# The Outlook for the Economy and Monetary Policy

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

**The Chicago Council on Global Affairs**
**Chicago, IL**

**May 8, 2017**

**Introduction**

I thank the Chicago Council on Global Affairs for this opportunity to speak about the economy and monetary policy. I was very pleased to receive this invitation from Michael Moskow. I have known Michael for quite a while now, having seen him in action around the FOMC table when he was president of the Chicago Fed and I was the director of research at the Philadelphia Fed. Michael personified what's best about the FOMC's collegial atmosphere. He was able to explain his thinking, listen to alternative views, and then persuade others about the appropriate path forward. Michael's last FOMC meeting was on August 16, 2007. It was the second unscheduled conference call that month and the FOMC discussed the profound deterioration in credit market conditions. Of course, we all know what happened to the economy after that. It is common knowledge that Michael stepped down as Chicago Fed president because he had reached the official term limit, but I'm now wondering if the timing might also reflect his very keen ability to forecast the future.

As everyone in this room knows, economic forecasting is both science and art. Today, I will discuss my outlook for the 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 economic expansion turns eight years old next month. It got off to a slow start from a very weak place, but now this expansion is one of the longest on record. While the quarterly pattern has had its share of ups and downs, output growth has maintained a moderate pace of a bit more than 2 percent, on average, over the expansion. The sustainability of the expansion through various economic shocks is a testament to the U.S. economy's resiliency. While some of the recent readings on real activity have been soft, it is normal to see variability in the monthly and quarterly data.

In my view, the underlying fundamentals supporting continued expansion remain sound. These fundamentals include accommodative monetary policy and financial conditions, improved household balance sheets, and strength in the labor market that has led to increases in personal income. In addition, although geopolitical risks remain, global economic conditions have improved. Supported by accommodative monetary policy, the recovery in Europe has gained traction, with unemployment rates down and inflation moving up, and the slowdown in the Chinese economy has been more orderly and moderate than what some had feared early last year.

While there are upside and downside risks around my forecast, my modal outlook is that over the next year, 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, and the unemployment rate will move further below its longer-run level, which I estimate to be about 5 percent. With appropriate adjustments in monetary policy, I believe the conditions are in place for a sustained return over the next year or so to our symmetric goal of 2 percent inflation. Let me put this outlook into context.

***Economic growth***

Despite the strong fundamentals, GDP growth in the first quarter was weak. At this point, I'm not taking much of a signal about future growth from that reading; there are reasons to think this was a transitory slowdown. We've seen a pattern over the past several years of weak growth in the first quarter followed by stronger growth in subsequent quarters. So even though the data are adjusted for seasonal effects, there appears to be some residual seasonality in the GDP data.[1]

The unseasonably warm weather early in the year appears to have weighed on growth, shifting spending from one quarter to another. For example, after growing strongly in the fourth quarter of last year,

[1] See Kurt G. Lunsford, "Lingering Residual Seasonality in GDP Growth," *Economic Commentary*, Federal Reserve Bank of Cleveland, Number 2017-06, March 28, 2017, and Glenn D. Rudebusch, Daniel Wilson, and Tim Mahedy, "The Puzzle of Weak First-Quarter GDP Growth," *Economic Letter*, Federal Reserve Bank of San Francisco, 2015-16, May 18, 2015.

consumer spending, which makes up about two-thirds of U.S. output, decelerated in the first quarter in part because the warm weather led to lower spending on utilities. It is usually a good idea to average through some of these ups and down when trying to detect the underlying trend. Readings on consumer sentiment and confidence remain high, but more important for spending, personal incomes are growing. So the softness in the first quarter hasn't changed my medium-run outlook, and I expect a rebound in consumer spending over the rest of the year.

The housing sector continues to gradually improve. Despite a rise in mortgage rates, demand for housing is increasing, and in some places, supply has not kept pace with demand. The months' supply of existing homes on the market has fallen to under four months, its lowest level since early 2005. Business contacts report that, in some cases, it has been difficult to find construction workers to build new supply. The mismatch between supply and demand is putting upward pressure on home prices, which are rising at about a 6 percent pace, on average, nationally.

