# Some Thoughts on the Economic Outlook and Monetary Policy

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**Introduction**
I'd like to thank the Iowa Bankers Association for inviting me to speak here today. And a special thank-you goes to Abe Tubbs for the kind introduction and for all his contributions as a director of the Chicago Fed. I always listen carefully to his thoughtful comments.

Abe tells me that the Iowa economy is generally in very good shape. Well, Iowa is not alone—economic activity across the country is also doing well. Today, I would like to first share with you my economic outlook and my views on monetary policy. I will then address some questions that I often get when I speak in public. I suspect you were thinking of asking some of these questions yourself, so this ought to put me a leg up in the Q&A.

But before I begin, let me remind you that my comments here today are my own and do not necessarily reflect the views of the Federal Reserve System or the Federal Open Market Committee (FOMC).

**Current economic situation and outlook for activity**
Economic activity was solid in 2017. Growth in gross domestic product (GDP) picked up noticeably after the first quarter, and for the year as a whole, real GDP rose 2.5 percent. Consumers have been the key engine of growth in recent years. Indeed, in the fourth quarter of last year, real personal consumption expenditures rose at a quite robust 3.8 percent annual rate.

Consumers are spending for a number of reasons. The household sector's net worth has grown impressively, reaching record levels as a percentage of disposable income. Labor markets continue to strengthen. Over the course of 2017, job gains averaged over 170,000 per month, and were even higher last month. This far exceeds the pace needed to absorb new entrants into the labor force; and not surprisingly, the unemployment rate declined by over half a percentage point to 4.1 percent over the course of 2017, and it remains there still. The solid job market and increases in wealth have left households feeling pretty good—with measures of consumer sentiment being at high levels since 2015.

These improvements in household fundamentals have generated a slow but steady recovery in housing markets as well. Residential construction, however, remains well below its pre-recession peak, in part reflecting the severe disruptions to these markets during the financial crisis.

In the business sector, equipment spending, which had been lackluster in 2016, picked up significantly in 2017, rising nearly 9 percent over the year. Orders for capital goods and other related indicators remain quite strong, so clearly there is a good deal of forward momentum to capital spending as we enter 2018.

Adding to this litany of positive trends, growth is picking up around the world. When I talk with CEOs of firms that have a broad global footprint, I am really impressed with how widespread these gains are. Given the slow growth advanced economies experienced in recent years, this is indeed a very positive sign. All told, the U.S. economy is firing on all cylinders and has plenty of momentum heading into this year.

Of course, another factor that will be influencing growth is the recently passed tax package. It is difficult to determine how households and firms will respond to the provisions in the bill, which could influence economic activity through a variety of channels.

In January we asked our Beige Book[1] contacts about the likely impact of the tax package on their businesses.[2] Their responses indicated that, on average, about a quarter of the tax savings is expected to go toward capital spending and about 15 percent to labor. Most of the remaining 60 percent is planned to be used to pay down debt, fund mergers and acquisitions, and return funds to shareholders.

How all these various activities will translate into GDP growth is highly uncertain. Still, by most analyses, the act should boost aggregate activity in the near and medium terms. The estimates for 2018 generally range between 0.4 and 0.8 percent.[3]

The longer-term impacts of the package are more uncertain. Long-term sustainable growth depends on the available labor in the economy, the capital stock that this labor works with, and the technology used in production. Aspects of the package could potentially boost capital spending and labor inputs. These obviously are difficult to estimate. Most analysts see the effects as being relatively small.

When I sum everything up, I expect GDP growth in 2018 to be in the 2-1/2 to 2-3/4 percent range. For the following two years, I anticipate growth to slow down some, as

[1] Before every FOMC meeting, the Fed publishes a report we call the Beige Book, which summarizes what the regional Federal Reserve Banks have heard from their contacts across a range of businesses in their respective Districts. Further details on the Beige Book, including the latest report, are available online, https://www.federalreserve.gov/monetarypolicy/beige-book-default.htm.

[2] See Walstrum (2018).

[3] The bottom of the range is reported by the International Monetary Fund (2018), in its latest *World Economic Outlook Update*. The top of the range comes from analysis conducted by Page et al. (2017) for the Tax Policy Center.

the tax cut bump wears off. These gains should be benchmarked against the underlying trend in GDP growth, which my staff estimates will be between 1-3/4 to 2 percent over the next few years.

With this growth outlook, I expect the unemployment rate to decline further to about 3.5 percent by the end of 2020. This is a full percentage point below my staff's estimate of what economists call its natural rate, which 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.[4]

What about inflation? Currently, core consumer inflation, which cuts through a lot of the statistical noise in overall prices, is 1.5 percent. That is also the average inflation rate we had over the past eight years. So, inflation has consistently undershot the FOMC's 2 percent objective for quite some time.[5]

I expect inflation to rise gradually over the next few years. If my forecast for the drop in the unemployment rate is correct, then we should see some pressures developing on productive resources in the economy, generating higher costs and higher prices.

