Perspectives on the Economy and Monetary Policy

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Introduction

Chris, thank you for that kind introduction and for your service as chair of the Federal Reserve Bank of Cleveland's Board of Directors. And thanks to the City Club for the opportunity to speak today to so many of Cleveland's business leaders. Since coming to Cleveland last year, I have made it a point to learn more about the city's many important institutions, and the City Club of Cleveland is certainly a leader among them. It is an honor for me to be included in your list of very distinguished speakers. For more than 100 years, the City Club has fostered the free and open exchange of ideas. It sees value in bringing together people with diverse viewpoints for a civil discussion of a wide variety of topics. The City Club's commitment to free speech in promoting a well-informed community is praiseworthy public service.

Although it might not be apparent, the City Club and the Federal Reserve have several things in common. Like the City Club, the Federal Reserve System is over 100 years old, and it, too, is committed to public service. At meetings of the Federal Open Market Committee, the body within the Fed that is charged with setting monetary policy, my colleagues and I engage in a free and open exchange of views. In our case, the topics covered aren't as wide ranging as those discussed at the City Club; we focus on the economy and monetary policy. By design, the discussions at our meetings contain a mosaic of economic information and analysis from all parts of the country. I believe this ability to share what are sometimes diverse views on the state of the economy and policy is one of the strengths of the Federal Reserve System. It allows us to work toward a better-informed consensus on monetary policy to promote the Fed's congressionally mandated goals of price stability and maximum employment.

Like the City Club, the Fed sees value in a well-informed public, and we feel an obligation to explain our policy decisions so that the public and its elected representatives can hold us accountable for those decisions. So today, before we move on to the question and answer portion of the program, which is a highlight of any speaking engagement at the City Club, I would like to offer my perspectives on the economy and monetary policy. As I just mentioned, while the Committee comes to a consensus policy decision, there can be a diversity of views around the FOMC table, so I want to note that the views I'll present today 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 may not come as news to you that at its October meeting, the FOMC decided to maintain the target for our policy rate – the federal funds rate – at essentially zero. The Committee reached this decision based on an assessment of both realized and expected progress toward our objectives of maximum employment and 2 percent inflation. To make such an assessment, the Committee looks at a wide range of economic information – the official economic statistical releases and financial market indicators, as well as the information I and other FOMC participants garner by speaking with business contacts in our regions, including members of our Boards of Directors and advisory groups. When the FOMC says its decisions are "data-dependent," this is really shorthand for this more comprehensive process of parsing economic and financial information, and assessing what it implies about the current state of the economy, the economic outlook, and the risks around that outlook. The FOMC will be doing this same type of analysis at our next meeting in mid-December. We will be looking at all the incoming information between now and then to see if it supports the FOMC's expectation that the economy will continue to grow at a pace sufficient to generate some further improvement in labor markets and a gradual return of inflation to our target of 2 percent over the medium run.

Growth

There is no denying that the U.S. economy has come a long way since the darkest days of the global financial crisis and the Great Recession, which officially ended more than six years ago. Supported by extraordinary monetary policy action, economic fundamentals have strengthened, and in the face of various shocks, the economy has been resilient enough to sustain a moderate pace of growth over the past six years.

Of course, over this expansion, the pattern of growth has not been smooth. It has varied over time and over sectors, and 2015 was no exception. We began this year with a slowdown in output growth to less than 1 percent at an annual rate. The slowdown mainly reflected temporary factors, including severe winter weather and labor disputes at West Coast ports. As those temporary factors abated, we saw growth rebound sharply to almost 4 percent in the second quarter, only to fall back to 1.5 percent in the third quarter. That slowdown largely reflected a sharp pullback in the rate at which firms were adding to their inventories from an unsustainably strong pace in the first half of the year. A better gauge of growth in demand is final sales adjusted for inflation. These grew at a solid 3.0 percent in the third quarter, suggesting that the economy still has solid underlying momentum.

The driver of growth this year has been consumer spending, which makes up about two-thirds of output. And when I say “driver,” you can take that literally. Consumers have been purchasing vehicles, especially light trucks, in very high volumes, higher than before the recession. Consumer spending on other durable goods and services has also been growing at a solid pace. Growth in personal income and continued improvement in household balance sheets have supported this spending. At a national level, house prices have recovered to levels seen before the crisis, adding to the wealth of homeowners, and we’ve seen a gradual pickup in housing activity, including sales and construction. Fewer households are underwater on their mortgages and mortgage delinquencies are down. Although stock prices are little changed, on net, so far this year, the cumulative increase in stock prices since the crisis is significant. Households lost $13 trillion in net worth over the Great Recession, but now thanks to the cumulative increase in stock and house prices, households have recovered that loss and have added another $18 trillion in net worth to their balance sheets.

