# Perspectives on the Economic Outlook and Monetary Policy in the Coming Year

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**Introduction**

I thank Barbara Snyder and The 50 Club for inviting me to speak tonight about the economy and monetary policy. I am especially looking forward to the question and answer portion of the program because as we navigate through the year, we will need to be particularly attuned to what is happening on the ground. The Federal Reserve System is actually well structured to do that. The Federal Reserve Bank of Cleveland, right up the street, is one of 12 regional Reserve Banks distributed across the country that, along with the Board of Governors in Washington, D.C., comprise the Federal Reserve System.

Congress designed the Fed more than 100 years ago as a decentralized central bank, independent *within* the government but not independent *from* the government. The Fed was designed to balance public-sector and private-sector interests, and Wall Street and Main Street concerns. This design has served the country well by allowing monetary policy decisions to take into account the diversity of the American economy and its people. The regional structure also allows us to carry out our other responsibilities, including supervising and regulating banks, offering financial services to the U.S. government, overseeing the payments system, and identifying policies that can help promote economic progress and access to credit in low- and moderate-income neighborhoods.

The Cleveland Fed is proud to be part of the civic landscape in Cleveland and the rest of our District, which includes the state of Ohio and parts of Pennsylvania, Kentucky, and West Virginia. Many of you provide us with your insights into business activity, labor markets, and financial conditions, collected through our surveys and advisory councils, and I thank you for that public service. This timely information is very helpful to me as I formulate my economic outlook and monetary policy views, which I’ll speak about tonight. 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, the monetary policymaking body within the Fed.

**The National Economic Outlook**

Rather than "bury the lede," let me start with last week's FOMC decision. The FOMC decided to keep the target range for the federal funds rate, our policy rate, at 2-1/4 to 2-1/2 percent, and we have adopted a wait-and-see approach regarding future rate adjustments. I fully supported this decision because I believe that policy, for the time being, is well-calibrated to the economic outlook and the risks around that outlook.

***Economic growth***

Congress has given the Fed its monetary policy goals of price stability and maximum employment, and from the standpoint of those goals, the U.S. economy has been doing very well. We have enjoyed above-trend output growth for the past couple of years, with estimates suggesting that growth was around 3 percent last year. After several years of being below-target, inflation has moved up and has been relatively stable around the FOMC's 2 percent objective, and labor markets are very strong, with above-trend job growth and very low unemployment.

The question is whether the economy can maintain its good performance in 2019. My expectation is that it will. In my view, the most likely case is that we will see somewhat slower growth than we did last year, in the 2 to 2-1/2 percent range, reflecting less of a boost from fiscal stimulus and less accommodative financial conditions. But this pace is still at or slightly above trend. Employment growth will also slow a bit, but it will remain strong enough to absorb those entering the workforce, and I expect the unemployment rate to remain at or below 4 percent. As this transition toward a sustainable pace occurs, I expect inflation to remain near 2 percent, with the usual transitory ups and downs.

If this outlook comes to pass, we will chalk up 2019 as another very good year for the economy. But the path to sustainability is rarely smooth, and uncertainty is clouding the outlook. The partial shutdown of the federal government is a case in point. It caused significant hardships for the workers who weren't getting paid and for businesses that rely on the parts of the government that weren't operating. In terms of the overall economy, we will see somewhat slower growth in the first quarter than we otherwise would, but I expect that to be made up in the second quarter, as long as we avoid another shutdown. The shutdown came at a time when people were already feeling a bit uneasy. In the fourth quarter of last year, investor sentiment shifted and investors began putting significant weight on downside risks to the forecast. As a result, there was a sharp increase in volatility, a decline in equity prices, and an increase in the credit spread of corporate bond yields relative to Treasury yields. It reminded me of Bette Davis's line in *All About Eve*: "Fasten your seatbelts; it's going to be a bumpy night."

Since the start of the year, conditions in financial markets have eased, although they remain tighter than they were last fall. The shift in sentiment is a good reminder that the economy is dynamic and can take unexpected turns. While we all have to look forward and make our best assessment of how the economy is doing, we also have to be ready to change those views should the incoming information warrant it.

