Perspectives on the Economic Outlook and Monetary Policy

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Introduction

Let me begin by thanking Dean Arjang Assad of the Katz Graduate School of Business and Dmitri Shiry of Deloitte for inviting me to speak with you this evening. Dmitri performs important public service as a member of the board of directors of the Cleveland Fed's Pittsburgh Branch, and it just so happens that this building formerly housed our branch. In addition to including the western part of Pennsylvania, the Cleveland Fed's District comprises the state of Ohio and parts of Kentucky and West Virginia. The regional nature of the Federal Reserve has served the country well for more than 100 years. It allows monetary policy decisions to take into account the diversity of the American economy and its people and helps ensure that those decisions incorporate information from all parts of the country, not just Washington, D.C. or Wall Street.

This evening, I would like to give you my perspectives on the economy and monetary policy. My remarks will reflect my own views and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.

Some Context: The Medium-Run Outlook and Monetary Policy

Let me start with some context. Monetary policy affects the economy with a lag. Some sectors are more sensitive to interest rates than others, so it takes some time for changes in monetary policy to be transmitted through all parts of the economy. This means monetary policymakers have to formulate an outlook for the economy over the medium run and evaluate the risks around that outlook in order to set appropriate policy.

Although we use state-of-the-art techniques and incorporate official data and anecdotal information from our contacts across the country, there is still a lot of uncertainty around any economic forecast. Indeed, in speaking about FOMC projections, former Fed Chair Ben Bernanke said, "The only economic forecast in

which I have complete confidence is that the economy will not evolve along the precise path implied by our projections."[1]

But just because we cannot forecast the future with as much precision as we'd like does not mean that the exercise is without value. The discipline of forecasting and assessing risks over the medium run helps us avoid focusing too much on short-run changes in the economic data or volatility in financial markets. It helps us be systematic, yet responsive to changes in economic conditions to the extent that they change the outlook. And the more that people understand this process, the more they'll be able to anticipate where policy is likely to go even if the economy develops in unexpected ways.

With that as background, let me turn to the outlook.

The Economy

I expect 2018 to be another good year for the economy, with above-trend growth, continued labor market strength, and firming inflation. The economy will be supported by favorable fundamentals, including accommodative monetary and fiscal policy, healthy household balance sheets, rising personal income, and an improving global economy. Nonetheless, financial market volatility has risen from the very low levels of recent years, the trade picture has created uncertainty, and geopolitical concerns have risen. I view these as risks to the outlook, but at this point, these factors have not caused me to change my outlook for the overall economy. The task before monetary policymakers is to calibrate policy to this healthy economy to sustain the expansion. Monetary policy is still accommodative, and as the economy strengthens, we don't want to get behind the curve and find ourselves in a position of having to raise rates

[1] See Bernanke, Ben S., "Federal Reserve Communications," Cato Institute 25th Annual Monetary Conference, Washington, D.C., November 14, 2007.
(https://www.federalreserve.gov/newsevents/speech/bernanke20071114a.htm)

more aggressively than anticipated. But we also don't want to overreact to the positive outlook by raising rates too aggressively and potentially curtail the expansion. This takes some careful balancing.

Economic growth

Last year, economic growth picked up to around 2-1/2 percent, and I expect growth this year to be a bit stronger. Admittedly, incoming data suggest a moderation in consumer and business spending in the first quarter. But this moderation was from high levels, and I expect the first-quarter softness in output growth to be temporary, just as it was in the past couple of years.

Last year, growth became more balanced across sectors and less dependent on only the consumer. Nonresidential investment grew at a pace of about 6 percent in 2017, a significant pickup from the anemic pace of less than 1 percent in the prior two years. That earlier weakness reflected the steep decline in oil prices between mid-2014 and early 2016, which caused a sharp pullback in drilling, mining, and their suppliers. The oil price decline was accompanied by a sharp appreciation of the dollar, which hurt manufacturers and other firms dependent on exports. But last year, oil prices rose, the dollar depreciated, and the economies of our trading partners began to strengthen, all of which supported increased business spending.

