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Navigating Monetary Policy as Headwinds Shift to Tailwinds

Remarks by

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I appreciate the invitation from the Money Marketeers to discuss the path ahead for our economy and monetary policy.<sup>1</sup>

Many of the forces that acted as headwinds to U.S. growth and weighed on policy in previous years are generating tailwinds currently. Today many economies around the world are experiencing synchronized growth, in contrast to the 2015–16 period when important foreign economies experienced adverse shocks and anemic demand. The International Monetary Fund revised up its outlook for the world economy in January, continuing a recent pattern of upward revisions, in contrast to a string of downward revisions in 2015 and 2016.<sup>2</sup> Stronger economies abroad should increase demand for America’s exports and boost the foreign earnings of U.S. companies.

The upward revisions to the foreign economic outlook are also pulling forward expectations of monetary policy tightening abroad and contributing to an appreciation of foreign currencies and increases in U.S. import prices. By contrast, foreign currencies weakened in the earlier period, pushing the dollar higher and U.S. import prices lower. Since the end of 2016, a broad index of the exchange value of the dollar has depreciated nearly 8 percent, whereas it appreciated by 25 percent from mid-2014 to 2016.

In recent quarters, the combination of higher oil prices and robust global demand has been providing strong support to business investment--in contrast to the sharp pullback from 2015 to 2016. Business spending on fixed investment rose at more than a 6 percent

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<sup>1</sup> I am grateful to John Roberts of the Federal Reserve Board for his assistance in preparing this text. These remarks represent my own views, which do not necessarily represent those of the Federal Reserve Board or the Federal Open Market Committee.

<sup>2</sup> See various issues of the International Monetary Fund (IMF) *World Economic Outlook* ([www.imf.org/en/publications/weo](http://www.imf.org/en/publications/weo)) and *World Economic Outlook (WEO) Updates* ([www.imf.org/external/ns/cs.aspx?id=231](http://www.imf.org/external/ns/cs.aspx?id=231)).

pace in 2017. This rise followed two years of weak growth, dragged down by declines in the drilling and mining sector.

Financial conditions are currently supportive of economic growth despite the recent choppiness in financial markets and some tightening since the beginning of the year. Various measures of equity valuations remain elevated relative to historical norms even after recent movements, and corporate bond spreads remain quite compressed.<sup>3</sup> This compares with the period from mid-2014 through the second half of 2016, when equity prices were flat and the dollar rose steeply. The Federal Reserve Bank of Chicago's National Financial Conditions Index provides a useful summary statistic.<sup>4</sup> According to this measure, financial conditions tightened significantly from the middle of 2014 to early 2016. By comparison, financial conditions today remain near the accommodative end of the range since the financial crisis, even with the recent tightening in conditions.

The most notable tailwind is the shift in America's fiscal policy stance from restraint to substantial stimulus in an economy close to full employment. In the earlier period, the economy had just weathered a challenging adjustment to a sharp withdrawal of fiscal support. Today, from a position near full employment, the economy is poised to absorb \$1-1/2 trillion in personal and corporate tax cuts and a \$300 billion increase in federal spending. Estimates suggest December's tax legislation could boost the growth rate of real gross domestic product (GDP) as much as 1/2 percentage point this year and next.<sup>5</sup>

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<sup>3</sup> See Board of Governors (2018b).

<sup>4</sup> The National Financial Conditions Index is available on the Federal Reserve Bank of Chicago's website at <https://www.chicagofed.org/publications/nfci/index>. Other indexes of financial conditions, such as the indexes published by the Federal Reserve Banks of Kansas City and St. Louis, tell a similar story.

<sup>5</sup> For example, the IMF 2018 *WEO Updates* (see note 2) estimates that the tax cut legislation will raise the level of U.S. GDP 1-1/4 percent by 2020.

On top of that, the recently agreed-to budget deal is likely to raise federal spending by around 0.4 percent of GDP in each of the next two years.<sup>6</sup>

### **Achieving Our Inflation Objective and Sustaining Full Employment**

Although the economy is currently around full employment and has been expanding at an above-trend pace, inflation has remained subdued for quite some time. Over the past year, overall PCE (personal consumption expenditures) inflation was 1.7 percent, and core PCE inflation was 1.5 percent--not very different from the average level of core inflation over the past five years.

The persistence of subdued inflation, despite an unemployment rate that has moved below most estimates of its natural rate, suggests some risk that underlying inflation may have softened. While transitory factors no doubt played a role in last year's step-down in core PCE inflation, various empirical analyses conclude that persistent factors are at play in the stubbornly low level of core inflation. According to a variety of measures, underlying inflation--the slow-moving trend that exerts a pull on wage and price setting--may be running below levels that are consistent with the Federal Open Market Committee's (FOMC) 2 percent inflation objective.<sup>7</sup> For example, some survey measures of longer-run inflation expectations are currently lower than they were before the financial crisis, as are most estimates based on statistical filters. Inflation compensation has moved up recently, but is still running somewhat below levels that prevailed before the crisis.

