

The Economic Outlook and Monetary Policy



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Introduction

It is a pleasure to welcome you to the Federal Reserve Bank of Cleveland. Since my arrival in Cleveland over two years ago, I have seen first-hand the important role that the Greater Cleveland Partnership plays in supporting the growth of our regional economy and I am very proud to serve on its board. Of course, as president of one of the country's 12 Federal Reserve Banks I have a keen interest in our regional economy. As we gather in the lobby of this historic building, it is hard not to think back to a time more than 100 years ago and applaud the Congressmen – yes, they were all men back then – who came up with such an ingenious design for our Federal Reserve System. Congress established the Fed in 1913 as a decentralized central bank, independent *within* the government but not independent *from* the government. The Fed's design balances public-sector and private-sector interests, and Wall Street and Main Street concerns. I believe the design has served the country well by allowing monetary policy decisions to take into account the diversity of the American economy and its people.

As president of the Cleveland Fed, I make it a point to bring the economic information we have garnered from business, consumer, and labor contacts throughout the District to meetings of the Federal Open Market Committee (FOMC). The FOMC is the body within the Fed that sets monetary policy. The insightful regional perspectives provided by our directors, advisory council members, and other regional contacts, along with economic and financial data and analysis, all play an important part in the Fed's setting of national monetary policy in pursuit of our statutory goals of maximum employment and price stability. I commend Chair Janet Yellen for fostering an atmosphere of serious deliberation and the free exchange of ideas in FOMC meetings. Setting monetary policy is a complex undertaking, and I believe the history of this institution has shown that better policy decisions are made when a diversity of information and views is considered.

Some of that diversity was on display when the FOMC met last week and decided to maintain its policy rate at 1/4 to 1/2 percent. I, along with two of my colleagues, dissented from that consensus decision in

favor of moving the federal funds rate up by 25 basis points. The reason I believe a gradual upward path of policy continues to be appropriate and that I favored taking another step on that path in September is because of the realized progress the economy has made on our monetary policy goals and my expectation of further progress. That expectation is based on my outlook for the economy. So today, I would like to discuss my outlook for both the national and regional economy and my views on monetary policy. 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 underlying fundamentals supporting the economic expansion remain sound. Household balance sheets have improved greatly since the recession and households feel confident enough to be borrowing again. We have seen sustained progress in the labor market and wages are gradually beginning to accelerate. Oil prices remain low, and while the decline in energy prices has been a considerable negative for the energy-producing sector, it has benefited households and the many businesses that consume energy. The underlying strength in the economy is demonstrated by the resiliency it has shown through a number of bumps along the road of expansion. Some of the recent bumps include the gyrations in financial markets at the beginning of the year, the slowdown in growth in China, economic weakness in Europe, the large appreciation of the dollar between mid-2014 and the start of this year, and the uncertainty surrounding the United Kingdom's vote to leave the European Union.

All forecasts carry risk, and sometimes it is difficult to extract the signal about where the economy is headed from noisy economic and financial market data. With those usual caveats, my modal forecast is that over the next couple of years, the U.S. economy will expand at a pace at or slightly above its longer-run trend, which I estimate to be about 2 percent; that the unemployment rate will move further below its longer-run level, which I estimate to be about 5 percent; and that inflation will continue to gradually return to the Federal Reserve's 2 percent target.

Economic growth

U.S. output growth in the first half of the year was quite slow, coming in at only around 1 percent. Much of that sluggishness was due to a decline in business inventories, and so GDP growth underestimated the underlying strength in demand. Based on incoming data, growth is poised to rebound in the second half of the year. Consumer spending, which makes up about two-thirds of U.S. output, has been a driver of growth and I expect that to continue. Improving household balance sheets, growth in personal income, low borrowing rates, and low oil prices have all buoyed consumer spending.

