The Economic Outlook, Monetary Policy, and Normal Policymaking Now and in the Future

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Introduction

I thank the Money Marketeers of New York University for inviting me back to speak tonight. When I was here four years ago, I discussed the important role that Federal Reserve communications play in making effective monetary policy and the need for these communications to evolve as we moved from a period of extraordinary monetary policymaking to more normal policymaking. At this point, that transition to more normal policymaking has been underway for some time, reflecting the health of the U.S. economy and the progress that's been made on the FOMC's monetary policy goals. Tonight, I'll talk about the economic outlook and monetary policy, FOMC communications, and upcoming considerations that will help determine what normal policymaking will look like in the future. 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.

Economic Growth

From the perspectives of the Fed's goals of maximum employment and price stability, the U.S. economy is doing very well. Growth has been running above trend for the past couple of years, inflation has moved up to the FOMC's 2 percent target, and labor markets are very strong. The unemployment rate is at its lowest level since the late 1960s and job growth is well above trend.

Last year, economic growth picked up to 2-1/2 percent, and it has been running around 3 percent over the first three quarters of this year. Early this month, longer-term interest rates moved up, and over the past couple of weeks, volatility in equity markets has increased. While a deeper and more persistent drop in equity markets could dash confidence and lead to a significant pullback in risk-taking and spending, we are far from this scenario. The S&P 500 index remains higher than it was a year ago. Similar to the swings in the market we saw earlier this year, the movements of late do not seem to be signaling that investors are becoming overly pessimistic. While the market volatility poses a risk to the forecast and bears monitoring, it has not led me to change my modal medium-run outlook. I expect growth to come in a tad above 3 percent this year and to be in the 2-3/4 to 3 percent range next year, well above my 2 percent estimate of the economy's trend growth rate.

Both consumer and business spending are making solid contributions to growth and I expect that to continue. Household incomes have been rising, reflecting the strength of the job market. In the aggregate, households have been able to increase savings and their debt levels are manageable, making for sound balance sheets. The changes in tax policy that became effective earlier this year added a positive element to an already healthy outlook for consumer spending.

Business activity and spending have also been healthy. Investment in equipment and intellectual property has strengthened this year and strong order flows suggest that strength will continue. The changes in tax policy, including lower corporate tax rates and full expensing for investment in equipment and intangibles, support further business spending. Increased federal government spending is also a positive for growth over the next couple of years. Despite the uncertainty around trade and tariff policies, business sentiment is high. Earlier, when the expansion was getting underway, businesses' main concern was weak demand; now it is the difficulty in finding workers to keep up with strong demand.

The housing market has slowed somewhat over the past year. Some softening is to be expected as interest rates have moved up; the 30-year fixed mortgage rate is about a percentage point higher than a year ago. In some areas, a lack of housing supply may also be negatively weighing on housing activity. In addition, the tax changes contain several provisions that affect homeownership, including the limit on the deduction for state and local taxes, which includes property taxes, and the limit on the mortgage interest deduction, both of which will affect those taxpayers who continue to itemize deductions. I am not anticipating a strong pullback in housing over the next year, but I also do not expect it to be a strong engine of growth for the overall economy.

Growth abroad has improved in recent years, but forecasts have recently been revised down. The divergence between economic growth prospects abroad and in the U.S. puts upward pressure on the dollar and suggests that net exports – the difference between exports and imports – will likely be a small drag on U.S. growth over the next couple of years. However, this assessment is complicated by the uncertainty around trade and tariff policies. The recent U.S.-Mexico-Canada trade agreement to replace NAFTA reduced some of this uncertainty, but rules under which the firms operate – for example, what constitutes off-shore content – still need to be worked out and the agreement needs Senate approval. The impact of trade developments between the U.S. and China will depend on the actions ultimately taken and on whether the uncertainty itself leads to a pullback in spending. The majority of business contacts from my District report that they have not changed their plans or revenue outlook in response to concerns about escalating trade tensions. However, some manufacturing contacts have reported that the tariffs have been quite disruptive to their supply chains, forcing them to find alternative suppliers or face increasing costs of production. These effects could last for some time because reorganizing supply chains cannot be done quickly. Thus, the tariffs will act as a tax on inputs to U.S. production and are a headwind to productivity growth, which has been low during the expansion.

