Views on the Economy and Monetary Policy

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

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Introduction

I thank the Dayton Area Chamber of Commerce for inviting me to speak at today's breakfast. Yesterday I had the opportunity to meet with several community organizations and to tour several Dayton neighborhoods. As I'm sure you know, we analyze a lot of data at the Fed. But augmenting the economic and financial statistics by getting out and about in the Fourth District gives me a better sense of what is happening in the economy in real time. Nothing provides a more powerful reminder that Federal Reserve policy affects real people and local communities. They say that all politics is local. In a sense, monetary policy is, too. Although we set a national monetary policy, the local information we gather from contacts around the country allows those policy decisions to take into account the diversity of the American economy and its people. The Fed's regional structure, with 12 Reserve Banks distributed across the country, overseen by the Board of Governors in Washington, D.C., supports us in this work. The information we get in the field helps us evaluate economic developments, formulate an outlook, and ultimately make better policy decisions.

Today, I will provide my assessment of economic developments, and my outlook for the economy and monetary policy. As always, the views I'll present today are my own and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.

The Economy

Let me start with an issue that is on everybody's mind: what's going on in financial markets? The past week or so has been a roller coaster ride of ups and downs in the stock market, with a sudden increase in volatility. Longer-term bond rates have also moved up. It's helpful to put this into perspective. Equity markets had generally been on a sizable upswing over the past year, with the S&P 500 index up 19 percent in 2017, amidst extremely low volatility. While some commentators thought that the low level of interest rates and high earnings prospects supported high stock market valuations, others thought that equity prices had begun to outpace earnings, that bond yields were too low given the economic outlook,

and that a correction was waiting to happen, it was just a matter of time. Of course, it is investors, not commentators, who determine prices and yields. Even with the recent movements, as of Friday, the S&P 500 index is still significantly higher than it was a year ago. Bond yields are at levels seen at the start of 2014.

Whenever there are such big swings in the market, we need to assess their implications. In the near term, we look at whether the market swing is accompanied by disorderly trading, a lack of liquidity, or contagion to other markets. We have not seen this: trading has been relatively orderly, markets have remained generally liquid, and there hasn't been a pullback in credit. We also assess whether there are spillovers to the broader economy that could affect the medium-run economic outlook. While a deeper and more persistent drop in equity markets could dash confidence and lead to a pullback in risk-taking and spending, the movements we have seen are far away from this scenario. I'll continue to monitor financial market developments closely, but for now, I expect the economy will work through this episode of market turbulence and I have not changed my outlook. In my view, the underlying fundamentals supporting the economy are very sound.

Financial conditions remain accommodative. Household and business balance sheets are healthy and incomes are growing. We've also seen improvement in the economies of many of our trading partners, which helps U.S. export growth. Monetary policy is accommodative and the changes in tax policy will also have a positive effect on growth this year and next.

The economic expansion is now in its ninth year, and I expect 2018 will be another good year for the economy, with growth around 2-1/2 percent, which is stronger than my 2 percent estimate of trend growth. I anticipate that the tax package will add about 1/4 to 1/2 percentage point to annual growth over the next couple of years, but based on the positive reactions so far, there's an upside risk that the effect could be larger. Labor markets have been strong, and I expect that strength to continue, with above-trend

employment growth continuing and the unemployment rate falling below 4 percent. Inflation has been running under 2 percent, but I expect it to gradually move up to our goal of 2 percent over the next one to two years.

The task before Fed policymakers is to calibrate monetary policy to this healthy economy so that our congressionally mandated long-run goals of maximum employment and price stability are met. This means making sure we don't get behind the curve given the economy's strength but also making sure we don't overreact to the positive outlook. To my mind, that means if economic conditions evolve as expected, we'll need to make some further increases in interest rates this year and next year, at a pace similar to last year's. I think this gradual approach is the best strategy for sustaining the expansion and balancing the risks to our dual-mandate goals.

That's a summary of my outlook, which is informed by economic information, so let's review some of that now.

Economic growth

Last year, economic growth picked up to 2-1/2 percent from a moderate annual pace of about 2 percent over the prior years of the expansion. Consumer spending, which makes up over two-thirds of output, showed strength last year and my outlook is that it will remain healthy. Personal incomes are growing because labor market conditions are strong. In addition, household balance sheets are in much better shape since the Great Recession, reflecting a combination of deleveraging and increased savings. Even after the recent downturn in stock prices, increases in stock prices and house prices over the past year have contributed to a rise in household wealth in the aggregate. In fact, the housing equity held by households is now above its peak before the housing crash.

