Views on the U.S. Economy and Monetary Policy

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Introduction

It is a real pleasure to be participating again in the European Economics and Financial Centre's Distinguished Speakers Seminar series. It was three years ago, almost to the day, when I was last before you. Since that time, there have been several economic and policy developments in the U.S. that I will update you on today. One thing has not changed: monetary policymakers are operating in a world of economic and geopolitical uncertainties that cloud the outlook. When I was here three years ago, U.K. voters had just decided to exit the European Union, and it was too soon to determine with any precision what the ramifications of that vote would be for the U.K. and global economy. Today, the terms of Brexit remain unresolved while a new source of uncertainty has emerged, namely, international trade policy. Political tensions in the Middle East have also arisen, with implications for energy prices and financial markets. Of course, forecasting in an uncertain world is a difficult task, but it is something economists and monetary policymakers must always do.

The Federal Reserve has a statutory mandate to set U.S. monetary policy to achieve the longer-run goals of price stability and maximum employment. At its meeting two weeks ago, the Federal Open Market Committee (FOMC), the Fed's monetary policymaking body, decided to maintain the target range of the federal funds rate at 2-1/4 to 2-1/2 percent. In its statement, the FOMC indicated that it "continues to view sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes, but uncertainties about this outlook have increased." The Committee said that "in light of these uncertainties and muted inflation pressures," it "will closely monitor the implications of incoming information for the economic outlook and will act as appropriate to sustain the expansion, with a strong labor market and inflation near its symmetric 2 percent objective."

Today, I will discuss why I agree with this assessment of the economic outlook, and its implications for monetary policy. It is important to point out that 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

Last month, the U.S. economic expansion reached its 10-year anniversary. For the past couple of years, the economy has been growing at an above-trend pace, and last year, real GDP growth was a strong 3 percent. Growth was supported by fiscal stimulus in the form of tax cuts to households and businesses and higher federal government spending, as well as financial conditions that were accommodative for much of the year. I anticipated that output growth would slow this year as this stimulus waned. The question is whether growth will slow toward a more sustainable trend pace, which I estimate to be around 2 percent, or whether we will see a more significant deceleration in output and labor market conditions. In my view, the most likely outcome continues to be that the economy will maintain its good performance in 2019 – a sustainable-growth scenario in which output growth slows to a sustainable pace, labor markets remain strong, and after some near term softness, inflation moves back to our 2 percent goal over time. But mixed recent data suggest that the downside risks to this forecast have risen and that there is some chance that an alternative, weak-growth scenario could be emerging, one in which growth slows more significantly, the unemployment rate rises, and inflation remains low because aggregate demand is weak. The declines in longer-term Treasury yields and other sovereign debt yields over the past two months suggest that bond investors are putting a higher likelihood on this scenario than they did earlier this year.

The path to sustainability is rarely smooth, and this year has been no different. Real GDP growth remained at a strong 3.1 percent in the first quarter, but about half of that growth came from inventory investment and net exports, which is not sustainable. Most estimates of second quarter growth suggest growth will slow to a range of 1.5 to 2 percent. Of course, this still means a solid showing for the first half of the year.

There is variation across sectors in terms of their contributions to overall growth. On the positive side is consumer spending. Although the monthly readings have been volatile, the overall data suggest that consumer spending picked up in the second quarter after being subdued in the first quarter. First quarter spending was weighed down in part by the partial federal government shutdown that delayed income tax refunds and by declines in equity prices at the end of last year, which reduced household wealth. These temporary factors have dissipated. The healthy labor market is adding jobs and producing wage gains in excess of inflation, which are supportive of consumer spending. Financial conditions remain relatively accommodative by a number of measures, even with the increase in volatility of late. While consumer confidence and sentiment fell in June, they remain at relatively high levels and it is too soon to determine whether June's drop is the start of a more sustained falloff in consumer attitudes that could weigh on consumer spending.

