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## **Monetary Policy: Assessing Crosscurrents**

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FEDERAL RESERVE BANK OF CHICAGO

The views expressed today are my own and not necessarily those of the  
Federal Reserve System or the FOMC.

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## Introduction

Thank you, Roger, for that kind introduction. I really value the opportunity to speak to groups such as yours. Obviously, it provides me with a forum to communicate my views about monetary policy. Clear communication is essential for the accountability and effectiveness of our policy decisions. But the occasion offers an additional opportunity. Your experiences and perspectives help me formulate my thinking about the economy and monetary policy. Our timely assessment of developments is critically informed by the observations of people directly involved in business, labor, and community development. Such insights are particularly important at times like today when there appear to be a number of tough-to-read crosscurrents in the economy. Therefore, I look forward with great interest to your questions and observations at the end of my remarks.

Today, I'd like to discuss my outlook for the economy, the risks around my forecast, and how these assessments shape my thinking on monetary policy. Of course, my comments reflect my own views and not necessarily the views of the Federal Reserve System or the Federal Open Market Committee (FOMC).

## Synopsis

January is a time when I get plenty of speaking invitations to talk about my economic outlook for the new year. Of course, just like my annual forecast that I won't overdo it on holiday desserts, my economic predictions for 2019 come with a healthy slice of humility. With all of the developments over the past few months, this is a particularly treacherous forecasting period. One could easily end up with egg on one's face before too long.

Why is that? It's because even though the fundamentals for growth here in the U.S. are solid, there are many uncertainties and risks currently staring us in the face. There are a lot of crosscurrents to work through when making a forecast today.

Let me begin by laying out my main points.

- Twenty eighteen was a very strong year, with gross domestic product (GDP) growth currently expected to come in at around 3 percent. This is about a percentage point above the long-run norm—or what economists call the economy's potential rate of growth.

- Solid fundamentals lead me—and most other forecasters—to expect another good year in 2019, with growth coming in somewhat above potential. That said, this forecast has output decelerating, with growth closer to 2 percent. So, compared with 2018, this economy might not feel like it is doing very well. Nonetheless, such growth in 2019 would come with healthy gains in household and business spending, keep the unemployment rate low, and have wages rising at a decent clip.
- Beyond 2019, I see output slowing further toward its longer-run potential, which I currently see as around 1-3/4 percent. By the way, this is a quite modest pace for trend growth relative to historical standards.
- In some other good news, the concerns we've had about inflation being too low have dissipated. I expect inflation to be near 2 percent this year. If fundamentals stay strong, I expect inflation to rise a little higher in 2020 and 2021, though certainly not by enough to be inconsistent with our symmetric 2 percent inflation target.
- But clearly, there are risks surrounding my forecast. In particular, recent financial market developments and uncertainties regarding growth abroad, trade policy, and possible fiscal headwinds have cumulated to increase the downside risks. Now, there are upside risks as well. Further momentum in consumer and business spending could cause stronger growth, or pressure on productive resources could boost inflation faster than I currently expect.
- Any of these various crosscurrents could pull the economy in a different direction than my baseline expectations. So, as we move forward in this fluid environment, I will be particularly attentive to factoring the incoming information into my assessment of the economy and the balance of risks to the outlook. And it is this outlook and risk assessment that will determine my views about the appropriate monetary policy we need to follow to achieve our dual mandate objectives of price stability and maximum employment.

### **Good progress toward our dual mandate goals**

Let's now look back a bit at last year. Twenty eighteen was a strong year for the U.S. economy. With impetus from still-accommodative monetary policy and expansionary fiscal policies, the pace of economic activity picked up noticeably.

We'll get the first read for the year as a whole at the end of the month; most forecasters are expecting it to come in around 3 percent. This is significantly above both what growth had averaged over the previous eight years and the economy's long-run potential growth rate, which I estimate to be a little below 2 percent. It's also better than what most forecasters were expecting at the beginning of last year. For example, back then I projected growth to be around

2.5 percent. So 2018 turned out to be a nice change for me, because over the past ten years, I—along with most forecasters—had often been too optimistic about how the economy would perform. It is good, for once, to miss on the upside.

With this growth, labor markets continued to strengthen. Last year more than 2.6 million jobs were created, and the unemployment rate declined further to an average of 3.8 percent in the fourth quarter. This is noticeably below the 4.4 percent rate that most FOMC participants currently associate with full employment. And a wide array of other labor market indicators, such as the number of discouraged workers or those working part time for economic reasons, also point to a healthy labor market.

The vibrant labor market and corresponding increases in household income were key factors behind strong consumer spending; the 2017 personal income tax cuts also contributed. In addition, business investment was strong last year, boosted in part by a variety of changes to the tax code.

In another nice change from previous years, the news on inflation also has been good. After underrunning our 2 percent target for almost a decade, underlying inflation—as measured by the Price Index for Personal Consumption Expenditures excluding food and energy—has finally picked up and has been near our target since last March.

