

The Outlook for the Economy and Monetary Policy



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**Vantage Point: Economists on the Economy Series
The Council for Economic Education
New York, NY**

January 18, 2018

Introduction

I thank Nan Morrison, president and CEO of the Council for Economic Education, for inviting me to speak this evening, and I thank Nan and Barry Haimes, chairman of the board, for inviting me to join the board of the CEE. The CEE's vision is to teach every child in America about personal finance and economics, and the Council offers abundant resources to help teachers do just that. The Federal Reserve System also supports economic education as part of our mission to engage in our communities. The Cleveland Fed's Learning Center and Money Museum offers various programs for teachers and students with the goal of increasing financial and economic literacy. What we have learned over the years is that when people have a better understanding of the economy, they can make better financial decisions and be part of the national discourse on the important economic policy choices facing the country.

Federal Reserve policymakers are also in the economic education business. One of our tasks is to explain our views on the economy and monetary policy to the public. When they understand the rationale for our policy decisions, people can hold us accountable for those decisions. But in addition, our policy is more effective when people understand how policy is likely to react to changes in the economic outlook. So I'm very happy to have this opportunity to talk about the economy and monetary policy. Let me remind you that the views I'll provide today are my own and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.

The Economic Outlook

The economic expansion is 8-1/2 years long and counting. It is now the third longest on record. But looking at it this way is a little misleading. Remember, the economy had to dig out of a very deep hole after the financial crisis and Great Recession. So it took quite a long time for the labor market to heal and the expansion to gain traction. Now labor markets are strong and economic growth picked up to around 2-1/2 percent last year, compared to the 2 percent pace seen over much of the expansion. This is about a quarter of a percentage point stronger than I expected at the beginning of last year. So the economy is

coming into 2018 with positive momentum, and for the first time in a while, there are some more salient upside risks to the forecast.

The underlying fundamentals supporting the economy are very sound. Monetary policy and financial conditions are accommodative. Household and business balance sheets continue to improve, and incomes are growing. In addition, conditions in the economies of many of our trading partners are improving. You'll notice that I haven't said anything yet about the recently passed tax package. The reduction in business and personal taxes will likely also have some positive effect on growth this year and next.

Overall, I expect 2018 to be a good year for the economy. My own expectation is that output growth will be around 2-1/2 percent, above my 2 percent estimate of trend growth. I anticipate that fiscal policy will add about 1/4 to 1/2 percentage points to growth over the next couple of years. There's an upside risk that the effect could be larger. I expect labor markets will remain strong this year, with above-trend employment growth continuing and the unemployment rate falling below 4 percent. Inflation ended up last year slightly lower than I thought it would at the start of the year, but I anticipate it will gradually move up to 2 percent over the next one to two years.

The goals of monetary policy, given to us by Congress, are to promote maximum employment and price stability. The task before us is to calibrate monetary policy to this healthy economy, so that the economic expansion is sustained. In my view, this means that if the economy evolves as I anticipate, we'll need to make some further increases in interest rates this year and next year, at a pace similar to last year's. That's a summary of my outlook, but let me give you some context so you'll see how I got there.

Economic growth

Over the expansion, output growth has maintained a moderate pace of a bit more than 2 percent, on average. But last year, after a weak first quarter, growth picked up to an average pace of around 3 percent

over the remainder of the year. This pickup came in the midst of a severe hurricane season that caused a lot of damage in parts of the country. Growth was relatively balanced across sectors. Earlier in the expansion, while consumer spending was relatively good, business spending was weak, and net exports were a drag on growth. Last year, all three sectors made positive contributions, as did residential housing. This balance should help to sustain the expansion going forward.

As I mentioned, I expect real GDP will grow at an above-trend 2-1/2 percent pace this year. Consumer spending makes up over two-thirds of output and the outlook for consumers remains sound. Spending during the fourth quarter, including the holiday season, was healthy. Readings on consumer sentiment and confidence remain high, but even more important for spending, personal incomes are growing because labor market conditions are strong. Household balance sheets are in much better shape since the Great Recession, reflecting a combination of deleveraging and increased savings. The increases in stock prices and house prices over the past year have contributed to a rise in wealth in the household sector in the aggregate. Although not true for every homeowner, the equity that households as a group have in housing has risen above its previous peak before the housing crash.