Although surveys of households and businesses indicate they are less confident about the economy than they were, much of the incoming data are consistent with slower but still solid growth. Household incomes have been rising, reflecting the strength of the job market and lower taxes. In the aggregate, households have been able to increase savings and their debt levels are manageable, making for sound balance sheets. These factors have been supporting solid consumer spending. Lower equity prices and higher volatility no doubt add an air of caution, but many households benefit from lower oil and gasoline prices. Consumer spending is over two-thirds of output, so we will need to keep a close eye on whether household sentiment weakens so much that people postpone spending or whether they remain cautiously optimistic and continue to spend.

The housing market has slowed over the past year. The 30-year mortgage rate moved up nearly 1 percentage point from late 2017 to late 2018, and house price appreciation continues to exceed income growth, making affordability an issue for many households. Looking forward, the tax changes contain several provisions that affect homeownership. There is a limit on the deduction for state and local taxes, which includes property taxes, and a limit on the deduction for mortgage interest, both of which will affect those taxpayers who continue to itemize deductions. On the other hand, strong labor markets mean more people are now in the position to make the commitment to purchase a home. On balance, I don't expect housing to contribute much to economic growth this year, but I don't expect to see a sharp pullback in the sector either.

Business spending was quite strong in the first half of last year, supported by strong earnings growth and changes in tax policy that included lower corporate tax rates and full expensing of investment in equipment and intangibles. But business spending moderated in the second half of the year, as financial conditions tightened and uncertainty over tariffs, trade policy, and growth abroad began to weigh on manufacturers and other firms dependent on exports. Lower energy prices benefit consumers, but they tend to dampen mining and drilling investment. I don't expect the drag on investment in this sector to be nearly as large as in 2015-2016, unless energy prices fall considerably more.

While the Fed's monetary policy goals pertain to the U.S. economy, how economies in the rest of the world fare can spill over to the U.S. through trade and financial markets. Growth abroad, including China and Europe, is expected to slow this year, but there is some uncertainty around how much of a slowdown there will be. The path and outcome of Brexit add further uncertainty, as does the outcome of trade and tariff negotiations. Indeed, some of the slowdown abroad is likely related to changes in and uncertainty over trade policy. China is Ohio's third largest export destination, after Canada and Mexico, and Ohio's largest import source. The majority of our business contacts continue to report that while their concerns about trade policy and global growth are rising, their investment plans remain intact. But some larger multinational firms have become more hesitant, and several manufacturing contacts have said that the tariffs have been disruptive to their supply chains, forcing them to find alternative suppliers or face increasing costs of production. You can think of the tariffs as a tax on inputs to U.S. production; they reduce profitability or are passed along to consumers in the form of higher prices. To the extent that the tariffs disrupt the most efficient use of resources, they are a headwind to longer-term productivity growth, which has already been low during the expansion. Should the slowdown in the economies of our major trading partners, including China and Germany, be sharper than expected or should the continued uncertainty persuade more firms to take a wait-and-see attitude, U.S. growth may slow more than anticipated. Of course, a favorable resolution to some of the uncertainty could buoy sentiment and foster a pickup in investment, leading to stronger than expected growth in the U.S.

Overall, in my view the most likely outcome is that the economic expansion will continue this year, with growth moving down to a more sustainable pace, at or slightly above trend. But the move may not be a smooth one and there is uncertainty around the forecast. Slowing global growth, uncertainty over trade policy, tighter financial conditions, and the downturn in sentiment pose risks to this forecast and bear watching.