It shouldn't be too surprising that the housing recovery has been a moderate one. The housing boom and crash are not something anyone wants to repeat. It took some time for household balance sheets and the labor market to recover to a point where households were confident enough to take on mortgage debt again. Borrowers are being careful not to take on more debt than they can handle, and lenders are extending credit, but to those with good credit quality. Multifamily housing activity has picked up more than single-family housing. Going forward, the mix between multifamily and single-family housing may differ from what it has been in the past, as both younger people and empty-nesters are drawn to urban environments, and some prefer to rent rather than buy. Overall, I expect activity in the sector to continue to expand at a sustainable pace.

Business activity and investment are starting to strengthen after being quite subdued last year and through much of the expansion. The sizable drop in oil prices from over $100 per barrel in mid-2014 to around $30 in early 2016 led to a sharp pullback in the drilling and mining sectors and their suppliers. The 20 percent appreciation of the dollar from mid-2014 to the end of 2015 hurt manufacturers and other firms dependent on exports. But since then, conditions supporting business spending have improved. Oil prices began to firm in early 2016 and have been roughly stable near $50 per barrel since then, and the dollar has appreciated only modestly, on net, over the past year. In addition, the firming in global economic growth has increased demand for U.S. exports.

U.S. business sentiment is at a very high level, but it has not translated into a surge in activity. Nonetheless, we are starting to see a pickup in business spending, driven by the improvement in underlying economic conditions. This gives me some confidence in positive momentum even if there is some downward adjustment in expectations going forward. Mining activity has increased: the number of active oil drilling rigs remains well below the level seen before the oil price drop, but has roughly doubled over the past year. National and regional manufacturing surveys suggest an improvement in activity and capital spending plans even if overall sentiment has been tempered. Even though motor vehicle production softened in March, manufacturing production was higher in the first quarter compared to the fourth quarter and compared to a year ago. This is particularly good news for the Cleveland Fed and Chicago Fed Districts, which have a higher share of employment in manufacturing compared to the nation. Both regions felt the brunt of the cyclical pullback in manufacturing, as well as the longer-run shift from manufacturing to services.[2] Contacts in the Cleveland Fed District tell us that even if some of the proposals for tax reform, health insurance, infrastructure spending, and regulatory changes are delayed, they expect the business environment to remain positive and that this will translate into further increases in business spending and hiring.

I would welcome a pickup in business investment in plant, equipment, and research and development because investment is an important factor influencing underlying productivity growth. Structural

[2] The Cleveland Fed District includes Ohio, western Pennsylvania, eastern Kentucky, and the northern panhandle of West Virginia. The Chicago Fed District includes all of Iowa and most of Illinois, Indiana, Michigan, and Wisconsin. Manufacturing employment is 8.5 percent of total payroll employment in the U.S. and 12 percent of total payroll employment in these nine states; these states account for 32 percent of U.S. manufacturing employment.

productivity growth – how effectively the economy combines its labor and capital inputs to create output – is a key determinant of an economy's longer-run growth rate, the standard of living of its people, and wage growth. And productivity growth depends on factors like investment in human and physical capital and R&D that yields innovative products and processes.

Over the past five years, labor productivity, measured by output per hour worked in the nonfarm business sector, has grown at an annual rate of only about a half of a percent; over the entire expansion it has averaged 1 percent. This is a step down from the 2-1/4 to 2-1/2 percent pace seen over the prior two expansions. Some of the slowdown in productivity growth likely reflects the difficulty in measuring productivity in the service sector, including health care, intellectual property, and information technology, which is becoming a larger share of the U.S. economy. Some of the slowdown is likely cyclical, reflecting persistent effects of the Great Recession. Indeed, it took a long time for investment in physical and human capital, key determinants of productivity growth, to emerge during this expansion.