This housing recovery has taken some time, but activity has picked up in recent months. Buyers, sellers, developers, and bankers were all wary about reentering the market, and rightfully so, given the fallout from the housing bust. But low interest rates and the improved financial condition of households and lenders have led to increased construction and sales. Rebuilding after the hurricanes and fires in California will also add to construction activity for a time. In some places, demand for housing is outpacing supply and house prices are accelerating. They are rising at between 6 and 7 percent, on average, nationally. Overall, I expect activity in the housing sector to continue to expand at a sustainable pace.

Business investment has also picked up and this is a welcome development. Investment was weak in 2015 and 2016, as the sharp drop in oil prices and the strengthening of the dollar weighed on the energy and manufacturing sectors. But conditions improved last year. Oil prices rose and the dollar depreciated as the economies of our trading partners began to strengthen. In fact, for the first time in many years, growth around the world is picking up. Business sentiment remains at high levels, and our business contacts in manufacturing and services report increasing demand, consistent with readings from national and regional business surveys.

Labor markets

The labor market is strong. Last year, the economy added over 2 million jobs, about 170 thousand per month, and the unemployment rate fell by six-tenths of a percentage point, to 4.1 percent. The pace of job growth is well above trend, which most estimates put in the range of 75,000 to 120,000 jobs per month. The unemployment rate is below the lowest level reached during the last expansion; it is well below the range most economists associate with full employment; and it is below the 4.3-5.0 percent range that FOMC participants project for the unemployment rate over the longer run.¹ In addition, the broader measure of the unemployment rate that includes discouraged workers and those working part-time who would prefer full-time jobs is near its pre-Great Recession low, and other labor market indicators like job openings and turnover rates indicate a strong labor market. I expect this strength to continue and that the unemployment rate will move down further, ending the year at slightly under 4 percent. This is low by historical standards and well below my current estimate of its longer-run rate, which I put at 4-3/4 percent.

¹ See Minutes of the FOMC Meeting of December 12-13, 2017 (<https://www.federalreserve.gov/monetarypolicy/fomcminutes20171213.htm>).

We continue to hear from a wide range of firms that labor market conditions are tight and businesses are finding it hard to find workers, both in high-skill occupations and in lower-skill jobs. Wages have accelerated from under 2 percent earlier in the expansion to about 2-1/2 percent more recently. That strikes some people as a rather modest acceleration given the tightness in labor markets, but it is consistent with the low level of productivity growth we've seen over this expansion.² Our business contacts are increasingly reporting that they are responding to labor shortages by increasing wages and offering other benefits to attract and retain workers. These increases should eventually find their way into the aggregate compensation measures.

Overall, my assessment is that from the standpoint of the cyclical conditions that monetary policy can address, we are slightly beyond the maximum employment part of the Fed's monetary policy mandate. One might ask, what's wrong with low unemployment? An unemployment rate below what is sustainable can be a positive in the short run by bringing in workers from the sidelines of the labor market, but over time, it can be a negative by creating bottlenecks, lowering productivity growth, and putting upward pressure on inflation, which might require a policy response.

Inflation

Consistent with meeting the price stability part of its mandate, the FOMC has set a symmetric goal of 2 percent inflation, as measured by the year-over-year change in the price index for personal consumption expenditures, that is, PCE inflation. The 2 percent inflation goal isn't a ceiling. The inflation measures will vary from month to month, sometimes above and sometimes below 2 percent, but we aim to keep inflation at 2 percent on average over the longer run.

² Although actual wage setting is a complicated process, in economic models of competitive markets, real wages reflect the marginal product of workers. For a discussion of wages and their relationship to productivity growth over the expansion, see Pinheiro, Roberto and Yang, Meifeng, "Wage Growth after the Great Recession," Federal Reserve Bank of Cleveland, *Economic Commentary*, March 21, 2017 (<https://www.clevelandfed.org/newsroom-and-events/publications/economic-commentary/2017-economic-commentaries/ec-201704-wage-growth-after-great-recession.aspx>).

Inflation has been running below this goal for some time. Inflation moved up from the very low levels seen in 2015, when it was held down by falling oil and import prices. Inflation readings were above 2 percent early last year, but then fell below 2 percent partly due to special factors, like the drop in the prices of prescription drugs and cell phone service plans. Toward the end of the year, inflation readings showed some stability, but inflation ended the year at 1-3/4 percent, below our goal.

