Federal Reserve Bank *of* Atlanta

The Path toward Policy Neutrality

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Knoxville Economics Forum
Club LeConte
Knoxville, Tennessee

March 23, 2018

- In a speech to the Knoxville Economics Forum on March 23, 2018, Atlanta Fed president and CEO Raphael Bostic shares his thoughts on economic conditions and the recent Federal Open Market Committee vote to increase the federal funds rate target range.
- With the economy operating near its potential and inflation approaching the long-run target, Bostic finds it appropriate for monetary policy to move toward a more neutral stance.
- Bostic will likely support further rate increases over the course of this year, but feels that less aggressive rate rises may be prudent as the Fed continues to shrink its balance sheet.
- Bostic's forecasts for the next several years assume that fiscal policy will provide a relatively modest boost to GDP growth.
- Bostic feels that despite strong employment growth, U.S. labor markets are not substantially overheated.
- Bostic expects the relatively calm inflation environment to persist, but sees the potential for inflation to run somewhat above the 2 percent target.

Good morning. It's a pleasure to be with all of you today.

I've been fortunate to have had the chance to visit many parts of the Sixth Federal Reserve District since I came on board last year. This is my first trip to Knoxville and to this university. I'm looking forward to learning more about this part of the region. I'll meet with some students and faculty later this morning, and then with some business leaders and your mayor before I head back to Atlanta.

The insights from regional experts help my staff and me understand emerging trends in the economy in real time, so these visits are a critical, and quite enjoyable, part of my job.

As you may know, the Fed wrapped up its second monetary policy meeting of the year on Wednesday, voting to increase the federal funds rate target range. This morning, I'd like to share my thoughts on why this policy move made sense based on some signposts my team and I are seeing in the current economic landscape. I am going to characterize Wednesday's policy decision as another step toward a more neutral monetary policy stance.

Though I expect that a sequence of further rate hikes will be appropriate over the next couple of years, that view is based on certain assumptions about how economic conditions will evolve going forward. In the last part of my talk this morning, I will highlight some key assumptions that underlie my view of the economy, and I'll highlight some of the key risks to my outlook.

Let me state the usual disclaimer before I begin. I'll present only my personal opinions today. I'm not speaking for anyone else in the Federal Reserve or for the Federal Open Market Committee, or FOMC.

State of the economy
So let's begin with the current state of our national economy. Unemployment rates are at or below levels that prevailed before the crisis a decade ago. This is true for the official rate that dominates the headlines after the employment report is released every month. But, importantly, it is also true for broader jobless measures that, for example, count as unemployed those individuals who have part-time jobs but who would rather work full-time.

Inflation, which has been persistently below the FOMC's longer-run 2 percent target for six years, has been trending upward toward that target. The six-month average inflation rate—expressed as the annual growth rate of the Personal Consumption Expenditures, or PCE, price index—is now well above the 2 percent target.

That may sound like we have actually overshot our inflation objective, but I think it is important to explain that the overall, or headline, rate of inflation is not usually the best way to think about the inflation trend. The reason is that temporary influences can dominate the headline measure over shorter periods of time. That means that headline inflation today is not the best predictor of headline inflation tomorrow.

This is why we look at so-called core measures of inflation, which are better predictors of future overall inflation than is today's headline inflation rate. The annualized six-month core inflation rate has been steadily increasing since August, and it hit 2 percent in January. This is true whether we measure core inflation by the traditional index that removes food and energy from the inflation calculation or whether we use more sophisticated measures of trend inflation, like the Dallas Fed's trimmed-mean estimates.

Two percent, of course, is the magic number because it is the longer-run inflation rate that the FOMC has identified as consistent with price stability.

These two observations—unemployment at or near precrisis levels and trend inflation measures at or near 2 percent—give me confidence we are at or near the FOMC's sustainable employment and inflation objectives. And, subject to some caveats I will explain later, I am reasonably comfortable with a

forecast that this situation will persist into the future.

Moving toward neutrality
With the economy operating near its potential and inflation finally approaching the long-run target, it is appropriate, in my opinion, for monetary policy to be moving toward a more neutral stance. By neutral, I mean neither stepping on the gas to move the economy faster nor pumping on the brakes to slow the economy down.

Conceptually, the neutral policy rate is pretty straightforward. It is the interest rate determined by fundamental saving and business investment decisions, plus an adjustment for the rate of inflation.

It's hard to pin down the neutral rate with precision. But our estimates suggest a neutral rate that will over time fall in the range from 2 1/4 to 2 3/4 percent.

As of the FOMC decision on Wednesday, the upper end of the target federal funds rate range is 1 3/4 percent. This is below the lower end of the long-run range identified in the Summary of Economic Projections—or SEP. Even assuming that the underlying interest rate is still somewhat below its long-run value, the current setting remains below what I would characterize as neutral.

That is why I voted in favor of the 1/4 percentage point increase in the target federal funds rate range at the FOMC meeting. If the economy evolves roughly as I suspect, I will likely support further increases over the course of the year.

Why not support an immediate adjustment toward full neutrality of the federal funds rate? Three reasons.

First, the SEP makes clear that most Committee members anticipate gradual increases in the policy rate over the next several years if inflation, GDP growth, and unemployment perform as forecasted. Market participants appear to be incorporating this path into the pricing of financial market instruments, so some of the effect of future target increases may already be priced into borrowing and lending rates.