The recovery in housing took some time to gain traction. Buyers, sellers, developers, and bankers were all wary about re-entering the market because of the fallout from the housing bust. But low interest rates and the improved financial condition of households and lenders have led to increased construction and sales. Overall, I expect activity in the housing sector to continue to expand at a sustainable pace.

The pickup in business investment last year was a welcome development. Investment was weak in 2015 and 2016, as the sharp drop in oil prices and the strengthening of the dollar weighed on the energy and manufacturing sectors. Last year, conditions improved: oil prices rose and the dollar depreciated as the economies of our trading partners began to strengthen. For the first time in many years, growth around the world is picking up and forecasts for global growth are being revised up. This has a positive feedback effect on the U.S. economy via exports. In the U.S., business sentiment is high, our business contacts are reporting increasing demand, and national and regional surveys show rising levels of activity and orders in the manufacturing and service sectors.

Labor markets

The labor market is strong and I expect that strength to continue. Last year, the economy added over 2 million jobs, about 180 thousand per month. In January, payroll jobs rose by 200 thousand. This pace of job growth is well above trend, which most estimates put in the range of 75,000 to 120,000 jobs per month. The unemployment rate is now 4.1 percent. This is seven-tenths of a percentage point lower than it was a year ago and below its lowest point during the last expansion. It is well below the range most economists associate with full employment, including my own estimate of 4-3/4 percent. Other indicators, including broader measures of unemployment, the job openings rate, and the job turnover rate, show that the labor market is strong. I expect this strength to continue and that the unemployment rate will move down below 4 percent this year.

Dayton has also benefited from an improving job market. After peaking at just over 12 percent after the Great Recession, the unemployment rate has fallen to 4.5 percent. Over the past year, payrolls have grown at a brisk 2-3/4 percent pace. This is quite a reversal, as Dayton has had its challenges. Over the 2001-2007 expansion, the Dayton region lost over 5 percent of its payroll jobs, while jobs grew more than 5 percent in the nation. During the Great Recession, payroll jobs fell about 8 percent here compared to 5 percent in the nation. But things have improved. In the Dayton region, payrolls are up 10 percent since the start of the expansion, an increase of about 35 thousand jobs.

Some of the regional differences reflect differences in industry mix. Wright-Patterson Air Force Base remains the largest employer in the area. It added jobs during the recession and helped to cushion some of the job losses in other sectors. On the other hand, manufacturing employment has been on a longer-term downward trend, at both the regional and the national level, and compared to the nation, manufacturing represents a relatively larger share of payroll jobs in the Dayton region. Even so, that difference has narrowed over time as Dayton's economy has been transitioning from one that is largely dependent on manufacturing and heavy industry to one that is diversifying into health care and education. In the 1990s, manufacturing represented about 19 percent of Dayton's jobs and "eds and meds" represented about 13 percent. Those shares have now reversed. In the past decade, the share of jobs in eds and meds has been 19 percent, while the share in manufacturing has been 11 percent. Regions that have diversified their industrial base have generally fared better over time, and effective leadership, like that provided by the Dayton Area Chamber of Commerce, can help the region navigate this transition.

As both national and regional labor markets have tightened, our contacts throughout the Fourth District have been reporting for a while that they've had trouble finding qualified workers. These reports are now coming from a wide range of firms across different sectors and cover both higher-skill and lower-skill occupations. Anecdotal evidence suggests that the tightness in the labor market is gradually showing up in higher compensation. Earlier in the expansion compensation growth was under 2 percent; more

recently, it has increased to over 2-1/2 percent. The latest employment report showed another pickup in wage growth. These increases are consistent with the increasing number of reports from firm contacts who tell us that they are responding to labor shortages by offering higher wages and benefits to attract and retain workers.

Overall, my assessment is that from the standpoint of the cyclical conditions monetary policy can address, we are slightly beyond the maximum employment part of the Fed's monetary policy mandate.

Inflation

The other part of the Fed's mandate is price stability. The FOMC has set a symmetric 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. "Symmetric" means that the 2 percent inflation goal isn't a ceiling. The inflation measures will vary from month to month, sometimes above and sometimes below 2 percent, but we aim to keep inflation at 2 percent on average over the longer run.