There is a hint that this may be in train today. Some inflation indicators over the past couple of months have been positive. I also am hearing a bit more commentary from manufacturers about higher commodity prices. While wage increases have been disappointingly low, the most recent data exhibit a firming trend. And I've recently been hearing from more of my business contacts that firms are raising wages, giving additional bonuses, and boosting benefits. These are all positive signs for wage growth and clear signs of tighter labor markets.

In my forecast, I expect inflation to rise gradually to our 2 percent target, perhaps reaching it in late 2019 or in 2020. But despite the indicators I just noted, I have not yet seen many actual increases in consumer prices. So, my forecast of reaching our target is still just a forecast. There is still a role for accommodative monetary policy to bring us back to our 2 percent inflation target.

This brings me to the first question I've been getting lately.

**The case for delaying rate increases**

That is, if real activity in the U.S. is on such a solid footing and you expect further improvements that will take the unemployment rate below its natural rate, why did you prefer to delay a rate increase in December?[6]

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[4] The natural rate of unemployment is the unemployment rate that would prevail in an economy making full use of its productive resources. Consequently, it is the rate of unemployment that would predominate over the longer run in the absence of shocks to the economy.

[5] Two percent inflation—measured by the annual change in the Price Index for Personal Consumption Expenditures (PCE)—is the explicit inflation target consistent with the Federal Reserve's price stability mandate. This inflation target was officially set by the FOMC in January 2012 and reaffirmed annually; see Federal Open Market Committee (2012).

[6] Evans (2017).

I thought the December decision was a close one, and at the time, I carefully considered all the arguments for and against raising rates. In the end, my decision rested on my concerns about the inflation outlook. As I just noted, core PCE inflation is 1.5 percent and has averaged about that over the past eight years. This is noticeably below the FOMC's 2 percent symmetric inflation target.

Early in 2017, inflation had moved up to 1.9 percent, and it looked as if our inflation goal was finally within reach. But our hopes were dashed last spring when inflation dropped unexpectedly. In delving into the details, we saw a few developments—such as less expensive cell phone plans—that could explain a portion of the decline. Some think that once these and other unusual declines are past us, inflation will bounce back up this coming spring. And if these earlier declines were truly transitory, then there is more justification for raising rates today.

However, I am concerned that more persistent factors are holding down inflation. In particular, I am concerned that the public's inflation expectations may have drifted down below the FOMC's symmetric 2 percent inflation target.

Expectations of future inflation are a key determinant of actual inflation because they serve as an important benchmark for the wage demands of workers and the pricing decisions of businesses.

Over the past several years, numerous measures of longer-run inflation expectations have moved down noticeably, and they remain uncomfortably low today. To be sure, compensation for inflation that investors price into inflation-protected Treasury securities has risen some in recent months. Nonetheless, it remains 30 to 50 basis points below where it was in 2014. And some survey-based measures, such as the University of Michigan's Index of Consumer Sentiment,[7] haven't budged much from their relatively low levels.

I am also concerned that too many observers have the impression that the FOMC's 2 percent objective is a ceiling that policymakers do not want to breach. This belief would then cause them to think inflation over the long run would average somewhere below 2 percent.

Let me stress that the FOMC has stated firmly that our inflation objective is symmetric. In the long run, we would like to see the odds of inflation running modestly below 2 percent be equal to the odds of it running modestly above this target. But what matters for expectations is what the public thinks we will do. And I am not sure they believe our commitment to such symmetry.

When looking at all of these factors, I thought a pause in our normalization process was the best policy. I believe it would have provided a useful nudge up to inflation

[7] Details on the University of Michigan's *Surveys of Consumers*, including its Index of Consumer Sentiment, are available online, http://www.sca.isr.umich.edu/.

expectations. Such a pause also would have better allowed us time to assess the incoming inflation data and better determine how transitory last year's soft readings really were.

This leads me to another question I get frequently.

**The monetary policy path and managing risk**

I often get asked this: Can you describe the kinds of things that you will be concentrating on when making your monetary policy decisions going forward? And I'm also often asked these related questions: What if you are wrong and inflation starts to increase a good deal more rapidly than you expect? What would you do then?

I should start by saying that I am comfortable with the general strategy the FOMC has laid out—namely, the planned gradual approach to removing monetary policy accommodation, with the federal funds rate eventually settling at around 2.8 percent in the long run. I agree with that.

In determining the exact path I think we should follow, I will approach the future in the same way that I have approached every policy decision in the past. It all begins with a careful evaluation of incoming data. Armed with that new information, I think critically about its implications for my outlook and update my thinking on monetary policy accordingly.

What does this mean for the near term? With the data I see today, my policy strategy would be to keep policy on hold until midyear or so in order to assess the incoming inflation data. If we get to that point and have more confidence that inflation is moving up sustainably, then further rate increases would be warranted.

In contrast, suppose inflation picks up more assuredly, as many expect. Then, we still could easily raise rates another three or even four times in 2018 if that were necessary. And I would support such a faster pace if the data point convincingly in this direction.

