On Mid-Cycle Adjustments

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Introduction

Thank you for the invitation to speak to you this morning. Before I begin my remarks, let me remind you that my comments reflect my own views and not necessarily those of the Federal Reserve System or the Federal Open Market Committee (FOMC).

Today, I'd like to share with you my perspective on the evolution of U.S. monetary policy over the past ten months—from a time when some further gradual rate increases seemed to be in store to one in which cuts have been made and rates are likely to remain low for some time. I also will talk about some longer-run strategic monetary policy framework issues.

Before I go into detail about policy, for context, let me first provide a brief summary of current macroeconomic conditions and my outlook for growth and inflation.

Over the past year and a half, the U.S. economy has expanded at a solid 2-1/2 percent annual rate on average. One constant over this time has been strong consumer expenditures. The incoming data suggest this vitality should carry forward in the near term, reflecting healthy household balance sheets; elevated consumer confidence; and, most notably, a vibrant labor market. At 3.7 percent, the unemployment rate is near a 50-year low. Importantly, many who had been left behind are gaining a welcome foothold into the job market—some for the first time. As labor markets have tightened, wage growth—which had been anemic for many years—finally picked up last year and has maintained a solid pace so far in 2019.

However, in contrast to the consumer sector, the business sector has seen some unfavorable changes. After posting robust gains last year, business fixed investment has lost considerable momentum over the past ten months. Manufacturing output has declined, and business sentiment has deteriorated.

Some of this softness is a consequence of weaker foreign growth reducing the demand for U.S. products. Growth in a number of advanced and emerging economies has slowed over the past two years, and most analysts have revised down their forecasts for future growth.[1] Furthermore, higher tariffs, the ebb and flow of trade tensions, heightened geopolitical risks, and concerns over an even more pronounced and prolonged slowdown abroad have introduced a good deal of uncertainty into business decision-making.[2] A natural reaction to this uncertainty is to pull back on expansion plans. An increasing number of my business contacts—particularly those in the manufacturing sector or ones with a large international footprint—are telling me about delayed or canceled investment

[1] For instance, since late 2018, the International Monetary Fund has reduced its forecast of world growth over the next three years by as much as 0.5 percentage points. See International Monetary Fund (2018, 2019).
[2] Indeed, uncertainty indexes based on keyword searches of news accounts—such as the economic policy uncertainty (EPU) index by Baker, Bloom, and Davis (2016) and the trade policy uncertainty (TPU) index by Caldara et al. (2019)—at times reached historically high levels over the past year.

projects. In addition, I have heard reports of some firms downsizing workforce plans.

Putting together all of these developments, I expect the U.S. economy to grow about 2-1/4 percent this year, as continued strength in consumer spending offsets weakness in business outlays and net exports. This is a solid number, as it exceeds my view of the economy's long-run potential growth rate, which is slightly below 2 percent. Looking beyond this year, I expect growth to run roughly in line with potential. In this environment, I anticipate the unemployment rate to remain close to its current level for some time.

What about inflation? Well, inflation in the U.S. had been running below our symmetric 2 percent objective throughout most of the recovery. Then, in 2018, inflation rose back to 2 percent. This was quite a welcome but relatively short-lived development, as inflation subsequently faltered over the first half of 2019, falling to as low as 1-1/2 percent. Currently, core PCE inflation is 1.8 percent on a 12-month basis.[3] In 2018, I had been reluctant to declare victory and say that our below-target inflation worries were behind us. But undeniably, the environment at the time did seem much more favorable given the inflation improvements we had seen and an expectation that they would continue amid a solid outlook for growth. However, the disappointing inflation developments this year suggest that more work is necessary. I do project that inflation will move up

[3] While our inflation objective is stated in terms of overall inflation according to the Price Index for Personal Consumption Expenditures (PCE), core inflation—which strips out the volatile food and energy sectors—is a better gauge of sustained inflationary pressures and where inflation is headed in the future.

and then modestly overshoot our 2 percent target over the next few years; but this requires aid from a more accommodative monetary policy path now than I thought appropriate in December.

My rationale for mid-cycle adjustments

The forecasts for economic activity and inflation in my September submission to the Fed's quarterly Summary of Economic Projections (SEP) actually are very close to those I made at the end of 2018.[4] Given all the developments in the U.S. and abroad over the past ten months, you might wonder why my projections have not changed much; indeed, you might question whether I have been paying any attention to the news!

