The Outlook for the Economy
and Monetary Policy Communications

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Introduction

Good afternoon. I thank the National Association for Business Economics for inviting me to participate in this year's Economic Policy Conference. As an economist and policymaker, I appreciate learning the perspective of market and business economists. Just as the different views expressed by my colleagues around the FOMC table help to inform my own policy views, the insights of economists like you, whose business it is to forecast economic developments, help to shape my own economic projections.

Today, I will present my outlook for the economy and monetary policy, and then turn to the important role clear communications can play in setting monetary policy. As always, the views I'll present today 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

It has been almost six years since the start of the recovery from the Great Recession. Although it hasn't been the smoothest of rides, the economy has made significant progress. While there are a number of risks to the forecast – which you business economists know is always the case – I believe the improvement in underlying fundamentals points to an economy that has built sustainable momentum.

My optimism stems from the fact that a number of the so-called headwinds that held back growth earlier in the recovery and dampened the transmission of very accommodative monetary policy to the economy have waned. The Great Recession wreaked havoc on household and business balance sheets. But balance sheets have improved substantially over the expansion. Households have reduced debt levels relative to disposable income from a peak of 130 percent before the recession to about 100 percent today. Very low interest rates mean that households are spending less to service their debt. And thanks to higher prices of equities and houses, households have more than made up the $10 trillion in net worth destroyed in 2008.

U.S. businesses are also in better financial condition after deleveraging. They are positioned to expand investment and hiring, and both are happening.

The headwind from government spending is also abating. Government spending declined over 2010 to 2013, but began to rise again last year. With tax revenues recovering, state and local governments have been adding to their payrolls and increasing expenditures. The drag from federal government spending has lessened over time.

The banking sector is regaining its health, with higher capital levels and lower loan delinquencies. Bankers are working through the new regulatory requirements and augmenting systems to better monitor and evaluate risks in their portfolios. Loans to consumers and businesses are now rising and delinquencies and write-offs are at low levels.

As the headwinds continue to diminish, we now also have a tailwind in the form of lower oil prices. No doubt, the drop in oil prices has led to reduced investment and dislocation in parts of the domestic energy sector, and this is affecting growth in certain regions of the country. However, for an oil-importing country like the U.S., the benefits of lower energy prices will offset the costs and result in a net positive for the U.S. economy in terms of consumer, business, and local government spending.

Despite the positives, I should note that not all sectors will be equal contributors to growth. I don’t expect housing to come back strongly this year. However, easing of mortgage credit conditions will help support continued moderate improvement in housing.

Net exports are also unlikely to contribute much to U.S. growth this year. The relative strength of the U.S. economy compared to that of many of our trading partners has contributed to a more than 10 percent appreciation in the broad value of the dollar over the past year and has meant a slowdown in U.S. export growth. Accommodative monetary policy actions have brightened the outlook for European economies, but growth and inflation are likely to remain low in the Eurozone for a while longer.

In addition, the harsh weather that has plagued most of the U.S. this winter will likely be a drag on growth in the first quarter. But I believe the effect will be temporary, as it was last winter. While some of the regional manufacturing surveys have come in a bit softer of late, I expect that softening reflects temporary factors and typical month-to-month variability rather than something more fundamental.

On balance, my modal outlook is for the U.S. economy to grow at about a 3 percent pace over 2015 and 2016. This is somewhat above my estimate of 2.5 percent longer-run growth, and is strong enough to support continued improvement in labor markets.

Indeed, we have seen a significant improvement in labor market conditions. Last year, average monthly job growth strengthened to 260,000 jobs. Over the first two months of this year, average monthly gains increased again, to 267,000 jobs, despite the chilly winter weather. Nonfarm payrolls are now about 2.7 million above their pre-recession peak.

In February, the unemployment rate fell to 5.5 percent, down sharply from its peak of 10 percent in 2009 and more than a full percentage point lower than it was last February. I continue to view the unemployment rate as a useful indicator of labor market conditions. Some people feel its sharp decline is overstating the improvement in labor markets because of the confounding effect of cyclical declines in labor force participation. However, research, including some by my staff at the Cleveland Fed, finds that a large part of the decline we have seen in labor force participation since 2007 reflects a longer-run structural trend driven by factors like the aging of the population.[1] Aging will also lead to declines in the employment-to-population ratio over time, yet last year, we saw a nice increase in this ratio as the acceleration in hiring was enough to overcome the effect of demographics. In addition, although they haven't yet reached their pre-recession levels, we've seen significant declines in the broader measures of the unemployment rate such as those that include discouraged workers and those that include people working part-time who would prefer to work full-time.

In my view, taken together, labor market indicators point to an economy that is near the Fed's goal of full employment. I expect the unemployment rate to decline to 5-1/4 percent or lower by the end of this year, somewhat below my longer-run estimate of 5-1/2 percent. Although wage growth has been subdued, it typically lags improvement in labor market conditions, and as employment continues to grow, I anticipate that wages will begin to accelerate and provide support for stronger consumer spending.