Inflation has been running below this goal for some time, but the recent news on inflation has been positive. Inflation moved up from the very low levels seen in 2015, when it was held down by falling oil and import prices. Inflation readings were above 2 percent early last year, but then fell below 2 percent partly due to special factors, like the drop in the prices of prescription drugs and cell phone service plans. Since the lows seen last summer, inflation has moved up. We will likely see higher inflation numbers once the price declines of last March drop out of the year-over-year measures. But just as we didn't overreact to last summer's weaker inflation readings, we shouldn't overreact to these increases either. Instead, I remain focused on the medium-run outlook for inflation, and I anticipate that with the economy growing above trend and the demand for labor resources continuing to strengthen, inflation will gradually move up to 2 percent on a sustainable basis over the next one to two years.

Stable inflation expectations are an important component of this forecast. Inflation expectations help to anchor actual inflation rates, and this stability has already proved its value during this business cycle. During the dark days of the Great Recession, the deep pullback in activity and collapse in demand could have led to deflation – not just low inflation rates but actually falling prices. But deflationary conditions did not develop because policy responses helped to maintain people's expectations that prices would remain stable over the longer run and that inflation would eventually return to goal. The fact that inflation expectations remain reasonably stable gives me confidence that inflation will gradually move back to goal. But since inflation forecasts are subject to considerable uncertainty, I'll keep evaluating my inflation forecast as the year progresses.[1,2] I'll also need to continue to evaluate the effects of the recent changes in tax policy. So let me discuss fiscal policy before I turn to monetary policy.

Fiscal Policy

I expect that the tax changes will increase spending and raise economic growth over the next couple of years. At this point, it is difficult to be precise about the magnitude of the effect of the fiscal stimulus from the tax changes; as I mentioned, I'm estimating an additional 1/4 to 1/2 percentage point of annual growth this year and next year, but there is some upside risk that the effects could be larger. The impact on individual households will depend on the level and sources of their income, but in the aggregate, I expect lower personal tax rates and higher standard deductions to spur some additional household spending. On the corporate side, lower tax rates and full expensing for investment in equipment and intangibles should spur additional business spending to meet higher near-term demand, but how much remains to be seen. Except for firms in the tax consulting business, the majority of our business contacts

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[1] 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. (See Table 2: "Average Historical Projection Error Ranges," in the Summary of Economic Projections portion of the Minutes of the Federal Open Market Committee, December 12-13, 2017 (https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20171213.pdf).

[2] A significant portion of the variation in inflation rates comes from idiosyncratic factors that can't be forecasted. See Yellen, Janet, "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).

have told us that while they welcome lower tax rates, they aren't planning to make significant changes to their capital or hiring plans as a result of the change in taxes. Instead, those firms planning to increase spending and hiring say those increases are driven by brighter sales prospects and stronger demand. At the same time, some businesses attributed the firm-wide bonuses they paid to workers at the end of the year to the tax cuts, and others have taken the occasion to implement wage increases they had contemplated for some time. Firms might also be expected to spend some of their tax savings on increased dividends and share buybacks. I expect to have a better read on how households and firms are actually responding to the tax changes over the next several months.

A stronger outlook for business spending and hiring is a welcome development because investment and labor force growth are key determinants of productivity growth and productivity growth is a key determinant of an economy's longer-run output growth and of living standards. The U.S. economy has been struggling with very low productivity growth during this expansion, on the order of only 1 percent.[3] This is less than half the pace over the prior two expansions, and partially explains why wage growth has been relatively sluggish despite the tightness in labor markets. In addition, as a result of lower population growth and labor force participation, the growth of the U.S. labor force has slowed considerably, from 2.5 percent per year, on average, in the 1970s, to around 0.5 percent per year over 2010-2016. It is expected to remain near that level over the next decade.[4]

I expect some increase in productivity growth as the expansion continues. It is possible that the tax changes could spur higher labor force participation and investment in physical and human capital, thereby having a positive effect on the economy's productive capacity, its productivity growth, and its trend

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[3] Labor productivity as measured by output per hour worked in the nonfarm business sector has averaged 1 percent over this expansion.

