Keynote Address: The Economic Outlook

Central Bucks Chamber of Commerce
Ivyland, PA

January 12, 2018

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President and Chief Executive Officer
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Good afternoon and thank you. I have to say that I'm a native son of the Fed's Third District, and I'm always pleased to travel around, especially to places like beautiful Bucks County. That said, the winter months make me wonder what it's like to be president of the Dallas Fed …

We've just exited the season of looking back — of year-end recaps, of "the best and worst of 2017," and enough top-ten lists to make your head spin. So, in the spirit of the new year, I'd like to take the opportunity to look forward instead.

Of course, in giving my outlook, I'm aware that we're standing in week two of 2018, and December — when the next round of "the year in review" commences — is very far away. Still, I have my forecast at least penciled in as well as some areas I'll be watching for development.

Now is the perfect time to note, with the standard Fed disclaimer, that the views I express today are mine alone and do not necessarily reflect those of anyone else in the Federal Reserve System.

With that caveat firmly in place, I'll start with the outlook.

The Outlook

That outlook is, by most measures, pretty good. We're headed into the ninth year of the expansion, and we've maintained a steady momentum.

Regarding growth, I've revised my forecast up slightly for 2018. Factoring in fiscal policy, I see GDP growth averaging just under 2½ percent for the year, and then dropping a little lower, to 2.2 percent, for 2019.

On the employment side of our mandate, things are looking robust. Unemployment stands at 4.1 percent, the lowest in 17 years, and a variety of other indicators show a labor market with very little slack left.

The U6 measure of unemployment, which casts a wider net to include marginally attached workers and people who are working part time for economic reasons, has also moved back down to prerecession lows at 8.1 percent.

Quits and job turnover rates are high, and the most common feedback I'm getting is that businesses are having a difficult time filling positions.

In fact, of the things to watch in 2018, it's the shortage of workers, rather than jobs, that I'll be keeping an eye on.

Of course, that's the 30,000-foot view. I'm well aware that the numbers we analyze and debate are more nuanced in such a multifaceted country than the macro view would indicate. Though my District is the smallest in the Federal Reserve System — covering about two-thirds of Pennsylvania from Johnstown and east, southern New Jersey, and all of Delaware — it encompasses the spectrum of economic fortunes. There are some areas that are still struggling, and some areas that are booming.

On a local level, this is one of the areas that is doing well. Looking at the Montgomery-Bucks-Chester County Metro Division, overall labor market conditions have been solid for some time, and the unemployment rate is below the state average. Job growth was driven largely by sectors such as Professional and Business Services, Financial Services, and Education and Health.

Turning to inflation, that's the one area of marginal concern in an otherwise solid economy as it continues to run below target, not just at home, but abroad. I often note that this is something that only central bankers and policymakers seem to have an issue with. If you ask the average person on the street, or the average business owner, he's likely to think low inflation is great. But for the policy wonks, we do want to see it rise. The Fed has a target of 2 percent average inflation, and it's been a few years since we've hit that mark.

I expect inflation in the U.S. to continue to run just under our mark this year, rise a bit above target in 2019, and then come back down to our 2 percent goal the following year. But projections are only that — projections — and I'm more guarded in my view about the path of inflation than I am about economic activity.

For that reason — and this is the part people always care about the most — I see two rate increases as the likely appropriate path for 2018. Of course, I'll continue to monitor the data as they roll in, but that's the view in the first month of the new year.

As I noted, the beginning of the new year is a chance to look forward. And the beginning of 2018 marks something of a new point in the journey of modern economic history. We talk frequently about the "new normal" when it comes to the economy and to monetary policy; it's perhaps the most overused phrase in this context. But just because something has become cliché doesn't mean it's not accurate. The truth is, things are unlikely to return to what we considered their relative norms before the recession.

There are, therefore, a few issues on the horizon that I'm keeping my eye on. None of them are likely to cause disruption — to be frank, most of them would make for boring conversation — but they are facets of what the landscape will likely look like.

Unwinding the Balance Sheet

The first is that, as you know, we are unwinding the Fed's balance sheet. You also likely know how it got to its current size but as a quick reminder: In the aftermath of the financial crisis and subsequent recession, the Fed turned to extraordinary monetary policy, the most well-known — and definitely the most discussed — being quantitative easing, or QE. During the three rounds we engaged in, QE involved buying more and different assets than our usual practice of holding mostly short-term Treasuries. We purchased longer-term Treasuries and bought mortgage-backed securities as well. That swelled the balance sheet to approximately $4.5 trillion, significantly larger than the roughly $900 billion before the crisis. Additionally, because of the infusion of mortgage-backed securities, the balance sheet as a whole looks quite different now.

Once we ended the purchases, in late 2014, we simply reinvested the proceedings as they reached maturity to keep the balance sheet constant.