Indeed, for the first time in many years, economic activity around the world is picking up. This should be a positive for U.S. exports. However, the tariffs on steel and aluminum imports, rhetoric suggesting an escalation of reciprocal tariffs on certain goods traded between the U.S. and China, and the ongoing renegotiations of the North American Free Trade Agreement (NAFTA) have clouded the trade picture. This cloud may not pass over quickly. Assessing the impact on the U.S. macroeconomy will ultimately depend on the actions taken by the U.S. and its trading partners with respect to trade, and whether those actions or the continuing uncertainty causes businesses and investors to reevaluate their outlook for the U.S. economy.

We have already seen a marked increase in volatility in the equity markets this year. However, it is helpful to put this volatility into perspective. Last year, the S&P 500 index rose 19 percent, amid extremely low volatility. Equity prices are little changed, on net, this year. More notable is the rise in volatility. We are less than four months into the year, but as of yesterday's close, there have already been 29 days on which the S&P 500 rose or fell by more than 1 percent. Through all of last year, there were only eight such days – a very low number compared to the average of about 60 days per year from 2010 through 2016.

Whenever there are such big swings in the market, we need to assess their implications. The increased volatility this year has not been associated with signs of financial market stress, such as disorderly trading, a lack of liquidity, or contagion to other markets. And while a deeper and more persistent drop in equity markets could lead to a pullback in risk-taking and spending, the movements we have seen thus far are not close to this scenario. Contacts tell us higher volatility has not deterred planned spending. Equity prices remain considerably above their levels at the start of last year, and both business and consumer sentiment remain at high levels.

The changes in tax policy are expected to buoy both business and household spending this year. Lower tax rates and full expensing for investment in equipment and intangibles should spur additional business spending to meet higher near-term demand, some of which will be driven by higher federal spending. In a recent Cleveland Fed staff survey of firms in the District, over a third of the firms expecting tax savings this year said they planned to use some of the proceeds to increase investment.

The tax package adds a positive element to an already healthy outlook for consumer spending. Personal incomes are growing because labor market conditions are strong. Lower personal tax rates and higher standard deductions should spur some additional household spending in the aggregate, although the impact of tax changes on individual households will depend on the level and sources of their income.

Household balance sheets are in much better shape since the Great Recession, reflecting a combination of deleveraging and increased savings.

The strength in the household sector is also supporting a moderately paced expansion of the housing sector, despite the increase in mortgage rates. In the aggregate, housing equity held by households is now above its peak before the housing crash. While the new tax law contains several provisions that affect the tax treatment of homeownership, I expect activity in the housing sector to continue to expand at a sustainable pace.

Labor markets

The economy's strength is well illustrated by the very strong conditions in labor markets. I expect that strength to continue. The unemployment rate, at 4.1 percent, is below its lowest point during the last expansion. It is under the 4-1/2 percent rate I gauge to be consistent with full employment over the longer run. I expect the unemployment rate to move below 4 percent this year and to remain below 4 percent next year.

Over the first three months of the year, payroll jobs have grown by an average of about 200,000 per month. This is a pickup from last year's average monthly gain of about 180,000 jobs and is well above most economists' estimates of trend monthly job growth, which lie in the range of 75,000 to 120,000. Based on demographic factors, including the aging of the population, the longer-run trend in labor force participation is downward sloping, but participation has been fairly stable over the past two years, another sign of a strong labor market.

Regional contacts continue to report that finding workers, both for higher-skill and lower-skill occupations, is very difficult, and that they are responding to labor shortages by offering higher wages and benefits and more flexible work schedules. The official statistics indicate that compensation growth

has moved up, from under 2 percent earlier in the expansion to over 2-1/2 percent more recently. That's less of a pickup than what is typically seen given the tightness in labor markets, but it is consistent with the low productivity growth we've seen over the expansion.[2] As investment continues to pick up, which should help to promote productivity growth, and firms continue to move wages up to attract and retain workers, I expect to see some strengthening in wage growth.