Lower energy prices have also boosted household purchasing power. Oil prices are down about $40 per barrel from a year ago and gasoline is currently running about $2.30 per gallon, 80 cents lower than a year ago. The U.S. Energy Information Administration estimates that the drop in gasoline prices this year has saved the average household about $700, and it is projecting that expenditures on home heating oil will be 25 percent lower this winter than last.

While, on net, lower oil prices will be a positive for U.S. economic growth over the medium run, in the near term, the drop in oil prices has been a drag on investment in the domestic energy sector and its suppliers. This is affecting growth in certain regions of the country, including parts of eastern Ohio. Investment in drilling and mining equipment is likely to continue to decline for a few more quarters, but outside of energy-related sectors, business investment in equipment and intellectual property continues to grow moderately.

Manufacturing, aside from motor vehicles, has been one of the soft spots in the economy. Lower oil prices have led to a pullback in manufacturing related to the energy sector. The appreciation in the value of the U.S. dollar over the past year has also weighed on firms with international exposure. Dollar appreciation reflects the expectation that economic growth in the U.S. will continue to be stronger than growth abroad. 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, slower growth in our trading partners and the dollar appreciation are drags on U.S. export growth, and I expect net exports to be a negative influence on real GDP growth for somewhat longer. The good news is that recent changes in the value of the dollar and oil prices haven't been as sharp, so I expect both drags to lessen over time and to be outweighed by growth in other sectors, including consumer spending and housing.

You may recall that in August there was an episode of significant volatility in financial markets and a tightening in credit conditions: stock prices fell and credit spreads rose. These financial market developments appeared to have been touched off by concerns about the prospects for growth in China and other emerging market economies. Since then, volatility has subsided and equity markets have stabilized. As the FOMC indicated in its October statement, some of the downside risks related to global economic and financial developments have diminished. But the possibility of a sharper-than-anticipated decline in global growth remains a risk to the outlook, and we will continue to monitor for signs of spillovers to the U.S. economy.

One question is whether the softening we saw in U.S. growth in the third quarter is signaling a more persistent slowdown in momentum that changes the medium-run outlook, which is the relevant time horizon for monetary policy. My answer is no. The resiliency of the economy through the episode in August, as well as the strength in final sales in the third quarter, suggests to me that there continues to be positive economic momentum. I anticipate that after the weak third quarter, growth will pick up over the rest of this year and next, to an above-trend pace in the 2.5 to 2.75 percent range. I recently revised down my estimate of longer-run growth to 2.25 percent, a quarter of a percentage point lower than my previous estimate. My revision reflects the Bureau of Labor Statistics' recent downward revisions to past productivity growth.

Many factors, including trend labor force participation, structural productivity growth, and technological innovation, affect the nation's longer-run growth potential, and there is considerable uncertainty around estimates of potential growth. In fact, it is noteworthy that economists have been revising down their estimates of potential growth almost every year since the Great Recession started. For example, in 2008, the Congressional Budget Office estimated that potential growth between 2008 and 2013 would average 2.5 percent, well above its current estimate of 1.5 percent for that same time period. Similarly, over time, FOMC participants have lowered their projections for longer-run growth. The FOMC began releasing these longer-run projections in January 2009. At that time, the central tendency of the participants' projections of longer-run GDP growth was 2.5 to 2.7 percent. In the projections released in September, the central tendency was down to 1.8 to 2.2 percent.

The implication is that even though the economy has been growing at a relatively moderate pace over the expansion, that pace has been sufficient to generate significant cumulative improvements in the labor market.

Labor Markets

It is good to remember how far we have come. Over the past six years, the unemployment rate has been halved, falling from a high of 10 percent in October 2009 to 5.0 percent this October. It's down over half of a percentage point since the end of last year. Nonfarm payrolls are now more than 4 million above their previous peak before the Great Recession. More than 2 million jobs have been added this year, and these have been full-time jobs. Last Friday, we learned that following softer gains in August and September, firms added a very robust 271,000 jobs in October. So far this year, payroll gains have averaged a little more than 200,000 jobs per month. As we often say, we shouldn't read too much into one month's number given the month-to-month variation in these readings and the fact that there are still revisions to come. That was true of the softer numbers in August and September, but it's just as true of the outsized gain in October, which I doubt will be repeated in November. It's better to smooth through the volatility: over the past three months, firms added an average of 187,000 jobs per month. This is somewhat slower than the pace seen earlier in the year, but given the cumulative gains that have been made on the job front and the level of employment growth that is consistent with full employment over the longer run, we should be expecting payroll job growth to slow.

