Views on the Economy and Monetary Policy

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

The Economic Club of Pittsburgh, the World Affairs Council of Pittsburgh,
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Introduction

I thank the organizers for inviting me to share my views on the economy and monetary policy. This is a very opportune time for me to be here. The Federal Open Market Committee, the monetary policymaking body within the Fed, meets in less than two weeks. Traveling to Pittsburgh allows me to hear first-hand from people in this part of the Fourth Federal Reserve District, which comprises western Pennsylvania, Ohio, eastern Kentucky, and the northern panhandle of West Virginia. Of course, as an economist, I look at data and economic models to help formulate my views, but the information on emerging issues that the Cleveland Fed staff and I gather directly from contacts throughout the District is also very important in assessing how the economy is doing. The FOMC spends considerable time discussing regional economic conditions at our meetings, and this information from all across the country helps us set national monetary policy.

In addition to providing an opportunity to hear from you, my talk today also lets me explain my views on monetary policy. Congress has given the Fed its monetary policy goals of maximum employment and price stability. At the same time, Congress has also wisely granted the Fed independence in setting monetary policy in pursuit of those goals, meaning that policy decisions are insulated from short-run political considerations. But accountability must go hand in hand with that independence. I call this “accountable independence.” In order for the public and Congress to have the information they need to hold the Fed accountable for monetary policy decisions, it is important for Fed policymakers to regularly communicate their views. So I value this time with you today.

At this point, it is probably a good idea to remind people that the views I’ll provide 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

The economic expansion is now in its ninth year, one of the longest on record. But as everyone knows, age does not always indicate maturity. It's good to remember that the economy had to climb out of a very deep hole after the financial crisis and Great Recession, and it took some time for the expansion to gain traction. Of course, there have been some ups and downs along the journey. Our thoughts are with the people in Texas and along the Gulf Coast, and all those coping with the destruction in the wake of Hurricane Harvey. We are gathering information from our contacts, but it is still too early to assess the full economic impact of the storm. Experience suggests that soon after the storm passes, clean-up and rebuilding begin, oil refineries are assessed and brought back on-line, and shipping channels reopen. These are huge undertakings and I expect we will see fortitude and resilience as this hard work proceeds. One help is that the underlying fundamentals supporting the economy remain sound. These fundamentals include accommodative monetary policy and financial conditions, a stronger U.S. banking system, improved household balance sheets and income growth, continued strength in the U.S. labor market, and improving conditions in the economies of our trading partners.

Economic growth

Over the expansion, output growth has maintained a moderate pace of a bit more than 2 percent, on average, and I anticipate that GDP will expand over the next year or so at a pace somewhat above trend, which I estimate at 2 percent. The hurricane in the Gulf will likely dampen economic activity in the current quarter, with subsequent rebuilding efforts adding to growth in subsequent quarters. Although storms like Harvey and Irma are atypical – thank goodness – quarterly variation in the data is not unusual. Consumer spending, which makes up over two-thirds of output, slowed in the first quarter but picked up in the second quarter. The outlook for household spending remains sound. Readings on consumer sentiment and confidence remain high, but more important for spending, personal incomes are growing because labor markets continue to improve. Household balance sheets are in much better shape since the Great Recession, reflecting a combination of deleveraging and increased savings, coupled with cumulative increases in stock and house prices. Although not true for every homeowner, in the aggregate, the equity households have in housing is now back to what it was at the peak.

The recovery in the housing market has taken some time. Buyers, sellers, developers, and bankers were all wary about reentering the market, and rightfully so, given the fallout from the housing bust. But with support from low interest rates and the improved financial condition of households and lenders, we've seen a gradual increase in housing construction and sales over the expansion. In some places, demand for housing is outpacing supply, putting upward pressure on home prices, which are rising at about a 6 percent pace, on average, nationally.[1] Overall, I expect activity in the housing sector to continue to expand at a sustainable pace.

An encouraging sign in the economy is the strengthening in business activity and investment this year, after subdued readings in 2015 and 2016. In recent years, oil prices and the value of the dollar have been important influences on business spending. You'll recall that there was a sharp drop in oil prices from over $100 per barrel in mid-2014 to around $30 in early 2016. This led to a sharp pullback in activity in the mining and drilling sector and its suppliers, including the steel industry. At the same time, a sharp 20 percent appreciation of the dollar hurt manufacturers and other firms dependent on exports. Since then, conditions supporting business spending have improved. The rebound in oil prices to around $50 per barrel and the rise in natural gas prices have spurred a strong recovery in mining and drilling activity. The modest appreciation in the dollar over the second half of 2016 and depreciation since the start of this year reflect improved conditions in the economies in our trading partners. This has led to a pickup in U.S. manufacturing activity and in our exports to other countries.