So, as I look back to the economy's performance in 2018, I am encouraged with the progress toward our dual mandate goals.

### **Recent economic crosscurrents**

As we enter 2019, the incoming data on economic activity generally continue to be strong—witness the December jobs report. Moreover, the most recent reports from my business contacts support these data. If these were all you were looking at, you would have popped another bottle of champagne on New Year's Eve. But, as we all know, a lot else has been going on over the past few months.

First, there are a number of uncertainties on the international front. Foreign growth in 2018 slowed from a strong pace in 2017, and markets are wary of a further step-down. There also is concern that events such as a disorderly Brexit could have important spillovers to U.S. financial markets. And there is a good deal of uncertainty over U.S. trade negotiations with China and other trading partners and the prospects for larger tariffs that could impose significant costs on U.S. firms and consumers.

Second, the U.S. fiscal policy picture is unclear. In addition to the near-term risk of a prolonged government shutdown, there are questions about the feasibility of shaping an appropriate fiscal policy response to any future downside shocks.

Third, financial markets have been, well, shall we say, busy. Investors seem to be concerned about these international and fiscal risks, the sustainability of corporate earnings growth in an

environment with such risks, and the possibility of the Fed removing policy accommodation too aggressively. Since the beginning of October, stock prices have declined noticeably, equity market volatility has increased, corporate bond spreads—particularly for riskier firms—have widened, and the exchange value of the dollar has risen. Taken together, these amount to a tightening in financial conditions.

The question is this: How much will these factors impinge on U.S. growth and employment prospects, and what then should be the proper response of monetary policy?

My view is these are important risks to monitor carefully, and that it will be prudent to exercise cautious data dependence when setting policy. That said, a case can be made that the economy could continue to perform smartly in 2019 if appropriate economic policies are pursued. Let me explain.

First of all, when looked at from a broader perspective, the current tightening in the overall level of financial market conditions may reflect a recalibration by investors as they recognize the economy is now likely decelerating toward a modest longer-run trend rate of growth. For example, the drop in equity prices comes after almost two years of fairly steady increases. Indeed, some analysts had argued that stock market valuations had gotten ahead of a reasonable outlook for earnings, and the recent declines in equity prices have brought the S&P 500 price-to-forward earnings ratio back down to around its long-run historical average.

Similarly, the recent increases in corporate bond spreads come from very low levels, and spreads currently are just a bit above their average over the past five years. And like equities, this change in risk pricing may be a recalibration reflecting market recognition that growth is decelerating toward a 1-3/4 percent trend. In addition, while capital markets have turned less hospitable, banks are still reporting easier terms on business loans and commercial and industrial bank lending has been rising notably.<sup>1</sup> So, it is likely that most firms still have access to reasonably priced funding.

On the household side, the recent declines in stock prices have reduced household wealth some, and home price gains have moderated. But overall, household balance sheets are still in good shape. Furthermore, consumer borrowing rates have not risen to the degree that corporate rates have.

With regard to international issues, forecasters had become optimistic about rising foreign growth prospects last spring, and the recent growth downgrades may be more of a retracing of this prior optimism. Furthermore, even with the latest markdowns, projections are still for growth in the neighborhood of potential.

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<sup>1</sup> According to the results of the most recent *Senior Loan Officer Opinion Survey on Bank Lending Practices*, conducted in early October 2018, nearly 27 percent of respondents, on net, reported easing spreads of commercial and industrial loan rates over their cost of funds for large and medium-sized firms and 20 percent, on net, reported similar easing on loans to small firms. Additional details are available in Board of Governors of the Federal Reserve System (2018).

Like I said, a case can be made for a reasonably good 2019 economic outcome.

But I do not want to downplay the risks too much. This is where the “egg on my face” risk may better be referenced as a high “goosey, cream-filled pie in the face” risk. Volatility could continue, and financial conditions could tighten further. Another question is how well will more fundamental valuation judgments anchor asset prices in the face of shorter-term momentum trading strategies. On the international front, some currently unforeseen shock could materialize and send foreign growth lower. Geopolitical uncertainty is relatively high, and other difficult international challenges could emerge. Or we could find that U.S. growth in 2018 was driven more by stimulative fiscal actions and monetary accommodation and less by underlying private-sector strength than we previously thought. And we have to be attentive for heightened uncertainty and caution weighing on consumers’ and businesses’ spending and investment decisions.

Therefore, as the FOMC noted in its December policy statement, as we go forward we will be in a data-dependent mode—which means we will continually monitor global and financial developments to assess their implications for the economic outlook and the stance for policy.<sup>2</sup>

### **Economic outlook**

Having gone over the caveats, I will now give you the specifics for my baseline projection. I expect real GDP growth to be a bit above 2 percent in 2019. With waning impetus from monetary and fiscal policies, growth should moderate a bit more and come in at about its longer-run potential in 2020.