Labor Markets

Above-trend growth has led to continued strong job growth and declines in the unemployment rate. Payroll job gains have averaged over 200,000 jobs per month this year, up from about 180,000 per month last year, and are well above most estimates of trend, which lie in the range of 75,000 to 120,000. Another sign of a strong labor market is the stability of the labor force participation rate, which demographics suggest will be trending down over time. The unemployment rate has been at or below 4 percent for the past six months. It fell to 3.7 percent in September, which is lower than the levels reached during the past two expansions, and is well below my 4.5 percent estimate of the unemployment rate that is sustainable over the longer run. I expect that strong growth will support further tightening of the labor market, with the unemployment rate falling to slightly under 3-1/2 percent by the end of next year.

As I mentioned, firms continue to report that it is very difficult to find workers. These reports are coming from a variety of industries, across skill levels and geographic regions. Firms are responding to labor shortages by offering higher wages and more flexible work schedules. In fact, some of my contacts tell me they are offering incentive payments to workers based solely on their attendance. Other firms tell me they are automating faster, although they recognize that finding even the reduced number of workers needed for automated plants is going to be a problem in the short run. Some manufacturers have told me they would be investing more in plant and equipment if they thought they could find workers. So the tightness in labor markets may develop into a headwind on growth.

The official statistics on wages and compensation have been lagging the anecdotal reports, but recently, the readings have caught up. Various year-over-year measures of wage growth are nearing 3 percent, up from 2 percent early in the expansion. Some people ask: if labor markets are so tight, why aren't we seeing wage growth in the 3 to 4 percent range like we saw in the prior two expansions? This is a legitimate question.

First, it has to be acknowledged that it is difficult to know with any precision how tight labor markets are; maybe they aren't as tight as we once thought. In fact, the behavior of labor force participation and the fact that wage growth has remained moderate even as labor markets have strengthened have led many policymakers to reassess the level of the unemployment rate they view as sustainable in the long run. Five years ago, the central tendency of projections of the longer-run unemployment rate among FOMC policymakers ranged from 5.2 to 5.8 percent.[1] In projections this September, the central tendency was

[1] See the Summary of Economic Projections section of FOMC, "Minutes of the Federal Open Market Committee," September 17-18, 2013.
(https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20130918.pdf)

about a percentage point lower, at 4.3 to 4.6 percent, with a median projection of 4.5 percent.[2] Over time, I have also moved down my own estimate of the longer-run unemployment rate to my current estimate of 4.5 percent.

But even relative to these lower longer-run estimates, labor markets are tight, and based on a broad set of labor market indicators, my assessment is that we are beyond maximum employment, one part of the Fed's monetary policy mandate. So there is still some explaining to do regarding the relatively moderate wage growth we've seen so far. Much of the explanation lies with the low levels of inflation and productivity growth over this expansion.[3] The recent increase in nominal wage growth reflects the recent firming in both factors, but I wouldn't expect to see a strong acceleration in wages unless we see a strong pickup in productivity growth. Such a scenario would be welcome, since wage growth reflecting higher productivity growth does not contribute to inflationary pressures in a competitive economy.

Inflation

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 goal is symmetric, meaning that the FOMC would be concerned if inflation were running persistently above or persistently below this goal and such persistent deviations would warrant a policy response.[4] But month-to-month variations in the inflation measures, due to idiosyncratic factors or in response to temporary economic and

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[2] See the Summary of Economic Projections section of FOMC, "Minutes of the Federal Open Market Committee," September 25-26, 2018.
(https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20180926.pdf)

[3] Over the longer run, wages, adjusted for inflation, tend to reflect the marginal product of workers. During this expansion, the annualized growth rate of labor productivity, measured by output per hour worked in the nonfarm business sector, has been about 1.1 percent, less than half the pace over the prior two expansions.

