The Outlook for the Economy and Monetary Policy in 2020

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Introduction

Good afternoon. I thank the National Association for Business Economics for inviting me to participate in this year's economic policy conference. I had the pleasure of speaking at this conference five years ago and I recall a very engaging question-and-answer session following my remarks. I hope we will have a similar session today because I believe that one of the responsibilities (and pleasures) of being a monetary policymaker is listening to other people's perspectives and learning from them. Today, I will give you an update of my own take on the economy and monetary policy for the coming year. As always, the views I'll present today are my own and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee.

Economic Growth

The U.S. economic expansion is now in its 11th year, making this the longest expansion on record. It has not been a smooth ride; risks of various kinds have risen and ebbed over the journey. Last year, uncertainties around trade policy and tariffs and slow growth abroad clouded the outlook. In prior years, the sharp drop in oil prices and strength of the dollar weighed on the U.S. economy. Yet, with support from fiscal and monetary policy, the expansion continued. The length of the expansion is a true testament to the resiliency of the U.S. economy. For 2020, my outlook is for the expansion to continue, with growth around trend, solid performance in the labor market, and low and stable inflation. As is always the case, there are risks to the outlook, including the recent emergence of the coronavirus in Wuhan, China. There are also longer-run challenges for the U.S. economy, including low productivity growth, limits on access to education and training for the jobs of the future, and rising income inequality. But viewed through the lens of the Fed's statutory goals of maximum employment and price stability, the economy has been performing well and I expect that to continue.

Last year, real GDP grew at a 2.3 percent pace, down a bit from 2018's 2.5 percent pace. My estimate of longer-run growth is 2 percent, so the economy has been growing somewhat above trend. Indeed, last

year's performance was better than many economists and businesses had expected. Before the start of last year, it was widely anticipated that output growth would be slower than in 2018 because the effects of the fiscal stimulus from the tax cuts and federal government spending were expected to wane and financial conditions were expected to be less accommodative. But as 2019 started, concerns developed that a sharper slowdown in the economy was a real possibility. In light of the FOMC's reassessment of the outlook and risks, the FOMC's anticipated path of appropriate monetary policy flattened, leading to more accommodative financial conditions that helped to support the expansion. As the year wore on, several downside risks to the outlook worsened and new ones emerged. These risks include those associated with trade policy and slower global growth, as well as geopolitical risks surrounding the possibility of a "hard" Brexit, social unrest in Hong Kong, and rising tensions in the Middle East. The FOMC responded to these risks to the outlook by lowering the federal funds rate a cumulative 75 basis points. More accommodative financial conditions and some easing of trade tensions and uncertainty by the end of the year helped to support last year's above-trend growth.

With respect to the mix of growth across sectors, it is a tale of two cities. For most of the expansion, consumer spending, which accounts for nearly 70 percent of output, has been driving the economy forward; the strength in business spending has varied and it has been weak of late. Although consumer spending softened a bit in the fourth quarter, this isn't troubling as it followed strong readings in the second and third quarters. Solid fundamentals will continue to support consumer spending this year. The strong performance of the labor market has brought more people into the labor force and has sustained wage growth, so household incomes are rising. Measures of consumer confidence are at high levels. And household balance sheets, at the aggregate level, are healthy. Equity prices have been rising and the interest rates paid by consumers are at low levels.

These same factors have led to a pickup in housing market activity over the past year. Residential investment turned around in the second half of 2019, rising for the first time since the end of 2017. On a

year-over-year basis, housing starts, new single-family home sales, and existing home sales all posted double-digit rates of increase at the end of last year. Demand is outstripping supply. One indicator of this is the month's supply of homes on the market. At the December sales pace, the current inventory of homes up for sale would last three months. This is the lowest level in the history of the series, which dates back to 1982. As a consequence, house prices are beginning to accelerate.

In contrast to the strength in consumer spending and the improvement in housing conditions, business investment, manufacturing, and exports have been weak, declining over most of last year. Slow growth abroad, especially in Europe and China, and uncertainty over trade policy and tariffs have weakened demand for U.S. exports, which has weighed on the U.S. manufacturing and agricultural sectors. The uncertainty also dampened business sentiment and caused some firms to postpone planned investment. If it continues, the low level of investment will be troubling for the economy over the longer run. The economy's long-run growth potential is determined by the growth of its labor and capital stock and how productively it uses these inputs. Without investment in new technologies and capital, productivity will continue to be weak, dampening the economy's growth potential and living standards.