Economists currently estimate that monthly payroll growth in the 75,000 to 120,000 range would be enough to keep the unemployment rate constant. This is lower than in the past because labor force participation rates have been trending down with the aging of the population and the increase in college enrollments. But notice that this means that even the softer average monthly gain of 145,000 in August and September is enough to put downward pressure on the unemployment rate.

A broad array of other labor market indicators have improved significantly over the past few years, although they are not quite back to pre-recession levels. These measures include the long-term unemployment rate, as well as the unemployment rate that includes discouraged workers and part-time workers who would rather work full-time. Despite the improvement in labor markets, so far we have not seen broad-based acceleration in wages. But signs point to firming. Average hourly earnings growth strengthened in October. We have heard from business contacts in our region that it is becoming increasingly difficult to find qualified workers in specific occupations and industries, including construction, IT, and specialized manufacturing. In fact, our construction contacts report that the primary downside risk they face is a shortage of labor, not potentially higher interest rates. There are similar indications from other parts of the country; firms report having to raise wages to attract and retain workers in these occupations. The recent contract deal at General Motors includes salary increases in the 3 to 4 percent range and higher entry-level wages. As labor markets continue to improve, I expect to see some broader acceleration in compensation.

In my view, the totality of evidence suggests that the economy is at or very nearly at the Fed's mandated monetary policy goal of maximum employment, and with growth resuming at an above-trend pace, I expect to see further improvement. 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. Monetary policy is not the tool for addressing this important issue, but the Federal Reserve, through its role in promoting community development, is certainly committed to helping identify effective policies and best practices for strengthening and increasing access to education and training. In fact, this past June, the Cleveland, Philadelphia, and Richmond Feds hosted a policy summit that brought together practitioners, researchers, and policymakers working on these issues.

Regional Growth and Labor Markets

As I mentioned, an important role of a Federal Reserve Bank President is gathering information from Main Street to help inform monetary policy. So let me spend a few minutes on economic developments in the Fourth Federal Reserve District, which encompasses all of Ohio, western Pennsylvania, eastern Kentucky, and the northern panhandle of West Virginia. While our region is quite diverse, the path of economic expansion here has been similar to the nation's. Regional firms with international exposure, such as the steel industry, continue to struggle. Shale gas production levels remain high but growth in drilling activity has slowed considerably. Auto and auto parts manufacturing represents a significant share of manufacturing in Ohio and Kentucky, and the strength we've seen in this sector has helped to offset some of the weaker manufacturing segments.

Like the nation, our region has also seen considerable improvement in labor markets. In Ohio, the unemployment rate has fallen sharply from a peak of 11 percent in December 2009 to 4.5 percent in September, below the national average. Firms have been adding jobs, but at a slower pace than in the nation. Over the past year, the pace of job growth in Ohio has been only half that of the U.S. as a whole. And while U.S. employment is now 3 percent above its pre-recession peak, employment in Ohio is not quite back to that benchmark.

This slower job growth in the state relative to the nation is not a new phenomenon – it's been happening since the mid-1990s. It partly reflects the slower population growth and older population in Ohio, as well as Ohio's higher share of jobs in manufacturing, a sector that has been experiencing a long-run decline 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.

As the regional economy becomes less reliant on old-style manufacturing, and more reliant on higher-skilled manufacturing and service-sector jobs in fields such as education and health care, it faces the challenge of ensuring that its population can gain the necessary skills to enter and remain productive members of the modern labor force. So workforce development is a challenge here, just as it is for the nation as a whole.

Inflation

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 1.3 percent. Low inflation partly reflects the transitory effects of the sharp drop in energy prices, as well as the appreciation of the dollar, which makes non-petroleum imports cheaper in the U.S.

Incoming data are consistent with the inflation dynamics that the FOMC has been expecting. As changes in oil prices and the value of the dollar have tempered, the downward pressure on inflation has started to wane. Recent readings on underlying inflation, including the core, trimmed mean, and median CPI measures, have moved up. For example, the year-over-year change in the Cleveland Fed's median CPI measure rose to 2.5 percent in September. There is considerable uncertainty around any inflation forecast, but analysis by Cleveland staff and others suggests that core measures of inflation can improve forecasts of headline inflation at least over some time horizons; in some cases, the improvement is statistically significant.