Combining all the indicators, my assessment is that from the standpoint of the cyclical conditions monetary policy can address, we are slightly beyond maximum employment, one 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. The FOMC aims for inflation to be 2 percent because it believes that this rate is most consistent over the longer run with our statutory mandate. Inflation measures can vary from month to month due to idiosyncratic factors and in response to temporary economic and financial disturbances. So to assess where we are relative to goal, it's always a good idea to look through transitory movements in the numbers, both those above and those below our goal, and focus on where inflation is going on a sustained basis.

Getting inflation back to 2 percent has been somewhat of a challenge, but since 2015, inflation has been generally moving up. At 1.8 percent, PCE inflation is near, but still slightly under, our goal. In the near term, we will likely see some higher inflation readings as last March's sharp decline in the prices of cell

[2] Over the longer run, wages, adjusted for inflation, tend to reflect the marginal product of workers. During this expansion, growth in labor productivity, as measured by output per hour worked in the nonfarm business sector, has been on the order of only 1 percent, less than half the pace over the prior two expansions.

phone data plans drop out of the year-over-year measures, but we need to remain focused on the medium-run outlook for inflation.

With growth above trend, strong labor demand, and inflation expectations relatively stable, my outlook is that inflation will gradually move up to 2 percent on a sustainable basis over the next one to two years. I don't expect inflation to move up sharply. But as inflation firms, it is important that monetary policymakers continue to convey through policy decisions and communications that we are committed to achieving our dual mandate goals. Before I turn to monetary policy, let me discuss the Pittsburgh economy.

The Pittsburgh economy

The path of the expansion in the Pittsburgh region reflects its industrial mix and the nature of the shocks that have hit the broader U.S. economy. Pittsburgh saw relatively strong employment growth early in the expansion. But by mid-2012, payroll growth had begun to weaken. The pullback in mining, drilling, and manufacturing in 2015 and 2016 had a significant effect on the Pittsburgh region. The region lost jobs in 2015, barely saw any job growth in 2016, and the unemployment rate moved up. But last year saw a significant improvement in job growth, and the unemployment rate resumed its decline and now stands at 4.8 percent.

Payroll job growth picked up to a pace of nearly 2 percent last year, stronger than job growth in the state of Pennsylvania and in the nation. Reflecting the turnaround in energy prices, gains were especially strong in mining and construction. The region's growing reputation as an attractive tourist destination also led to a rise in tourism-related jobs. The rise seen in education and healthcare jobs reflects a longer-run trend of economic diversification in the Pittsburgh region, which was discussed in a recent Cleveland

Fed report in the Bank's *Industrial Heartland Series*.[3] Such diversification allows regions to better adapt to changing economic forces.

But the region faces some challenges. Pittsburgh's population has been declining over the past two decades, the population is aging, and despite the presence of some of the best colleges and universities in the country, many students leave the region after graduation. The Allegheny Conference on Community Development recently updated its report on regional labor supply and demand.[4] The report projects that healthcare and information technology workers will remain in high demand, but there will also be a sizable demand for engineers and skilled technicians linked to emerging technologies, including autonomous vehicles, additive manufacturing, robotics, and ethane cracker and petrochemical development. The report documents a mismatch in the skill sets of residents in the region and the requirements for workers who will be in highest demand. Reading the report gives you a sense of the complexity of the issues at hand. But you also learn of the positive steps being taken by business, community, and civic leaders to address workforce development issues to ensure that Pittsburgh remains economically competitive in the future.

Monetary Policy

Let me now turn to monetary policy. For some time now, the FOMC has been engaged in a strategy of gradually removing the high level of accommodation that was needed to address the Great Recession. This strategy is a balanced approach, reflecting the improvement in the economy over time and the progress that has been made on our longer-run monetary policy goals of maximum employment and price

[3] Venkatu, Guhan, "Rust and Renewal: A Pittsburgh Retrospective," *Industrial Heartland Series*, Federal Reserve Bank of Cleveland, February 2018. (https://clevelandfed.org/region/industrial-heartland/retrospectives.aspx#pittsburghreport)

[4] The Allegheny Conference on Community Development, "Inflection Point 2017-18: Supply, Demand and the Future of Work in the Pittsburgh Region," December 2017. (https://www.alleghenyconference.org/wp-content/uploads/2017/12/018_InflectionPoint.pdf)

stability. In March, the FOMC raised the target range for the fed funds rate to 1-1/2 to 1-3/4 percent. I supported this increase, and if the economy evolves as I anticipate, I believe further increases in interest rates will be appropriate this year and next year.