Well, yes, I've been reading the news and crunching the data. (Well, at least I've had my staff crunching the data.) The number one reason for this stability in my outlook is that, overall, the economic fundamentals remain solid. Most of the concerns over growth are about potential risks that could be costly, but also may never occur. That said, those risks appear somewhat more pronounced today. Furthermore, as I just noted, progress on inflation has been disappointing. Given this assessment, I have altered my view for the appropriate path for policy rates in order to support an outlook for continued solid growth and to boost inflation. In other words, the adjustments were made in order to keep my baseline forecast on a track to meet our dual mandate goals of maximum employment and

[4] See, for instance, Evans (2019).

symmetric 2 percent inflation. This is a policy strategy I refer to as outcome-based monetary policy.

As you know, my colleagues on the FOMC have made similar adjustments to their projections for the economy and the appropriate path for policy. The Committee has moved from 1) most participants in December 2018 expecting continued gradual increases in the policy rates through 2019–20 to 2) holding rates constant from January through June of this year in order to assess developments and then, ultimately, to 3) the Committee cutting rates by 50 basis points at the July and September meetings. Over this time the median path of the federal funds rate projected forward by FOMC participants went from one of gradual increases to an essentially flat funds rate through the end of next year.

Chair Powell characterized the July rate cut as a “mid-cycle adjustment” to policy—similar to the adjustments the FOMC had made in 1995 and 1998—and laid out three reasons for the policy move: to mitigate the depressing effects of international developments on U.S. growth; to manage downside risks to the economy; and to support the return of inflation to our 2 percent symmetric target.[5]

To appreciate the changes in views about appropriate policy, I need to first take you back to the end of 2018.

[5] See Powell (2019).

After a series of *very* gradual rate increases in the previous three years, the FOMC raised the federal funds rate to the range of 2-1/4 to 2-1/2 percent in December 2018. I, along with most of my colleagues on the FOMC, thought at the time that it would likely be appropriate to raise policy rates another two or three times in 2019.[6]

I thought this path was consistent with the sustained achievement of our dual mandate objectives of maximum employment and symmetric 2 percent inflation. Indeed, I projected that inflation would eventually overshoot 2 percent by a quarter of a percentage point or so, even with the federal funds rate target range heading to 3 to 3-1/4 percent.

As I weighed the incoming data at that time, two themes came into focus. First, we had the wind in our sails. The outlook for growth was good, aided in part by fiscal stimulus that some were touting as quite strong. And, as I said, I expected the inflation improvements of 2018 to continue. Recall these forecasts were made in the context of a continued, long expansion, dating back to 2009. Labor markets were vibrant, with the unemployment rate somewhat below our estimate of its long-run neutral rate.[7] Consumer spending was strong. Firms had invested at healthy rates in 2018, and their optimism was high, in part because of changes in the tax code and business deregulation. Foreign growth still looked relatively

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[6] Federal Open Market Committee (2018).

[7] The long-run neutral rate of unemployment (or the "natural" rate of unemployment) is the unemployment rate that would prevail in an economy making full use of its productive resources without generating inflationary pressures. Consequently, it is the rate of unemployment that would predominate over the longer run in the absence of shocks to the economy.

good. True, financial market conditions had tightened some in the final few months of the year as investors became more concerned about the slowdown in growth abroad, trade tensions, and a prolonged government shutdown in the U.S. But the effects on the U.S. economy weren't seen to be that large. Forecasts were for a modest deceleration in U.S. activity, with growth in 2019 to be around to 2-1/4 percent—still above the economy's underlying trend.

I've already mentioned the second theme—that the inflation outlook had improved. This development requires emphasis. After underrunning our target for what was then a nine-year recovery, core PCE inflation had risen and been close to 2 percent since February 2018. With the outlook for solid growth, a continued strong labor market, and low unemployment, there was even some potential for inflation to rise persistently above 2 percent. But this modest possibility of inflation above 2 percent needed to be balanced against the fact that inflation expectations were still too low relative to target and past experiences in which expected increases in inflation had failed to materialize. The likelihood that the inflation gains would be sustained had definitely increased, but I was still quite wary of the possibility the improvements would instead prove to be ephemeral.

Together, these two plotlines argued for a removal of policy accommodation, but at a pace that was unusually gradual and would eventually leave rates only in a modestly restrictive policy stance—about 50 basis points above a neutral setting. In my view, this would have been sufficient to engineer a soft landing for the economic cycle. Again, I note that this would have been a *very* modest tightening by historical standards, as I felt moving too aggressively would have prevented inflation expectations from firming symmetrically around 2 percent.

With this in mind, at the December 2018 meeting, I thought it made sense to tighten a bit further. And the FOMC did increase the range for the federal funds rate by 25 basis points to 2-1/4 to 2-1/2 percent.