On the neutral side is the housing market, which has seen only a protracted recovery from the Great Recession. Indeed, residential investment subtracted from growth throughout 2018 and in the first quarter of this year. Until very recently, affordability was becoming an issue because the 30-year mortgage rate had been trending up since mid-2016 and house price appreciation was exceeding income growth. In addition, recent changes to the U.S. tax code reduced the deductibility of housing-related taxes for some taxpayers, affecting the incentives to own a home. Going forward, several factors should help stabilize the housing sector. These include the recent decline in mortgage rates; slower house price appreciation, which was running 6 to 7 percent in early 2018 and is now in the 3 to 4 percent range; and an increase in household formation driven by the strong labor market, which allows more people to commit to purchasing a home. On balance, I don't expect housing to contribute much to economic growth this year, nor do I expect to see a sharp pullback in the sector.

On the negative side is business investment. Business investment in equipment was strong last year, but weakened sharply in the first quarter despite favorable earnings and lower taxes. Surveys of business

activity point to solid conditions in the services sector, but manufacturing activity has softened. New orders and shipments of capital goods excluding aircraft and defense have decelerated from their year-ago levels, and orders and shipments of aircraft have decreased sharply since the start of the year, reflecting the problems with Boeing's 737 Max airplane. Thanks to shale, the U.S. is now a major energy producer. Oil prices are about $12 per barrel lower than they were a year ago. Lower energy prices are weighing a bit on oil and natural gas drilling activity and investment. But this downturn is slight compared to the decline seen from mid-2014 to early 2016, when oil prices fell from over $100 per barrel to about $30 per barrel. We will need to gather further data and anecdotal reports to determine whether the slowdown in business spending will be sustained over the rest of the year or whether activity will remain consistent with trend growth.

International economic developments are weighing on the U.S. outlook and contributing to the recent slowdown in investment. Sometimes I am asked why the Federal Reserve takes into account how other economies are doing when our monetary policy goals of price stability and maximum employment pertain to the U.S. economy. The answer is because economic and financial conditions in other parts of the world can spill over to the U.S. through trade linkages and financial markets. Global growth slowed in the second half of last year and forecasts have been revised down. Subdued global growth and the strengthening dollar have weighed on U.S. export orders and manufacturing. As I mentioned earlier, uncertainty around trade policy and tariffs is also clouding the outlook. Indeed, it was a factor cited by consumers in the recent confidence and sentiment surveys.

The direct effects of the tariffs already imposed have been relatively modest. However, some multinational firms have taken steps to reorganize their supply chains to limit the tariffs' effects on their cost of production. So the imposition of tariffs creates deadweight losses to the extent that the new suppliers are not as efficient as the old ones sans the tariff. Firms in the Cleveland Federal Reserve District have been citing the uncertainty around tariffs and trade policy as a concern for some time. That

concern is growing, especially in light of the announcement of potential tariffs with Mexico, in addition to a possible expansion of tariffs to more goods imported from China. Many of our firms tell us they have not yet postponed their planned investment, but some firms say they are beginning to reassess those plans and others are holding off on acquiring financing for new projects because of the trade uncertainty. If more firms begin to take a wait-and-see attitude, the uncertainty itself could dampen business spending for some time to come. The effects could be amplified through adverse shifts in business, consumer, and financial market sentiment. On the other hand, a favorable outcome from trade talks could boost sentiment.

Despite firms' concerns about trade policy, labor market conditions have remained strong and consistent with continued expansion. In May, payroll job growth slowed to about 75,000, but over the past three months, it has averaged about 150,000 jobs per month. This is a step down from last year's strong pace of over 220,000 per month, but it is still well above trend, which most estimates put in a range of 75,000 to 120,000 per month. In my baseline outlook, as output growth slows toward a more sustainable pace, I expect job growth to slow toward trend as well, but to be strong enough to absorb those entering the labor force, keeping the unemployment rate low and under 4 percent. The unemployment rate, which has been at or below 4 percent for over a year, is currently at 3.6 percent, its lowest level in nearly 50 years. The broader measures of the unemployment rate that include discouraged workers and those working part-time who would prefer to work full-time are at the lowest levels of this business cycle. In my view, the unemployment rate is below the level that is sustainable over the longer run, but in recognition of the fact that it has been very low for some time and inflation has remained subdued, I recently lowered my estimate of the longer-run unemployment rate. I had been estimating this rate to be about 4.5 percent; I now put it between 4 and 4.5 percent. Even with this revision, labor markets are tight. This is the resounding theme we have heard from all of our contacts for some time, across a variety of occupations and sectors. And according to the most recent survey of small businesses conducted by the National Federation of Independent Business, a quarter of firms reported that the quality of labor was their single

most important problem, matching the highest reported share since the survey began asking this question in 1974.