The housing sector is gradually improving and I expect activity in the sector will continue to expand at a sustainable pace. The monthly home sales numbers have been volatile from month-to-month, reflecting a mixture of supply and demand factors. Builders have been telling us that they are having trouble finding qualified workers in some of the construction trades and they are cautiously avoiding over-building, having learned from the housing boom and crash. Mortgage rates are low, but households are being careful not to take on more mortgage debt than they can handle, and banks are lending but to those with good credit quality.

In contrast to housing, business fixed investment remains weak, and this weakness is somewhat of a puzzle. Given the sharp drop in oil prices since mid-2014, it's not surprising that firms in the drilling and mining sector, their suppliers, and regions whose economies depend on the energy sector were hurt. We have seen the effects in parts of the Cleveland Fed District where steel production, which supplies the energy industry, has been down and other firms tied to energy have cut jobs and reduced investment. But even outside of the energy sector, business investment has been soft despite generally accommodative financial conditions. Manufacturing firms are telling us they are investing, but mainly to sustain current operations rather than to expand. Some of the softness in investment reflects weak demand outside of the U.S., which has hurt U.S. exports. Other firms seem to be using the low interest rate environment to buy

back stock rather than to expand plant and equipment spending. More generally, there just seems to be a sense of caution on the part of firms.

I expect investment to begin to pick up with economic growth. But the weakness in investment and the associated slow pace of productivity growth pose a risk for the longer-run growth of the U.S. economy. Structural productivity growth is a key determinant of the longer-run growth of output and increases in living standards. And a key determinant of productivity growth is investment in physical and human capital. Labor productivity growth has risen at an annual rate of only one-half percent over the past five years. Part of this weakness is cyclical; some of it reflects longer-run demographics, including the aging of the population, and some of it likely reflects difficulties measuring productivity in the service sector, including intellectual property and information technology. It is difficult to forecast productivity growth, so the recent softness may reverse itself, or it may be longer lasting and reflect a structural issue. If it's the latter, then the longer-run growth rate of the U.S. economy may be lower than the 2 percent growth I've been assuming.

Monetary policy cannot affect these longer-term structural aspects of the economy, but it needs to consider them. For example, in an economy with lower trend growth and productivity, the average level of interest rates that balances supply and demand – what economists call the neutral rate of interest – will be lower. But just because monetary policy can't move the trend growth rate higher doesn't mean there aren't other steps the country can take to address these longer-run issues: policies that encourage investments in technology and human capital, tax and regulatory changes, and longer-run fiscal policy should all be under consideration.

As this brief overview suggests, some parts of the U.S. economy have fared better than others. But overall, economic growth has proven to be resilient and I expect growth over the next two years to be at

or slightly above a trend of around 2 percent. The pace of growth, while lower than in other expansions, has been sufficient to generate significant and sustained progress in labor markets.

Labor markets

Since the trough in early 2010, the U.S. labor market has added more than 14 million jobs, which is about 10 percent of employment, and the unemployment rate has fallen more than 5 percentage points from its peak of 10 percent in late 2009. The past two years have also seen significant improvements in other gauges of the under-utilization of labor, such as measures tracking the number of part-time workers who would rather work full-time and the number of people who have been discouraged from looking for a job.

So far this year, firms have added over 1.4 million payroll jobs, an average of about 180,000 jobs per month. That's well above estimates of trend employment growth, which range from 75,000 to 120,000 per month. We are increasingly hearing from businesses across a broad set of industries that they are having trouble finding qualified workers, both in high-skilled occupations and in lower-skilled jobs. And we are now beginning to see firms respond by raising wages.

I expect to see the labor market continue to tighten. Although payroll job growth is projected to slow a bit from the current pace given the progress that's been made, it will be sufficient to put further downward pressure on the unemployment rate. I expect the unemployment rate to stay below 5 percent over the next two years.

I do not want to underestimate the difficulty that many people have had finding work during the recession and slow recovery and that many continue to have, or the persistent differences in the employment situation faced by different demographic groups in the U.S. Technological advances and globalization are changing the nature of available jobs and the skill sets needed to perform those jobs.