[4] See FOMC, "Statement on Longer-Run Goals and Monetary Policy Strategy," adopted effective January 24, 2012; as amended effective January 30, 2018.
(https://www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf).

financial disturbances, are to be expected. Policymakers look through temporary undershoots or overshoots of our inflation goal and focus on where inflation is going on a sustained basis.

As the expansion has continued, inflation has gradually firmed, consistent with reports from business contacts that they now have a greater ability to raise their own prices in response to higher input costs and strong demand. PCE inflation and core PCE inflation, which excludes food and energy prices, have been running near 2 percent for several months. Inflation expectations have been stable, and this has helped anchor inflation despite the tightness in labor markets and the strength of the economy. In this environment, maintaining stable inflation expectations will be the key to maintaining inflation at target. With appropriate adjustments in monetary policy, my outlook is that inflation will remain near 2 percent, subject to the usual monthly variations in the measures.

Monetary Policy and Communications

At its meeting in September, the FOMC raised the target range for the federal funds rate by 25 basis points, to 2 to 2-1/4 percent, and continued on its pre-announced plan for gradually reducing the amount of assets held on its balance sheet.

As the economy has improved, the FOMC has been engaged in a strategy to gradually reduce the extraordinary accommodation that was put in place to address the Great Recession. This approach is one that balances the upside and downside risks to achieving and maintaining our dual mandate goals so that the expansion is sustained. We want to avoid a buildup in risks to macroeconomic stability that could arise if the economy were allowed to overheat, but we also want to avoid choking off the expansion. In addition, gradually reducing accommodation helps mitigate the risks of financial imbalances that can arise in a low interest rate environment. Currently, I would characterize these risks as moderate. But growth in leveraged lending is strong, commercial real estate valuations are lofty, and I believe we are at a point in the business cycle where increased attention to financial stability risk is warranted because the economy continues to grow above trend and financial conditions remain accommodative, even taking into account the recent increase in long-term interest rates.

As the funds rate target gets closer to the range of estimates of the neutral rate – the level of interest rates consistent with stable prices and maximum employment in the long run – we are nearing the completion of the exit from the period of extraordinary monetary policymaking and moving close to a period of normal policymaking. Our communications are appropriately changing. You may have noticed that in September, we removed language indicating that the stance of monetary policy remains accommodative. This wasn't meant to signal any change in policy strategy or the likely path of policy. Indeed, we said that given the economic outlook we expect further gradual increases in the funds rate will likely be warranted. Instead, I view the change in language as an indication that we are getting back to a period of normal policymaking.

In the period of extraordinary monetary policymaking, when the policy rate was at its effective lower bound, the FOMC used forward guidance about the expected future path of interest rates as a policy tool. We conveyed that our future path was going to be very accommodative for a long time. But in normal times, there is no need to use guidance as a policy tool and there is less certainty around the future policy path. That path will depend on the evolution of economic conditions and their effect on the medium-run outlook and risks around the outlook. So instead of giving explicit guidance, normal policy communications should convey the rationale for policy decisions and the FOMC's reaction function, that is, how policy is likely to systematically respond to changes in economic conditions – whether those changes are anticipated or unanticipated.

Let me underscore that just because the future policy path isn't known with certainty and will depend on economic developments doesn't mean that policymakers will be nonsystematic in their approach to policymaking. It just means that in normal times, it would be inappropriate to commit to a future path because the path taken will depend on how economic conditions evolve. Let me also note that in addition to contributing to transparency and accountability, being systematic and communicating so that the public understands normal policymaking will make the forward guidance we use in extraordinary times more effective. They will understand that keeping interest rates lower for longer is not business as usual, and this awareness can help put downward pressure on longer-term interest rates.

Might the return to normal policymaking be an argument for the FOMC's dropping the so-called dot plot from the Summary of Economic Projections, as some have suggested we do? I think it would be a mistake to discontinue the dot plot. The dot plot provides information on the policy paths that individual FOMC participants view as appropriate to promoting the FOMC's monetary policy goals. The dots can change over time because of economic developments, but that's a design feature, not a flaw. The FOMC also provides a chart illustrating the uncertainty band around the median policy path across participants.[5] It clearly shows that the farther out in the projection horizon one goes, the wider the degree of uncertainty – this is a characteristic of normal policymaking. Omitting this information would not make the divergence in views across FOMC participants or the uncertainty around their projections disappear, but it would be a significant step back in transparency.