As the expansion continues and investment expands, it is reasonable to assume that the cyclical impediments will abate and we'll see somewhat stronger productivity growth. This assumption underlies my expectation that longer-run growth will be 2 percent. But, in addition to measurement and cyclical issues, structural factors are likely weighing on productivity growth, as well. Monetary policy cannot address these structural issues, but other government policies, if they are well-designed and focused on spurring productive investments in human and physical capital, R&D, and innovation, would be helpful, and could, with sufficient time, lead to a somewhat higher longer-run growth rate.[3]

Another important determinant of long-run growth is growth in the labor force. U.S. demographic factors, including the aging of the population and a lower birth rate, especially if coupled with restrictions on immigration, suggest that labor force growth will be considerably slower than it has been in recent

[3] See the discussion in Loretta J. Mester, "A Serenity Prayer for Monetary Policymakers," remarks at the Global Interdependence Center Central Banking Series, Singapore, February 20, 2017.

decades. This means longer-run growth will likely remain lower than the 3 to 3-1/2 percent rate seen over the 1980s and 1990s.[4]

Indeed, the downward trend in the labor force participation rate is one of the factors we consider when assessing the condition of the labor market. So let me discuss labor market developments now.

***Labor markets***

In 2016, the economy added over 2.2 million jobs, about 187,000 jobs per month on average. Over the first four months of this year, firms sustained that pace, with a monthly average gain of 185,000 jobs. This is a slower pace than in the two expansions in the 1980s and 1990s.[5] But it's important to remember that because trend labor force participation is lower, trend employment growth is also lower. Indeed, estimates of trend employment growth range from around 75,000 to 120,000 per month, depending on the precise assumptions one makes about labor force participation. So the recent employment growth numbers are well above trend.

As the economy has added jobs, the unemployment rate has moved down. It stood at 4.4 percent in April, less than half its peak of 10 percent in late 2009 and at the lowest reading achieved in the previous expansion. Although payroll job growth is likely to slow a bit from its current pace given the progress that has already been made in the labor market, I expect the pace will be sufficient to keep the unemployment rate below my estimate of its longer-run rate of 5 percent over the next two years.

Other gauges of the under-utilization of labor have also improved significantly. For example, the broader U6 measure of unemployment, which includes the number of part-time workers who would rather work

[4] The Congressional Budget Office currently estimates that potential GDP growth averaged 3.4 percent per year over 1982-1990 and 3.3 percent per year over 1991-2001; it projects that potential growth will average 1.8 percent per year over 2017-2027. See Congressional Budget Office, *The Budget and Economic Outlook: 2017 to 2027*, January 2017.

[5] Payroll job gains averaged nearly 230,000 per month over the December 1982-July 1990 expansion and about 200,000 per month over the April 1991-March 2001 expansion.

full time and the number of people who have been discouraged from looking for a job, has fallen to its lowest level since late 2007. In addition, the labor force participation rate has been essentially stable for the past three years. So relative to the downward trend, the stability we've seen in participation is actually another sign of strength in the labor market.

For much of the expansion, wage growth has been subdued compared to what we've experienced in other expansions. Partly this reflects slow productivity growth.[6] Still, we have seen a gradual acceleration in wages over time as labor market conditions have strengthened. For some time we have heard from our labor and business contacts across a broad set of industries that firms are having trouble finding qualified workers, both in high-skill occupations and in lower-skill jobs. More and more of these firms are responding by raising wages and offering other benefits to attract and retain workers. Contacts in the Cleveland Fed District expect wage increases to average about 3 percent this year, with significantly higher increases expected for highly skilled workers. These anecdotal reports are showing through to the wage data, where measures such as the employment cost index and average hourly earnings have accelerated from earlier in the recovery. This is a welcome state of affairs. As one of the characters in Beethoven's opera "Fidelio" sings: "If you haven't money by you, happiness is hard to find...But when it jingles round your pockets fate is at your mercy."

On balance, we've seen a sustained cyclical recovery in labor markets since the Great Recession. There are some longer-run structural issues that the country must tackle, such as making sure people have access to the training and development needed for the jobs in the modern economy. But from the standpoint of the cyclical conditions that monetary policy can address, I believe we have achieved the maximum employment part of the Fed's monetary policy mandate.

---

[6] Although actual wage setting is a complicated process, in economic models of competitive markets, real wages reflect the marginal product of workers. For a discussion of wages and their relationship to productivity growth over the expansion, see Roberto Pinheiro and Meifeng Yang, "Wage Growth after the Great Recession," *Economic Commentary*, Federal Reserve Bank of Cleveland, March 21, 2017.