I recently visited Hazard, Kentucky, a part of the Cleveland District in the heart of Appalachia. I spoke with some coal miners who were graduating from an electrical-fiber optic lineman training program at the Hazard Community and Technical College.¹ All 28 graduates had jobs lined up or were entertaining several job offers. Although this is just one program, it does demonstrate that progress can be made in addressing the longer-run workforce development issues our country faces.

The Federal Reserve, through its Community Development function, has a role to play in easing such regional transitions. By objective analysis, we can help measure the scope of the problems communities in transition face, determine how best to scale up small, effective programs, and evaluate the pros and cons of alternative approaches and policies.

Monetary policy has an important role to play in fostering conditions to ensure that the economy achieves an enduring economic expansion. This economic stability will help those demographic groups – minorities, older workers, lower-income people – who are disproportionately harmed by economic downturns. But monetary policy cannot directly affect longer-run workforce development problems, and from the vantage point of our dual-mandated goals, I believe we are at maximum employment.

Inflation

The other part of the Fed's dual mandate is price stability. Inflation has been running below the Fed's target of 2 percent for quite a while, but it has picked up over the past year. I believe the conditions are in place for a gradual increase in inflation back to 2 percent over the next couple of years. The current low inflation rate partly reflects the effects of earlier declines in the price of oil and other commodities, as well as the appreciation of the dollar, which has held down import prices. As these effects have worked

¹ The program is part of Kentucky's Hiring Our Miners Everyday, or H.O.M.E., program, which is housed within the Eastern Kentucky Concentrated Employment Program and is funded by an emergency grant from the U.S. Department of Labor.

themselves through, headline PCE and CPI inflation, measured year-over-year, have moved up from the very low levels recorded last year to around 1 percent in recent months. To get a better sense of the underlying trend in inflation, economists often look at other measures of inflation that smooth through or strip out some of the more volatile components. These include core PCE inflation and trimmed-mean PCE inflation, which are both at 1.6 percent and gradually nearing the 2 percent goal, as well as core CPI inflation and median CPI inflation, which are now over 2 percent. Indeed, the Cleveland Fed median CPI measure has been above 2-1/4 percent all year, and at or above 2-1/2 percent for the past four months.²

Stable long-run inflation expectations are an important component of inflation dynamics. We look at a number of different indicators of inflation expectations. Some are based on surveys of consumers and of professional forecasters; others are based on financial market data. The Cleveland Fed's expectations measure of five-year inflation, five years from now, which combines survey and market data, has been stable this year, in a range of 1-3/4 to 2 percent.³

Reasonably stable long-run inflation expectations, evidence that inflation is moving up, continued strength in the labor market, and growth expected to be at or slightly above trend all suggest that inflation is on a path of gradually returning to our 2 percent goal over the next couple of years.

Regional growth and labor markets

Before I turn to the implications of the economic outlook for monetary policy, let me talk about our regional economy. The Cleveland District comprises all of Ohio, western Pennsylvania, eastern Kentucky, and the northern panhandle of West Virginia. Our regional economy is quite diverse, but the

² The Cleveland Fed's median CPI inflation rate is available at <https://clevelandfed.org/our-research/indicators-and-data/median-cpi.aspx>.

³ The Cleveland Fed's inflation expectations measure is available at <https://clevelandfed.org/our-research/indicators-and-data/inflation-expectations.aspx>.

path of economic expansion here and the outlook are similar to the nation's. To be sure, our region tends to be more dependent on manufacturing than other parts of the country. For example, manufacturing accounts for 15 percent of private-sector jobs in Ohio compared to about 10 percent in the U.S. as a whole. So the region has borne the brunt of the weakness in manufacturing. Similarly, the region had enjoyed the benefits of a sharp increase in production and employment in the oil and gas extraction sector as new technologies were brought to bear, but the sharp drop in oil prices since mid-2014 has resulted in a significant slowdown in natural gas and oil exploration in the Marcellus and Utica shale regions, which include northern Ohio and western Pennsylvania. The weakness in the energy sector is expected to persist somewhat longer, and the longer-term shift away from coal as a source of energy will have lasting effects on the coal-producing parts of the region that have not diversified their economies.⁴