[4] According to the latest available projections, the U.S. Bureau of Labor Statistics estimates that annual growth in the labor force over 2016-2026 will average 0.6 percent. See U.S. Bureau of Labor Statistics, "Economic Projections – 2016-26," October 24, 2017, p. 2 (https://www.bls.gov/news.release/pdf/ecopro.pdf).

growth rate. But these effects from the tax changes are even more difficult to estimate than the effects on near-term spending, and they would play out over a longer period of time. So I have not incorporated them into my own projection for longer-run growth, which I put at 2 percent.

Another aspect of fiscal policy that needs to be considered is its effect on the longer-run budget deficit. Before the tax package and recently passed federal budget deal, projected longer-run fiscal imbalances were unlikely to be sustainable.[5] Were the trend growth rate not to pick up, lower tax revenues and higher federal spending would add to the deficit relative to GDP, making it even more likely that the government would eventually need to respond with some combination of increased borrowing, reduced or restructured benefits, and increased taxes, thereby reducing any long-run positive effects of the recent changes in fiscal policy. We will need to continue to evaluate the responses to tax changes not only as the year progresses but into the future.

Monetary Policy

This brings me to monetary policy. At its January meeting, the FOMC maintained the target range for the fed funds rate at 1-1/4 to 1-1/2 percent. This range was set in December, which saw the fifth increase in rates since December 2015, when the FOMC began removing some of the extraordinary monetary policy accommodation that was necessary in the wake of the financial crisis and Great Recession. In January, the FOMC also continued to implement its plan to normalize its balance sheet in terms of the size and composition of assets.[6] To address the Great Recession and put downward pressure on longer-term interest rates once the fed funds rate had hit effectively zero, the Fed undertook several programs to

[5] For further discussion, see Mester, Loretta J., “Demographics and Their Implications for the Economy and Policy,” Cato Institute’s 35th Annual Monetary Conference: The Future of Monetary Policy, Washington, D.C., November 16, 2017 (https://www.clevelandfed.org/en/newsroom-and-events/speeches/sp-20171116-demographics-and-their-implications-for-the-economy-and-policy.aspx).

[6] See FOMC, “Addendum to the Policy Normalization Principles and Plans,” June 13, 2017 (https://www.federalreserve.gov/monetarypolicy/files/FOMC_PolicyNormalization.20170613.pdf).

purchase longer-term assets, including longer-maturity Treasuries and agency mortgage-backed securities (MBS). 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. The composition changed from mainly short-term Treasuries to longer-maturity Treasuries and agency MBS. The normalization plan, which began last October and will take several years to complete, involves letting maturing Treasuries and principal payments of agency MBS and agency debt to gradually roll off the balance sheet up to a monthly cap, with the caps rising over time. The gradual, predictable decline in assets allows balance-sheet normalization to run in the background and monetary policy to focus on setting the appropriate level of the fed funds rate, our conventional monetary policy tool. The ultimate size of the balance sheet will depend on how the FOMC decides to implement monetary policy in the future, a decision that has not yet been made.[7]

I supported implementing the balance-sheet normalization plan and the December and January decisions on interest rates. If the economy evolves as I anticipate, I believe further increases in interest rates will be appropriate this year and next year, at a pace similar to last year's. I believe this gradual upward path of interest rates will help balance the risks and prolong the expansion so that our longer-run goals of price stability and maximum employment are met and maintained. This policy path gives inflation time to move back to goal while, at the same time, avoiding a build-up of risks to macroeconomic stability that could arise if the economy is allowed to overheat, with the Fed then having to raise rates sharply in response. It helps avoid a build-up of risks to financial stability should overly low interest rates encourage investors to take on excessively risky investments in a search for yield. And it puts monetary policy in a better position to address whatever risks, whether to the upside or to the downside, are ultimately realized.

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[7] For an accessible description of frameworks for implementing monetary policy, see Ihrig, Jane E., Meade, Ellen E., and Weinbach, Gretchen C., "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).

Of course, this is my current view of monetary policy. We will need to calibrate our policy decisions to how the economy actually evolves and the implications of incoming information for the medium-run outlook and risks around the outlook. If the upside risks to growth come to pass, we may need to steepen the path a bit; if inflation surprises on the downside, we may need to go a bit slower. But this is normal monetary-policy-setting behavior – we will calibrate our policy based on the outlook and the realized and expected progress on our dual-mandate monetary policy goals.