***Inflation***

The other part of the Fed's dual mandate is price stability. Consistent with meeting this part of the mandate over the longer run, the FOMC has set a goal of 2 percent inflation, as measured by the year-over-year change in the price index for personal consumption expenditures, that is, PCE inflation. Most people understand why high inflation is a problem: it erodes the purchasing power of their money. But inflation that is too low is also a problem: it can lead consumers and businesses to delay purchases, thereby slowing the economy, and it increases debt burdens.

For some time, inflation has been running below the Fed's 2 percent goal, but over the past two years, inflation has been moving up. In March, we saw a decline in readings on consumer price inflation. But I'm taking little signal about the future path of inflation from those numbers. They partly reflected some one-off changes, such as the decline in prices for cell phone service plans, and they came after strong readings in January and February. Measured year-over-year, headline PCE inflation stood at 1.8 percent in March, up from under 1 percent a year ago.

In determining where inflation is relative to our goal, we need to look through transitory movements in the numbers, both those below and those above our goal, and focus on where inflation is headed and where it will be maintained on a sustained basis. The inflation rate over the longer run is primarily determined by monetary policy, but we know that we can't keep actual inflation at 2 percent at each point in time; inevitably shocks hit the economy and the inflation numbers move, sometimes below our goal and sometimes above. Still, we want to take actions to keep inflation from running either persistently below or persistently above 2 percent. In other words, our goal is symmetric – it isn't a ceiling – and we aim to keep inflation at 2 percent on a sustainable basis.

With appropriate adjustments in monetary policy, I believe the conditions are in place for a sustained return over the next year or so to our symmetric goal of 2 percent inflation. These conditions include the firming in inflation that we've seen over time, reasonably stable inflation expectations, continued strength in the labor market, and growth expected to be at or slightly above trend.

**Monetary Policy**

Appropriate adjustments in monetary policy are those that will sustain the expansion so that our longer-run goals of price stability and maximum employment are met and maintained. In my view, we have met the maximum employment part of our mandate and inflation is nearing our 2 percent goal. Although we live in a high-frequency world, we cannot overreact to transitory movements in incoming data; our policymaking has to focus on what changes in economic and financial conditions imply for the medium-run outlook and risks around the outlook.[7]

If economic conditions evolve as anticipated, I believe further removal of accommodation via increases in the federal funds rate will be needed. In March, the FOMC raised the target range for the fed funds rate by one-quarter percentage point to 3/4 to 1 percent, and last week, the FOMC decided to maintain this range. Both decisions are consistent with the gradual upward path of interest rates that the Committee has indicated for some time is likely to be appropriate to achieve and maintain our objectives, should the economy evolve as anticipated. This upward policy path will help prolong the expansion, not curtail it. It will help avoid a build-up of risks to macroeconomic stability that could arise if the economy is allowed to overheat and risks to financial stability, should overly low interest rates encourage investors to take on excessively risky investments in a search for yield. It will put monetary policy in a better position to address whichever risks, whether to the upside or downside, are ultimately realized.

Given my outlook, I don't believe that removing accommodation calls for an increase in the fed funds rate at each meeting, but I do anticipate more than the one-increase-per-year seen in the past two years. In

[7] See the discussion in Loretta J. Mester, "The Outlook for the Economy and Monetary Policy: Low-Frequency Policymaking in a High-Frequency World," remarks to the New York Association for Business Economics, New York, NY, April 1, 2016.

addition, I think that it's important for the FOMC to remain very vigilant against falling behind as we continue to make progress on our goals, especially given the low level of interest rates and the large size of our balance sheet. We know that monetary policy affects the economy with long and variable lags, so policy actions have to be taken before our policy goals are fully met. If we delay too long in taking the next normalization step 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. This is a bad outcome that disproportionately harms the more vulnerable parts of our society.

In addition to removing accommodation by raising interest rates, we also have to consider the Fed's balance sheet. To address the financial crisis and Great Recession, the FOMC undertook several programs to purchase longer-maturity assets. These purchases aimed at putting downward pressure on longer-term interest rates once the FOMC's traditional policy tool, the fed funds rate, had been reduced to effectively zero. As a result of the purchases, the Fed's balance sheet has grown from nearly $900 billion in assets in 2007 to about $4.5 trillion today, and its composition has changed from mainly short-term Treasury securities to mortgage-backed securities and longer-maturity Treasuries.