[1] As has been typically the case, house prices in the Pittsburgh metropolitan area are growing less rapidly than the national average, in the 3 to 4 percent range.

Currently, business sentiment remains at high levels and supportive of continued spending, but some of my business contacts report that mounting political and fiscal policy uncertainty has begun to temper some of that optimism. There are scattered reports from a few firms that they are delaying some of their planned investment until the picture becomes clearer. We'll need to keep a watch on whether this wait-and-see attitude spreads and begins to weigh more broadly on spending and investment decisions.

A pullback on investments in physical and human capital or in research and development leading to innovations would be particularly troubling because these investments can have a positive effect on productivity growth, which measures how effectively the economy combines its labor and capital inputs to make output. Productivity growth is a key determinant of an economy's longer-run output growth and of living standards. But the U.S. economy has been struggling with very low productivity growth. Over the expansion, annual growth in labor productivity, measured by output per hour worked in the nonfarm business sector, 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. Low productivity growth, coupled with slower growth of the labor force, helps to explain why the trend economic growth rate, which I estimate at 2 percent, is lower than the 3 to 3-1/2 percent rate seen over the 1980s and 1990s. It also helps to explain why the acceleration in wages since 2013 has been relatively subdued despite the strength we've seen in labor markets and reports of shortages of qualified workers in many occupations.

Labor markets

As the economic expansion has progressed, firms have been adding people to their payrolls. So far this year, job increases have averaged 176,000 per month, a bit under last year's pace. This rate exceeds most estimates of trend employment growth, which fall in the range of 75,000 to 120,000 per month. The unemployment rate peaked at 10 percent after the Great Recession, but as the economy has added jobs at an above-trend pace, the unemployment rate moved down. For the past five months, the unemployment rate has stabilized, with monthly readings bouncing between 4.3 and 4.4 percent; the rate is now essentially at the lowest level reached during the last expansion. Of course, to gauge labor market conditions, we look at more than payroll employment growth and this headline measure of the unemployment rate. We examine a broad set of indicators, including job opening and turnover rates, and broader measures of the unemployment rate, such as those that include 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. These measures also indicate that substantial progress has been made in the labor market. Although we may see a weaker payroll employment number for September due to the hurricane, I expect that labor market conditions will remain healthy and that over the next year the unemployment rate will stay below 4-3/4 percent, my current estimate of its longer-run rate.

Granted, there is considerable uncertainty around estimates of the longer-run unemployment rate. The relatively modest acceleration in wages, from under 2 percent earlier in the expansion to 2-1/4 to 2-1/2 percent in recent quarters, suggests to some that there is still considerable slack in labor markets and that the longer-run unemployment rate is lower than the current rate. For me, a more salient factor in the relatively slow growth in wages is the low level of productivity growth.[2] Firms have indicated that there isn't much slack in the labor market, and we are hearing more frequent reports from our labor and business contacts across a broad set of industries that businesses are having trouble finding qualified workers, both in high-skill occupations and in lower-skill jobs. Some of these firms report they are responding by raising wages and offering other benefits to attract and retain workers. These increases should eventually find their way into the aggregate compensation measures, but unless productivity growth picks up, I wouldn't expect to see a strong acceleration in wages.

[2] 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," Federal Reserve Bank of Cleveland, *Economic Commentary*, March 21, 2017 (https://www.clevelandfed.org/newsroom-and-events/publications/economic-commentary/2017-economic-commentaries/ec-201704-wage-growth-after-great-recession.aspx).

So my assessment is that from the standpoint of the cyclical conditions that monetary policy can address, we have achieved the maximum employment part of the Fed's monetary policy mandate. At the same time, there are some longer-run structural issues in the labor market that cannot be addressed by monetary policy but that the country must tackle. Technological advances and globalization are changing the nature of available jobs and the skill sets needed to perform those jobs. While the overall economy will eventually benefit from these forces, many individuals and some regions are adversely affected by these structural trends. Government policies and programs and public-private partnerships can and should be brought to bear to help people gain the skills needed for jobs in the modern economy and to help communities make the transition. This is already happening in Pittsburgh. The Allegheny Conference on Community Development has published an in-depth analysis of the expected supply and demand for labor in the Pittsburgh region over the next decade and has made a number of recommendations to help the region prepare for the coming changes.[3] The study drew on some of the work being conducted by the Federal Reserve System's community development function. In October, the Fed will hold a capstone conference on a collaborative initiative that has focused on reframing workforce development efforts as investments, allowing for larger-scale solutions with increased accountability for outcomes.[4]