***Labor markets***

Strong economic growth like we have seen over the past few years is usually accompanied by strong labor market conditions, and 2018 was no exception. Last year, the economy added more than 2.6 million jobs, over 220,000 jobs per month, and more than 300,000 jobs were added in January. This is much stronger than the estimates of trend job growth, which range from 75,000 to 120,000 per month. The unemployment rate has been at or below 4.0 percent for almost a year, near the historical lows seen over the past 50 years. It seems unlikely that this low level can be maintained over the longer run. Business and labor contacts throughout the Cleveland Federal Reserve District, across a variety of industries, have been reporting to us for quite some time that it is very difficult to find workers across all skill levels. Some firms have shifted from looking for new hires to doing all they can to retain their current workers, including offering more flexible work schedules and raising wages. These anecdotal reports have shown through to the national statistics. Aggregate measures of compensation are now in the 3 percent range, after being quite subdued earlier in the expansion. This is a welcome increase. It gives workers more purchasing power, but because the pickup has been in line with productivity growth and inflation, it has not added to inflationary pressures.

***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. Our goal is symmetric, meaning that we don't want to see inflation run either persistently above or persistently below this goal. There is always some short-term variation in the inflation measures, but monetary policymakers focus on the underlying medium- to long-term trends in inflation.

After running below 2 percent for much of the expansion, inflation rates have firmed over the last several years. Last year, higher energy prices boosted headline PCE inflation above 2 percent, and the recent decline in energy prices will likely mean that inflation will move below 2 percent in the first part of the year. But the core inflation measures, which exclude food and energy prices, show that underlying trend inflation is essentially at the Fed's goal of 2 percent. The key to this good performance is that expectations about inflation over the medium to longer term have been stable. This has kept inflation pressures at bay despite the tightness in labor markets, the strength of the economy, and reports from business contacts that they have more pricing power now than they have had in many years. Going forward, with appropriate adjustments in monetary policy that maintain stable inflation expectations, my outlook is that inflation will remain near our symmetric 2 percent goal.

Before turning to monetary policy, let me say something about the regional economy.

**The Regional Economy**

How the Cleveland region has fared over the economic expansion reflects not only trends in the national economy but also the region's own transformation over the past couple of decades. From 1996 to 2008, the metro area lost about 3 percent of its population and more than 3 percent of its jobs. In contrast, Ohio's population grew by 3 percent, and while the state didn't add jobs, on net, it didn't lose them either. The U.S., overall, did much better than either Cleveland or Ohio: population grew by 16 percent, and jobs grew by 14 percent, or a compounded rate of 1 percent per year. This better job growth meant that per capita income growth, adjusted for inflation, was stronger for the nation than for either Cleveland or Ohio.

But recent trends have been more positive. Over the past five years, the regional economy has grown slowly but steadily, the population decline has slowed considerably, the metro area has been adding jobs, and real per capita income growth has been similar to that of the U.S. Demographics suggest that the region's trend job growth will remain below that of the nation and our unemployment rate will be higher. But the metro area has benefited by becoming more diversified. In the 1990s, manufacturing represented almost 20 percent of Cleveland's and Ohio's jobs; that share has fallen to about 12 percent. Manufacturing is still a relatively more important sector here than in other parts of the country, so the region has been particularly affected by the downward trend in manufacturing employment.[1] But the region now has specializations in healthcare, insurance, and business management, which should make it more resilient.

Of course, this shift in sectoral mix presents a challenge: As the regional economy becomes less reliant on lower-skilled manufacturing, and more reliant on higher-skilled manufacturing and service-sector jobs,

[1] In the U.S., the share of jobs in manufacturing has fallen from about 15 percent in the 1990s to about 8 percent today.

how can it ensure that its population acquires the necessary skills for jobs available now and in the future?

Investments in education and training will be key.[2] Cleveland is off to a good start. The metro area compares favorably with the nation, with a slightly higher percentage of high school graduates and a similar share of those with a bachelor's degree or higher,[3] and we are home to strong universities. Not all jobs will require a college degree. Cleveland Fed research indicates that compared to many parts of the country, Cleveland has a higher share of so-called "opportunity occupations." These are jobs that pay above-median wages but don't require a bachelor's degree.[4] These types of jobs still require training, but it often takes less time and money to transition into them. The area has a number of innovative training programs, including those offered at Cuyahoga Community College's Manufacturing Technology Center, which I had the pleasure of touring.

