

**An Update on the U.S. Economy and the
Federal Reserve's Review of Its Monetary Policy Framework**



**Loretta J. Mester
President and Chief Executive Officer
Federal Reserve Bank of Cleveland**

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Introduction

Good evening. I thank the Society of Professional Economists for inviting me to speak at the society's annual dinner. It is truly an honor to join you and to count myself among the list of distinguished speakers who have addressed you at previous events. This evening I will update you on the outlook for the economy and monetary policy from my side of the pond and on the Federal Reserve's review of our monetary policy framework: the strategy, tools, and communications we use to make monetary policy. As always, the views I'll present are my own and not necessarily those of the Federal Reserve System or of my colleagues on the Federal Open Market Committee.

The Economic Outlook for the U.S.

Let me start with the topic on everyone's mind: the coronavirus. The recent emergence of the coronavirus in Wuhan, China, and its spread to other countries in the world, including the U.K. and the U.S., is causing considerable human suffering. It is also clouding the outlook for the global economy. This is a rapidly evolving situation that we are continuing to monitor closely. For the U.S. economy, the risks and uncertainty surrounding the outlook have increased in a short period of time. In China, the reductions in travel and shutdown in activity are widely expected to cause a sharp decline in output in China in the first quarter. China is a large player in the global economy, accounting for 16 percent of global GDP. So what happens there will have effects in other countries, especially those with strong trade ties to China. Trade and supply chain disruptions, travel spending cuts, and declines in consumer and business sentiment will also weigh on U.S. growth at least in the first half of the year, as will the extreme moves we have experienced in U.S. financial markets. These moves have reflected a sharp pullback in investors' willingness to take on risk and the flight to quality into U.S. Treasury securities.

At this point, both the magnitude and duration of the economic effects of the virus are highly uncertain. They will depend on how the disease progresses, the efficacy of the actions countries take to help contain the spread of the virus and treat the sick, public health officials' contingency planning and

implementation of those plans, and other actions policymakers take to mitigate the effects on sentiment and economic activity. Today, the FOMC reduced its target range for the federal funds rate, our policy rate, by 50 basis points to 1 to 1-1/4 percent in response to the risks to the outlook.

I am currently putting together the forecast I will submit as part of the FOMC's Summary of Economic Projections, which will be released after the conclusion of our March FOMC meeting in two weeks. In structuring my remarks, I thought it would be helpful to first discuss my views on the U.S. economy before the emergence of the coronavirus, and then discuss the potential ramifications of this risk.

The economic expansion in the U.S. is now in its 11th year, the longest expansion on record. The course of the expansion has seen its ups and downs, but the resiliency of the U.S. economy has been remarkable. Last year, uncertainties around trade policy and tariffs, as well as slow global growth, clouded the U.S. 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 Federal Reserve has a statutory mandate to set U.S. monetary policy to achieve the longer-run goals of price stability and maximum employment. Viewed through this lens, the U.S. economy has been performing well.

Last year, real GDP grew at a 2.3 percent pace, above my 2 percent estimate of its longer-run trend and better than many economists and businesses had expected. Indeed, at the start of last year, concerns developed that a sharper slowdown in the economy was a real possibility. In light of the FOMC's reassessment of its 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 included 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, our policy rate, a cumulative 75 basis points. More accommodative financial conditions, coupled with 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 has been a tale of two cities. Business spending has been soft, while consumer spending, which accounts for nearly 70 percent of output in the U.S., has been solid. Business investment, manufacturing, and exports declined 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. Problems with the Boeing 737 MAX airplane also weighed on investment and the decision to halt production of the plane will be a drag on U.S. growth at least in the first quarter of this year and perhaps longer. On the positive side, some of the uncertainty over trade policy and its impact on business sentiment eased with the signing of the United States–Mexico–Canada Agreement (USMCA) and the Phase One trade deal with China.

