Monetary Policy: The Road Ahead

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Introduction

I'd like to thank the Northeast Indiana Regional Economic Forum for the invitation to speak here this morning. It's a pleasure to visit Fort Wayne and to observe firsthand the area's flourishing economy. In my remarks this morning, I would like to share with you my outlook for the economy and my views on the future of monetary policy. Naturally, my comments are my own and do not necessarily reflect the views of the Federal Reserve System or the Federal Open Market Committee (FOMC).

First, let me give you a preview of some of my comments: The U.S. economy is firing on all cylinders, with strong growth, low unemployment, and inflation approaching our 2 percent symmetric target on a sustained basis.[1] I expect this good performance to continue over the next few years. While there are some risks to the outlook, I see them as being balanced.

Given the strong growth fundamentals and positive inflation outlook, it is time for the Fed to return to the conventional monetary policymaking of yesteryear. Such policy will rely on gradual adjustments in interest rates to meet our mandated objectives of maximum employment and 2 percent inflation, rather than the unconventional tools we had to use in response to the financial crisis and ensuing Great Recession.

There is an important caveat, however. As I will discuss in more detail, the longer-run normal level of interest rates—what economists call the neutral level—is noticeably lower today than it was during earlier times of conventional monetary policymaking. This means we don't have the same capacity to cut interest rates in response to adverse economic shocks as we did in the past. And if we run out of such room, then we may again have to turn to unconventional tools such as large-scale asset purchases and forward guidance about the funds rate to provide monetary accommodation. So, we aren't quite going back to the same old monetary policy world that we had in the past. My son might refer to this as a "remix."

The current economic situation and outlook

We are now approaching the tenth year of the expansion, and the fundamentals for growth are solid. We entered 2018 with a good deal of momentum, with real gross domestic product (GDP) increasing at a very robust 3.3 percent annual rate in the first half of the year.

[1] In January 2012, the FOMC set 2 percent inflation—measured by the annual change in the Price Index for Personal Consumption Expenditures (PCE)—as the explicit symmetric inflation target consistent with our price stability mandate (Federal Open Market Committee, 2012). For more on the Federal Reserve's dual mandate, see our dual mandate webpage, https://www.chicagofed.org/research/dual-mandate/dual-mandate.

As has been the case for some time, consumer spending has been quite strong. A key source of this strength comes from the income gains and job security associated with a healthy labor market. Over the course of 2017, job gains averaged over 180,000 per month; and they have risen to average over 200,000 per month so far this year. These increases far exceed the pace needed to absorb new entrants into the labor force; as a result, the unemployment rate has declined to 3.9 percent—near its lowest level since 2000. In addition, against the backdrop of a declining trend, the labor force participation rate—which is the share of the working-age population that is either working or actively seeking a job—has stabilized in recent years, as those with marginal attachments returned to the labor market. Other labor market indicators—such as job openings, quits, and the number of people working part time for economic reasons—also are quite positive.

In addition to the gains in households' well-being generated by a healthy labor market, households' disposable income has been boosted by recent tax cuts. And increases in the stock market and housing prices have boosted household net worth. So, all in all, the consumer is feeling pretty good.

Business capital spending has been another source of strength in the economy, having risen more than 6-3/4 percent at an annual rate over the first half of the year. Moreover, forward-looking indicators—such as the backlog of unfilled orders for capital goods and upbeat business sentiment—point to a continuation of robust gains in investment. Likewise, my business contacts in Indiana and elsewhere report solid momentum in capital expenditures in the near term, but there are concerns that continued uncertainty over the international trade situation may impinge on some firms' investment plans further out in the future.

Housing, however, is one sector where activity has been soft. Residential investment, which had been on a modest uptrend since 2010, has flattened out over the past year and a half as mortgage rates have moved up. Still, at about 4-1/2 percent, the level of mortgage rates isn't very high by historical standards. Indeed, favorable credit conditions continue to support household and business spending, with accommodative lending rates and ample access to credit for both consumers and firms with solid credit scores.

Of course, recent fiscal policy actions also are influencing the economy. There are many details in the Tax Cuts and Jobs Act (TCJA) of 2017 and the Bipartisan Budget Act (BBA) of 2018 to evaluate. For the tax act in particular, there are a variety of channels that influence spending, and its overall effect on GDP growth is highly uncertain. That said, most analyses find that the two fiscal policy changes should boost aggregate activity by a moderate amount in the near and medium terms; but the longer-run effects are likely to be relatively small.

All told, I expect GDP growth in 2018 to be in the neighborhood of 3 percent. I anticipate growth will slow down some in 2019 and 2020, as the fiscal bump wears off and typical cyclical dynamics—including the normalization of monetary policy—result in activity settling into its long-run sustainable path. For reference, my staff estimates that the growth rate of GDP along this path is a bit under 2 percent.