Let me conclude by touching on two considerations that will help determine what normal policymaking looks like in the future. The first is the *operating framework* the Fed uses to ensure that its policy rate is

[5] The FOMC began providing charts of the confidence bands around the median projections in the March 2017 Summary of Economic Projections. For the latest charts, see the Summary of Economic Projections section of FOMC, "Minutes of the Federal Open Market Committee," September 25-26, 2018. (https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20180926.pdf)

being maintained at the appropriate level, and the second is the *monetary policy strategic framework* that the FOMC uses to determine what that appropriate level of the policy rate is.[6]

Monetary Policy Frameworks: Operations and Strategy

Since last October, the FOMC has been in the process of gradually and predictably reducing the holdings of Treasury and agency securities that were purchased to address the financial crisis and Great Recession.[7] We plan to shrink the balance sheet until the Fed is holding no more securities than necessary to implement policy efficiently and effectively, and as noted in the minutes of the July FOMC meeting, the FOMC will likely soon be resuming a discussion of what that implementation framework will be.[8]

One option is to try to return to operating like we did before the financial crisis, when the FOMC kept the supply of bank reserves scarce. In June 2007, banks were holding about $10 billion in reserve accounts at the Fed. The FOMC could make small changes in that supply by buying or selling short-term Treasuries, and this allowed the FOMC to ensure that the fed funds rate was maintained at the FOMC's target. But now, as a result of the Fed's large-scale asset purchases, reserves are very abundant. While reserve levels are down from their peaks, banks are still holding about $1.8 trillion in reserve accounts at the Fed, and almost all of this is in excess of what is required by regulation. At these levels, small changes in the

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[6] For further discussion of monetary policy frameworks, see Mester, Loretta J., "Monetary Policy Frameworks," National Association for Business Economics and American Economic Association Session at the Allied Social Science Associations Annual Meeting, Philadelphia, PA, January 5, 2018 (https://www.clevelandfed.org/newsroom-and-events/speeches/sp-20180105-monetary-policy-frameworks), and Mester, Loretta J., "Remarks on the FOMC's Monetary Policy Framework," panel remarks at the 2018 U.S. Monetary Policy Forum, sponsored by the Initiative on Global Markets at the University of Chicago Booth School of Business, New York, NY, February 23, 2018. (https://www.clevelandfed.org/newsroom-and-events/speeches/sp-20180223-remarks-on-the-fomcs-monetary-policy-framework)

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

[8] See "Minutes of the Federal Open Market Committee," July 31-August 1, 2018. (https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20180801.pdf)

supply of reserves have little effect on the fed funds rate. Instead, the Fed brings the fed funds rate into its target range by adjusting the rate it pays on excess reserves, and by using overnight reverse repurchase agreements, which help put a floor on the fed funds rate. Reserves and currency are the main liabilities on the Fed's balance sheet, so the choice between these two frameworks will determine the volume of assets the Fed will hold on its balance sheet.

Both operating frameworks have proven to be effective during the periods in which they have been used. There are several things to consider in determining which implementation framework will be most effective going forward. The fed funds market has changed considerably since the financial crisis,[9] and the regulatory changes put in place since the crisis have likely affected the banking system's demand for reserve balances. This may limit the feasibility of returning to a framework with scarce reserves, and it also raises the question of whether the fed funds rate will remain the best indicator of the general level of short-term interest rates, regardless of the operating framework. On the other hand, a relatively large balance sheet, which would accompany an abundant reserves framework, might be viewed with some skepticism or generate requests for the Fed to aid other industries or use the balance sheet to fund government initiatives, as occurred during and since the crisis.[10,11] I believe this type of risk can be effectively handled by clear and timely communication by the FOMC on the rationale for its decision

