An Update on the Economic Outlook and Monetary Policy

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Introduction

I thank Professor William Elliott and John Carroll University for inviting me to participate in the Mellen Executive Speakers series. It was a pleasure meeting with John Carroll students earlier this afternoon, and I am looking forward to the question and answer session moderated by Jack Kleinhenz. Jack is not only one of John Carroll's impressive alumni, but he is also chief economist for the National Retail Federation, so hearing his views on the economy is always valuable. Before we get started, I thought it might be useful to set the stage by giving you a brief update of my own take on the economy and 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 Economic Outlook

In July, the U.S. economic expansion entered its 11th year, making this the longest expansion on record. Last year, we saw strong economic growth: real GDP grew at a 2.5 percent pace, well above most economists' estimates of trend growth. This growth was supported by fiscal stimulus in the form of tax cuts to households and businesses and higher federal government spending. In addition, financial conditions were accommodative for much of the year. It was widely anticipated that output growth would slow this year as this stimulus waned. But over the course of this year, several risks to the outlook emerged. These risks include those associated with trade policy, tariffs, and slower growth abroad, as well as geopolitical risks including Brexit, the events in Hong Kong, and tensions in the Middle East. The question is whether the economy will remain resilient, with growth stepping down to its trend pace, which I estimate to be about 2 percent, or whether these downside risks will lead to a more significant deceleration in growth.

Despite the risks to the outlook, the data indicate that the economy continues to perform well along a number of dimensions. Over the first half of the year, the economy grew at about a 2.5 percent pace, the

same as last year. Consumer spending, which accounts for about 70 percent of GDP, continues to show strength, buoyed by solid fundamentals. Household balance sheets are healthy, consumer sentiment is at a high level, and incomes are growing thanks to the solid performance of the labor market.

Payroll job growth has averaged about 160,000 jobs per month this year; the expected benchmark revisions will lower this number somewhat. This pace is a step down from last year's strong pace of over 220,000 jobs per month. But it is important to put this into context. Most economists estimate that the economy can sustain job growth in the range of 75,000 to 120,000 per month, depending on what one assumes about trend labor force participation. Demographic factors, including the aging of our population, have resulted in a downward trend in participation, which is one of the reasons trend employment growth is lower than it was a few decades ago. Rather than declining like its trend, the participation rate has actually been relatively stable over the past three years, a sign of the robust labor market.

Last month, the unemployment rate fell to a 50-year low of 3.5 percent, and the broader measures of unemployment that include discouraged workers and those working part-time who would prefer to work full-time are at very low levels. In the Cleveland Fed's District, which includes the state of Ohio, western Pennsylvania, eastern Kentucky, and the panhandle of West Virginia, the unemployment rate is about 4 percent, near the lowest level seen in four decades.

Congress has given the Fed two long-run monetary policy goals: maximum employment and price stability. So assessing how the labor market is doing relative to what is sustainable over the longer run is a key factor when setting monetary policy. The strong performance of the labor market over this expansion has made many economists reevaluate what unemployment rate is sustainable and consistent with price stability. This is true of participants on the Federal Open Market Committee (FOMC) as well. Five years ago, their estimates of unemployment over the longer run ranged from 5 to 6 percent; the

current range is 3.6 to 4.5 percent. I recently lowered my own estimate to a range of 4 to 4-1/4 percent, in recognition of the fact that the unemployment rate has been quite low for some time and inflation has remained subdued. But it's important to remember that there is quite a bit of uncertainty about such estimates.

Even with economists reevaluating the degree of tightness in the labor market, if you speak to business owners, it is hard to conclude that labor markets aren't tight. We have heard from firms of all sizes that they cannot find workers with the skills they need; even for the relatively lower-skill positions, workers are hard to come by. Firms have been raising wages and benefits to attract and retain workers. Some firms have told us they have had to turn away business because labor is so scarce. The steady acceleration in labor compensation associated with such a vibrant labor market is a positive for consumer spending. But there is a downside to the tightness. Several members of our Cleveland Business Advisory Council have mentioned that their ability to innovate has been lessened because so much of their time is spent on recruiting, and less innovation could negatively affect future growth. Other firms tell us that because workers are so hard to find, they are speeding up their efforts to automate more of their operations. In the long run, such automation can make production more efficient and raise the potential growth rate of the economy. However, in the short to medium run, workers without the necessary skills to operate in a highly automated production process may be left behind. This makes the need for affordable training programs even more urgent so that workers can acquire the skills that are in demand now and in the future. Educational institutions like John Carroll will continue to play an important role as technological change remains a driving force in our economy.

Offsetting the positives of consumer spending and labor market conditions are developments in the business sector. After increasing robustly last year, growth of business investment in equipment weakened sharply over the first half of this year, and manufacturing activity has declined. New orders and shipments of nondefense capital goods excluding aircraft 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. Business sentiment has deteriorated.

This turn of events reflects a slowdown in growth abroad, especially in Europe and China; the imposition of an expanding menu of tariffs; and continued uncertainty about where trade policy is going. These developments have weakened demand for U.S. exports, which has weighed on the U.S. manufacturing and agricultural sectors. As trade tensions between the U.S. and China have continued to escalate, the uncertainty around trade policy has dampened business sentiment and has caused some firms to postpone investment. Rising geopolitical risks, including Brexit, events in Hong Kong, and the attack on oil production facilities in Saudi Arabia, have also weighed on sentiment. Firms in the Cleveland Fed District have been citing the uncertainty around tariffs and trade policy as a concern for some time. While many have not yet postponed planned investments, they have told us they are beginning to reassess those plans in light of the cloudy picture surrounding future tariffs and the outlook for U.S. growth.