Given this outlook for growth, I expect the unemployment rate will decline further to about 3-1/2 percent by the end of 2020. This is almost a full percentage point below my staff's estimate of what economists call its natural rate. This 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.

What about inflation? I am more comfortable with the inflation outlook today than I have been for the past several years. Core consumer inflation, which cuts through a lot of the statistical noise in overall prices, averaged only 1.6 percent between 2010 and 2017—well below our symmetric 2 percent target. However, core inflation picked up earlier this year and has been running close to 2 percent since last March.

Looking ahead, I expect inflation to rise a bit further over the next few years. If my forecast for the drop in the unemployment rate is correct, then we should see some more pressure developing on productive resources in the economy, generating higher costs and higher prices. I also expect to see some further firming in the inflation expectations of households and businesses, which have only partially recovered from their downturn in 2013 and 2014. Similarly, while wage increases have been disappointingly low, more and more of my business contacts—including those in Indiana—say they are willing to increase compensation to hire or keep qualified workers. So I expect tighter labor markets to lead to higher wage growth before too long.

To sum up, I expect the economy to expand at a solid rate over the next several years; the unemployment rate to decline somewhat further; and inflation to edge up a bit above 2 percent—but certainly not to anything high enough to be inconsistent with our symmetric 2 percent target. Let me also note that my economic outlook is generally in line with those of my colleagues on the FOMC as indicated by the median of the projections we all submitted during our last regular quarterly forecasting exercise this past June.[2] In other words, we are more or less singing the same tune.

A return to conventional monetary policymaking

As we move forward, what does this outlook imply for monetary policy? The current range for the federal funds rate target is between 1-3/4 and 2 percent. In the FOMC's June projections, the median participant expected the federal funds rate to be 2.4 percent by the end of 2018 (so two more 25 basis point increases this year) and then to move up to 3.1 percent by the end of 2019 and 3.4 percent by the end of 2020. At the same time, in the background we have a gradual reduction in the Fed's balance sheet as securities acquired during our asset purchase programs mature.

[2] 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 (2018b).

To put the projected interest rate path in perspective, note that in our quarterly forecasts each FOMC participant also writes down where the federal funds rate should settle at when policy is neutral—that is, when policy is neither expansionary nor contractionary. Most FOMC participants put this neutral federal funds rate somewhere in the range of 2-1/2 to 3 percent. This means that the 3 to 3-1/2 percent level of the funds rate projected for 2019 and 2020 is mildly restrictive. Given an unemployment rate forecast below the natural rate, such a policy stance would be quite normal and consistent with some moderation in growth and a gradual return of employment to its longer-run sustainable level.

Of course, these are just forecasts. In the end, actual policy will differ from this path depending on whatever headwinds and tailwinds arise from the various shocks that inevitably will hit the economy.

On the one hand, we may need to tighten somewhat further if currently unexpected tailwinds emerge that push the economy too far beyond sustainable growth and employment levels, potentially leading to unacceptably high inflation beyond our symmetric 2 percent objective. This could happen if we discover that we underestimated the forward momentum imparted by earlier monetary accommodation. Another possibility is that we might experience greater-than-expected impetus from the fiscal policy changes I just spoke about and that extra growth is not accompanied by gains in the economy's underlying productive potential.

On the other hand, we may need to take a shallower policy path if unexpected headwinds emerge. This could occur if, for example, continued uncertainty over the international trade situation generated adverse business sentiment and reduced spending or, alternatively, if the firming of inflation expectations stalls out before they are clearly centered around our 2 percent inflation target.

Absent these types of surprises, I expect the strong fundamentals for growth to continue and inflation will reach our symmetric 2 percent target on a sustained basis. Given this outlook, it is time to return to the more conventional, mainstream monetary policy that characterized the Fed's policymaking in the 20 years prior to the financial crisis.

A basic tenet of such good conventional monetary policy is that it is a supporting actor: The lead roles in the economy are played by households and competitive private businesses making their best saving, investment, and employment decisions and by governments at all levels (federal, state, and local) doing their best to design and execute effective public policy programs. As a supporting actor, monetary policy focuses on 1) assessing the various headwinds and tailwinds influencing the economy and 2) moving policy into a modestly accommodative or modestly restrictive stance, when appropriate, to help the main actors achieve maximum sustainable employment and price stability.

A lower neutral interest rate is challenging

There is, however, an important difference between the conventional monetary policy of today and conventional policy prior to the Great Recession. That is, the neutral interest rate—the rate when policy is neither expansionary nor contractionary—is a good deal lower than it used to be.