Inflation

Price stability is the other part of the Fed's mandate. Inflation has had its ups and downs over the expansion. It has moved up from the very low levels seen in 2015, when it was held down by falling oil and import prices. But the last couple of readings were on the weak side and inflation continues to run

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[3] "Inflection Point: Supply, Demand and the Future of Work in the Pittsburgh Region," report prepared by Burning Glass Technologies and the Council for Adult and Experiential Learning with Allegheny Conference on Community Development, May 2016 (http://www.alleghenyconference.org/wp-content/uploads/2016/08/InflectionPoint.pdf).

[4] The initiative, "Investing in America's Workforce: Improving Outcomes for Workers and Employers," is a Federal Reserve System initiative in collaboration with the John J. Heldrich Center for Workforce Development at Rutgers University, the Ray Marshall Center of the Lyndon B. Johnson School of Public Affairs at the University of Texas, and the W.E. Upjohn Institute for Employment Research. The capstone conference will be held on October 4-6, 2017 in Austin, Texas. More information on the initiative and the conference is available at https://www.investinwork.org/.

below the Fed's goal of 2 percent. The year-over-year increase in PCE inflation stood at 1.4 percent in July, up from about 1 percent a year ago. 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 and it increases debt burdens, either of which could slow the economy.

In assessing where we are relative to the inflation goal, it's always a good idea to look through temporary movements in the numbers, both those above and those below our goal, and focus on where inflation is going on a sustained basis. For example, when assessing the underlying trend in inflation, we should look through a temporary increase in gasoline prices stemming from disruptions caused by Hurricane Harvey. Similarly, some of the weakness in recent inflation reports reflects special factors, like the drop in the prices of prescription drugs and cell phone service plans earlier in the year. It may take a couple more months for these factors to work themselves through, but these types of price declines aren't signaling a general downward trend in consumer prices from weak demand. Instead, they reflect supply-side factors and relative price changes. At the same time, we need to recognize that weak inflation numbers, no matter what the source, can become a problem if they start to undermine the public's expectations about future inflation. If inflation expectations were to become unanchored and began steadily declining, it would be much more difficult to raise inflation back to the Fed's goal.

I don't expect the economy to get to that point, and my current assessment is that inflation will remain below our goal for somewhat longer but that the conditions remain in place for inflation to gradually return over the next year or so to our symmetric goal of 2 percent on a sustained basis. These conditions include growth that's expected to be at or slightly above trend, continued strength in the labor market, and reasonably stable inflation expectations.

We need to recognize that there are risks around any inflation projection – both upside risks, considering the current and future expected strength in labor markets, and downside risks, given the softness in recent inflation readings. In fact, inflation is difficult to forecast: based on historical forecast errors over the past 20 years, the 70 percent confidence range for forecasts of PCE inflation one year ahead is plus or minus 1 percentage point,[5] and a significant portion of the variation in inflation rates comes from idiosyncratic factors that can't be forecasted.[6] Indeed, since the 1990s, assuming that inflation will return to 2 percent over the next one to two years has been one of the most accurate forecasts. In the recent period, this is perhaps a testament to the importance of well-anchored inflation expectations and of the FOMC's commitment to its 2 percent symmetric inflation goal. In any case, I will be scrutinizing incoming data on inflation and inflation expectations and the reports from my business contacts to help me assess the inflation outlook.

Economic developments in Pittsburgh

As I mentioned at the start of my talk, evaluating regional economic conditions plays an important role in setting national monetary policy, so let me spend a few minutes discussing the Pittsburgh-area economy. For some time, this region's economy has been transitioning from one that is largely dependent on steel, coal mining, and heavy industry, to one that is diversifying into health care, education, financial services, and technology.[7] This is a promising development because regions that remain dependent on one

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[5] See "Table 2. Average Historical Projection Error Ranges," in the Summary of Economic Projections portion of the Minutes of the Federal Open Market Committee, June 13-14, 2017 (https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20170614.pdf).

[6] See Janet Yellen, "Inflation Dynamics and Monetary Policy," remarks delivered at the Philip Gamble Memorial Lecture, University of Massachusetts, Amherst, September 24, 2015 (https://www.federalreserve.gov/newsevents/speech/files/yellen20150924a.pdf).