In my view, a gradual upward path of interest rates will help sustain the expansion and balance the risks so that our monetary policy goals are met and maintained. We want to give inflation time to move back to goal, and I don't expect inflation to pick up sharply; this argues against a steep path. At the same time, the economy is slightly beyond maximum employment, and despite an increase in market volatility and longer-term interest rates since the start of the year, financial conditions are accommodative. It is appropriate to continue to remove some of the monetary policy accommodation to ensure we avoid a build-up in risks to macroeconomic stability that could arise if the economy were allowed to overheat. Recent research from the Cleveland Fed suggests that a strategy to overheat the economy in an attempt to pull more people back into the workforce is unlikely to have any lasting effect on labor force participation.[5] Yet, overheating would have costs – it would necessitate sharper rate increases that could in themselves be destabilizing.

A gradual upward path of interest rates should also help to avoid financial imbalances and a potential build-up of financial stability risks that could arise from the extended period of very low interest rates. Currently, in my assessment, financial stability vulnerabilities are at a moderate level. Leverage levels in the household, nonfinancial, and financial sectors are low to moderate, and vulnerabilities arising from the financial system's role in transforming the maturity of assets or funding long-term assets with short-term liabilities are moderate. But corporate bond yields relative to Treasury yields are quite low, and prices in the commercial real estate market continue to rise while capitalization rates, which measure

[5] Fallick, Bruce, and Pawel Krolikowski, "Hysteresis in Employment among Disadvantaged Workers," Federal Reserve Bank of Cleveland Working Paper 18-01, February 2018. (https://www.clevelandfed.org/en/newsroom-and-events/publications/working-papers/2018-working-papers/wp-1801-hysteresis-in-employment-among-disadvantaged-workers.aspx)

operating income relative to the sale price of commercial properties, are at or near historical lows. These developments are worth watching.

Continued gradual reduction in monetary policy accommodation, given the economic outlook, will put monetary policy in a better position to address whatever risks, whether to the upside or to the downside, are ultimately realized. The path policy actually takes will depend on how the economy actually evolves. 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.

Since last October, the FOMC has also been implementing its plan to normalize the Fed's balance sheet in terms of the size and composition of assets.[6] To address the Great Recession, after the FOMC brought the fed funds rate down to effectively zero, it undertook several programs to purchase longer-term assets, including longer-maturity Treasuries and agency mortgage-backed securities. These purchases were undertaken to put further downward pressure on longer-term interest rates. We are now allowing maturing longer-term assets to roll off the balance sheet in a gradual and predictable way; this will take several years to complete.

Longer-Run Issues

I have been discussing the medium-run economic outlook and associated risks, but to conclude my talk, I'd like to address two interconnected longer-run issues facing the U.S. economy.

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

A country's standard of living over the longer run depends on its longer-run growth rate, which, in turn, depends on the growth of the labor force and the growth of productivity, which measures how effectively the economy combines labor and capital to create output.

Based on demographics, labor force growth is projected to be considerably slower than it has been in recent decades. In the 1970s, the labor force grew about 2-1/2 percent per year, on average, as baby boomers and women entered the workforce. But since then, labor force growth has slowed, rising at slightly more than 1/2 percent per year over 2010-2016, and it is expected to remain near that level over the next decade.[7]

Labor productivity growth has also been slow during this expansion. Some of this is cyclical, but more persistent structural factors may also be at play.[8] For example, the American spirit of innovation, entrepreneurship, ease of business entry and exit, and labor market flexibility have contributed to economic growth and well-being in the U.S. These factors of dynamism allow resources to be reallocated from less-productive to more-productive businesses and allow workers to move up the career ladder. But the level of dynamism has been declining for some time.