This logic carries over to faster-than-expected increases in inflation more generally. That's an issue the FOMC knows how to fix. We would respond by increasing the federal funds rate more quickly. During the current tightening cycle, the FOMC has raised rates by 125 basis points over the course of two years. This is a very gradual path by historical standards. Even during the so-called measured pace of increases during the 2004–06 tightening cycle, the target rate rose by 125 basis points in six months. So raising rates more rapidly without derailing economic growth is clearly an option.

This brings me to the last question. Whenever I mention that the long-run neutral level of the funds rate is 2.8 percent,[8] even those with only a little gray hair think, "Gee, that is really low!" We're used to thinking about interest rates averaging much higher. So a

[8] The neutral, or equilibrium, federal funds rate is the funds rate associated with a neutral monetary policy (policy that is neither expansionary nor contractionary).

question I frequently get asked, particularly if there are bankers in the audience, is the next one.

**The challenges of low interest rates and a flatter yield curve**[9]

Why are interest rates so low? This question is typically followed by another: Are you also concerned that long-run interest rates are not much higher than short-term rates—that the yield curve is so flat?

Of course, the concerns here are that low rates pose special challenges for financial investors. The flat yield curve can test the business models of many financial institutions. Some argue that together, these could induce a “reach for yield” and increase financial stability risks.

I have spoken extensively in previous speeches on why short-term neutral rates are lower today than they were in the past. So I will spare you the details today and just mention some of the forces that have been driving rates lower.

As you may know, there is near consensus among economists that the trend rate of economic growth in the U.S. is much lower now than in the past on account of a number of factors: slower growth in total labor force; declines in labor force participation; and the slower pace of technological innovations. Standard economic theory teaches us that, all else being equal, in a low-trend-growth economy, short-term real interest rates will be lower. Note, too, that these factors pushing down rates have nothing to do with monetary policy.

By one estimate made by colleagues Thomas Laubach and John Williams, the real, or inflation-adjusted, neutral federal funds rate averaged 3.4 percent over the three decades from the 1970s through the 1990s.[10] Today, the real neutral fed funds rate is estimated to be near zero.[11] Now most expect some increase in this over time, but not too much. The median FOMC participant’s estimate is that the long-run real neutral federal funds rate is just 80 basis points. Taking this estimate and adding our 2 percent inflation target, we get a nominal neutral funds rate of 2.8 percent.[12]

What about long-term interest rates? First of all, because the principle component of long-term interest rates is the average expectation for future short-term interest rates, the low neutral fed funds rate translates into low long-term interest rates. There are several other forces exerting downward pressure on long rates: Strong global private demand for safe assets, the continuing effects of quantitative easing by central banks

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[9] A yield curve is the line plotting the yields or interest rates of assets of the same credit quality but with differing maturity dates at a certain point in time. These assets, such as U.S. Treasury securities, typically yield incrementally more at longer maturities.

[10] Laubach and Williams (2003).

[11] For the updated estimates, see Laubach and Williams (2017).

[12] Four times a year the FOMC releases its Summary of Economic Projections (SEP), which presents FOMC participants’ forecasts of key economic variables over the next three years and for the longer run. Participants also provide their assessments of the appropriate monetary policy that supports those forecasts. For the most recent SEP, see Federal Open Market Committee (2017).

around the world,[13] and the fact that long-term U.S. Treasury bonds are perceived to be a good hedge against downside economic risks.

So, today we are facing low short- and long-term interest rates and a fairly flat differential between the two—although not as flat as a few weeks ago.

Now, for financial institutions whose bread-and-butter business is maturity transformation that relies on an upward-sloping yield curve, the current situation might seem challenging.

If higher short-term rates cause funding costs to rise faster than the rates on interest-earning assets, net interest margins and overall profitability might decline. In turn, this could put a check on lending activity.

However, for the banking sector as a whole, bank profitability has not been challenged significantly during past episodes of flat yield curves associated with policy normalizations. For one thing, deposit rates generally are slow to increase, so for those who rely on deposit funding, costs may not rise immediately. At the same time, a lot of bank lending is at variable rates that increase more in tandem with policy rates. So, net interest margins often will initially increase when the yield curve flattens as assets reprice faster than liabilities.

Ultimately, the profitability of bank lending depends on the underlying strength of the economy.[14] In the past, the macroeconomic environment has been more important than the yield curve per se in determining bank behavior. Today, the vigor of the economy can only be considered a positive for the sector.

Of course, some financial intermediaries may adjust their business practices in light of these yield curve conditions. We need to be on the lookout for behaviors that could have financial stability implications. Today, these don't appear to be emanating from the banking sector, which is generally well capitalized. And many of our financial market contacts, who extend outside of banking, also do not see today's flat yield curve as being a significant driver of risk-taking activity.

This concludes my prepared remarks. I hope I've preemptively answered a few of your questions. I look forward to taking the rest of them now.

[13] For more information on the Fed's quantitative easing (QE) programs (or large-scale asset purchases), see the Board of Governors of the Federal Reserve System (2015).
[14] For more on this point, see Genay and Podjasek (2014) and Altavilla, Boucinha, and Peydró (2017).

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