[7] Pittsburgh has a higher share of employment in the service-producing sector than does the U.S., and this share has risen over time, from about 71 percent of employment in the 1990s to about 77 percent today. The comparable shares in the U.S. are 64 percent and 71 percent, respectively. The share of employment in the education and health services component of the service sector in Pittsburgh is higher than in the U.S., and it has shown considerable growth over time. In Pittsburgh, this share rose from 17 percent in the 1990s to 21 percent today. The comparable shares in the U.S. are 11 percent and 16 percent, respectively. (Author's calculations using payroll employment data from the U.S. Bureau of Labor Statistics.)

particular industry have fared less well over time than those that have been able to diversify their industrial bases and adapt to changing economic forces. Nonetheless, Pittsburgh's industrial mix and the types of shocks that hit the economy played a role in how the area has fared over the expansion.

The Great Recession took its toll on the region but Pittsburgh was an early achiever in the expansion. In 2012, Pittsburgh was one of the first major U.S. metropolitan areas to see payroll jobs move back up to pre-Great Recession levels. The U.S. as a whole didn't achieve that milestone until mid-2014, and Pennsylvania, not until 2015. The unemployment rate in the Pittsburgh metropolitan area peaked at around 8-1/2 percent in 2010 and had fallen to about 5-1/4 percent by the end of 2014.

But the decline in energy prices and the appreciation of the dollar in 2014 to 2016 took a toll on the region, causing a contraction in energy exploration and production, and steel production. Though job losses in these sectors were offset by continued increases in service-sector jobs, the unemployment rate began to rise.

The good news is that once energy prices and the dollar stabilized, the unemployment rate began falling again to its current level of just over 5 percent, and overall employment began growing again. Certain sectors are still losing jobs, but the pace of job cuts in mining and drilling has slowed and job cuts in manufacturing have stabilized. Losses in these sectors are being more than offset by gains in the service sector, where we see relatively strong growth in scientific R&D jobs in the metro area.

Monetary Policy

As I mentioned earlier, the FOMC will be meeting later this month to discuss the economy and decide on monetary policy. We will also be releasing a new round of economic projections, something we do four times a year. Based on the economic outlook and risks around the outlook, the FOMC has begun to normalize the stance of monetary policy by removing some of the extraordinary accommodation that was necessary in the wake of the financial crisis and Great Recession. Appropriate adjustments in monetary policy are those that will sustain the expansion, not curtail it, so that our longer-run goals of price stability and maximum employment are met and maintained.

Because we know that it takes some time for monetary policy to work itself through the economy, we can't wait until these policy goals are fully met to act. We need to assess what incoming information is telling us about where the economy is going over the medium run, and the risks around that medium-run outlook, and set policy appropriately.

In my view, if economic conditions evolve as anticipated, I believe further removal of accommodation via gradual increases in the fed funds rate will be needed and will help sustain the expansion. A gradual removal of accommodation helps avoid a build-up of risks to macroeconomic stability that could arise if the economy is allowed to overheat, as well as risks to financial stability if interest rates remain too low, encouraging investors to take on excessively risky investments in a search for yield or engendering other financial imbalances. The gradual approach to normalization allows for the kind of fluctuations we've seen in the data on the economy and inflation without having to change our strategy. I see this consistency as a positive in that it underscores our systematic approach to promoting our policy goals and it removes policy ambiguity at a time when uncertainty seems to be rising on other fronts.

It's important to notice that the gradual path I anticipate does not entail an increase at each FOMC meeting. At its July meeting, the FOMC decided to maintain the target range for the federal funds rate at 1 to 1-1/4 percent. It also announced that economic conditions are expected to evolve in a way that will warrant further gradual increases; the pace of those increases will depend on what incoming information implies about the medium-run outlook.

Normalizing the stance of monetary policy also means taking steps to normalize the Fed's balance sheet in terms of the size and composition of assets. To address the Great Recession, the Fed undertook several programs to purchase longer-term assets, including longer-maturity Treasuries and agency mortgage-backed securities (MBS). These purchases aimed to put 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 grew, from nearly $900 billion in assets in 2007, or 6 percent of nominal GDP, to about $4.5 trillion today, or 23 percent of nominal GDP.[8] In addition, the composition of the Fed's assets has changed from mainly short-term Treasury securities to mainly longer-maturity Treasuries and agency MBS. In tandem with the increase in Fed assets, there was a sizable increase in Fed liabilities, namely, depository institution deposits, or reserves, held at the Fed. Reserves have increased from about $11 billion in 2007 to over $2 trillion today. In October 2014, the Fed stopped the program to increase the size of its balance sheet, but since then, we've been reinvesting the returns from maturing securities, thereby maintaining the balance sheet's large size.