I anticipate that with the economy growing above trend and the demand for labor resources continuing to strengthen, inflation will gradually move up to 2 percent on a sustainable basis over the next one to two years. Stable inflation expectations are an important component of this forecast. Inflation expectations help to anchor actual inflation rates, and this stability has already proved its value during this business cycle. During the dark days of the Great Recession, the collapse in demand could have led to deflation – not only low inflation rates but actually falling prices – because the pullback in activity was so deep. But deflationary conditions did not develop because policy responses helped to maintain people’s expectations that prices would remain stable over the longer run and that inflation would eventually return to goal. The fact that inflation expectations remain reasonably stable gives me confidence that inflation will gradually move back to goal. Of course, I also recognize that inflation forecasts – including my own – are subject to a lot of uncertainty.^{3,4} In determining appropriate monetary policy, we’ll need to keep evaluating the inflation forecast as the year moves on. We’ll also need to evaluate the effects of the recent changes in tax policy, which are part of the economic environment. So let me discuss fiscal policy before I turn to monetary policy.

³ Based on historical forecast errors over the past 20 years, the 70 percent confidence range for forecasts of PCE inflation one year ahead is plus or minus 1 percentage point. (See Table 2: “Average Historical Projection Error Ranges,” in the Summary of Economic Projections portion of the Minutes of the Federal Open Market Committee, December 12-13, 2017 (<https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20171213.pdf>).

⁴ A significant portion of the variation in inflation rates comes from idiosyncratic factors that can’t be forecasted. See Yellen, Janet, “Inflation Dynamics and Monetary Policy,” remarks delivered at the Philip Gamble Memorial Lecture, University of Massachusetts, Amherst, September 24, 2015 (<https://www.federalreserve.gov/newsevents/speech/files/yellen20150924a.pdf>).

Fiscal Policy

I expect that the recently enacted tax changes will have a positive effect on economic growth over the next couple of years. It is difficult to be precise about the magnitude of the effect of the fiscal stimulus; I'm estimating an additional $\frac{1}{4}$ to $\frac{1}{2}$ percentage point of growth this year and next, but there is some upside risk that the effects could be larger. While the impact on individual households will depend on the level and sources of their income, in the aggregate, lower personal tax rates and higher standard deductions are expected to spur some additional household spending. On the corporate side, lower tax rates and full expensing for investment in equipment and intangibles should spur additional business spending to meet higher near-term demand, but how much remains to be seen. The majority of our business contacts have told us that while they welcome lower tax rates, they aren't planning to make significant changes to their capital or hiring plans as a result of the change in taxes. Instead, those firms planning to increase spending and hiring say the increases are being driven by brighter sales prospects and the pickup in activity in the second half of last year. At the same time, some businesses attributed the firm-wide bonuses they paid to workers at the end of the year to the tax cuts, and others have taken the occasion to implement wage increases they had contemplated for some time.

A stronger outlook for business spending and hiring is a welcome development. In addition to having a positive effect on near-term demand, if lower taxes spur higher labor force participation, investment in physical and human capital, research and development, and innovation, the tax package could also have a positive effect on the economy's productive capacity, its productivity growth, and its trend growth rate. Productivity growth is a key determinant of an economy's longer-run output growth and of living standards. The U.S. economy has been struggling with very low productivity growth during this expansion, on the order of only 1 percent.⁵ This is less than half the pace over the prior two expansions,

⁵ Labor productivity as measured by output per hour worked in the nonfarm business sector has averaged 1 percent over this expansion.

and partially explains why wage growth has been relatively sluggish despite the tightness in labor markets. In addition, as a result of lower population growth and labor force participation, the growth of the U.S. labor force has slowed considerably, from 2.5 percent per year, on average, in the 1970s, to around 0.5 percent per year over 2010-2016. It is expected to remain near that level over the next decade.⁶

While I expect some increase in productivity growth as the expansion continues, the effects of changes in tax policy on productivity growth and labor force participation are even more difficult to estimate than their effects on near-term spending, and they would play out over a longer period of time. So I have not incorporated them into my own projection for longer-run growth, which I put at 2 percent.