Before I talk about its implications for policy, let me describe why we think the neutral rate is lower. One reason is that, unfortunately, trend economic growth is quite a bit lower today than in earlier times. Standard economic theory teaches us that, all else being equal, the neutral real interest rate will be lower in a low-trend-growth economy.

The reasons for the slowdown are well known. Growth in the labor force has moderated with slower population growth and a downtrend in labor force participation. Furthermore, labor productivity has been disappointing, especially when compared with the large gains seen in the second half of the 1990s and the early 2000s. These realities will likely be with us for a long time. I should note, too, that the U.S. isn't alone here; most advanced economies are facing similar situations.

As I mentioned before, at the Chicago Fed, we see the longer-run U.S. growth potential at a bit under 2 percent. I hope this assessment turns out to be too pessimistic. Higher sustainable growth would be great. However, we can't get there without boosting the underlying trends in labor input or productivity. As a nation, we should work on public policy that could be effective in doing so. But such policies are clearly outside the realm of monetary policy.

There are other reasons why the neutral interest rate is lower now. One is the large demand—from both domestic and foreign sources—for U.S. Treasuries and other high-quality assets. And, of course, low inflation also reduces the neutral nominal interest rate.

This new reality has important implications for monetary policy. When the economy is hit with disinflationary shocks, the Fed provides offsetting stimulus by reducing its main policy tool, the federal funds rate. But there is a limit to how far the funds rate can be cut without causing large-scale counterproductive disruptions in short-term money markets. Some central banks found they could take their policy rates a touch negative, but not very much so; in the U.S. we think this so-called effective lower bound—or ELB—on the funds rate is essentially zero.

With this in mind, it's clear that a lower neutral interest rate will mean that monetary policy will have less headroom to provide adequate rate cuts when large disinflationary shocks hit the economy. Between the mid-1980s and early 2000s, we typically reduced short-term policy rates something in the neighborhood of 500 basis points when mitigating economic downturns. Today, given a neutral federal funds rate in the range of, say, 2-1/2 to 3 percent, we simply do not have that kind of rate-cutting capacity. So, unfortunately, the risks of returning to the ELB are higher than we would like. Although it's very hard to estimate, nearly 20 years ago one well-known study put these risks at about 15 percent; work done in 2017 put the odds today closer to 40 percent.[3]

[3] See Reifschneider and Williams (2000) and Kiley and Roberts (2017).

Once at the ELB, policymakers must turn to alternative, nonconventional policies to provide accommodation. Of course, this is what happened during the Great Recession. By late 2008 we had reduced the federal funds rate to essentially zero and had to turn to purchases of large amounts of long-term Treasury and government-sponsored enterprise (GSE) securities and to forward guidance about the future path of interest rates.

While these tools proved useful, they are not perfect substitutes for our usual interest rate policy. Indeed, there is a good deal of research going on today in academia and in central banks on alternative frameworks that might improve the performance of monetary policy in a world with higher risks of returning to the ELB.[4] But there are no panaceas. Alternatives may lessen the odds of hitting the ELB, but they cannot drive them to zero. And whenever we are at the ELB, the question of alternative policy tools becomes relevant again.

Personally, the most important lesson I learned from our experience at the ELB is that policymakers have to promise to use all available means to bring inflation and employment back to their objectives within a reasonable period of time. And, crucially, this promise must be credible. Failing to back it up with actions and communications all along the way would have rendered our unconventional policies stillborn and ineffective. We must remember this lesson for any future encounters we may have with the ELB.

Indeed, the FOMC has made clear that it stands ready to use alternative policies if needed. In an addendum to our Policy Normalization Principles and Plans made a little over a year ago, the Committee stated it would be ready to use its full range of tools if future economic conditions warranted more accommodative policy than could be achieved by use of the federal funds rate alone.[5] You can find this point reiterated in the minutes of our meeting last month.[6] And in his Jackson Hole address in August, Chair Powell reiterated the importance of the "do whatever it takes" approach to policy when faced with difficult situations such as the risk of a protracted period at the ELB or if inflation expectations were to move into material conflict with our inflation objective.[7]

So, to conclude, while today the improvements in the economy are allowing us to return to a more conventional monetary policymaking, we must remain vigilant. There will be many challenges facing the Fed—as well as other central banks—as we make the transition. And we will have to be aware of the higher risks we face of hitting the ELB as we settle in to the "new normal" world. But hopefully, our challenges in the future will prove more familiar and easier to deal with than those we experienced over the past ten years.

[4] A number of alternative monetary policy frameworks have been proposed to address the ELB risks: Examples include an explicitly higher inflation target; nominal GDP targeting; temporary, state-contingent price-level targeting; and unconditional price-level targeting. For my thoughts on the monetary policy frameworks, see Evans (2018).
[5] Federal Open Market Committee (2017).
[6] Federal Open Market Committee (2018a).
[7] Powell (2018).

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