The FOMC's intention is to reduce the size of the balance sheet over time to the smallest size needed to implement monetary policy efficiently and effectively and, in the longer run, to hold primarily Treasury securities.[9] In June, the FOMC described its program for normalizing the balance sheet by gradually reducing the amount of reinvestments it is making in a predictable way.[10] The gradual, predictable decline allows balance-sheet normalization to run in the background and monetary policy to focus on

[8] The comparable figures for the European Central Bank and the Bank of Japan, which are also using asset purchases to increase accommodation, are 38 percent and 91 percent, respectively. (Balance-sheet data for the European Central Bank from the Eurosystem are available at https://www.ecb.europa.eu/press/pr/wfs/2017/html/ecb.fs170808.en.html. Balance-sheet data for the Bank of Japan are available at https://www.boj.or.jp/en/statistics/boj/other/acmai/release/2017/ac170731.htm/.)

[9] See "Policy Normalization Principles and Plans," FOMC, September 17, 2014 (https://www.federalreserve.gov/newsevents/press/monetary/20140917c.htm).

[10] See "FOMC Issues Addendum to the Policy Normalization Principles and Plans," Board of Governors of the Federal Reserve System press release, June 14, 2017 (https://www.federalreserve.gov/newsevents/pressreleases/monetary20170614c.htm).

setting the appropriate level of the fed funds rate, our conventional monetary policy tool. The FOMC expects to begin implementing the program relatively soon,[11] and I favor doing this in the near future. First, by design, it will be a very gradual process of decreasing the amount of assets reinvested each month, with balance sheet normalization taking several years.[12] Second, the plan has been well telegraphed in advance. Both of these aspects make it less likely that we will see a sudden or sizable increase in long-term yields as a result of the announcement of the start of implementation. Indeed, in my view, other factors, including the ongoing discussions about the debt ceiling, rising geopolitical tensions, and political uncertainty, would be more likely to influence Treasury yields in the near term.

Regarding the ultimate size of the balance sheet, we know the balance sheet will be larger than it was prior to the financial crisis for the simple reason that the public's demand for currency is rising over time.[13] But it will also likely be considerably smaller than it is today. How much smaller depends on how the FOMC decides to implement monetary policy in the future.[14] But because it will take several years to reduce the size of the balance sheet through asset run-off, there is no reason to delay the start of normalization until this decision is made.

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[11] See the FOMC post-meeting statement of July 26, 2017 (https://www.federalreserve.gov/newsevents/pressreleases/monetary20170726a.htm).

[12] Once started, the plan is to allow up to $6 billion a month of maturing Treasuries and $4 billion a month of principal payments of agency MBS and agency debt to run off the balance sheet. These caps would be increased by $6 billion and $4 billion per month, respectively, every three months, until they reach $30 billion per month for Treasuries and $20 billion per month for agency MBS and agency debt. Thereafter, those caps would be maintained and the balance sheet would gradually decline. (See "FOMC Issues Addendum to the Policy Normalization Principles and Plans," Board of Governors of the Federal Reserve System press release, June 14, 2017 (https://www.federalreserve.gov/newsevents/pressreleases/monetary20170614c.htm)).

For projections of the Fed's balance sheet under various scenarios, see "Projections for the SOMA Portfolio and Net Income," Federal Reserve Bank of New York, July 2017 (https://www.newyorkfed.org/medialibrary/media/markets/omo/SOMAPortfolioandIncomeProjections_July2017Update.pdf).

[13] Since the financial crisis, currency has doubled in quantity, from about $770 billion in 2007 to about $1.5 trillion today.

[14] For an accessible description of frameworks for implementing monetary policy, see Jane E. Ihrig, Ellen E. Meade, and Gretchen C. Weinbach, "Rewriting Monetary Policy 101: What's the Fed's Preferred Post-Crisis Approach to Raising Interest Rates?" *Journal of Economic Perspectives* 29 (Fall 2015), pp. 177-198 (http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.29.4.177).

As a final remark, it's important to remind everyone that there are risks around the economic outlook, and because of that, monetary policy is not pre-set. The confidence bands the FOMC is now providing around its economic and policy path projections are visual reminders to both the public and policymakers that there is always a lot of uncertainty around economic forecasts. 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. That said, I view the steps the FOMC is taking to gradually normalize monetary policy – both the fed funds rate and the balance sheet – as a welcome acknowledgment that the economy itself has normalized.