

Transitions: The Economy, Monetary Policy, and Policy Communications



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Introduction

I thank the University of Delaware and Lyons Companies for inviting me to speak today at your annual forum on the economic outlook. I spent a large part of my career in Philadelphia and had the pleasure of interacting with faculty and students from the University of Delaware on a number of occasions. So it is nice to be back.

If I had to choose a banner headline, I would characterize 2019 as a year of transitions, for the economy, for monetary policy, and for how we communicate about policy. I would like to spend my time this morning on some of the factors affecting these transitions. The views I'll present today are my own and not necessarily those of the Federal Reserve System or my colleagues on the Federal Open Market Committee.

The Economy

Last year was another strong one for the U.S. economy. The economy has been growing at an above-trend pace for the past couple of years, with estimates suggesting that growth was a strong 3 percent in 2018. Growth has been supported by fiscal stimulus in the form of tax cuts and higher federal government spending, as well as accommodative financial conditions. Labor market conditions continue to be very strong. Last year, the economy added more than 2.6 million jobs; that's over 220,000 jobs per month. In January, payrolls rose by more than 300,000 jobs. The unemployment rate has been at or below 4.0 percent for almost a year, which is near the historical lows seen over the past 50 years and well below estimates of its sustainable level over the longer run. Along with this strong employment growth, wages have accelerated, and because the pickup has been in line with productivity growth and inflation, it has not added to inflationary pressures. After several years of being below-target, inflation moved up and has been relatively stable around the FOMC's 2 percent objective. So from the perspective of the Fed's congressionally mandated goals of maximum employment and price stability, the U.S. economy has performed very well.

To achieve this performance, since December 2015, when the expansion was well underway, the FOMC has been gradually moving our policy rate, the federal funds rate, up from the extraordinarily low level that was needed to address the Great Recession. The current target range for the federal funds rate is 2-1/4 to 2-1/2 percent, which is at the bottom of the range of FOMC participants' estimates of its longer-run neutral rate, a level that neither stimulates nor restricts the economy and is consistent with maximum employment and price stability. In addition to bringing interest rates up to more normal levels, since October 2017, the FOMC has also been letting the longer-term assets that we purchased to add accommodation to address the financial crisis and Great Recession gradually roll off the Fed's balance sheet.

The question is: where do the economy and monetary policy go from here? As I mentioned, I believe 2019 will be a year of transitions. Let me address the economy first, and then turn to policy and communications.

My expectation is that the economy will maintain its good performance in 2019. Underlying economic fundamentals remain sound. Household incomes have been rising, reflecting the strength of the job market and lower taxes. In the aggregate, households have been able to increase savings and their debt levels are manageable, making for sound balance sheets. Overall, the business sector also remains sound, with favorable profits and lower taxes supporting investment spending and hiring. In my view, the most likely case is that this year, the economy will transition from above-trend growth to a somewhat slower pace, in the 2 to 2-1/2 percent range, reflecting less of a boost from fiscal stimulus and less accommodative financial conditions. Employment growth will also slow a bit, but it will remain strong enough to absorb those entering the workforce, and I expect the unemployment rate to remain at or below 4 percent. As this transition toward a sustainable pace occurs, I expect inflation to remain near 2 percent, with the usual transitory ups and downs.

But with all economic forecasts, there are risks. While the economy begins the year with sound fundamentals, it faces some cross-currents and headwinds. Surveys indicate that households and businesses are less confident about the economy than they were, and in the fourth quarter of last year, investor sentiment shifted and investors began putting significant weight on downside risks to the forecast. The increase in volatility, the decline in equity prices, and the increase in credit spreads of corporate bond yields relative to Treasury yields that occurred in the fourth quarter have partially reversed since the start of this year. But risks to the outlook remain. Growth abroad, including China and Europe, is expected to slow this year, but there is some uncertainty around how much of a slowdown there will be. The path and outcome of Brexit add further uncertainty, as does the outcome of U.S. trade and tariff negotiations.

The Cleveland Federal Reserve District has greater exposure to trade, manufacturing, and motor vehicle production than other parts of the country. The majority of our business contacts report that while their concerns about trade policy and global growth are rising, they have not yet deferred or canceled planned investment because of the uncertainty. However, some firms, including larger multinational firms, have become more hesitant. Should the slowdown in the economies of our major trading partners, including China and Germany, be sharper than expected or should the continued uncertainty persuade more firms to take a wait-and-see attitude, U.S. growth may slow more than anticipated. Of course, a favorable resolution to some of the uncertainty could buoy sentiment and lead to a pickup in investment and stronger than expected growth in the U.S.