As we moved into the new year, some domestic and international data came in a bit softer. In addition, there were some sharp moves in equity and bond markets and an appreciation of the dollar. Apparently, financial market participants thought the risks were larger than most macroeconomic forecasters and the FOMC were thinking in December. They also may have been disappointed in Fed communications about balance sheet plans, often referred to as quantitative tightening (QT) by Fed critics. Regardless of the reasons, financial conditions tightened some in the U.S.

With the emergence of less uniformly strong economic data and rising risks, I agreed that it made sense from a risk-management perspective for the Committee to pause from the expected December 2018 (SEP) rate path and take more time to see how the risks would evolve before making our next policy move. Subsequently, as we went through 2019, the outlook for foreign growth weakened substantially. As I noted earlier, investment spending in the U.S. softened. And in a repeat of what has become a seemingly perennial source of frustration, inflation fell back below 2 percent. Some of the softness was due to what we thought were idiosyncratic transitory factors, which have since reversed.

But, more importantly, inflation expectations appeared to slip even further below levels consistent with our goal.

By midyear, my assessments had changed. This takes me to my mid-cycle adjustment. I concluded that the situation called for us to cut policy rates 50 to 75 basis points below the long-run neutral rate and then leave policy on hold for a time. This was a notable change in what I judged to be appropriate policy: Within six months, I went from thinking it appropriate to eventually take policy rates 50 basis points above neutral to one where 50 basis points below neutral was in order. I think this more accommodative stance is needed to support a roughly similar growth outlook to what I had anticipated before and, importantly, to support moving inflation up with greater assurance to achieve our symmetric 2 percent goal within a reasonable time.

Limits to what monetary policy can accomplish

I have adjusted my policy path in a way I see as most likely to yield economic outcomes consistent with our dual mandate objectives. As I have since last fall, I see economic fundamentals as being good. But the intermediate-term path for monetary policy simply needed some modest repositioning in order to better align against possible risks. But, beyond such adjustments, we also need to acknowledge that there is a limit to what monetary policy alone can accomplish.

My outlook recognizes that the economy faces a number of important challenges today—difficult trade negotiations over important long-term disagreements, slowing foreign growth, and uncertainty weighing on domestic demand. These are the types of problems that monetary policy is able to address to some degree, as more accommodative financial conditions can provide an offsetting boost to weakening aggregate demand. Furthermore, inflation is below target; and as theory tells us so forcefully, in the end, it's the monetary actions of central banks that determine the inflation rate.

That said, there are limits to what monetary policy can do. An important reason is constraints on our capacity to cut policy rates in the event of a serious downturn. These constraints arise because we also face longer-term structural issues that monetary policy has little impact on, but nonetheless have important implications for central banks. Altogether, these longer-term factors point to an environment of lower trend growth and lower interest rates that is likely to persist for years. My colleagues and I have spoken frequently and in depth about these issues, so I will be brief in explaining their causes.

An economy's long-run growth rate is constrained by its productive capacity—it's a speed limit of sorts; you can exceed it for brief periods, but not forever. That capacity depends on the economy's available labor resources and on the productivity of that labor. Unfortunately, demographics in the U.S. and in most advanced economies are working to lower the growth in labor input: Populations are aging; and in the U.S., the labor force participation rate has been on a downtrend for nearly 20 years.

Along with slower labor force growth, the U.S. also has experienced slower growth in labor productivity. Improvements in labor quality—that is, gains in education and worker experience—are no longer adding much to productivity in the U.S. Business investment has been relatively soft during this expansion, so that capital used by the workforce has increased only modestly. Likewise, despite widespread gains in technology, we've seen only modest growth in total factor productivity, which reflects how well we put various inputs together to produce output.

When my research staff does the growth accounting arithmetic, they expect labor hours to grow by one-half percent and labor productivity to grow by 1-1/4 percent on an annual basis. This puts the sustainable growth rate of the U.S. currently at about 1-3/4 percent.

Today's uncertain and hostile trade climate may weigh further on potential growth. This is because trade fosters cross-border competition among businesses, which in turn leads to productivity enhancement and innovation. Conversely, insulation from international market forces typically reduces a business enterprise's motivation to innovate, as it faces less competition. So trend growth could be even lower than the estimate I just cited. [8]

These adverse long-term trends have enormous implications for standards of living. But there is little monetary policy can do about them; it can't affect demographics and at best has a second- or third-order impact on productivity trends. Other kinds of policies can address some of these factors, such as by

[8] Furthermore, if there were an increase in restrictions on legal immigration and related actions on undocumented immigration, then the growth in trend labor hours would be weaker.

ensuring a well-educated workforce, but these are the responsibility of other branches of government.