On the other hand, the region has benefited from the strength in auto sales, construction, and the service sector, including health and education. We are seeing a modest pickup in regional manufacturing, particularly in firms that are more focused on domestic markets and the auto sector. The auto industry represents a significant share of manufacturing in Ohio and Kentucky, and over the past few years, District auto plants have produced about 17 percent of the nation's autos and light trucks. As auto sales have risen to record levels, regional production has risen as well. Our contacts in the District's auto sector remain optimistic, even though the record sales pace is leveling off.

Housing markets in the region have shown improvement over time. During the housing boom, we didn't see the sharp increases in home prices experienced in other parts of the country. But we did suffer from

⁴ For further discussion of trends in the energy, steel, and auto sectors in the Cleveland Federal Reserve District, see Mark E. Schweitzer, Robert Sadowski, and Christopher Vecchio, "Three Trends Influencing the Region's Growth," *Forefront*, Federal Reserve Bank of Cleveland, January 15, 2016, available at <https://www.clevelandfed.org/newsroom-and-events/publications/forefront/ff-v6n03/ff-20160115-v6n03-three-trends-influencing-the-regions-growth.aspx>.

the housing bust with a large number of foreclosures and vacant properties. The situation has improved. Residential real estate prices in Ohio are now increasing in the 3-1/2 to 4 percent range, with the usual variation across local markets. And according to the Cleveland Fed's Community Stabilization Index, communities across the Fourth District experienced increased housing market stability in 2015, with mortgage delinquencies and foreclosure rates down.⁵ Residential builders tell us they are optimistic that regional housing markets will continue to strengthen.

Like the nation, our region has seen considerable improvement in labor markets since the start of the recovery. In Ohio, the unemployment rate peaked at 11 percent in December 2009, and is now down to 4.7 percent. This is near the national average and quite a bit lower than the near 6 percent average Ohio experienced during the last expansion. Since the start of the recovery, Ohio has had a net gain of a half million jobs, and payrolls have now surpassed their previous peak by more than 1 percent. People have been reentering the work force, and over the past year, payroll employment has risen nearly 1-1/2 percent in Ohio – a net addition of 78,000 jobs. Job growth here is somewhat slower than the national pace of 1-3/4 percent, but we are doing considerably better than during the previous expansion, when employment in Ohio was essentially flat.

This is all good news. But like the nation, the regional economy also faces longer-run challenges regarding investments in human and physical capital, as well as low levels of population growth and business formation. These challenges will need to be addressed if we are to remain a region with a healthy economy.

⁵ The Cleveland Fed's Community Stabilization Index is a composite index that provides a relative measure of local housing market conditions at the ZIP code level, with a particular focus on recovery potential. It is available at <https://www.clevelandfed.org/en/community-development/community-stabilization-index.aspx>.

Monetary Policy

Let me now turn to monetary policy by first laying some groundwork. The theory and practice of central banking provides several lessons for monetary policymakers. First, policymakers should be forward-looking because monetary policy affects the economy with long and variable lags. This means policy actions need to be taken *before* our policy goals are fully met, based on the economic outlook over the medium run and the risks around that outlook. Second, policymakers should strive to be consistent in how they respond to economic conditions and to effectively communicate the rationale for their decisions. This helps the public form expectations about the future path of policy and raises public confidence in the policy itself. Third, policymakers should always remain humble about what they know about the economy and how monetary policy can affect it. There is uncertainty around the outlook, around the monetary policy transmission mechanism, and around underlying structural aspects of the economy, such as the longer-run levels of the unemployment rate, trend output growth, structural productivity growth, and equilibrium interest rates. Policymakers need to recognize that it is possible for the structure of the economy to change, but they should not throw out all that's been learned from past experience or be led astray by thinking this time is completely different.