The strength in the labor market has led to a steady acceleration in labor compensation. Aggregate measures of compensation are now in the 3 percent range, after being quite subdued earlier in the expansion. While this acceleration is not as strong as was seen in earlier expansions, the rise has been in line with productivity growth and inflation, and it has not added to inflationary pressures. Recent readings indicate a pickup in productivity growth; if this is sustained, it would be a positive development for wage growth going forward.

Before I turn to inflation, let me mention that the aggregate numbers on the labor market hide a lot of heterogeneity across locations and demographic groups. The Cleveland Fed recently held our biennial Policy Summit where issues facing low- and moderate-income communities were discussed at length with practitioners, researchers, and policymakers.[1] While more people have been brought into the labor force, including those from underrepresented groups, it should be recognized that not everyone has enjoyed the benefits of the 10-year expansion of the U.S. economy. In certain communities there is limited access to jobs because of gaps in the transportation system, a lack of affordable housing near the available jobs, and few daycare options. Some people cannot afford the costs of training and education to advance in the job market, and are having to juggle multiple jobs to earn a living wage. These are not cyclical problems that can be solved with monetary policy. Trying to do so would create other imbalances that ultimately disproportionately harm the very people the policy was meant to help. But as our Policy Summit discussions revealed, well-designed government policies can be used to address these structural issues and help ensure that the aggregate longer-term gains from technological change and globalization are better distributed so that everyone can have the opportunity to benefit from a vibrant economy.

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[1] More information about the Cleveland Fed's Policy Summit is available on our website at https://www.clevelandfed.org/newsroom-and-events/events/2019/policy-summit.aspx.

Turning to inflation, as I mentioned, despite the tightness in labor markets, inflation pressures have been muted. The FOMC has set a 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. Over the expansion, inflation has gradually moved up, and last year, it was near our 2 percent goal. More recent readings of total PCE and core PCE inflation, which omits food and energy prices, have been soft, with year-over-year total PCE and core PCE inflation at 1.5 and 1.6 percent, respectively, in May. Total inflation was held down in part by declining energy prices, which will likely further weigh on inflation in the near term. Both total and core inflation readings also reflect some idiosyncratic, and likely transitory, declines in selected components, including apparel and imputed prices of financial services. In the 1990s, the Cleveland Fed pioneered measures of inflation that omitted components showing the most extreme price movements in any month to better gauge inflation trends.[2] These indicators of underlying inflation trends have been more stable and point to inflation gradually rising back to trend. The Cleveland Fed's median and trimmed mean CPI measures, which tend to run higher than PCE inflation, were 2.7 and 2.2 percent, respectively, in May, in line with their levels for most of the year. The Dallas Fed's trimmed mean PCE inflation measure has been running between 1.9 and 2 percent over the past year and currently is at 2 percent.

Stable inflation expectations are an important component of inflation dynamics because they help to guide price- and wage-setting decisions. While expectations have been relatively stable, there was a softening in the latest readings of the University of Michigan and New York Fed survey measures of longer-term inflation expectations, while the Cleveland Fed's 5-year/5-year-forward measure, which combines survey readings with market-based readings, was little changed in June. We have seen mixed data on inflation and inflation expectations at other points over the expansion. But the recent declines bear watching

[2] The Cleveland Fed's Center for Inflation Research aims to further the understanding of inflation among policymakers, researchers, and the public by providing data, forecasts, analysis, and research. The center's website is https://www.clevelandfed.org/en/our-research/center-for-inflation-research.aspx.

because if inflation expectations become unanchored, it will be more difficult for inflation to be maintained near our target.

In light of the data, I have revised down my inflation forecast for this year. I continue to think that the most likely case is that inflation expectations will remain relatively well anchored and that this, coupled with continued strength in labor markets and output growth near trend, will support a gradual, although slower, rise in inflation back to 2 percent over the next couple of years. Nonetheless, it is important to acknowledge that there are structural factors holding back inflation, including technological change and product innovation. These are nonmonetary factors, and they may be more powerful than I have assumed. If so, inflation could remain lower for longer than in my baseline forecast. On the other side, there is also the possibility that tariffs could be passed along to customers, as some firms have told us they are beginning to do. While this would be a one-time change in the level of prices, to the extent that it changes inflation expectations, it could put upward pressure on inflation as well. Tightness in labor markets might also begin to put more pressure on wages and prices than we've yet seen.