Fortunately, the picture for 2020 is somewhat better on the trade front. Some of the uncertainty over trade policy eased with the signing of the United States–Mexico–Canada Agreement (USMCA) and the Phase One trade deal with China; this reduction in uncertainty should prove positive for investment. Nevertheless, some long-lasting effects arising from the trade war are likely. For example, some of our business contacts report that foreign firms have reoriented their supply chains away from U.S. firms, which means these exports may be permanently lost.

The start of the year brought some tentative signs that growth abroad in our trading partners was stabilizing. But offsetting the positive news on foreign growth and trade are the continuing problems with

the Boeing 737 MAX airplane. The decision to halt production of the plane will be a drag on growth at least in the first quarter of this year and perhaps longer.

In addition, the coronavirus is exacting a heavy human toll. It is also clouding the near-term economic outlook for China, with potential spillovers to the rest of the world. Most estimates of the possible impact draw on the experience of the SARS epidemic in 2003. A Brookings study suggested that that epidemic reduced growth in China by about 1 percentage point in 2003 and growth in the U.S. by only about 0.1 percentage point.[1] However, there are many differences between 2003 and 2020. China was not as big a player in the global economy back then as it is today, so there is the potential for a larger impact, through decreases in tourism and travel, reductions in consumer spending in China and by Chinese tourists elsewhere, disruptions in supply chains, and a pullback in investors' willingness to take on risk. On the other hand, China now has more resources with which to address the epidemic than it had in 2003 and early actions have been taken to try to limit the spread and cushion the Chinese economy. This might mean a larger negative impact on growth in China in the near term but perhaps a less protracted one. At this point, it is difficult to assess the magnitude of the economic effects, but this new source of uncertainty is something I will be carefully monitoring. I've incorporated it as a downside risk to my modal forecast, which calls for growth to continue at trend, slightly slower than the pace of last year, with continued healthy consumption growth and some pickup in investment spending.

Labor Markets

Supporting this forecast is the strength we've seen in labor markets. I expect solid labor market conditions to continue. Last year, firms added an average of 175,000 jobs per month to their payrolls, and in January, an even stronger 225,000 jobs were added. So the pace of job growth has been well above

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[1] Jong-Wha Lee and Warwick J. McKibbin, "Globalization and Disease: The Case of SARS," Brookings Discussion Papers in International Economics, No. 156, February 2004. (https://www.brookings.edu/wp-content/uploads/2016/06/20040203-1.pdf)

trend, which most estimates put in the range of 75,000 to 120,000 per month. The unemployment rate, at 3.6 percent, is near its 50-year low; it has fallen nearly half of a percentage point over the past year. A broader measure of the unemployment rate, the U-6 measure, which includes workers who haven't been actively looking for work and those working part-time who would prefer full-time work, is under 7 percent, near its lowest level since the start of this series in January 1994. 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 4-1/4 percent, near the lowest levels seen in two decades. My expectation is that job growth will remain solid and the unemployment rate will remain near its current level this year.

A benefit of the long expansion is that more people have been drawn into the labor force. Even though demographic forces such as the aging of the large baby boom generation mean people are leaving the workforce through retirement, the participation rate has held up. The prime-age participation rate of those between ages 25 and 54 has been rising and is now at its highest level of the expansion. Women have been leading this rise. The participation rate for prime-age women has risen over 2 percentage points over the past two years, and the rate for men has edged up as well.[2] Business contacts have continually reported that they are having trouble finding qualified workers. Some tell us that they have turned away orders and would be able to take on more work if they could attract and retain the employees they need.

Aggregate wages have been rising in line with productivity growth and inflation, and we've seen stronger wage gains for lower paying jobs. But wages have not accelerated as much as one might have expected based on the reports from firms about how hard it is to find workers. It could be a question of labor mix, with those older workers exiting the labor force typically being higher paid than those entering. It could

[2] According to data from the Bureau of Labor Statistics, as compiled by Haver Analytics, the (combined) prime-age participation rate rose to 83.1 percent in January 2020, its highest level since August 2008. From January 2018 to January 2020, the participation rate for prime-age women rose from 74.8 percent to 77.0 percent; over the same period, the rate for prime-age men edged up from 89.0 percent to 89.3 percent.

also reflect a faster pace of automation. Some of our business contacts have told us they are substituting machines for workers rather than increasing wages. Others tell us they don't believe that raising wages will attract qualified workers and are not willing to go that route to fill positions. It remains to be seen how much longer that situation can last, especially if labor markets tighten further.