In contrast to soft business spending, consumer spending has been driving the U.S. economy forward, and that has been the case for most of the expansion. Solid fundamentals have helped to support consumer spending. Household balance sheets are healthy. Low mortgage rates contributed to the turnaround in residential investment in the second half of 2019, which rose for the first time since the end of 2017. Household income has been growing, reflecting the solid performance of the labor market.

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 in the U.S. has been well above trend, which most estimates put in the range of 75,000 to 120,000 per month. A benefit of the long expansion is that more people have been drawn into the labor force. The participation rate has held up even though the

large baby boom generation is aging and leaving the workforce through retirement. 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, led by women. 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. Broader measures of the unemployment rate that include discouraged workers and those working part-time who would prefer full-time work are also near historic lows.

Strong labor markets mean aggregate wages are rising in the U.S., especially 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. This could reflect labor mix: older workers exiting the labor force typically are higher paid than those entering. It could also reflect a faster pace of automation, one way some of our business contacts are addressing labor shortages. Other contacts tell us that they don't believe 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.

In assessing how the labor market is doing relative to what is sustainable over the longer run, we need to remain humble. Five years ago, FOMC participants' estimates of unemployment over the longer run ranged from 5.0 to 5.8 percent; the current range is 3.5 to 4.5 percent. I've brought my estimate down over time and recently I've 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.

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; it stood at 1.7 percent in January. Core PCE inflation, which excludes food and energy prices to strip out some volatility, also moved down last year; it now stands at 1.6 percent. But other measures of inflation show

firmer readings, at or above 2 percent.¹ These alternative gauges are not a substitute for the PCE inflation measure that the FOMC has targeted, but they do reduce my concern that inflation will continue to be weak. Inflation expectations have been relatively well anchored near 2 percent. Conditional on that, research done by the Cleveland Fed's Center for Inflation Research suggests that if labor markets remain strong, then we should see the components of 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.²

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 longer-run goals of price stability and maximum employment, 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 because it seemed appropriate to take the opportunity to assess the cumulative effects of last year's policy easing on the economy and 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 was 1.6 percent. I viewed this flatter policy path as being consistent with taking an opportunistic approach to

¹ The Cleveland Fed's median PCE inflation measure was 2.6 percent in January and the Dallas Fed's trimmed-mean PCE inflation measure has been stable at 2 percent. In January, CPI inflation rose to 2.5 percent, core CPI inflation was 2.3 percent, and the Cleveland Fed's median and trimmed-mean CPI measures were 2.9 and 2.4 percent, respectively.

² 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>.

raising inflation to our symmetric goal – refraining from taking deliberate policy action to lift inflation more quickly but 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.

Before the emergence of the coronavirus, my expectation was that output growth would be about trend this year, with solid performance in the labor market, and inflation continuing to move up gradually over the next year or two to the FOMC's goal of 2 percent. The underlying fundamentals of the U.S. economy remain strong, but the coronavirus will weigh on U.S. growth at least during the first half of the year, with a pullback in spending by households and businesses. It is what economists call a negative supply shock. Much is still unknown about the disease making it difficult to predict how large and persistent the economic impact will be. Heightened and persistent uncertainty can affect the economy. It raises the possibility that negative effects on consumer and business sentiment and a pullback in investor risk-taking could last after the spread of the coronavirus has stabilized. The supply shock could evolve into a demand shock.

The extreme volatility in financial markets is noteworthy. When a shock like this hits financial markets, the first task of central bankers is to ensure that there is sufficient liquidity and funding to allow markets to continue to function in an orderly way in the midst of extreme volatility, and to assure the public that they are prepared to act as necessary. Fed Chair Jay Powell issued such a statement last Friday. The Bank of England, Bank of Japan, and European Central Bank took similar steps; the International Monetary Fund and World Bank jointly stated that they stand ready to help affected countries with emergency financing, policy advice, and technical assistance; and the G7 finance ministers and central bankers released a joint statement this morning reaffirming their commitment to use all appropriate policy tools to support growth and safeguard against downside risks. Times like this underscore the value of an

effective framework of financial system regulation and supervision to help ensure that the financial system is well-capitalized and resilient, enabling financial institutions to better withstand volatility so that they can continue to extend credit to households and businesses.