[9] For a review of changes in the fed funds market since the financial crisis, see Craig, Ben R. and Sara Millington, "The Federal Funds Market since the Financial Crisis," Federal Reserve Bank of Cleveland *Economic Commentary*, April 5, 2017. (https://www.clevelandfed.org/newsroom-and-events/publications/economic-commentary/2017-economic-commentaries/ec-201707-the-federal-funds-market-since-the-financial-crisis.aspx)

[10] For example, during December 2008, as Congress debated a bailout for American automakers, several members of Congress requested of then-Chair Ben Bernanke that the Fed lend directly to auto companies. Needless to say, the Fed was reluctant to go down this path, which would have put it squarely in the midst of industrial policy, a responsibility of Congress. See the discussion in Chapter 17 of Ben S. Bernanke, *The Courage to Act: A Memoir of a Crisis and its Aftermath*, New York: W.W. Norton and Company, 2015.

[11] More recently, Congress used funds from the Fed's surplus account to pay for highways and other budget initiatives, and put limits on the size of the surplus. See the 2015 Fixing America's Surface Act, or FAST Act, and the Bipartisan Budget Act of 2018.

about the implementation framework, as well as its other policy decisions in pursuit of our goals of maximum employment and price stability.

Which brings me to the other important issue that will determine what normal monetary policymaking is in the future, namely, the strategic framework used to determine appropriate monetary policy. Currently, we use a flexible inflation-targeting framework, which has served the FOMC well in effectively promoting our policy goals. But based on demographics, higher demand for safe assets, and other factors, many economists anticipate that the longer-term equilibrium real interest rate will remain lower than in past decades. This would mean there would be less room for monetary policymakers to cushion against a negative economic shock, the probability of the policy rate hitting the effective lower bound would be higher, and nontraditional monetary policy tools would need to be used more often. To the extent that these tools are less effective than the traditional interest rate tool or are constrained from being used, the potential would be for longer recessions and longer bouts of inflation well below target.[12]

So we need to ask whether there are alternative policy strategies that could lower the probability of getting into this situation, and at the July FOMC meeting, participants agreed to discuss this topic at future meetings.[13] Researchers have suggested several alternative frameworks, such as targeting an inflation rate higher than 2 percent, moving to an inflation-targeting range instead of a point goal, or targeting a path for the price level or for nominal GDP rather than for inflation. None of these alternative frameworks are without challenges but all are worth thorough review. It might be useful to do something akin to simulated stress testing to see how each framework might fare when confronted with things like data revisions; uncertainty about the levels of the equilibrium interest rate, potential growth, and longer-

[12] Although I don't discuss them here, other government policies might also be brought to bear to increase the long-term growth rate and equilibrium interest rate, which would give monetary policy more room to act. Such policies would focus on increasing productivity growth and labor force participation.

[13] See "Minutes of the Federal Open Market Committee," July 31-August 1, 2018. (https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20180801.pdf)

run unemployment rate; and the challenges of effective policy communications. My colleague Eric Rosengren, president of the Boston Fed, recently put out a proposal for regular review of the Fed's strategic framework.[14] I support this idea; it makes sense to me that, as a matter of good governance, a central bank should periodically review its assumptions, methods, and models. I also believe that to inform our evaluation of the framework, we should seek a wide range of perspectives, including those from experts in academia, the private sector, and other central banks. I am confident in predicting that there won't be a consensus among this wide-ranging group, but I am equally confident in predicting that we will ultimately get to a better decision – whether it be to stay with our current framework or adopt an alternative – if we listen to a diverse set of views on the subject.

[14] See Fuhrer, Jeffery C., Giovanni P. Olivei, Eric S. Rosengren, and Geoffrey M.B. Tootell, "Should the Fed Regularly Evaluate its Monetary Policy Framework?" *Brookings Papers on Economic Activity Conference Drafts*, September 13-14, 2018. (https://www.brookings.edu/wp-content/uploads/2018/09/BPEA_Fall2018_Should-the-Fed-Regularly-Evlauate-its-Monetary-Policy-Framework.pdf)