Assessing how the labor market is doing relative to what is sustainable over the longer run is a key factor when setting monetary policy, as maximum employment and price stability are our mandated goals. The behavior of the labor market over this expansion has led me to believe that one needs to be humble about this assessment and let not only past experience but also current experience be a guide. In fact, the strong performance of the labor market over this expansion has made many economists reevaluate what unemployment rate is sustainable over the longer run and consistent with price stability. This is true of participants on the FOMC as well. Five years ago, their estimates of the unemployment rate over the longer run ranged from 5.0 to 5.8 percent; the current range is 3.5 to 4.5 percent.[3] I've brought my estimate down over time and recently have been estimating a range of 4 to 4-1/4 percent. But if the unemployment rate continues at these low rates and wage pressures remain muted, I'm open to lowering my estimate again.

Inflation

Turning to inflation, the FOMC's longer-run inflation goal is 2 percent, as measured by the year-over-year change in the personal consumption expenditures (PCE) price index. This measure moved up to 2 percent in 2018, but the increase wasn't sustained as PCE inflation moved back down in 2019 and stood at 1.6 percent in December. Core PCE inflation, which excludes food and energy prices to strip out some volatility, also moved down to 1.6 percent. Although core inflation is often used as an indicator of the

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[3] See the Summary of Economic Projections included in the Minutes of the FOMC, December 16-17, 2014, at https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20141217.pdf and the Summary of Economic Projections included in the Minutes of the FOMC, December 10-11, 2019, at https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20191211.pdf.

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. So to gauge the underlying trend I look at a broad set of inflation measures. These measures show firmer inflation readings. The CPI measures typically run about 1/4 percentage point above the PCE measures. In January, CPI inflation rose to 2.5 percent and core CPI inflation was 2.3 percent. The Dallas Fed's trimmed-mean PCE inflation measure has been stable at 2 percent. The Cleveland Fed's new Center for Inflation Research is carrying on the pioneering work done at the Bank to develop better measures of underlying inflation trends.[4] In January, the Cleveland Fed's median and trimmed-mean CPI measures were 2.9 and 2.4 percent, respectively, and our median PCE inflation measure was 2.6 percent in December. These alternative gauges are not a substitute for the PCE inflation measure that the FOMC has targeted, but they do reduce some of my concern that inflation will continue to be weak. Indeed, research done by our Center suggests that if labor markets remain strong, then we should see the components of the PCE that are more responsive to labor market conditions continue to firm, helping total PCE inflation return to our 2 percent goal on a sustainable basis over time.[5]

This forecast depends on inflation expectations remaining stable. If firms and households begin to expect that lower inflation will prevail over the longer run, the Fed would have a harder time hitting its inflation target, because theory suggests that these expectations influence actual price- and wage-setting decisions. Lower inflation expectations could lead to lower inflation. In my view, expectations have been relatively well anchored near 2 percent. The movements in the monthly readings of some of the measures have been within the typical variation seen in these measures. The Cleveland Fed produces a measure of inflation expectations that combines survey readings with market-based readings; the 5-year/5-year-

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[4] 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.

[5] 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.

forward reading on inflation from this measure has been fairly stable over the past 12 months, although somewhat under 2 percent.

My projection is that PCE inflation will move up to our 2 percent goal in line with the FOMC's objective, but this will be a gradual return over the next year or two.

Monetary Policy

Because monetary policy affects the economy with a lag, policymakers need to be forward looking and determine what interest rate path will best achieve the FOMC's dual mandate goals of price stability and maximum employment over the longer run, based on the economic outlook and risks around the outlook.