Another aspect of the tax package that needs to be considered is its effect on the longer-run budget deficit. Before the tax package, projected longer-run fiscal imbalances were unlikely to be sustainable.⁷ Were the trend growth rate not to pick up, lower tax revenues would add to the deficit relative to GDP, making it even more likely that the government would need to respond with some combination of increased borrowing, reduced or restructured benefits, and increased taxes, thereby reducing any long-run benefits of the tax package. We will need to continue to evaluate the responses to tax changes as the year progresses and into the future.

⁶ According to the latest available projections, the U.S. Bureau of Labor Statistics estimates that annual growth in the labor force over 2016-2026 will average 0.6 percent. See U.S. Bureau of Labor Statistics, "Economic Projections – 2016-26," October 24, 2017, p. 2 (<https://www.bls.gov/news.release/pdf/ecopro.pdf>).

⁷ For further discussion, see Mester, Loretta J., "Demographics and Their Implications for the Economy and Policy," Cato Institute's 35th Annual Monetary Conference: The Future of Monetary Policy, Washington, D.C., November 16, 2017 (<https://www.clevelandfed.org/en/newsroom-and-events/speeches/sp-20171116-demographics-and-their-implications-for-the-economy-and-policy.aspx>).

Monetary Policy

At its meeting last month, the FOMC raised the target range for the fed funds rate by one-quarter percentage point to 1-1/4 to 1-1/2 percent. This was the fifth increase in rates since December 2015, when the FOMC began removing some of the extraordinary monetary policy accommodation that was necessary in the wake of the financial crisis and Great Recession.

In October, the Fed began implementing the plan to normalize its balance sheet in terms of the size and composition of assets.⁸ To address the Great Recession and put downward pressure on longer-term interest rates once the fed funds rate had hit effectively zero, the Fed undertook several programs to purchase longer-term assets, including longer-maturity Treasuries and agency mortgage-backed securities (MBS). As a result of the purchases, the Fed's balance sheet grew, from nearly \$900 billion in assets in 2007, or 6 percent of nominal GDP, to about \$4.5 trillion today, or 23 percent of nominal GDP. The composition changed from mainly short-term Treasuries to longer-maturity Treasuries and agency MBS. The normalization plan, which will take several years to complete, involves letting maturing Treasuries and principal payments of agency MBS and agency debt to gradually roll off the balance sheet up to a monthly cap, with the caps rising over time. The gradual, predictable decline in assets allows balance-sheet normalization to run in the background and monetary policy to focus on setting the appropriate level of the fed funds rate, our conventional monetary policy tool. The ultimate size of the balance sheet will depend on how the FOMC decides to implement monetary policy in the future, a decision that has not yet been made.⁹

⁸ See FOMC, "Addendum to the Policy Normalization Principles and Plans," June 13, 2017 (https://www.federalreserve.gov/monetarypolicy/files/FOMC_PolicyNormalization.20170613.pdf).

⁹ For an accessible description of frameworks for implementing monetary policy, see Ihrig, Jane E., Meade, Ellen E., and Weinbach, Gretchen C., "Rewriting Monetary Policy 101: What's the Fed's Preferred Post-Crisis Approach to Raising Interest Rates?" *Journal of Economic Perspectives* 29 (Fall 2015), pp. 177-198 (<http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.29.4.177>).

I supported implementing the balance-sheet normalization plan and the December decision to raise rates. If the economy evolves as I anticipate, I believe further increases in interest rates will be appropriate this year and next year, at a pace similar to last year's.

Based on my medium-run outlook, I believe this gradual upward path of interest rates will help balance the risks and prolong the expansion so that our longer-run goals of price stability and maximum employment are met and maintained. This policy path gives inflation time to move back to goal while, at the same time, avoiding a build-up of risks to macroeconomic stability that could arise if the economy is allowed to overheat, with the Fed then having to raise rates sharply in response. It helps avoid a build-up of risks to financial stability should overly low interest rates encourage investors to take on excessively risky investments in a search for yield. And it puts monetary policy in a better position to address whatever risks, whether to the upside or to the downside, are ultimately realized.

Of course, this is my current view of monetary policy. We will need to calibrate our policy decisions to how the economy actually evolves and the implications of incoming information for the medium-run outlook and risks around the outlook. If you think this sounds like normal monetary policy-setting behavior, you're right – a positive sign that the economy is finally back to normal.