Inflation expectations are an important factor shaping the inflation outlook, and in my view, inflation expectations remain well-anchored. Survey-based measures of inflation expectations of both consumers and professional forecasters have been stable despite the low readings of actual inflation. These survey measures have historically done well at capturing longer-run trends in inflation and they have been shown to help in forecasting inflation.[1] Inflation compensation, measured by the spread between yields on Treasury securities and Treasury inflation-protected securities, so-called TIPS, has moved down a bit, but analysis suggests that this likely reflects liquidity effects and changes in inflation risk premiums more so than changes in inflation expectations. Cleveland Fed staff analysis also suggests that the fall in inflation compensation may be reflecting the sharp drop in energy prices since last year, which might reverse as movements in oil prices moderate.[2]

I expect inflation to remain low in the near term, but the firming in the core measures, the stability in inflation expectations, the economy's expected return to above-trend growth, and continued improvement in labor markets are all factors making me reasonably confident that inflation will gradually return to our 2 percent goal over the medium run.

Of course, my economic outlook is dependent on appropriate monetary policy, so let me turn to that now.

Monetary Policy

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

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[1] See Jon Faust and Jonathan H. Wright, "Forecasting Inflation," *Handbook of Economic Forecasting*, 2A, Graham Elliott and Allan Timmermann, eds., New York: Elsevier, pp. 3-56, and Todd E. Clark and Taeyoung Doh, "Evaluating Alternative Models of Trend Inflation," *International Journal of Forecasting*, 30(3), 2014, pp. 426-448.

[2] Randal Verbrugge and Amy Higgins, "Do Energy Prices Drive the Long-Term Inflation Expectations of Households?" Federal Reserve Bank of Cleveland *Economic Trends*, March 24, 2015.

In deciding whether these conditions have been met and whether it is appropriate to raise the target range for the fed funds rate, the FOMC has to balance a number of considerations. My colleagues and I are all committed to promoting the 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. Given the current stage of the business and policy cycles, I find this diversity neither surprising nor troubling.

In September and October, the FOMC's consensus expectation was that labor market conditions will continue to improve and that inflation will return to target over time, but the Committee decided that it was prudent to await further evidence supporting this expectation before lifting off from zero.

My own assessment is that with the economic progress we've made and that I expect to continue, the economy can handle an increase in the fed funds rate. In my view, if economic information continues to come in consistent with the outlook, then there will be a strong case that the conditions for liftoff have been met and it would be prudent for monetary policy to take a step back from the emergency measure of zero interest rates. A small increase in interest rates from zero is not tight monetary policy. And while I would expect some reaction in financial markets to the first move in interest rates in over six years, I wouldn't expect financial conditions to tighten enough to affect the medium-term outlook.

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. Decisions about the path will depend on incoming information on the economy's performance, but according to the FOMC's current assessment of the economic outlook, 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.

Of course, in the aftermath of the Great Recession there is some uncertainty about what that "normal" level of interest rates is. If the potential growth rate of the economy over the longer run has moved lower, as many economists estimate, that means the longer-run level of the fed funds rate consistent with price stability and maximum employment is also lower than it was in earlier periods. But estimates of long-run growth are imprecise and subject to revision, so this means there is considerable uncertainty around this neutral fed funds rate as well.

One benefit of a gradual approach to normalization is that it will allow us to recalibrate policy over time as some of the uncertainties surrounding the longer-term level of interest rates, the economy's potential growth rate, and the longer-run unemployment rate are resolved. But uncertainty about the longer-run destination is not an argument to delay taking the first step. In fact, in my view, given the economic outlook, starting the process to normalize interest rates will help ensure that we can, indeed, take a gradual approach. Delay risks having to move rates up more steeply in order to promote attainment of our goals over time.

Another cost of postponing liftoff too long is the potential for building risks to financial stability stemming 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. However, we need to acknowledge that leading up to the financial crisis, some of the vulnerabilities of the financial system were not fully recognized by policymakers. Although we have made significant strides since then, there likely remain some gaps in our ability to assess the risks in every part of the financial system. The longer interest rates are maintained at zero in an economy that is getting back to normal, the higher the potential risk to financial stability. This potential cost is one that needs to be considered when determining appropriate policy.

I believe the extraordinary monetary policy actions taken by the FOMC in response to the financial crisis and Great Recession were effective in easing monetary and financial conditions; they kept the Great Recession from turning into another Great Depression. I'd like to ensure that these actions remain a part of the monetary policymakers' toolkit, available for use if such an unfortunate situation arises again in the future. But, ultimately, how history judges those extraordinary actions will depend on our demonstrating that there is a way out. The time to start that demonstration is quickly approaching.

In summary, the economy has made considerable progress over the expansion and my medium-run outlook is for above-trend growth, continued improvement in labor markets, and inflation gradually returning to our 2 percent target over the medium run. If incoming economic information continues to support this forecast, then in my view it will be time to take the first step in the policy normalization process. As I'm sure the learned audience at the City Club knows, Jean-Paul Sartre was a famous French philosopher and author. His play "No Exit" is a celebrated contribution to the existentialist literature; it should not be a guidebook for monetary policymakers.