The U.S. Economy and Monetary Policy

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Remarks for the Panel Discussion, "The United States and the Global Economic Outlook"
National Association for Business Economics/American Economic Association Meetings
San Francisco, CA

January 3, 2016

Introduction

I thank the National Association for Business Economics for organizing this session and giving me the opportunity to discuss the outlook for the U.S. economy and monetary policy. The views I'll present today are my own and not necessarily those of the Federal Reserve System or my colleagues on the FOMC.

The Economic Outlook

At its December meeting held about two weeks ago, the Federal Open Market Committee decided to raise the target range for the federal funds rate by a quarter of a percentage point, bringing the range to one quarter of a percent to one half of a percent. Much public attention was focused on this decision, which was the first change in the policy rate in 7 years and the first rate increase in 9-1/2 years. The increase in the rate from essentially zero recognizes the considerable progress the economy has made since the Great Recession, which officially ended more than six years ago. It also reflects the FOMC's outlook that the economy will improve further, supported by monetary policy that continues to be quite accommodative even after the December increase.

The decision in December was based on an assessment of both realized and expected progress toward the FOMC's congressionally mandated objectives of maximum employment and price stability. 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. When the FOMC says its decisions are "data-dependent," I view this as shorthand for this more comprehensive process of parsing economic and financial information to determine current economic conditions, and then assessing what that information implies about the economic outlook and the risks around that outlook. Thus, "data dependent" policymaking does not mean that policy will react to every short-run change in the data, but rather that policy will react to changes in the medium-run outlook with respect to the Committee's monetary policy goals as informed by changes in economic conditions.

Growth

So let's discuss the outlook. 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. The same was true last year, yet U.S. growth is estimated to have increased at an average pace of about 2-1/4 percent over the first three quarters of 2015.

Consumer spending, which makes up about two-thirds of output, has been an important driver of growth – indeed, motor vehicle sales have been particularly strong. Growth in personal income, reflecting progress in the labor market, and continued improvement in household balance sheets have supported this spending. Although stock prices changed little, on net, in 2015, the cumulative increase in stock prices since the financial crisis ended is significant. Households lost $13 trillion in net worth during 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 households' purchasing power. 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. 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 both the expectation that economic growth in the U.S. will continue to be stronger than growth abroad, as well as projected interest rate differentials between the U.S. and foreign economies. 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. However, I expect both drags to lessen over time and to be outweighed by growth in other sectors, including consumer spending, as well as housing, which has picked up over the past year. Fiscal policy will also make a modestly positive contribution to growth.

I anticipate that growth over the fourth quarter of last year and through this year will be at an above-trend pace in the 2.5 to 2.75 percent range. My estimate of longer-run growth is 2.25 percent, which is at the upper end of the 1.8 percent to 2.3 percent range among FOMC participants. Many factors, including trend labor force participation, structural productivity growth, and technological innovation, affect the nation's longer-run growth potential. There is considerable uncertainty around estimates of potential growth, and economists have been revising down their estimates of potential growth almost every year since the Great Recession started. 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 percent in November 2015. Nonfarm payrolls are now about 4-1/2 million above their previous peak before the Great Recession. More than 2 million jobs were added over the first 11 months of last year, an average of over 200,000 jobs per month.

This amount is considerably stronger than the 75,000 to 120,000 jobs per month range that economists currently estimate would be enough to keep the unemployment rate constant.

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 a broad-based acceleration in wages. But signs point to firming, and as labor markets continue to improve, I expect to see some broader acceleration in compensation.

Although there continue to be some longer-run challenges facing the labor market, 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. With economic growth resuming at an above-trend pace, I expect to see further improvement in the labor market.

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, as measured by the price index for personal consumption expenditures, was about 0.4 percent over the 12 months ending in November. Excluding food and energy prices, which tend to be volatile, so-called core inflation has been running at about 1.3 percent. Low inflation partly reflects the transitory effects of the sharp decline in oil and other commodity prices since mid-2014, as well as the appreciation of the dollar, which has held down the prices of nonpetroleum imports into the U.S.

Recent readings on several measures of underlying inflation like the core, trimmed mean, and median CPI have been moving higher. For example, the year-over-year change in the Cleveland Fed's median CPI measure moved up from 2.2 percent at the beginning of 2015 to 2.5 percent in September, October, and November. There is considerable uncertainty around any inflation forecast, but analysis by the 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. As Federal Reserve Chair Janet Yellen noted in her December press conference, in the Committee's view, longer-run inflation expectations remain well-anchored. I agree with this assessment. The movements in survey-based measures of inflation expectations have been small, and the low levels of market-based measures of inflation compensation likely reflect liquidity effects, changes in inflation risk premiums, and the sharp move in oil prices.

I expect headline PCE inflation to remain low in the near term, but as the expansion continues and as the effects of the declines in energy and other commodity prices and the appreciation of the dollar wane, I am reasonably confident that inflation will gradually return to our 2 percent goal over the medium run.