That said, these trends influence the monetary policymaking environment a great deal. Economic theory tells us that as the potential growth rate of the economy declines, so does the equilibrium level of real interest rates; this is the rate consistent with full employment of the economy's productive resources and is often referred to as real *r**. To get to the federal funds rate that is neither contractionary nor expansionary—the so-called equilibrium federal funds rate—you need to add our 2 percent inflation target to real *r**. Today, the median estimate of my colleagues on the FOMC for that rate is 2-1/2 percent. That is significantly below the median participant's evaluation of over 4 percent just a few years ago.[9] It is also below the 5 percent or so rate in the early 2000s, as estimated by some models.[10]

Simply put, a lower equilibrium rate means a smaller capacity for monetary policy to counteract negative shocks to the economy. In the past, policymakers were able to provide 500 basis points of accommodation on average during an easing cycle. Today, if circumstances demand it, there is far less room to cut the federal funds rate before it reaches the neighborhood of zero—what we refer to as the effective lower bound on rates, or ELB. The FOMC would then be forced to turn to less effective tools to provide the necessary accommodation, making it more

[9] Federal Open Market Committee (2012).
[10] See, for example, Federal Reserve Bank of New York, *Measuring the Natural Rate of Interest*, report, available online, https://www.newyorkfed.org/research/policy/rstar.

difficult to achieve our mandated policy goals. The calculus is even more challenging if we fail to meet our 2 percent inflation objective, as nominal interest rates would settle out at an even lower level. That's why meeting our inflation objective is especially important.

Opportunity to make better use of the current framework

Because a low *r** environment presents practical limits on the capacity of traditional tools, the FOMC is in the process of evaluating alternative monetary policy frameworks that might be helpful in addressing the ELB constraint.

I don't want to prejudge the results of our discussions. But regardless of the outcome of the review, I think there is an opportunity to make better use of our current framework. Here I am thinking specifically about the adjective "symmetric" that describes our 2 percent inflation target. The FOMC has stated and reaffirmed annually that "the Committee would be concerned if inflation were running persistently above or below this objective."[11] I think there is room for us to better describe what symmetry means for the proactive operation of monetary policy.

Let me illustrate this point with the current situation in which we have persistently underrun our inflation objective. As I noted, this may have resulted in businesses, households, and financial markets expecting inflation will underrun 2 percent for some time to come. In order to boost these expectations, we need to provide

[11] See Federal Open Market Committee (2019).

aggressive enough accommodation to get inflation moving up with some momentum. After all, no one ever made a free throw without enough muscle behind it to first get the ball to the hoop. This kind of force could well result in inflation modestly overrunning 2 percent for some time. But in the current situation, this would not be a policy error. Engineering a modest overshoot of our inflation objective better guarantees that we would actually meet our inflation target in the future. Moreover, tolerating inflation as high as 2-1/2 percent does not entail much of a welfare loss—especially given the lengthy undershoot we've permitted. This is because for me, more generally, symmetry means paying attention to both past and prospective misses from our target to ensure that inflation averages 2 percent over the long haul.

In terms of a broad monetary policy strategy, I favor a powerful, full-throated commitment to follow outcome-based monetary policies aimed at achieving maximum employment and symmetric 2 percent inflation within a reasonable time. The best tactics to achieve these outcomes may change over time. For example, at times this approach could prescribe forward guidance with thresholds that need to be met before changing rates. At other times, it could prescribe overshooting our 2 percent inflation objective with momentum. The point is to focus on our objectives—and not on the specific operational tools used to obtain them.

Importantly, in a world where monetary policy is challenged by low equilibrium rates and elevated odds of hitting the ELB, outcome-based policy calls for a relentless focus on our symmetric 2 percent inflation objective throughout the cycle. We have to have a “do-whatever-it-takes” attitude toward policy all the time—in a downturn, when we are constrained by the effective lower bound, as well as in an expansion, if inflation remains stubbornly below our objective.

I recognize and accept that monetary policy will never be a panacea to all the negative shocks hitting the economy. But when it comes to price stability, the monetary authority has the sole responsibility for achieving an inflation objective. For us, that is symmetric 2 percent inflation.

Conclusion

To summarize, as I have for some time, I advocate for an outcome-based approach to monetary policy that would achieve our dual mandate goals on a timely basis while effectively managing various risks. Over the past ten months—as the forces affecting the U.S. economy changed from tailwinds to headwinds and as we lost the inflation momentum we had seemed to build—this outcome-based approach has dictated a shift in my appropriate policy path. Looking ahead, no matter which framework the FOMC adopts, I will continue to advocate for using all the available and best tools to achieve our dual mandate goals.

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