While the economic fundamentals underlying the U.S. economy remain strong, in light of the risks to the outlook and guided by our statutory goals to promote price stability and maximum employment, today the FOMC lowered its target range for the federal funds rate by 50 basis points to 1 to 1-1/4 percent. The virus's near-term effects on the supply side of the economy, including the reduction in activity from closures, reduced social interactions, cuts in travel and tourism, and disruptions in supply chains, are not things that can be affected by lowering interest rates. However, the action taken by the FOMC can help support confidence and ease financial conditions of indebted households and firms, thereby helping to mitigate potential demand-side impacts of the virus. It was within this context that I supported today's interest rate reduction, while recognizing that appropriate actions taken by other parties, including global public health officials and fiscal authorities, would likely do more to support confidence and spending by helping to contain the spread of the virus, ensure adequate healthcare services are available to the sick, speed development of a vaccine, and provide relief to workers and smaller businesses that are affected by the pullback in activity.

Review of the Federal Reserve's Monetary Policy Framework

Let me now step away from current monetary policy and discuss future monetary policy. While the U.S. Congress has specified the Fed's longer-run monetary policy goals of price stability and maximum employment, it has given the Fed considerable independence in choosing the framework used to achieve these goals.³ The FOMC currently uses a flexible inflation-targeting framework. This framework

³ Section 2A of the Federal Reserve Act says that the Fed should conduct monetary policy to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." (<https://www.federalreserve.gov/aboutthefed/section2a.htm>) When prices are stable and the economy is at maximum employment, long-term interest rates are typically at moderate levels, so it is often said that the U.S. Congress has given the Fed a dual mandate.

recognizes that, over the longer run, monetary policy can influence only inflation and not the underlying real structural aspects of the economy such as the natural rate of unemployment or maximum employment, but that monetary policy can be used to help offset shorter-run fluctuations in employment around maximum employment. The framework is briefly described in the FOMC's statement on longer-run goals and monetary policy strategy, which was originally released in January 2012.⁴

The flexible inflation-targeting framework has served the FOMC well and has been effective in promoting our monetary policy goals. But the economic environment of the future is likely to differ from the past environment in some important dimensions. The expected slowdown in population growth and lower labor force participation rates due to changes in demographics will weigh on long-run economic growth, the natural rate of unemployment, and the longer-term equilibrium interest rate.⁵ This is true not only in the U.S., but in other advanced economies as well.⁶ Real interest rates are expected to remain lower than in past decades. If so, this means there will be less room for monetary policymakers to cushion against a negative economic shock by lowering its policy rate and a higher likelihood that the policy rate will hit its effective lower bound more frequently. In this case, tools including forward guidance and balance-sheet policies such as longer-term asset purchases will need to be used more often.

⁴ See FOMC, "Statement on Longer-Run Goals and Monetary Policy Strategy," adopted effective January 24, 2012; as amended effective January 29, 2019. (https://www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf)

⁵ See Loretta J. Mester, "Demographics and Their Implications for the Economy and Policy," *Cato Journal*, 38 (Spring/Summer 2018), pp. 399-413. (<https://www.cato.org/sites/cato.org/files/serials/files/cato-journal/2018/5/cj-v38n2-6.pdf>)

⁶ FOMC participants have been lowering their estimates of the fed funds rate that will be consistent with maximum employment and price stability over the longer run. The median estimate has decreased from 4 percent in March 2014 to 2.5 percent in December 2019, the most recently available estimate. (See the Summary of Economic Projections included in the Minutes of the FOMC, March 18-19, 2014, at <https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20140319.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>.) Also, empirical estimates of the equilibrium real fed funds rate, so-called *r*-star, while highly uncertain, are lower than in the past. For a review of the literature on the equilibrium interest rate, see Hamilton, James D., Ethan S. Harris, Jan Hatzius, and Kenneth D. West, "The Equilibrium Real Funds Rate: Past, Present and Future," *IMF Economic Review* 64, 2016, pp. 660-707. (<https://doi.org/10.1057/s41308-016-0015-z>)

In past recessions, the FOMC has reduced the federal funds rate target by 5 to 6 percentage points. With interest rates expected to stay low, that policy space will not be available. Moreover, in some economic models, the proximity to the effective lower bound on nominal interest rates can impart a downward bias to inflation, making it harder for central banks to hit their inflation targets. And inflation now appears to be less responsive to resource slack than it once was.