Consumer price inflation has also been running below the Fed's 2 percent objective, and I continue to monitor inflation developments closely. The sharp decline in oil prices is showing up in much lower headline inflation numbers, and the appreciation of the dollar has led to lower prices of imports. I expect further declines in inflation in the near term, but those should prove transitory as oil prices stabilize. I am reasonably confident that inflation will gradually return to the Fed's goal by the end of next year as above-trend economic growth continues.

I base this view on a couple of factors. First, while there has been some pass-through of oil-price declines to core measures of inflation that remove volatile food and energy prices, the pass-through has been relatively modest. For example, the Cleveland Fed's median CPI measure has remained near 2-1/4

[1] See Stephanie Aaronson, Tomaz Cajner, Bruce Fallick, Felix Galbis-Reig, Christopher L. Smith, and William Wascher, "Labor Force Participation: Recent Developments and Future Prospects," Finance and Economics Discussion Series Paper 2014-64, Federal Reserve Board, September 2014.

percent since last April. Cleveland staff research has found that this measure has some predictive power for headline inflation over the medium term.[2] In addition, in my view, inflation expectations remain well-anchored. The survey-based measures of inflation expectations of both consumers and of professional forecasters have been fairly stable. These survey measures have historically done well at capturing longer-run trends in inflation and they have been shown to help forecast inflation.[3] I am not inclined to take much of a signal about inflation expectations from the recent declines in market-based measures of inflation compensation based on the spread between yields on 10-year Treasury securities and 10-year Treasury inflation-protected securities, so-called TIPS. These market measures are likely being affected by the flight-to-quality flows into Treasuries from abroad, reflecting liquidity effects and changes in inflation risk premiums more so than inflation expectations.

It is important to recognize that forecasting inflation with any precision is very difficult. The confidence bands around the forecasts tend to be wide. For example, historical average projection errors across a range of private-sector and government forecasts indicate that the 70 percent confidence interval around a forecast of CPI inflation one year out is about plus or minus 1 percentage point.[4] So when I say I am "reasonably confident" that inflation will return to target by the end of next year, it is within that context – I am not requiring higher-than-normal precision around the forecast. I see quite a bit of difference between the situation in Europe, where inflation has been falling and growth has been weak, and the situation in the U.S., where an oil-price shock is driving down headline inflation rates and the economy is strengthening. We have been climbing out of a very deep recession and have experienced a negative oil-price shock. So long as inflation expectations remain anchored and growth continues to be at or above

[2] Brent Meyer, Guhan Venkatu, and Saeed Zaman, "Forecasting Inflation? Target the Middle," Federal Reserve Bank of Cleveland *Economic Commentary*, April 2013.

[3] See Jon Faust and Jonathan H. Wright, "Forecasting Inflation," *Handbook of Economic Forecasting*, 2A, Graham Elliott and Allan Timmermann, eds. New York: Elsevier, pp. 3-56, and Todd E. Clark and Taeyoung Doh, "Evaluating Alternative Models of Trend Inflation," *International Journal of Forecasting*, 30(3), 2014, pp. 426-448.

[4] See the FOMC's "Summary of Economic Projections of the Meeting of December 16-17, 2014," p. 11 (http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20141217.pdf).

trend, I am comfortable with it taking some time for inflation to return to our 2 percent goal. Of course, my projection is dependent on appropriate monetary policy, so let me discuss that next.

Monetary Policy

The financial crisis and the ensuing deep recession required an aggressive policy response. To support its goals of price stability and full employment, the FOMC has kept the federal funds rate at essentially zero since the end of 2008 and it conducted asset-purchase programs to exert downward pressure on long-term interest rates. This extraordinarily accommodative monetary policy has provided important support to the economy, helping to promote stronger labor markets and the pickup in growth that underlies my projection of a gradual return of inflation to our goal over time.

Because monetary policy affects the economy with a lag, policy needs to be forward looking and rates will need to begin to move up before we have fully reached our goals. Even after the first rate increase, policy will remain very accommodative for some time and this will promote attainment of our policy goals. The economy is now on firmer footing and our monetary policy stance should reflect that. Indeed, if incoming economic information continues to support my forecast, I would be comfortable with liftoff in the first half of this year. I would like our policy statement to allow for this possibility. However, I also want to emphasize, as the FOMC has, that policy is not on a pre-set path. Both liftoff and the path of policy thereafter will be based on incoming information to the extent that it affects the economic outlook and progress toward our goals of maximum employment and price stability.

At next week’s FOMC meeting, participants will have the opportunity to discuss their various views of the economic outlook and assessments of appropriate policy and I am looking forward to a fruitful discussion among my FOMC colleagues. One of the great strengths of the Fed is its structure. It is a decentralized central bank, which is independent *within* the government but not independent *from* the government. The Fed's structure is one of balance. It includes representation from across the nation, balancing public-sector and private-sector interests, and Wall Street and Main Street concerns. The various viewpoints expressed in our discussions of economic conditions, models, and forecasts help the FOMC set monetary policy in pursuit of our congressionally mandated goals on behalf of the public interest.