As I mentioned earlier, last week, the FOMC decided to keep the target range for the federal funds rate at 1/4 to 1/2 percent. In the Committee's view, the case for an interest rate increase has strengthened but it decided for the time being to wait for further evidence of continued progress toward the dual-mandate objectives. According to the new projections, FOMC participants continue to anticipate that a gradual upward path of the policy rate will be appropriate over the next three years. But the consensus view was that it was better not to take the next step on that path in September.

I, and two of my FOMC colleagues, dissented from that decision, preferring to see a 25-basis-point increase in September. All participants on the FOMC share the same objective – setting monetary policy

to promote our longer-run goals of maximum employment and price stability – even if we disagree from time to time on the best way to achieve those goals.

In my view, economic developments have corroborated the Committee's medium-run outlook that labor markets will continue to show strength, that growth will rebound to a pace at or slightly above trend, and that inflation will gradually rise to our 2 percent target. We have seen sustained improvement in the labor market, which is now basically at full employment from the standpoint of what monetary policy can do, and inflation has moved up over the past year. The risks that have concerned the Committee, including the volatility in financial markets at the start of the year, economic weakness abroad, and the aftermath of the U.K. vote to leave the European Union, have subsided, and the economic expansion has proved to be resilient.

I view another small step on the gradual upward path as appropriate, not because I want to curtail the expansion, but because I believe gradually moving rates up as we continue to make progress on our goals will help prolong the expansion. It is also consistent with the policy communications we have been issuing for quite a while. I note that the gradual path I'm anticipating means that policy will remain accommodative for some time, continuing to lend support to the economic expansion going forward. The gradual path will also allow us to recalibrate policy over time as we gain more insights into the underlying structural aspects of the post-crisis economy.

Now, one can always say it's better to wait for more information before making a move, and a cautious approach has served us well so far during the expansion. But there are also risks to delaying for too long. If we continue to delay even as we make further progress on our inflation goal and labor markets continue to tighten, we risk having to undertake a considerably steeper policy path later on. Such a strategy is inconsistent with what we have been communicating; it risks confusing the public about our policy rationale and undercutting the credibility of Fed communications. This would cause problems for future

policymaking. In addition, if we delay too long and then find ourselves in a situation where the labor market becomes unsustainably tight, price pressures become excessive, and we have to move rates up steeply, we could risk a recession, a bad outcome that history tells us disproportionately harms the more vulnerable parts of our society. I think we also have to recognize that if we fail to exit gracefully from the nontraditional policy actions we took in the aftermath of the crisis – actions I thought were necessary and effective – we could jeopardize their use in the future, should the need arise again.

For these reasons, I favor taking the next step on the gradual path of rising interest rates. The lesson that policy should be forward looking is based on the history of poor outcomes when that strategy hasn't been followed. In the face of evidence that the economy is on track to meet our goals over the medium run, sometimes being prudent means moving the policy rate up.

Conclusion

Two years ago in one of my first media interviews after becoming president of the Cleveland Fed, I was asked where I saw myself on the avian spectrum – would I be a dove, who would tend to favor low interest rates, or a hawk, who would tend to favor higher interest rates. My answer was that I'd prefer not be thought of as either; instead, my hope was to be viewed as an owl. Of course, that's not up to me to decide – being thought of as an owl is my aspiration. But what I can do and will continue to do is explain to the public my view of economic conditions, the economic outlook, and the rationale for my policy decisions. I view this as an essential part of Fed communications so that the public can hold us accountable for our policy decisions. I hope that you and our other regional contacts will continue to generously provide the Cleveland Fed with your perspectives on the regional economy. This regional information plays an important role in helping us to set national monetary policy in pursuit of the Federal Reserve's longer-run goals of price stability and maximum employment for the benefit of the public.