Monetary Policy

Because monetary policy affects the economy with a lag, policymakers need to be forward looking. So the current uncertainty around the economic outlook poses some challenges for policymakers. At our recent meeting, the FOMC maintained the target range of the federal funds rate at 2-1/4 to 2-1/2 percent. In assessing whether monetary policy is well calibrated, I will be monitoring incoming economic and financial data and reports from District contacts to determine whether my positive baseline outlook – the sustainable-growth scenario – remains intact or whether the downside risks are coming to pass and a material change in the outlook to the weak-growth scenario is underway. At the present time, I believe it is too soon to make that determination, and I prefer to gather more information before considering a change in our monetary policy stance. If I see a few weak job reports, further declines in manufacturing activity, indicators pointing to weaker business investment and consumption, and declines in readings of

longer-term inflation expectations, I would view this as evidence that the base case is shifting to the weak-growth scenario. In this scenario, the economy's short- to medium-term equilibrium interest rate would be moving down, and our policy rate could need to move down with it in order to sustain the expansion and foster achievement of our longer-run goals of maximum employment and price stability.

On the other hand, throughout this expansion, the U.S. economy has proven itself resilient to a variety of economic shocks, headwinds, and uncertainties. We have seen similar episodes of soft data and sentiment that subsequently reversed. If that is the case this time, and the sustainable-growth scenario plays out, there is still a question of how the Fed should react to the lower inflation readings we've seen in recent months. Some would argue that lowering the funds rate would be appropriate in an attempt to push up inflation expectations. However, if it is the case that nonmonetary structural factors are holding back measured inflation, thereby putting downward pressure on inflation expectations, rather than an aggregate demand problem, it is not clear how effective this policy would be. Cutting rates at this juncture could reinforce negative sentiment about a deterioration in the outlook even if this is not the baseline view, and could encourage financial imbalances given the current level of interest rates, which would be counterproductive.

The current period shares some similarities with the period from 2014 to 2016, when the slowdown in global demand, the decline in oil prices, and the appreciation in the dollar caused a drop-off in investment and manufacturing activity at the same time inflation was well below target. The Fed was patient during this period, with one rate increase in December 2015 and another in December 2016, allowing inflation to gradually move up. So long as the sustainable-growth scenario of continued expansion and strong labor markets remains the baseline outlook, I would favor taking a similar opportunistic approach to the recent softness in the inflation readings instead of trying to proactively move inflation up with rate cuts.[3] This

[3] Larry Meyer, while he was a governor on the Federal Reserve Board, described a strategy he termed "opportunistic disinflation."
(https://www.federalreserve.gov/boarddocs/speeches/1996/19960908.htm)

would mean maintaining a shallow policy path: keeping the funds rate at current levels for a while to support a gradual rise in inflation and not overreacting to shocks that might, for a time, move inflation somewhat above 2 percent. The strategy would be consistent with keeping inflation within a reasonable range around 2 percent. Given the current level of the funds rate, which is low but appears to be near neutral, and my current baseline outlook, I view this strategy as one that appropriately balances the risks to achieving our dual-mandate goals, avoiding a buildup in risks to macroeconomic stability, distortions in labor markets, or financial imbalances driven by low costs of borrowing.

Given the uncertainties around the outlook, it should not be surprising that views vary across the individuals on the FOMC, even though we all share the same longer-run monetary policy goals of price stability and maximum employment. The economic projections released at our recent meeting show that in pursuit of our goals, some policymakers believe it will be appropriate to maintain the funds rate at current levels this year, while others believe it will be appropriate to reduce rates. But the projections also indicate that conditional on appropriate policy, the Committee sees the economy managing through the uncertainties, with growth slowing toward trend, labor markets remaining strong, and inflation gradually moving up to 2 percent over time. This would be a favorable outcome and one consistent with the resilience the U.S. economy has shown throughout this expansion.