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<sup>6</sup> The Congressional Budget Office (2018) estimates that increased spending caps will allow additional spending worth about 3/4 percent of GDP in fiscal year 2019.

<sup>7</sup> See Brainard (2017).

Thus, it is important for monetary policy to ensure that underlying inflation is re-anchored firmly at 2 percent. At the same time, it is important for monetary policy to sustain full employment.

It is difficult to know with precision how much slack remains in the labor market. If the unemployment rate were to continue to fall in the coming year at the same pace as in the past couple of years, it would reach levels not seen since the late 1960s. On the other hand, the employment-to-population ratio for prime-age workers remains more than 1 percentage point below its pre-crisis level. If substantially more workers could be drawn into the labor force, it would be possible for the labor market to firm notably further without generating imbalances. But it is an open question as to what portion of the prime-age Americans who are out of the labor force may prove responsive to tight labor market conditions because declining labor force participation among prime-age workers predates the crisis, especially for men. In one encouraging development, the strong labor market has pulled some discouraged workers back into the labor force and into productive employment over the past few years. Also encouraging, our Beige Book and workforce surveys indicate that employers are casting a wider net to find job candidates and investing more in on-the-job training.

### **Navigating Monetary Policy**

Although last year we faced a disconnect between the continued strengthening in the labor market and the step-down in inflation, mounting tailwinds at a time of full employment and above-trend growth tip the balance of considerations in my view. With greater confidence in achieving the inflation target, continued gradual increases in the federal funds rate are likely to be appropriate.

Although experience in other countries suggests it can prove difficult to raise an underlying inflation trend that has been running below policymakers' target for several years, stronger tailwinds may help re-anchor inflation expectations at the symmetric 2 percent objective. Of course, it is conceivable we could see a mild, temporary overshoot of the inflation target over the medium term. If such a mild, temporary overshoot were to occur, it would likely be consistent with the symmetry of the FOMC's target and could help nudge underlying inflation back to our target.<sup>8</sup> Recent research has highlighted the downside risks to inflation and to longer-run inflation expectations that are posed by the effective lower bound on nominal interest rates, and it suggests the importance of ensuring underlying inflation does not slip below target in today's new normal.<sup>9</sup>

We also seek to sustain full employment, and we will want to be attentive to imbalances that could jeopardize this goal. If the unemployment rate continues to decline on the current trajectory, it could fall to levels that have been rarely seen over the past five decades. Historically, such episodes have tended to see elevated risks of imbalances, whether in the form of high inflation in earlier decades or of financial imbalances in recent decades. One of the striking features of the current recovery has been the absence of an acceleration in inflation as the unemployment rate has declined, a development that is consistent with a flat Phillips curve.<sup>10</sup> Although wage gains have seen some recent improvements, they continue to fall short of the pace seen before the financial crisis.<sup>11</sup>

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<sup>8</sup> See Board of Governors (2018a).

<sup>9</sup> See, for example, Kiley and Roberts (2017), Nakata and Schmidt (2016), and Brainard (2015, 2016).

<sup>10</sup> See Blanchard (2016) and Simon, Matheson, and Sandri (2013).

<sup>11</sup> Over the 12 months through January, average hourly earnings were up 2.9 percent relative to a year earlier, the highest 12-month change in almost nine years. The employment cost index rose 2.6 percent last year.

However, we do not have extensive experience with an economy at very low unemployment rates and cannot be sure how it might evolve. In particular, we will want to remain attentive to the risk of financial imbalances. While asset valuations appear to be elevated, overall risks to the financial system remain moderate because household borrowing is moderate, risks associated with liquidity and maturity transformation have declined, and, importantly, the banking system appears to be well capitalized.<sup>12</sup> History suggests, however, that a booming economy can lead to a relaxation in lending standards, and the attendant excessive borrowing can complicate the task of monetary policy. We will need to be vigilant.

### **Conclusion**

What do these considerations imply for the path of monetary policy? Continued gradual increases in the federal funds rate are likely to remain appropriate to ensure inflation rises sustainably to our target and to sustain full employment, keeping in mind that interest rate normalization is well under way and balance sheet runoff is set to reach its steady-state pace later this year.<sup>13</sup> Of course, we should be ready to adjust the path of policy in either direction if developments turn out differently than expected.

In many respects, the macro environment today is the mirror image of the environment we confronted a couple of years ago. In the earlier period, strong headwinds sapped the momentum of the recovery and weighed down the path of policy. Today, with headwinds shifting to tailwinds, the reverse could hold true.

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<sup>12</sup> See Board of Governors (2018b).

<sup>13</sup> As laid out in Board of Governors (2017), the caps determining the degree of reinvestment of maturing securities in the System Open Market Account are increasing gradually. The caps on the monthly runoff in the portfolio are expected to reach their maximum levels of \$30 billion for Treasury securities and \$20 billion for agency debt and mortgage-backed securities later this year. The actual pace of runoff will vary, however, depending on the volume of securities maturing in any given month.

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