

**The Economic Outlook, Monetary Policy, and Communications:
Progress on Multiple Journeys**



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

**The Economic Club of Pittsburgh, CFA Society Pittsburgh, and
the Pittsburgh Society of Investment Professionals**

**Pittsburgh, PA
September 4, 2014**

Introduction

It is a real pleasure to be here today and to address the Economic Club of Pittsburgh, the CFA Society Pittsburgh, and the Pittsburgh Society of Investment Professionals. I have been on quite a journey during my first three months on the job as the new president of the Cleveland Fed. Not only have I attended my first two Federal Open Market Committee meetings in Washington as a voting member, but I have been getting to know the Fourth Federal Reserve District, which includes Ohio, western Pennsylvania, the northern panhandle of West Virginia, and eastern Kentucky. One of my first stops was to Pittsburgh, and it is wonderful to be back here today for my first public speech since becoming president in June.

The economy and monetary policy have been on journeys of their own. Today, I want to share my views on both. But before I continue, let me note that these are my own views and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.

Economic Conditions and the Outlook

The economy is now in its sixth year of expansion. It has been a slow and difficult journey, with some stops and starts along the way. And while the final destination has not yet been reached, the economy has made significant progress on the road back toward fulfilling the Federal Reserve's goals of price stability and maximum employment.

Perhaps the clearest signals of that progress are in the labor market. Tomorrow all eyes, including my own, will be on the Labor Department's monthly jobs report for August. Because these statistics can vary from month to month, rather than focus on one monthly number, I like to look at the underlying trend in the data. Here, the news is good: We've seen steady improvement in labor market conditions. So far this year, nonfarm payrolls have risen an average of about 230,000 jobs per month, which is somewhat stronger than last year's pace and represents significant progress since the start of the recovery. In addition, there has been some consistency in those gains, with monthly increases of more than 200,000 jobs in each of the past six months. While the recovery in jobs has been much slower than anyone would have liked, as of this May, the economy finally met the milestone of having added more jobs during the expansion than the 8.7 million jobs lost during the Great Recession.

The unemployment rate is another important gauge of labor market conditions, and it, too, has shown substantial improvement. It currently stands at 6.2 percent, down from a peak of 10 percent in October 2009, and more than a percentage point lower than a year ago. Of course, unemployment rates vary by region, depending on a number of factors. The Pittsburgh metropolitan area's unemployment rate was near the nation's before the recession. But it did not rise as high and has been running somewhat below the national average over the expansion, reflecting the region's concentration of faster-growing "meds and eds" jobs.

Despite regional variation, overall, the fall in the national unemployment rate has been faster than many economists and policymakers, including some on the FOMC, had anticipated. For example, last September, according to the central tendency of their projections, FOMC participants were projecting that the unemployment rate would be 6.4 to 6.8 percent in the fourth quarter of this year. But the

unemployment rate is already lower than that. Other measures of unemployment or underemployment have also shown improvement over time. These include measures that track people who are working part time but would prefer a full-time job, and the long-term unemployed – people who have been out of work for more than six months.

Yet the labor market's journey is not yet complete – more progress needs to be made. My outlook is that as the expansion continues, firms will continue to add to their payrolls and the unemployment rate will continue to decline. I expect that by the end of next year, the unemployment rate will fall to around 5½ percent, which is what I view as the “natural rate,” or longer-run rate, of unemployment.

Unlike labor markets, economic growth needed some snow tires on its journey earlier this year. Real output fell at a slightly more than 2 percent annual rate in the first quarter. I attribute most of this stall-out to temporary factors, like the extremely bad winter weather, rather than a sign of weakening in the underlying economy. In fact, during the second quarter, we saw a significant rebound in activity, and I expect real GDP to expand at about a 3 percent annual pace in the second half of this year and next year. That growth rate is consistent with continued improvement in labor markets, which will help support income growth and keep consumer spending, which accounts for two-thirds of economic output, expanding at a moderate pace.

Another important positive is the considerable progress that households have made in repairing their balance sheets – but this has taken some time. The Great Recession destroyed a lot of wealth. At the aggregate level, household net worth fell by more than \$10 trillion in 2008. It took more than three years to make that up. Last year, rising prices of equity, which many families hold in their pension and retirement funds, and rising house values contributed to the increase in household wealth. The improvement in real estate prices means fewer homeowners are holding negative equity in their homes and delinquencies on mortgages are down significantly.

Currently, about one in 20 mortgages is seriously delinquent, meaning either 90 days or more past due or in the process of foreclosure. Three years ago that ratio was one in 12. So things have improved, but there is still a way to go before we return to the levels seen before the housing crisis, when only one in 50 mortgages was seriously delinquent.