Since the FOMC has been given the responsibility to set monetary policy, it is incumbent upon us to explain the rationale for our policy decisions. The Committee has been on a journey toward increased transparency for quite some time. As the time for policy normalization grows nearer, clear communication is becoming ever more important. 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 progress to a more normal policy stance. Of course, clear communication is not without challenges. Concepts like data dependency and forward-looking monetary policymaking might be fairly routine for business economists like you, but they are tougher to explain to the public at large. I would like to finish up my talk today with four concrete suggestions for how we might improve our monetary policy communications over the medium to longer run.

Steps Toward Clearer Communications Over the Medium to Longer Run

First, presenting a forecast that could serve as the benchmark for understanding the FOMC's policy actions and post-meeting statements would be an aid to communication. Such a forecast would make it easier to explain how the economic outlook is dependent on the future path of monetary policy. It would clarify that for the FOMC to achieve its policy goals over the longer run, rates will need to begin rising before both goals are fully attained. Several central banks publish a forecast as part of their communications; in some cases, it is the policymakers' forecast and in other cases it is a staff forecast.

The FOMC experimented with developing a forecast representing the consensus of the Committee in 2012.[5] But it proved difficult to reach a consensus on a consensus forecast. I believe there would be value in having such a benchmark forecast, and I think it should remain on our longer-run agenda of communication enhancements. But I also realize it will not be an easy task to accomplish.

In the meantime, the Summary of Economic Projections – or SEP – has been playing an important role in conveying the FOMC's economic outlook. Four times a year, the SEP provides information on the range of projections of real output growth, the unemployment rate, and inflation across participants, as well as the policy paths that individual participants view as appropriate in achieving those projections.

My second suggestion for improving communications is to link the variables in the SEP. That is, instead of presenting ranges, the SEP could indicate what each policymaker is projecting for growth, unemployment, and inflation, and what policy path he or she believes will achieve those outcomes. This could be done without revealing the identities of the participants. Linking the variables would convey information on each individual policymaker's view of the relationship among the variables and on his or her monetary policy reaction function – how the outlook is expected to play out under the policy path chosen.

My third suggestion is to enhance the SEP by providing more information on policymakers' views about the uncertainty around their projections. As I discussed earlier, error bands around forecasted variables can be wide; they can also vary over the business cycle. It might seem counterintuitive that presenting information on uncertainty would actually help clarify things. In general, people like certainty. But the future path of policy is not certain because the evolution of the economy is not certain. In my view,

[5] See the minutes from the July, September, and October 2012 FOMC meetings (http://www.federalreserve.gov/monetarypolicy/fomccalendars.htm#11655).

giving the public a better sense of the probabilities associated with the projections would help them understand the current forecast, differences among forecasters, and subsequent changes to the forecast.

My fourth suggestion pertains to the structure of the FOMC's post-meeting statement. The statement continues to serve the Committee well. But I believe we could simplify its organization to better illuminate that policy is being formulated based on the economic outlook and on realized and anticipated progress toward our policy goals. In this reorganized statement, economic developments would be discussed – not merely the changes in conditions but also the Committee's assessment of whether these changes are material enough to have affected the Committee's economic outlook. There would be more consistency about the conditions we systematically assess in calibrating the stance of policy so that the public would get a better sense of the Committee's reaction function over time. The statement would then summarize the Committee's outlook for progress toward its policy goals and the risks to that outlook. Of course, the outlook is dependent on the current and future stance of policy. So the statement would then describe the current stance of policy and any policy actions taken. This would include the funds rate, asset reinvestments, and any other policy tools being used. The statement would conclude by providing some information on the future path of policy. Depending on economic circumstances, this might be explicit forward guidance that serves as a policy tool, as it did during the Great Recession and early part of the recovery. But during more normal policy-setting times, the statement would, instead, provide a rationale for future policy decisions. It would articulate the considerations the Committee would take into account when determining future changes in policy, as well as information to help the public anticipate how policy is likely to change in response to changes in economic developments that affect the economic outlook. To the extent that households and businesses understand policymakers' reaction function, their policy expectations will better align with those of policymakers, thereby making policy more effective.

Conclusion

In summary, the economy is making substantial progress toward the Federal Reserve's goals of maximum employment and price stability. If incoming information is consistent with my forecast, I believe it will soon be appropriate to begin raising the fed funds rate from its extraordinarily low level. The path of rates thereafter will continue to depend on the assessment of incoming information relative to the economic outlook and on realized and expected progress toward our monetary policy goals. Although policy communication will likely always remain somewhat of a challenge, I believe the benefits of clearer communication are worth the effort. Better communication is not merely an aspirational goal. I have offered some concrete suggestions on how we might make progress over the medium to longer run in improving our policy communications and, with it, the effectiveness of our monetary policy.