Second, last September the Federal Reserve began the process of reducing its balance sheet.

The pace of balance-sheet reductions will ramp up over the course of this year, settling at a maximum rate of $50 billion per month by year-end. For reasons I have explained in earlier speeches, I expect the interest-rate effects of our balance sheet policy to be small. But that is a conjecture. It may be prudent to act somewhat less aggressively than we might do otherwise as we accumulate information about the effects of the balance-sheet side of the current policy mix.

Finally, forecasts are inherently uncertain. It is generally appropriate, in my view, to steadily ease our way to higher rates, moving gradually and assessing the emerging circumstances before taking another step along the path to full normalization.

As I stated, I believe a gradual increase in interest rates to move toward neutral is appropriate if the economy evolves as I expect.

Naturally, the key question for executing this strategy is: Will the economy evolve roughly as I anticipate? Clearly, there are many moving parts in such a large and complex economy. Let me now turn to three key assumptions that underlie my view of the economy, and the potential risks should these assumptions prove mistaken.

GDP growth and nonmonetary policy
First, my current forecasts for the next several years assume that fiscal policy will provide a positive, but relatively modest, boost to GDP growth.

In association with researchers from Stanford University and the Booth School at the University of Chicago, my staff conducted a survey last month asking business executives if the Tax Cuts and Jobs Act passed in December would materially change their capital expenditure plans in 2018 and 2019. Seventy-five percent of respondents indicated that the tax cuts would not change their investment plans in 2018. Seventy-three percent said investment plans for 2019 were unaffected.

Interestingly, this survey question was a follow-up to a similar question asked in November in anticipation of the tax cut bill's passage. Fewer respondents indicated that investment would be positively affected in the February survey than responded positively in the November survey.

These survey results are largely consistent with anecdotal reports we have received from many business contacts, so I am not assuming a huge boost to growth from tax cuts over the next couple of years.

The tax cut bill, of course, is not the only source of potential fiscal stimulus over the next couple of years. The Bipartisan Budget Act passed last month will add near-term direct spending that we estimate will add a little less than one-third of a percentage point or so to growth in each year. That's not immaterial, but neither is it a game-changing sort of effect.

So, my baseline view of the economy reflects a relatively modest stimulus from recent fiscal policy changes in the near term. It would be fair to say that the actual effects could well be larger than I am suggesting, representing an upside risk to my GDP growth forecast. I hasten to add, however, that the prospects of any significant or pervasive tariffs—and the reactions from trading partners that could follow—represent a counterbalancing downside risk.

Labor markets
Second on the list of assumptions underlying my forecast is the sense that, despite employment growth that is substantially outpacing the rates consistent with stable unemployment rates, U.S. labor markets aren't substantially "overheated."

I consistently hear reports from business contacts that labor markets are tight. But results from the most recent Federal Reserve Banks' Small Business Credit Survey provide some interesting insight into what this might mean.

Most firms in this national survey—which canvasses businesses with fewer than 500 employees—report hiring difficulties, and the vast majority are doing something about it. However, a firm's response to these difficulties seems to depend on the nature of those difficulties.

Increasing compensation is the most common response, particularly among firms that cite employer competition or too few applicants as a reason for hiring difficulties. However, a large share of firms are reacting by loosening job requirements, increasing training, or reallocating existing job duties. An

implication is that labor costs for firms have increased, but not only in the form of wages or benefits. Firms are spending more time on nonproduction activities such as training and the restructuring of employee responsibilities.

To me, one of the lessons is that many businesses are facing some pressure on labor costs, often in the form of nonwage expenses. Still, these costs do not yet seem to be accelerating, and my belief is that labor market conditions are not yet overheated.

"*Not yet* overheated" is the operative clause. With the U.S. economy creating about 200,000 jobs per month over the past two years—as I noted, well above the pace consistent in the longer run with a stable, and not falling, unemployment rate—there is an upside risk for explicit and implicit labor costs going forward.

Inflation

And that brings me to inflation. In a very informative speech last September, former Fed chair Janet Yellen offered a useful way to parse the inflation rate. She pointed to four elements: first, inflation expectations; second, the degree of tightness in the labor market; third, movements in import prices; and fourth, transitory factors that come and go.

Updating Chair Yellen's analysis, we find that virtually all of these elements that might drive headline inflation away from the Fed's longer-run 2 percent target are now benign. My own baseline forecast is that this relatively calm inflation environment will persist. However, with upside risks to GDP growth and employment, I do believe the risk to the inflation outlook is also to the upside.

In fact, my baseline forecast for the economy does contemplate some modest upward pressures on inflation over the next several years. For the first time in a long time, I see the potential for inflation to run somewhat above the Fed's longer-run 2 percent target as opposed to the below-target rate we have seen over the past six years.

How should the FOMC respond if inflation persistently runs somewhat above 2 percent? I have some thoughts about that, but they would take a long time to explain, and I have spoken long enough already this morning.

If you are interested, I suggest you look at the Atlanta Fed's *macroblog* next week for some details on those ideas. You can find it on the Atlanta Fed's website.

Thanks. Now I'll be glad to take a few of your questions.

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