Normalizing the stance of policy also means taking steps to normalize the balance sheet, and the FOMC recognized this need from the very start of using nontraditional tools. Currently, the FOMC is continuing to reinvest the proceeds of maturing Treasuries and principal payments from agency debt and mortgage-backed securities, essentially maintaining the balance sheet at its very large size. But, as indicated in the minutes of our March meeting, the FOMC is discussing its reinvestment policy, including when and how best to implement a change in reinvestments.[8] Such a change should be done in a way that allows for a

---

[8] The Minutes of the Federal Open Market Committee, March 14-15, 2017, pp. 2-3.

gradual and predictable reduction in the Fed's asset holdings so that over time the balance sheet is reduced to the smallest size needed to implement monetary policy efficiently and effectively.[9]

In my view, if economic conditions evolve as I anticipate, I would be comfortable changing our reinvestment policy this year, with clear communication in advance about how we plan to implement the change. My preference is that once we decide on a plan, we stay with it; the fed funds rate should be our main tool for responding to changes in the outlook during normal times. Because it will take several years to reduce the size of the balance sheet through asset run-off, we can end reinvestments before we have decided on the ultimate size of the balance sheet. This decision is essentially one about our longer-run monetary policy implementation framework: do we want to operate with scarce banking reserves (the so-called corridor system) or abundant reserves (the so-called floor system)?[10] Regardless of which framework is chosen, the Fed's balance sheet will be considerably smaller than it is today.

I view the purchase of longer-term assets as a nontraditional tool that should be reserved for nontraditional times, times when we have lowered our policy rate to near zero and we need to add more monetary policy stimulus because of a deterioration in economic and financial conditions. Ending reinvestments and beginning the journey toward a smaller balance sheet composed mainly of Treasury securities will be a welcome acknowledgment that the economy has entered normal times and policy is transitioning back to normal, too.

**Acknowledging Risks**

In concluding, it's important to remind everyone that there are risks around the economic outlook, and because of that, policy is not pre-set. Policy needs to remain systematic in how it reacts to incoming information relevant to the outlook, but not be dogmatic should the outlook indeed materially change.

---

[9] See "Policy Normalization Principles and Plans," FOMC, September 17, 2014.

[10] The FOMC has undertaken an extended effort to evaluate different frameworks for implementing monetary policy in the long run. See the Minutes of the Federal Open Market Committee, July 28-29, 2015, July 26-27, 2016, and November 1-2, 2016.

In March, the FOMC began providing confidence bands around its economic and policy path projections.[11] These are very good reminders to both the public and to policymakers that there is always a lot of uncertainty around economic forecasts. There's forecast uncertainty because the economy is constantly being buffeted by shocks, data are revised over time, and it isn't clear which model will best predict the future path of the economy.

Today, I view the risks to the real economy and to inflation over the medium run – the time horizon relevant for monetary policy – as roughly balanced and see a gradual reduction in monetary policy accommodation as appropriate. I acknowledge that there are geopolitical risks out there, including tensions in North Korea and the Middle East, but these aren't the kinds of risk that preemptive monetary policy action can mitigate. Still, these types of risk need to be recognized when assessing changes in economic and financial conditions. Indeed, some of the recent downward pressure on long-term interest rates likely reflects some flight-to-quality flows in the face of rising geopolitical tensions, rather than a material re-evaluation of the modal outlook.

In addition, there remains uncertainty around what fiscal and other economic policies might be forthcoming. These include changes to infrastructure spending, regulation, and policies pertaining to taxes, immigration, and trade. When one gauges the effects – both positive and negative – of any forthcoming policy changes on the outlook for growth, employment, and inflation over the short, medium, and longer runs, the devil will be in the details in terms of the size, composition, timing, and financing of such initiatives.

My view that it is appropriate to continue on our gradual path of monetary policy normalization is not dependent on fiscal policy but, instead, is based on my reading of the resiliency in the U.S. economy's

[11] See the confidence band charts in the Summary of Economic Projections portion of the Minutes of the Federal Open Market Committee, March 14-15, 2017.

underlying momentum and the progress we have made on reaching our monetary policy goals of maximum employment and price stability.