And I do expect to see continued progress in the housing market. We won't go back to the unsustainable levels of construction and surging prices that we saw prior to the crisis – nor should we want to. And like other sectors of the economy, housing won't follow a linear path. In fact, we saw a fairly strong increase in housing activity, including housing starts and sales, in 2012 and the first half of 2013. Then, as mortgage rates rose in the second half of last year and cold weather set in, that pace of activity slowed down.¹ Looking through the swing caused by the severe weather, single-family housing starts this year have been expanding at about the same pace as last year. The multifamily housing sector has shown more strength, which may represent a longer-run shift from owning to renting in the aftermath of the bursting of

¹ For an analysis of the factors that led to a slowdown in residential investment at the end of 2013 and beginning of 2014 see, Edward S. Knotek II and Saeed Zaman, “The Slowdown in Residential Investment and Future Prospects,” Federal Reserve Bank of Cleveland, *Economic Commentary*, No. 2014-10, May 28, 2014, www.clevelandfed.org/research/commentary/2014/2014-10.pdf.

the housing bubble and tighter mortgage credit conditions. Overall, my outlook is for the moderate improvement in housing to continue, supported by mortgage rates that are still very low by historical standards and a level of affordability that is better than before the crisis.

Similar to households, businesses have also been repairing their balance sheets during the expansion. Corporate profits are at high levels. Nonetheless, business investment has been somewhat slower than one would have expected based on economic fundamentals. We heard from many businesses over the past two years that they had the wherewithal to invest but wanted to wait a while longer until they were more confident that the economic expansion was sustainable and some of the uncertainty about fiscal policy was resolved. We are now seeing that happen. Fiscal policy is less of a drag this year than it has been over the last couple of years, and business confidence has risen. Manufacturing surveys and anecdotal reports indicate that firms are planning to increase capital spending, and we are seeing stronger orders and shipments.

Putting all of this together, I expect growth over the next six quarters to be somewhat above my estimate of trend growth, which I put at around 2.5 percent. Of course, there is always a good deal of uncertainty around estimates of trend growth, perhaps even more so today in the aftermath of such a deep recession. I am a bit more optimistic than some about longer-run growth because while productivity growth has been running low, I think it is good to remember the experience of the 1990s. Back then, over a period of several years, many forecasters revised down trend growth estimates only to subsequently revise them up significantly in response to strong productivity growth.

Turning to inflation, the recent news has been encouraging. Inflation is moving back toward the Fed's goal of 2 percent, measured by the year-over-year change in the price index for personal consumption expenditures, or PCE inflation. This measure of inflation has increased to 1.6 percent this year from 1.2 percent last year. This is encouraging because we wouldn't want to see inflation run either persistently above or persistently below our goal. Consistent with a pickup in economic growth, and expectations of inflation remaining well anchored, my forecast is that inflation will move back toward 2 percent over time.

One might ask whether that's a reasonable inflation forecast given that we haven't seen much acceleration in wages yet. I believe it is. Cleveland Fed analysis, based on several measures of wages and broader compensation, indicates that it is difficult to find a lead-lag relationship between wages and prices – the strongest correlations are contemporaneous ones, especially since the mid-1980s.² We should expect wages to rise with prices, not necessarily lead prices. In my view, it would not be prudent for policymakers to simply wait for wages to accelerate before assessing the implications of the stance of monetary policy for future price inflation. Indeed, policymakers must always be forward looking. We must continue to process incoming information on economic activity, labor market conditions, and prices, and assess whether or not that information is consistent with or has changed our outlook. We also have to keep in mind the risks that surround the forecast, including the geopolitical risks that have escalated in

² Edward S. Knotek II and Saeed Zaman, "On the Relationship between Wages, Prices, and Economic Activity," Federal Reserve Bank of Cleveland, *Economic Commentary*, No. 2014-14, August 19, 2014, www.clevelandfed.org/research/commentary/2014/2014-14.pdf.

recent weeks. Despite these risks, my read of the data and the incoming information we collect from our business contacts is that the economy is standing on firmer ground than it has been for some time. The economy has made, and continues to make, substantial progress on its journey back to our dual-mandate goals.

Monetary Policy

So that's my travelogue of the economy's journey. But in response to the financial crisis and deep recession, monetary policy took a journey of its own – into uncharted waters. The depth and nature of the recession required the Federal Reserve to run an extraordinarily accommodative monetary policy to promote our goals of price stability and maximum employment. The FOMC has kept its policy rate – the federal funds rate – at essentially zero since the end of 2008. To exert downward pressure on long-term interest rates, it has purchased longer-term Treasury securities and agency mortgage-backed securities, expanding the Fed's balance sheet from about \$900 billion in 2007 to almost \$4.5 trillion today. It has also used forward guidance to communicate the anticipated future path of policy.

As the economy journeys back to more normal territory, monetary policy will also need to navigate back to more normal seas – something you probably have heard referred to as “policy normalization.” Eventually we will be able to move away from our extraordinary policy tools, like asset purchases, and back toward implementing monetary policy by targeting short-term interest rates. In fact, already, based on the cumulative progress the economy has made in labor markets, since the start of the year, the FOMC has been scaling back the pace at which it has been buying assets. At our July meeting, the FOMC voted to reduce the pace by another \$10 billion, to \$25 billion a month. If the economy continues on my anticipated trajectory, then I expect the asset purchase program to end this fall.