Overall, in my view the most likely outcome is that the economic expansion will continue this year, with growth transitioning to a more sustainable pace, at or slightly above trend, but the risks around the forecast, including slowing global growth, uncertainty over trade policy, tighter financial conditions, and the changes in business and consumer sentiment, bear watching.

Monetary Policy

What does this mean for monetary policy? Similar to the economy's transition toward a more sustainable pace, monetary policy is also transitioning.

At its January meeting, the FOMC decided to keep the target range for the federal funds rate at 2-1/4 to 2-1/2 percent, and we have adopted a wait-and-see approach regarding future rate adjustments. I fully supported this decision because I believe that policy, for the time being, is well-calibrated to the economic outlook and the risks around that outlook.

When the economy was growing well above trend, labor market conditions were continuing to tighten, inflation was moving to target, and the funds rate was very low, policy decisions were fairly straightforward. The FOMC's strategy was to continue to gradually reduce the extraordinary accommodation that had been put in place to address the Great Recession.

Now we have entered a new phase – our policy decisions are less straightforward and we are transitioning back to normal monetary policymaking. The reduction in accommodation has brought our policy rate to the lower end of the range of FOMC participants' estimates of its longer-run neutral rate, although there is uncertainty around the exact level of the policy rate that is consistent with a neutral stance. In addition, our most recent policy rate increases are still working themselves through the economy, and we are gradually reducing the longer-term assets on our balance sheet, which likely is putting some upward pressure on term premia and, therefore, on longer-term interest rates.

With respect to our monetary policy goals of price stability and maximum employment, the economy is in a very good spot. Growth is slowing from an above-trend pace toward a more sustainable pace, and labor

markets are strong. While the unemployment rate is lower than the level that is sustainable in the longer run, inflation is near 2 percent and does not show signs of appreciably rising.

In my view, monetary policy does not appear to be far behind or far ahead of the curve. This environment gives us the opportunity to continue to gather information on the economy and assess our medium-run forecast and the risks around that forecast, before making any further adjustments in the policy rate. This information includes the official statistics, financial market indicators, the survey evidence on economic activity and sentiment, and reports from our regional contacts. The anecdotal information we gather from our contacts will be particularly useful in helping us understand household and business sentiment and how both sectors are dealing with some of the uncertainties clouding the outlook.

If the economy performs along the lines that I've outlined as most likely, the fed funds rate may need to move a bit higher than current levels. But if some of the downside risks to the forecast manifest themselves, and the economy turns out to be weaker than expected and jeopardizes our dual mandate goals, I will need to adjust my outlook and policy views. So the economy is going to give us a good sense of whether policy is where it needs to be or whether further action is needed.

In addition to normalizing interest rates, the FOMC has also been letting the longer-term assets on our balance sheet roll off, and bank reserves are down considerably from their peak level. As the FOMC announced in January, we plan to continue to use our current operating framework for implementing monetary policy. At coming meetings, we will be finalizing our plans for ending the balance-sheet runoff and completing balance-sheet normalization.¹

So with respect to both our policy rate setting and our balance sheet, we are transitioning back to normal monetary policymaking.

¹ See Transcript of Chairman Powell's Press Conference, January 30, 2019. (<https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20190130.pdf>)

Monetary Policy Communications

And with this transition, our policy communications will be transitioning as well. The FOMC's communications about monetary policy decisions are important for a couple of reasons. First, while Congress has set the Fed's goals, it has also wisely given the Fed independence in making monetary policy decisions in pursuit of those goals. Insulating monetary policy decisions from short-run political interference but holding policymakers accountable for those decisions yields better economic outcomes. In order to be held accountable, policymakers need to explain their decisions, their assessment of economic conditions, and their outlook for the economy and the risks to the outlook.

Clear communications also make monetary policy more effective. When households, businesses, and investors have a better sense of how monetary policy is likely to change conditional on the outlook, they can make better economic and financial decisions.

In response to the Great Recession, the FOMC gave fairly explicit guidance about the future path of interest rates. With no further room to reduce interest rates, this forward guidance worked not only as a communication device but also as a policy tool. Reassuring the public that the fed funds rate would be kept very low until the economy improved put downward pressure on longer-term interest rates and made monetary policy more accommodative.²

As the economic expansion took hold, the FOMC no longer needed to use forward guidance as a policy tool to add monetary accommodation. Economic conditions and the outlook indicated that our policy rate

² For further discussion of the forms of forward guidance used by the FOMC, see Loretta J. Mester, "Recent Developments in U.S. Monetary Policy: From Extraordinary Back to Ordinary," remarks at the GIC Central Banking Series: New Policies for the Post-Crisis Era, Banque de France, Paris, France, March 23, 2015, (<https://www.clevelandfed.org/newsroom-and-events/speeches/sp-20150323-recent-developments-in-us-monetary-policy>) and Loretta J. Mester, "Forward Guidance in Extraordinary Times, in Normal Times, and Betwixt the Two," Money Marketeers of New York University, Inc., New York, NY, November 6, 2014. (<https://www.clevelandfed.org/newsroom-and-events/speeches/sp-20141106-forward-guidance-in-extraordinary-times.aspx>)

would likely need to be on an upward path to promote our monetary policy goals. So in the interest of transparency, our policy statements still offered some guidance about this expected path of the federal funds rate.