The combination of slow labor force growth and slow productivity growth suggests that the potential growth rate of the economy will be lower than it was in the past. My own estimate of output growth over

[7] For further discussion of demographics and economic growth, 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, and forthcoming in the *Cato Journal*. (https://www.clevelandfed.org/newsroom-and-events/speeches/sp-20171116-demographics-and-their-implications-for-the-economy-and-policy.aspx)

[8] For example, on average, over the 1990s and until the Great Recession, business start-ups accounted for about 3 percent of total employment per year. Since then, this share has fallen to around 2 percent. For further discussion of dynamism, see Mester, Loretta J., "The National and Regional Economic Outlook and Monetary Policy," The African American Chamber of Commerce of Western Pennsylvania Annual Business Luncheon, Pittsburgh, PA, November 30, 2016. (https://www.clevelandfed.org/newsroom-and-events/speeches/sp-20161130-the-national-and-regional-economic-outlook-and-monetary-policy)

the longer run is 2 percent, which is a lot slower than the 3 to 3-1/2 percent rate seen over the 1980s and 1990s.

Of course, this is not a fait accompli. Investment in human capital, in the form of education and training, and investment in physical capital and infrastructure can improve outcomes. The recently adopted changes to the tax code may encourage such investment. Well-designed government policies can also help spur basic science, R&D, and innovation; make it easier for people to start up companies; and help to ease the transition for households, industries, and communities being negatively affected by globalization and technological change. A well-thought-out immigration policy that attracts labor to the U.S. is also a necessary ingredient to support longer-run growth.

But such policies need to be implemented as the country puts its longer-run fiscal situation on a sustainable path. Recently released projections by the Congressional Budget Office indicate that under current policy, the federal deficit as a share of GDP will be quite a bit higher 10 years from now, with the recent fiscal policy changes estimated to add $1.6 trillion to the cumulative deficit over the next 10 years.[9] Because of the accumulating deficits, the ratio of federal debt held by the public to GDP is projected to rise from 78 percent at the end of this year to nearly 100 percent in 2028, the highest it has been since 1946. Note that the CBO estimates would be higher if the major provisions of the new tax and spending policies are extended instead of expiring as they do under current law.

Ever-rising government debt levels would mean a higher share of government spending going to interest payments. This would tend to crowd out productive investments by the private sector and the

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[9] The deficit as a percentage of GDP (adjusted to exclude the effects of shifting payments from one fiscal year into another so that those payments are not made on a weekend) was 3.5 percent in 2017. Under the CBO's baseline assumptions, the CBO projects this ratio to rise to 4.2 percent this year and to be 4.8 percent in 2028. See Summary Table 2 from CBO, "The Budget and Economic Outlook: 2018 to 2028," Congress of the United States, April 2018. (https://www.cbo.gov/publication/53651)

government, thereby lowering productivity and longer-run growth. Investors would demand a higher risk premium in order to hold U.S. government debt. With over 40 percent of publicly held U.S. Treasury debt held by foreigners, these interest payments need not be reinvested in the U.S. In addition, the sovereign debt crisis in Europe over 2009-2012 shows that high debt levels can pose severe problems if investors lose faith in the ability of governments to service their debts, generating spikes in what had previously been viewed as risk-free rates. Longer-run fiscal sustainability in the U.S. will depend on what combination of tax increases and spending controls are put in place to ensure that debt-to-GDP is on a downward path.

And this brings me back to monetary policy. Unless the U.S. can get its longer-run fiscal situation in order, high debt levels will constrain using fiscal policy as a tool to buoy the economy in recessions. This will put more of the burden on monetary policy to stimulate the economy during downturns. But in a world with lower potential growth and lower equilibrium interest rates, monetary policy will also have less room to act. The zero lower bound on interest rates would be hit more often, and we would find ourselves having to rely more often on nonconventional policy tools like asset purchases.

Today’s healthy outlook for the U.S. economy over the medium run gives policymakers the opportunity to consider these longer-run issues, which the country will need to deal with in order to ensure a healthy economy in the future.

Before I overstay my welcome, let me end here and thank you for your attention. I look forward to your questions.