Yet, even with the end of the purchase program, the Fed's balance sheet will remain very large, with assets of much longer maturity than usual, and this will complicate the normalization journey. The FOMC has been developing tools to help during the trip. One of these tools, an overnight reverse repurchase agreement facility, is currently being tested. Basically, with reverse repos, the Fed lends securities from its large portfolio in return for liquidity, which is thereby drained from the market. The Fed also is testing the use of term deposits to absorb some of the excess reserves in the banking system. The FOMC has been discussing the design of these tools, which would be intended for limited use during normalization. The Fed's ability to pay interest on excess reserves, with these supplementary tools providing backup if needed, will allow the Fed to move interest rates up to target when it is appropriate to do so, despite the large size of our balance sheet.

In addition to taking another step to taper asset purchases, in July, the FOMC maintained its forward guidance on interest rates. This guidance indicated that given our assessment of realized and expected progress toward our dual-mandate objectives, it will likely be appropriate to maintain the current 0-to-¼ percentage point range for the federal funds rate for a considerable period after the asset purchase program ends. With the end of the program nearing, I believe it is again time for the Committee to reformulate its forward guidance. The forward guidance the FOMC has offered for the path of the policy interest rate has undergone several changes along the way as we've moved from the extraordinary times of financial crisis and deep recession to recovery and expansion. The guidance has tied the eventual

liftoff of the fed funds rate from zero to a calendar date, to a numerical threshold for the unemployment rate, and, more recently, to qualitative information rather than to quantitative measures.

While it might sound best to simply give a date about when liftoff is likely to occur, I believe using a calendar date at this point would be poor communication. It could mislead the public into thinking that policy is on a pre-set course. If the public doesn't understand that policy is dynamic and based on the economic outlook, then a change in the guidance can create its own disruption. Well-formulated forward guidance also has to recognize that economic conditions can evolve differently than anticipated. For example, over the past year the improvement in the unemployment rate has been faster than the FOMC anticipated just a year ago. My preference is for forward guidance to convey that changes in the stance of policy will be calibrated to the economy's actual progress and anticipated progress toward our dual-mandate goals, and to the speed with which that progress is being achieved. This latter piece recognizes the importance of policy to be forward looking: A faster pace of progress toward our goals would argue for a faster return to normal, while a more subdued pace would argue for a slower return.

Communication

Forward guidance is just one aspect of the communications that will be an important part of the journey back toward normal monetary policy. The FOMC will need to do its best to communicate the rationale for its policy decisions and to prepare the public for this unprecedented trip.

Of course, effective communication is not a trivial task. Yet the potential economic benefits have kept the FOMC striving for increased transparency over time. It's hard to believe that it was just 20 years ago, in 1994, when the FOMC first began to issue a statement after it had changed policy. Since then the FOMC has taken other steps, including expediting the release of the minutes of its meetings, publishing economic projections four times a year followed by the Chair's press conference, and releasing a statement clarifying our longer-run goals and monetary policy strategy.

The FOMC is continuing its journey toward more effective communications. This summer, Chair Yellen asked Governor Fischer to chair, and Governor Powell, President Williams of the San Francisco Fed, and myself to serve on a subcommittee on communications to help the FOMC frame and organize the discussion of a broad range of communications issues. I believe striving for clearer communication will yield benefits, especially as we undertake normalization. As normalization nears and progresses, there is likely to be increased volatility in financial markets; that is not necessarily a bad thing. Indeed, the goal of communication is not to reduce all volatility – volatility is a necessary part of price discovery in financial markets. But the better we can communicate our monetary policy framework and the basis for policy decisions, the more likely we can avoid undesirable disruptions and turbulence that could result from misunderstandings as we prepare for and progress on the journey to a more normal policymaking framework and policy stance.

Conclusion

In summary, the economy has made considerable progress on its journey back to maximum employment and price stability. Although there are risks around the forecast, including geopolitical ones, my

expectation is for the economy to continue to make progress, with growth at about 3 percent over the second half of this year and next year, the unemployment rate falling to 5½ percent – my estimate of the natural rate – by the end of next year, and inflation returning to 2 percent over the next two years. Monetary policy remains extraordinarily accommodative, but as labor markets have shown considerable improvement, the FOMC is tapering the pace at which it is purchasing longer-term securities, and I anticipate that program to end this fall.

Given the uncharted waters we are in, the journey back to a normal monetary policy stance and framework for conducting policy is a challenging one, and the FOMC continues to plan for it. The communication surrounding normalization is going to play an important part in how well the journey goes. Explaining the factors that influence the changes in the outlook and FOMC policy decisions, as well as how the FOMC plans to conduct policy, can help the public make informed expectations as the economy evolves and monetary policy travels back to normal.