In light of these structural changes in the economic environment and our experience during the Great Recession and its aftermath, the FOMC has engaged in a review of our monetary policy framework to ensure it will continue to be effective in maintaining macroeconomic stability in the future. The review covers our monetary policy strategy, tools, and communications, taking as given our statutory mandate and that an inflation rate of 2 percent is most consistent over the long run with this mandate.

Since the FOMC announced its review in November 2018, it has been spending time at its regularly scheduled meetings considering various aspects of its framework.⁷ The Committee is evaluating different strategies such as whether to target inflation, average inflation, or the price level. These latter two strategies attempt to make up for past misses on the inflation target; in contrast, targeting inflation lets bygones be bygones. We are also analyzing the types of policy tools and best formulations of these tools that could be used to add accommodation in a future downturn, once our policy rate has been brought down to its effective lower bound. The FOMC did not use negative interest rates during the Great Recession and its aftermath, but our review is open minded and we are taking a look at the experience of other central banks that have used negative interest rates to address low inflation and low growth. A third aspect of our framework review is monetary policy communications. Policy communications are an important part of policymaking because they can increase the effectiveness of monetary policy in a number of ways. For example, communications can help to anchor inflation expectations at the target and

⁷ Information about the Fed's monetary policy framework review is available at <https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications.htm>.

they can better convey the rationale for policymakers' decisions, helping to transmit monetary policy throughout the economy. Various aspects of the FOMC's communications are being evaluated, including forward guidance used as a policy tool at the effective lower bound on interest rates.

In addition to internal discussions, the Fed engaged with academics at a research conference held last June; selected papers from the conference were published in the *International Journal of Central Banking*.⁸ We also held a series of Fed Listens events across the U.S. to gain the perspectives of people with diverse backgrounds and in different economic circumstances 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.⁹ 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. If inflation were to get out of hand again as it was in the 1970s and early 1980s in the U.S., 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, which can put further downward pressure on inflation and pull down interest rates, which then puts further constraints on monetary policy's ability to stabilize the economy.

⁸ "Special Issue: Federal Reserve System Conference on Monetary Policy - Strategy, Tools, and Communication Practices," *International Journal of Central Banking*, February 2020. (<https://www.ijcb.org/journal/ijcb2002.htm>)

⁹ 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>.

Our framework review seeks to ensure that we are approaching monetary policy in the most effective way to achieve our mandated longer-run goals of maximum employment and price stability. The minutes of the FOMC meetings summarize the initial impressions of the Committee participants on the topics raised in the framework review. I'd like to conclude with some of my thoughts on the three broad areas of the review.

Regarding monetary policy strategy, in my view, while make-up strategies like price-level targeting tend to work well in some models, I am skeptical that they would be as effective in the real world because their benefits depend on high levels of credibility and commitment. For example, I question whether the public will think it credible that policymakers will keep interest rates low to make up for past shortfalls even when demand is growing strongly or that the public will believe that policymakers will tighten policy when demand is weak after a supply shock has raised the price level. Instead of adopting a make-up strategy, I think some changes to communication could help to convey a better sense of the FOMC's approach and commitment to its policy goals. For example, I think it would be useful for us to explain that it is normal for inflation to vary in a range around our target due to a number of factors, including measurement issues, idiosyncratic shocks, and economic developments. It would also be useful to explain that the lower general level of interest rates likely to prevail in the future and changes in inflation dynamics suggest that inflation would likely be lower during economic downturns. In terms of strategy, after a period when inflation has been running below our goal for a sustained period, I would be comfortable with inflation moving somewhat higher than 2 percent for a time during economic expansions in order to help anchor inflation expectations and achieve our long-run symmetric 2 percent inflation goal.