Last October, we began to taper reinvestments in a step to further normalize monetary policy. We will continue to let assets fall off, until the balance sheet reaches whatever the new normal is.

The first thing to note is that we are not yet sure what that eventual size will be. We are in a different economy than the one before the crisis, so it won't look the same as it did in, say, 2006. The economy has grown since then, and the Fed's balance sheet has always grown with the nominal economy. The second thing to note is that we haven't faced exactly this type of normalization before; no one has. The third thing to note is that this won't be anywhere near as dramatic as the first two things might make it sound. This will be a slow, mechanical process, and we are essentially letting the balance sheet unwind in the background. We will, of course, keep an eye on it, and if any shock to the economic system occurs, we'll revisit our plans. But fundamentally, this is perhaps the most boring function of current monetary policy. Still, it is new and will be an aspect of policy for this and the next few years or so.

The Yield Curve

The second issue I'm watching is the yield curve, and I'm sure I'm not alone in this room. My assessment is that the worries so far have been inflated. Again, for the uninitiated, the yield curve traces the difference in the rates of return on shorter- versus longer-term securities. The closer the rates get, the flatter the curve. A flattening yield curve can reflect the market's assessment of economic conditions, so a flattening is often thought to be a precursor to a downward shift in overall economic conditions. However, that's not a law of economic nature by any means, and consumer confidence is, in fact, high at the moment.

The situation we're in now is not the same as, for instance, the inversion of the yield curve associated with the '70s and '80s, although it does bear some resemblance to the flattening in the mid-2000s. One concern may be that financial institutions lengthen terms of loans and investment in a search for yield. But I think the continued removal of accommodation will help somewhat, and, overall, I don't think it's in need of more stringent monitoring than other developments.

Low R* and Policy Implications

Finally, what I think is the most important issue right now is that the new economic world we're entering may force policymakers to reevaluate our targets.

There has been a lot of research lately, including by my colleagues at the Board of Governors and other Reserve Banks, indicating that natural rates of interest may be lower than what's been typical in the past.

While we talk about the Fed "raising interest rates," what we actually mean is that the Federal Reserve sets the federal funds rate — or, more specifically, the range of the fed funds rate. That's the rate that banks lend to each other for short periods, generally overnight. That rate tends to influence overall interest rates, which is why the shorthand is generally acceptable for discussion. Then there is the natural rate of interest, or r* (r-star). This is the short-term rate of interest at which monetary policy neither inhibits nor encourages growth or inflation. R* is a function of economic variables and forces, such as, for instance, productivity, which is out of the Fed's control.

Market interest rates have been trending downward for years, starting long before the recession and appearing to have continued through the crisis and the current expansion. If it is the case that we are in a low r* world right now — and are likely to stay there for some time — that puts us in something of a bind because it means we're closer to what's known as the zero lower bound. That is, the Fed can't lower the feds fund rate much further than zero. So, if the natural rate of interest is lower, we have a smaller window in which to deploy rate moves, which is our primary monetary policy tool. That, in turn, means we have less policy ammunition in the event of an unexpected turn of events or, worse, a full-blown crisis. We can only play the hand we're dealt, and fed funds can only operate within the scope that the natural funds rate allows.

If it is the case that we're in a low r* environment, and one that is likely to last for a decent amount of time, it could be difficult to meet our inflation target. If that were to happen, it could impact inflation expectations, further complicating the issue. Inflation can fall victim to a self-fulfilling prophecy: One of economics' idiosyncrasies is that market expectations of low inflation can actually contribute to making it happen.

In that case, we at the Fed could be forced to rethink our policies. I am not — for the record and to be very clear — suggesting that we should. I am saying that if the possibilities we are currently debating turn out to be the new reality, then that is one option that is on the table.

In such a scenario, I have no particular option I'd prefer, but I would expect that the economics profession in general, and the Fed in particular, would debate them fully and equally. Ultimately, it's a question for the economics profession, and, if nothing else, I hope that the already substantial body of academic work gets even more robust.

That's the list of things I'm watching in 2018. It's a relatively short one, but it contains within it a lot of possible discussions. In having those, I'll give a final thought on what I see as important for 2018, and that is how and when we have those discussions.

One of the lessons we've learned most acutely over the past decade is the importance of clear, concise communication.

As an example, the taper tantrum of 2013 showed us very clearly that what we think we're communicating as policymakers, and what markets hear, are sometimes two different things. By contrast, our communications about unwinding the balance sheet came early, often, and almost via bullhorn. The markets heard us and more or less yawned; they knew what to expect.

So, to wrap up: There's a lot on the horizon for monetary policy in 2018. It will be a time of transition and change, but one that I expect, overall, to go smoothly. We've learned the lessons of the past and are being thoughtful and watchful as the year unfolds. While it should be a year of developments, it should also be a boring one.

Thank you.