Now, as we approach normal policymaking, our communication needs to transition because there is less certainty about the future path of policy. The economy is dynamic, and the future path of policy will depend on how economic and financial conditions actually change over time. Those changes cannot be fully known in advance, so policy cannot be pre-set. Some have used the term “data-dependent” policymaking, but it is important to know what this term means and what it doesn’t mean. It doesn’t mean that policy will react to every short-run change in the data. Some shocks that hit the economy will result in an accumulation of information that changes the medium-run outlook for the economy and the risks around the outlook in such a way that monetary policy will want to respond. But some shocks will not materially change the outlook or policymakers’ views of appropriate policy.

“Data-dependent” also doesn’t mean that policymakers will be unsystematic in their approach to policymaking. Policy needs to be flexible to respond to changes in economic and financial developments that inform the outlook, but the response should be fairly predictable and not a surprise if those developments occur.

The communication challenge, then, is to give the public a good sense of how policy is likely to respond *conditional* on how the economy evolves without implying that policy is pre-committed to a particular path *regardless* of how the economy evolves. Our policy statement can help to do this if it does three things: (1) discusses a consistent set of factors that inform our outlook, risks, and progress toward our monetary policy goals; (2) describes how accumulated changes in those economic and financial conditions have or have not affected our outlook and risk assessment since our last meeting; and

(3) points to this relationship between accumulated information and our outlook and risk assessment as the rationale for our policy decision.

The FOMC's Summary of Economic Projections can also help inform the public about the FOMC's outlook for the economy and policy, but it is very important to know what these projections are and what they are not. Four times a year, each FOMC participant submits projections of the most likely outcomes for real output growth, the unemployment rate, inflation, and core inflation, conditional on the path of policy that each participant sees as likely to be appropriate for promoting our policy goals. The FOMC provides summary information, including the median, central tendency, and range of projections for each variable across participants, as well as a dot plot of information on the policy paths that individual FOMC participants view as appropriate. The median path provides a reasonable view across participants of the Committee's current assessment of appropriate policy given the state of the economy and expected developments. But this path is not a commitment. When economic and financial conditions evolve differently than expected, policy may need to be set differently than previously anticipated. This happened in both 2015 and 2016, when the FOMC ended up raising the funds rate fewer times than anticipated in the median projection made in March of those years. The fact that the dots can change over time because of economic developments is a design feature, not a flaw.

Included with the projections are charts illustrating the uncertainty bands around the median projections of each variable, including the median policy path.³ These uncertainty bands deserve more attention. They are a good illustration of the reasonable amount of variation to expect in the projections. The bands get wider as the projection horizon extends because the future is uncertain and the economy can evolve in unexpected ways. The uncertainty band around the median policy path is a good reminder that policy is not pre-set. If the economy does evolve in an unanticipated way, policy will need to respond in an

³ The FOMC began providing charts with the confidence bands around the median projections in the March 2017 Summary of Economic Projections. For the latest charts, see the Summary of Economic Projections section of FOMC, "Minutes of the Federal Open Market Committee," December 18-19, 2018 (<https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20181219.pdf>)

appropriate and systematic way. So our anticipated policy path may change over time as the economy evolves. But this is normal monetary policymaking.

Summary

In summary, 2019 will be a year of transitions for the economy, for monetary policy, and for monetary policy communications. In my view, the most likely case this year is that the economy will transition toward a more sustainable pace of growth, with continued strength in labor markets and inflation near 2 percent. But we must remain attentive to several risks to the outlook, including the slowdown in global growth, uncertainty over trade policy, tighter financial conditions, and the changes in business and consumer sentiment. We are transitioning toward normal monetary policymaking where the future path of policy is determined by how changes in economic and financial conditions affect the medium-run outlook and risks around that outlook. With the federal funds rate now at the lower end of the range of FOMC participants' estimates of its longer-run neutral level and with monetary policy neither ahead of nor behind the curve, we can take the time to make that assessment. Our monetary policy communications are also transitioning with less emphasis on forward guidance about future interest rate moves and more focus on the economic and financial information that affects our medium-run outlook and on how policy is likely to respond to changes in the outlook and risks.