Regarding tools, I believe that asset purchases and forward guidance have been and will continue to be useful tools at the effective lower bound. I am skeptical that the benefits of negative interest rates would outweigh the costs in the U.S. The experiences in Europe and Japan suggest that negative rates may have

some beneficial effects on bank lending and so far have not had adverse effects on market functioning or financial stability. But the financial markets in the U.S. are considerably different and are less bank-centric than those in Europe or Japan.

Regarding policy communications, I have spoken often about improvements the FOMC might make to the way we explain the rationale for our policy decisions, thereby making monetary policy more effective.¹⁰ Indeed, for forward guidance at the effective lower bound to work, people need to understand that we have entered a different mode and are using it as a policy tool. But that means they need to understand our policy setting in normal times: in particular, the goals we are trying to achieve; how we use changes in the fed funds rate to influence inflation, economic activity, and the labor market; and the key elements in our reaction function. A post-meeting policy statement that gives a fuller view of the Committee's outlook and attendant risks to the outlook, and that ties the Committee's policy decisions to that outlook and assessment of risks would be a worthwhile enhancement.¹¹

These are some of my own thoughts, but our review is ongoing and Federal Reserve Chair Powell has indicated that the FOMC will publicly report the outcome of the review once it is completed.

One can view the FOMC's review of its monetary policy framework as a form of good governance that is becoming a standard best practice of central banks around the world. The Bank of Canada reviews its framework to support the renewal of its agreement with the government on its inflation target every five

¹⁰ See Loretta J. Mester, "Transitions: The Economy, Monetary Policy, and Policy Communications," Lyons Companies and the Center for Economic Education and Entrepreneurship, Alfred Lerner College of Business and Economics, University of Delaware, Newark, DE, February 19, 2019 (<https://www.clevelandfed.org/newsroom-and-events/speeches/sp-20190219-transitions-the-economy-monetary-policy-and-policy-communications>) and Loretta J. Mester, "Improving Our Monetary Policy Strategy," panel remarks for "Strategies for Monetary Policy: A Policy Conference," The Hoover Institution, Stanford University, Stanford, CA, May 3, 2019 (<https://www.clevelandfed.org/newsroom-and-events/speeches/sp-20190503-improving-our-monetary-policy-strategy>), and the references therein.

¹¹ See Loretta J. Mester, "Remarks for the Session: 'Hall of Mirrors: Feedback Between Monetary Policy and Financial Markets'," 2020 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 21, 2020. (<https://www.clevelandfed.org/newsroom-and-events/speeches/sp-20200221-hall-of-mirrors>)

years. In 2014, the Bank of England undertook an external review of its policy communications led by former Fed governor Kevin Warsh.¹² And earlier this year, the European Central Bank launched a review of its monetary policy strategy, which the ECB expects to conclude by the end of this year.¹³ In an economic environment of low interest rates that are likely to prevail for some time to come, reviewing the monetary policy framework is not only good governance, it is a prudent step to ensuring that monetary policy continues to be effective at providing macroeconomic stability.

¹² See “Bank of England Announces Measures to Bolster Transparency and Accountability,” news release, December 11, 2014 (<https://www.bankofengland.co.uk/-/media/boe/files/news/2014/december/boe-announces-measures-to-bolster-transparency-and-accountability.pdf>) and Kevin Warsh, “Transparency and the Bank of England’s Monetary Policy Committee,” December 2014. (<https://www.bankofengland.co.uk/-/media/boe/files/news/2014/december/transparency-and-the-boes-mpc-review-by-kevin-warsh.pdf>)

¹³ See “ECB Launches Review of Its Monetary Policy Strategy,” press release, January 23, 2020. (<https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200123~3b8d9fc08d.en.html>)