," manuscript, March 2015. The same type of pattern holds in the four states in the Cleveland Federal Reserve District: Ohio, Pennsylvania, Kentucky, and West Virginia.

in employment. Manufacturing accounts for about 15 percent of private-sector jobs in Ohio, compared to about 10 percent in the U.S. Those shares are down about 7 percentage points since the mid-1990s.

Within this bigger context, we can characterize the improvement in Ohio labor markets over this expansion as being pretty good but, at the same time, recognize that there are longer-run challenges as manufacturing continues to transform itself into a sector with higher-productivity production processes requiring higher-skilled workers.

The Columbus metro area is generally faring better than other regions in the state. As you know, Columbus benefits greatly from a highly educated workforce and a diversified industry base. This has contributed to broader gains in employment across multiple sectors in the Columbus area and puts the Columbus economy in a stronger position for sustainable growth.

In addition to maximum employment, the other part of the Fed's dual mandate is price stability. Inflation has been below the Fed's 2 percent goal for some time. Headline inflation has been running at about a quarter percent so far this year (as measured by the year-over-year percentage change in the price index for personal consumption expenditures). Excluding food and energy prices, which tend to be volatile, so-called core inflation has been running about 1-1/4 percent. Low inflation partly reflects the sharp drop in energy prices, as well as the appreciation of the dollar, which makes non-petroleum imports cheaper in the U.S. These downward pressures are starting to wane as oil prices and the value of the dollar have started to stabilize. Would I like to see higher inflation numbers? The answer is yes. Am I reasonably confident that inflation will move gradually back to the Fed's 2 percent objective over time? The answer is also yes. Supporting this view are above-trend economic growth, continued positive developments in labor markets, and the stability in measures of inflation expectations and some of the alternative measures of inflation, like the Cleveland Fed's median CPI and the Dallas Fed's trimmed mean PCE inflation.
Of course, my economic outlook is dependent on appropriate monetary policy, so let me turn to that now.

Monetary Policy: Timing Isn't Everything

As the FOMC has said, in determining the appropriate path of monetary policy, we assess both realized and expected progress toward our dual mandate goals of maximum employment and 2 percent inflation. So policy is not on a pre-set course; it depends on our read of what incoming data and economic information mean for our economic outlook and the risks around that outlook.

It is well accepted that monetary policy needs to be forward looking. Because monetary policy affects the economy with a lag, rates will need to begin to move up from their very low level before we have fully reached our goals. Moreover, with rates having been at zero for a sustained period, there is the potential for increased risks to financial stability from excessive leverage or from investors taking on risks they are ill-equipped to manage in a search for yield. The FOMC continues to carefully monitor financial markets for signs of these types of emerging problems, and so far so good.

The FOMC anticipates that two criteria need to be satisfied before it will be appropriate to raise the federal funds rate: further improvement in the labor market and reasonable confidence that inflation will move back to its 2 percent objective over the medium term.

According to the FOMC's June economic projections, 15 of 17 participants anticipate that it will be appropriate to begin to move interest rates up sometime this year. My own assessment is that the economy can handle an increase in the fed funds rate. A small increase in interest rates from zero is not tight monetary policy, and with the economic progress we've made and that I expect to continue, monetary policy can take a step back from the emergency measure of zero interest rates.

But I understand that others might like to see more confirming evidence before commencing a rate increase. My colleagues and I on the FOMC are all committed to promoting our dual mandate goals of price stability and maximum employment, but we may have different views about realized and anticipated progress toward those goals and about the potential costs and benefits to changes in policy with respect to achieving those goals.

While financial market participants are particularly focused on the timing of the first rate increase, when it comes to monetary policy, timing isn't everything. The FOMC meets eight times a year, and the difference in lifting off from a zero interest rate a meeting or two earlier or later is not significant. More important for macroeconomic performance is the expected path of policy beyond liftoff because expectations about the future path of policy can affect today's economic decisions. According to the FOMC's current assessment, even after the first rate increase, monetary policy is expected to remain very accommodative for some time to come, with rates expected to move up only gradually to more normal levels and with the decisions about that path depending on incoming information on the economy's performance. One benefit of the gradual approach is that it will allow us to recalibrate policy over time as some of the uncertainties surrounding the underlying economy in the post-crisis world, like the potential growth rate, are resolved.

Just like the timing of liftoff, the path of policy after liftoff will depend on how economic developments unfold. There is always uncertainty around projections of growth, unemployment, and inflation. If incoming economic information materially changes our outlook, we will adjust the funds rate up or down, as appropriate. But while our policy path is not pre-determined because the future is not pre-determined, one thing is certain: the Federal Reserve is committed to setting monetary policy to promote our congressionally mandated goals of maximum employment and stable prices.