Now, at this point in a quite mature business cycle, growth at potential is a pretty good outcome. But, as I noted before, it might seem a little disappointing when compared with 2018’s performance. It also seems disappointing when compared with the 3.5 percent trend we experienced from the 1960s through the early 2000s. But as I, along with my FOMC colleagues, have spoken about on previous occasions, the long-run structural trends in population growth, labor market participation, and productivity all point to a lower longer-run growth potential for the U.S. economy—to something more like 2 percent or a bit below. Changing this arithmetic by much would require some significant turnarounds in demographic or technological trends, all of which are beyond the scope of monetary policy.

Given my outlook for growth, I expect the unemployment rate will decline toward 3-1/2 percent by the end of this year before edging up to 3-3/4 percent by the end of 2021. This is about half a percentage point below my staff’s estimate of what economists call its natural rate. This is the unemployment rate consistent with the normal churning of people in and out of jobs at a time when the workforce is fully employed.

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<sup>2</sup> See Federal Open Market Committee (2018b).

I haven't mentioned inflation much, but of course, inflation developments play an important role in my data-dependence monitoring and assessment of policy risks. Those of you who have heard me in the past know that I had been concerned about the prolonged undershooting of our inflation target over the past ten years. However, with firmer inflation readings in the past year, the inflation outlook has improved.

Looking ahead, I expect inflation to rise a bit further over the next few years. With unemployment below its long-run normal rate, we should see continuing pressure developing on productive resources in the economy, generating higher costs and higher prices.

Indeed, we have already seen such pressures building over the past year. My business contacts almost uniformly report rising input costs and higher wages. In recent months, annualized wage gains have stepped up to about 3 percent. This is noticeably higher than the wage increases we experienced earlier in the expansion. Moreover, with strong demand for their products, more firms say they have been successful in passing higher costs on to their customers. So today the pricing environment seems much different than it did over the past few years.

My modal forecast is for inflation to edge up further and average a touch above 2 percent over the next three years. Now, you might ask if inflation above 2 percent is consistent with our 2 percent target. The short answer is yes. As the FOMC has stated, our target is symmetric. So, inflation running slightly above 2 percent is consistent with the symmetry of the FOMC's goal, particularly given the prolonged undershooting we had over the previous ten years.

The forecast that I just outlined is what I see as the most likely path for the economy in the next three years. Of course, there are risks to this modal outlook. I've already discussed the downside risks to the outlook for growth. But there are some upside ones as well. Importantly, many fundamentals for consumer and business spending remain quite solid and might support faster growth than my forecast—just like they did in 2018.

There also are two-sided risks to my inflation forecast. On the downside, I am mindful of how my optimism in previous years for inflation rising to our 2 percent target did not bear fruit. One thing that I'm wary of now is that with the improvements in inflation in 2018 and reports about rising resource and cost pressures, I would have expected to see various proxies for inflation expectations move up more than they have. I have worried before that inflation expectations are anchored somewhat below our 2 percent objective. Recent developments in inflation expectations continue to give me pause.

On the upside, we are running with historically tight labor markets that in some periods in the past have been associated with greater inflationary pressures than we see today. If these old relationships from the 1970s and 1980s reassert themselves, then inflation could exceed our goal by more than I currently anticipate. Yet, the long-running undershooting of our 2 percent inflation target, along with still-low inflation expectations, tell me that a modest period of inflation running nearer to 2-1/2 percent would not be a big policy concern.

## Implications for monetary policy

Let me conclude with my outlook for policy.

If the downside risks dissipate and the fundamentals continue to be strong, I expect that eventually the fed funds rate will rise a touch above its neutral level—say, up to a range between 3 and 3-1/4 percent. This range is higher than the 2-3/4 percent long-run neutral level in the median forecast of the FOMC’s December Summary of Economic Projections.<sup>3</sup>

That’s eventually. What about the timing? Because inflation is not showing any meaningful sign of heading above 2 percent in a way that would be inconsistent with our symmetric inflation objective, I feel we have good capacity to wait and carefully take stock of the incoming data and other developments. If they warrant meaningful adjustments to my modal outlook or the balance of risks to the economy, then I would change my views of the appropriate path of policy accordingly.

I think developments in the first half of 2019 will be very important for making this assessment of our future monetary policy actions. Hopefully, the economic data will be more like the strong December employment report and financial market volatility will settle down. But whatever transpires, we will need to be mindful of carefully weighing the various crosscurrents and discerning the more fundamental changes in the economic and financial environment—in either direction.

To finish where I started, as we go forward, informal, qualitative economic intelligence and conversations with groups such as yours will be an important input to my evaluation of economic and financial developments. Real-world perspectives and experiences will help us develop the appropriate context in which to interpret the data and forecasts from our statistical models.

I see the other direction in our communications as being just as important. As my colleagues and I reassess the outlook, the balance of risks, and the appropriate path of policy, it is incumbent on us to effectively communicate how our assessments and policy views bring us closer to achieving our dual mandate goals. The answers may not be as definitive as many would prefer, but that reflects the difficult nature of policymaking in an environment full of various economic crosscurrents like the ones we face today.

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<sup>3</sup> Federal Open Market Committee (2018a).



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