At our meeting at the end of January, the FOMC maintained the target range of the federal funds rate at 1-1/2 to 1-3/4 percent. I agreed with this decision. Keeping the fed funds rate at current levels for a time gives us an opportunity to assess the cumulative effects of last year's policy easing on the economy and to assess whether the economy is evolving according to our outlook. Even before last year's cumulative 75 basis point reduction, monetary policy had become easier as the Committee's view of the appropriate policy path had flattened. You can see this by looking at FOMC projections. In September 2018, the median participant thought it appropriate for the fed funds rate to rise to 3.4 percent by the end of this year. By June 2019, that rate had fallen over a percentage point, to 2.1 percent. The most recent reading from last December is 1.6 percent. Given the risks from slower growth abroad and trade policy uncertainty, I believed a flatter policy path was appropriate, although I would have preferred to wait for clearer evidence that the downside risks were materially affecting the economy before actually cutting the funds rate last year. Still, I am comfortable with the current stance of policy. While some of the downside risks have eased, including trade tensions, the possibility of a "hard" Brexit, and continued weakening of global growth, other risks like the coronavirus have emerged. In my view, our current policy stance is appropriate given the outlook of growth near its trend pace, solid labor market conditions,

and inflation rates not far from the FOMC's symmetric 2 percent objective, and given the risks around the outlook that we continue to monitor.

I am committed to achieving both of our dual mandate goals of maximum employment and price stability. As many of you know, the FOMC is in the process of assessing our monetary policy framework, including our strategy, tools, and policy communications. As part of that review, we conducted Fed Listens events around the country to hear from various groups about how our dual mandate goals of maximum employment and stable prices affect them. The Cleveland Fed held our Fed Listens event at our Community Development Policy Summit in Cincinnati.[6] One of the main themes that came out of this discussion was the importance of jobs. People were less concerned about inflation; in fact, some were skeptical of the Fed's view that inflation was too low, because in their experience it is costing more, not less, to get by. This lack of concern about inflation partially reflects the success the Fed has had in achieving price stability. It's a tribute to the late Paul Volcker, former Fed chair. If inflation were to get out of hand again as it was in the 1970s and early 1980s, it would become a major concern again for everyone. From an individual's perspective, low inflation is not a problem. But inflation running below our goal is a problem for the macroeconomy and for monetary policymakers. When inflation runs persistently below our goal, expected inflation can move lower, putting further downward pressure on inflation and pulling down interest rates. Lower rates constrain monetary policy's ability to stabilize the economy by giving us less room to reduce rates in the event of a future downturn. So hitting our symmetric inflation goal is an important part of ensuring a healthy economy over the longer run.

[6] A summary of the Cleveland Fed's Fed Listens event is available at https://www.clevelandfed.org/newsroom-and-events/events/2019/policy-summit/fed-listens.aspx. A full list of Fed Listens events is available at https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications-fed-listens-events.htm.

We have been undershooting our inflation goal for some time, so a natural question is whether policymakers should add even further accommodation to spur a faster return of inflation to our goal. I would not favor that at this time. In my view, doing so would raise the risk of generating imbalances that would threaten the expansion and undermine our employment goal. Even given the low level of interest rates, equity prices and commercial real estate valuations are elevated; corporate debt levels are high; and underwriting standards on leveraged loans are weak. While commercial banks are well capitalized, their capital buffers are falling, which could potentially limit their ability to lend through the cycle should a negative shock hit. I think we should be particularly attuned to financial market developments in the current environment.

Given the low level of the funds rate and the outlook for growth and the labor market, and the fact that inflation rates are already near our objective, I support taking an opportunistic approach to raising inflation to our symmetric goal. This entails leaving policy at current levels for a time to support a firming in inflation rates, refraining from taking deliberate policy action at this point to try to lift inflation more quickly, and also refraining from taking deliberate action against shocks that would, for a time, move inflation somewhat above 2 percent. This approach attempts to keep inflation sustainably in a reasonable range around 2 percent, consistent with our symmetric 2 percent objective, while balancing our dual mandate goals and risks to financial stability. I don't view this opportunistic approach as ignoring the inflation undershoot because it works to move inflation up by keeping policy more accommodative than if the Committee were behaving as it has in the past, as illustrated by the range of monetary policy rules that the Cleveland Fed publishes on its website.[7]

In assessing the appropriate path of policy going forward, I will be monitoring incoming economic and financial data and reports from District contacts to assess the outlook and risks to the outlook. My

[7] See the Cleveland Fed's simple monetary policy rules at https://www.clevelandfed.org/en/our-research/indicators-and-data/simple-monetary-policy-rules.aspx.

current view is that monetary policy is well calibrated to support our dual mandate goals, and a patient approach to policy changes is appropriate unless there is a material change to the outlook.