Risks to the Forecast

Of course, there are risks around any economic forecast, and mine is no exception. I see the risks as balanced and not overly large. On the downside, the dollar could appreciate more than I've built into my forecast, perhaps reflecting the divergent paths for economic growth and monetary policy abroad relative to the U.S., or oil prices could continue to decline rather than stabilize. Both of these could dampen growth in the trade and industrial sectors and put more downward pressure on inflation than in my baseline forecast. On the upside, lower oil prices may buoy consumer spending more than I anticipate, and accommodative monetary policy combined with an improving economy may lead to more-than-anticipated upward pressure on inflation over the medium run. Although many analysts have been focusing on downside inflation risks, analysis by the Cleveland staff shows that over the last 15 years historical forecast errors from several highly regarded inflation forecasting models have skewed to the upside; that is, the models have underestimated actual inflation.[1]

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, it was clear that rates would need to begin moving up from zero before our monetary policy goals had been fully met. Since March, the FOMC has said that two criteria would need to be satisfied before it would be appropriate to raise the federal funds rate from zero: further improvement in the labor market and reasonable confidence that inflation would move back to its 2 percent objective over the medium term. In December, the Committee judged that these two criteria had been met and raised the target range for the federal funds rate by 25 basis points. It implemented this change by raising the interest rate it pays on reserve balances that banks and other depository institutions hold at the Fed, supported by overnight and term reverse repurchase agreements, which are available to a broader array of counterparties.

I fully supported the FOMC's December action: Based on the economic outlook, I thought it was prudent to take the first step on the path of gradual normalization of interest rates.

More important for macroeconomic performance than the initial rate increase is the expected future path of policy because expectations about the future policy path can affect today's economic decisions. The

[1] Models whose forecast errors skew to the upside include the Faust and Wright inflation-expectations gap model and the Stock and Watson unobserved components model. See Jon Faust and Jonathan H. Wright, 2013, "Forecasting Inflation," in *Handbook of Economic Forecasting*, ed. by Graham Elliott and Allan Timmermann, Amsterdam: Elsevier Press, vol. 2A, pp. 2-56, and James H. Stock and Mark W. Watson, February 2007, "Why Has U.S. Inflation Become Harder to Forecast?" *Journal of Money, Credit and Banking*, supplement to vol. 39, no. 1, pp. 3-33.

actual path the fed funds rate will follow will depend on the economic outlook as informed by incoming information, but according to the FOMC's current assessment of the outlook, monetary policy is expected to remain 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 it has, that means the longer-run level of the fed funds rate consistent with price stability and maximum employment would also be 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. At the same time, starting on the gradual normalization path now helps ensure that policy doesn't lag too far behind the economy. Were that to happen, it might require raising rates more steeply in order to promote attainment of our monetary policy goals over the medium run. Starting on the gradual normalization path also helps to mitigate any 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.

In addition to some of the uncertainty around the longer-run steady state of the economy, it bears remembering that our economic forecasting models are, by necessity, simplifications. The economy is dynamic and can be hit by various shocks that might lead to changes in the medium-run outlook for employment and inflation to which policy would want to respond. Indeed, the FOMC's Summary of Economic Projections, aka the SEP, provides information on average historical errors across a range of forecasts and these show that the confidence bands around forecasts tend to be wide. For example, the 70 percent confidence interval around a forecast of CPI inflation one year out is about plus or minus 1 percentage point. Note that because there is uncertainty around the outlook, there is also uncertainty around the FOMC's policy path. If the economy's evolution turns out to be different from what we currently anticipate, our policy path may well have to deviate from what our current expectation is. I don't view this as problematic – we want policy to respond appropriately to changes in the outlook.

I believe the SEP and its dot plot of each FOMC participant's fed funds rate projection give a good sense of the participants' current assessment of the appropriate path of policy going forward. As can be seen in the December projections, the majority of FOMC participants believe it will be appropriate over the next couple of years for the level of the fed funds rate to lie below the level of the longer-run federal funds rate. Across participants, this longer-run level ranges from 3 to 4 percent, with a median projection of 3.5 percent. The evolution of the FOMC's dot plot over meetings to come will provide the public with information on how participants think monetary policy should appropriately respond to changes in the outlook. Thus, I view the SEP as having an important role to play in monetary policy communications.

Conclusion

In summary, the economy has made substantial progress toward the Fed's goals of maximum employment and price stability – enough progress that in December the FOMC moved its target federal funds rate up by 25 basis points from essentially zero, where it had stood for 7 years. Even with this increase, monetary policy is expected to remain accommodative for some time to come and will continue to support the expansion. I believe this first step on a gradual path toward more normal policy should be viewed as welcome news. It is an indication of monetary policymakers' confidence that the economic progress we have seen in recent years will continue.