On balance, I continue to expect that we will avoid a more serious turndown in the economy and that growth will be near its trend pace and the unemployment rate will remain below 4 percent over the next two years. As indicated by FOMC participants' economic projections, my colleagues have a similar view.[1] The current period shares some similarities with the period from 2014 to 2016, when the slowdown in global demand, a decline in oil prices, and appreciation in the dollar caused a drop-off in investment and manufacturing activity. In that period, the overall economy proved to be quite resilient. Nonetheless, the nature of the downside risks this time is different, and it is not too difficult to envision a scenario in which adverse shifts in business sentiment and uncertainty over the outlook cause firms not only to reduce capital spending but also to pull back on hiring, which then causes consumer sentiment and spending to weaken and unemployment to rise, with inflation staying below our target because of weak

[1] See the Summary of Economic Projections, September 2019.
(https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20190918.htm)

aggregate demand. 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. While lower bond rates have meant lower mortgage rates and some increased activity in housing markets, the overall signal about the outlook from the bond market is a negative one.

Turning to inflation, as I mentioned, despite the tightness in labor markets, inflation has remained subdued over much of the expansion. Last year, inflation, as measured by the year-over-year change in the personal consumption expenditures (PCE) price index, moved up to 2 percent, the FOMC's target. However, this year, inflation moved back down, with total PCE inflation weighed down by declines in energy prices earlier in the year. Total PCE inflation remains low at 1.4 percent. The core measure, which excludes food and energy prices, also moved down early this year because of transitory declines in apparel prices and imputed prices of financial services. But since then, core PCE inflation has moved up to 1.8 percent. Although we use core inflation as an indicator of the underlying trend in inflation, it is important to remember that a sizable fraction of the variability of core inflation is due to idiosyncratic factors, for example, changes in Medicare reimbursement rates or cell phone prices. When we look at other measures of the underlying inflation trend, which try to control for this, we also find that inflation is firming and close to our goal. These include the Dallas Fed's trimmed-mean PCE inflation measure, which has been stable at 2 percent; the Cleveland Fed's trimmed-mean CPI measure, which was 2.2 percent in August; and an experimental measure of median PCE produced by the Cleveland Fed staff, which was 2.7 percent in August.

Because understanding inflation dynamics is essential for making effective monetary policy, the Cleveland Fed has established a Center for Inflation Research.[2] The center builds on the pioneering work the bank has done over many years to measure and forecast inflation. One of the center's recent studies

[2] For more on the Cleveland Fed's inflation research and inflation-related products, see the Cleveland Fed's Center for Inflation Research website: https://www.clevelandfed.org/en/our-research/center-for-inflation-research.aspx.

sheds some light on the recent behavior of inflation.[3] This research disaggregates inflation into cyclical components, which vary with the degree of tightness in the labor market, and acyclical components, which are relatively unresponsive to the tightness in labor markets. The cyclical part of inflation accounts for only about 40 percent of core PCE inflation, but it has continued to rise over the expansion as the labor market has continued to tighten. The Cleveland Fed staff analysis indicates that as long as labor markets remain strong, cyclical inflation should continue to firm, helping headline inflation return gradually to our 2 percent objective over time.

While inflation tends to fluctuate around trend due to changes in resource utilization, changes in commodity and other input prices, and idiosyncratic factors, the underlying trend in inflation is determined by businesses' and households' expectations of inflation over the long run. Forecasts of inflation gradually returning to 2 percent are dependent on long-run inflation expectations remaining stable. If firms and households begin to expect lower inflation to prevail over the longer run, this would make it even harder for the Fed to hit its inflation target, because theory suggests that these expectations influence actual price- and wage-setting behavior. Recent readings on long-run inflation expectations have been mixed. So far, the softer readings in some of the household survey measures are in line with the typical variation in these measures, but these movements bear watching.

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. At each of its meetings in July and September, the FOMC reduced the target range of the federal funds rate by 25 basis points; the current target range is 1-3/4 to 2 percent. The Committee said that it views sustained expansion of

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[3] See Saeed Zaman (2019) "Cyclical versus Acyclical Inflation: A Deeper Dive," Federal Reserve Bank of Cleveland *Economic Commentary* 2019-13, https://www.clevelandfed.org/newsroom-and-events/publications/economic-commentary/2019-economic-commentaries/ec-201913-cyclical-versus-acyclical-inflation.

economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective as the most likely outcomes, but that uncertainties about this outlook remain. In light of the implications of global developments for the outlook and muted inflation pressures, the Committee decided to take these actions.

I was certainly sympathetic to the view expressed by the majority; indeed, my view of appropriate policy has become more accommodative since last year based on my assessment of economic and financial market developments. But my preference was to leave the fed funds rate unchanged at the July and September meetings. My preferred strategy was to take action only if there were evidence of a material deterioration in the outlook and not merely on heightened risks. Coming into those meetings, the overall economy was still performing well, financial conditions were accommodative, and access to credit was not the source of weakness in the business sector. Indeed, corporate debt is at a high level, and in the most recent survey from the National Federation of Independent Business (NFIB), small businesses indicated that credit conditions are about as accommodative as they have ever been in the survey's almost five-decade history.

In assessing the path of policy going forward, I will be monitoring incoming economic and financial data and reports from District contacts. I will be particularly attentive to signs that the weakness in investment and manufacturing is broadening, and spilling over to reductions in hiring and household spending, and to signs that long-run inflation expectations are destabilizing. Such signs would point to a material change in the outlook that could warrant policy action. Absent those signs, with labor markets strong and growth near trend, maintaining a shallow policy path 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 would be appropriate, in my view. It would be consistent with keeping inflation within a reasonable range around 2 percent, and balance the risks to achieving our dual-mandate goals.