In addition to a skilled workforce, effective leadership and collaboration among businesses, government, nonprofits, and individuals have helped areas navigate economic transitions driven by technological

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[2] Cleveland Fed researchers found that over a 75-year period, in our District, education levels were consistently one of the most reliable indicators for each state's per capita income growth and that counties with higher levels of high school graduates tend to have lower poverty rates and higher levels of labor force participation.
See "Altered States: A Perspective on 75 Years of State Income Growth," Federal Reserve Bank of Cleveland 2005 Annual Report. (https://www.clevelandfed.org/newsroom-and-events/publications/annual-reports/ar-2005-perspective-on-75-years-of-state-income-growth/ar-200502-altered-states-essay.aspx)
and Mark Schweitzer and Peter Rupert, "Understanding the Persistence of Poverty," Federal Reserve Bank of Cleveland 2006 Annual Report. (https://www.clevelandfed.org/newsroom-and-events/publications/annual-reports/ar-2006-understanding-the-persistence-of-poverty/ar-200602-understanding-the-persistence-of-poverty.aspx)

[3] Of the population age 25 years and over, 27.3 percent in the U.S. and 29.5 percent in the Cleveland metro area earned a high school diploma as their terminal degree, and 30.9 percent in the U.S. and 30.2 percent in the Cleveland metro area earned a bachelor's degree or higher.

[4] The researchers found that roughly a third of the jobs in the Cleveland region are in opportunity occupations, almost 10 percentage points higher than for the nation as a whole. See Keith Wardrip, Kyle Fee, Lisa Nelson, and Stuart Andreason, "Identifying Opportunity Occupations in the Nation's Largest Metropolitan Economies," Federal Reserve Banks of Philadelphia, Cleveland, and Atlanta, September 2015. (https://www.clevelandfed.org/newsroom-and-events/publications/special-reports/sr-20150909-identifying-opportunity-occupations.aspx)

change and globalization.[5] So our region will benefit from the work of many of the people in this room, who are already dedicated to addressing workforce development issues so that Cleveland remains economically competitive in the future.

**Monetary Policy**

Let me conclude with a few more remarks on where monetary policy goes from here. Since December 2015, when the expansion was well underway, the FOMC has been gradually moving the policy rate up from the extraordinarily low level that was needed to address the Great Recession. Our policy rate is now at the lower end of the range of FOMC participants' estimates of its longer-run neutral rate, a level that neither stimulates nor restricts the economy and is consistent with maximum employment and price stability, and our most recent policy rate increases are still working themselves through the economy. In addition, we have also been letting the longer-term assets that we purchased to add accommodation during the recession gradually roll off the Fed's balance sheet, and we have made considerable progress in bringing bank reserves down to more normal levels. As the FOMC announced last week, we plan to continue to use our current operating framework for implementing monetary policy, and at coming meetings, we will be finalizing our plans for ending the balance-sheet runoff and completing balance-sheet normalization.

With respect to our monetary policy goals of price stability and maximum employment, the economy is in a very good spot. Growth is slowing from an above-trend pace, and labor markets are strong. While the unemployment rate is lower than the level that is sustainable in the longer run, inflation is near 2 percent and does not show signs of appreciably rising. In my view, monetary policy does not appear to be far

[5] "Reinvigorating Springfield's Economy: Lessons from Resurgent Cities," Public Policy Discussion Paper No. 09-6, Federal Reserve Bank of Boston, October 1, 2009. (https://www.bostonfed.org/-/media/Documents/Workingpapers/PDF/ppdp0906.pdf)

behind or far ahead of the curve. This environment gives us the opportunity to continue to gather information on the economy and assess our forecast and the risks, before making any further adjustments in the policy rate. If the economy performs along the lines that I've outlined as most likely, the fed funds rate may need to move a bit higher than current levels. But if some of the downside risks to the forecast manifest themselves, and the economy turns out to be weaker than expected and jeopardizes our dual mandate goals, I will need to adjust my outlook and policy views. While I cannot predict what the future will bring, there is one thing I can say with certainty: My colleagues and I on the FOMC will strive to bring the best analysis and judgment to our monetary policy decisions, doing our part to support a healthy economy on behalf of the public.