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"Perspectives on the Economy and Fed Policy: Why Continuing to Remove Monetary Accommodation is Appropriate"

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Springfield Regional Chamber Outlook 2018

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It is great to be back in Springfield, one of the winners of the Boston Fed's Working Cities Challenge[1] competition. Springfield's winning proposal focuses on providing better workforce development opportunities for lower-income individuals to obtain meaningful employment. Achieving the goals that Springfield has set for itself is, of course, much easier in a robust economy, and the economic outlook I will share today is consistent with an economy that will require even more workers in the labor force.

Before I begin my remarks, let me note as I always do that the views I express are my own, not necessarily those of my colleagues on the Federal Reserve Board of Governors or the Federal Open Market Committee (FOMC).

Over the past year, the unemployment rate has fallen and is now below even the lowest estimates made by Federal Reserve policymakers (FOMC participants) for the level that is likely to be sustainable in the longer run. As labor markets have tightened, we have seen a gradual increase in wages and salaries. While inflation[2] is still a bit below the FOMC's target, most forecasters expect inflation to rise to, or near, the Fed's 2 percent target by the end of 2018.

Despite this good news, the stock and bond markets have become much more volatile in recent weeks. This likely reflects, in part, the realization that financial markets need to factor in the risk that wages and prices could grow *too* quickly, if there were too much fiscal and monetary stimulus – particularly with the economy currently at or beyond full employment and inflation approaching the Fed's goal. I view the underlying insight as a healthy realization by market participants that the risks are two-sided: Unsustainably strong growth that leads to excessive inflation or financial imbalances is now as much a risk as growth that falls short. And there is a realization that monetary policymakers need to be vigilant in calibrating the level of accommodation, if continued sustainable growth is to be achieved.

To be more specific, as inflation approaches the Federal Reserve's 2 percent target and unemployment remains below what we see as a sustainable rate, it is appropriate for the Fed to continue to remove monetary accommodation by gradually raising interest rates. At the December FOMC meeting, the median of Fed policymakers' estimates of "appropriate monetary policy" called for 75 basis points of additional rate increases over the course of 2018. My own view, at that time, was actually that somewhat further removal of accommodation might well be needed in 2018. That assessment remained dependent on the tenor of incoming data, of course.

And since the December FOMC meeting, we have all observed a mix of news: fiscal spending, a large tax cut, and continued strengthening of economies around the world provide support to U.S. growth. But, on average, household and business spending data have come in a bit weaker than expected, leading many to revise down their forecasts for the current quarter. Even so, most forecasters currently expect growth this year to exceed its sustainable pace, which implies further tightening of labor markets and more wage and price pressures over time. Thus, on balance, developments since December generally reinforce my view of the need for somewhat more removal of accommodation than was reflected in the December median Summary of Economic Projections (SEP). Of course, following through on this expectation is conditional on the economy unfolding about as expected, and that unexpected events such as a trade war or a substantial change in the geopolitical situation do not surprise on the downside.

Recent Developments in the Economic Outlook

Improvements in the economy over the past year have, in large part, been driven by strong consumer spending. This is not unusual for the U.S. economy, of course, since consumer spending accounts for roughly two-thirds of real GDP. As **Figure 1** highlights, consumption growth in the fourth quarter of 2017 was quite strong, at 3.8 percent.

However, as the figure also shows, forecasts for the first quarter of 2018 are for much slower consumption growth. This forecast, from the Blue Chip Economic Indicators, preceded the relatively weak retail sales reported for January. If retail sales continue to disappoint, consumption for the first quarter of this year may well be below that projected by forecasters in early February.

What is the likelihood that we will continue to get weak readings on consumer spending? That is difficult to say, but my view is that the data we have seen so far most likely reflect a temporary pause in this quarter, following unexpectedly strong growth in the fourth quarter of 2017 – and as a consequence, we will probably continue to see solid consumption growth over the balance of this year.

My optimism in this regard is driven by the relatively strong fundamentals that support consumption growth. **Figure 2** shows that household wealth has been rising, and is well above the level from the beginning of 2016. This gain reflects continued increases in housing wealth due to rising house prices in many areas of the country, as well as steady gains in the stock market. While there have been some sizable stock market declines in recent days, **Figure 3** shows that current stock prices remain at roughly the levels they achieved in December 2017.

Outside of stock market levels, there has been a notable increase in volatility. One measure of stock volatility, the Chicago Board Options Exchange (CBOE) Volatility Index (VIX), had been unusually low in 2017. This very low market volatility can lead investors to take on more risk, and in a period of still relatively low interest rates, to "reach for yield" – that is, buy riskier assets than one would otherwise, in order to achieve a desired profit or savings goal. Clearly, as can be seen in **Figure 4**, stock market volatility has increased significantly in recent weeks. From a financial stability standpoint, I view the increased volatility as an important reminder to market participants that stock prices can be quite sensitive to economic data.[3]

Figure 5 illustrates that despite an increase in market volatility, consumers' confidence in the strength of the economy remains high, well above index levels for 2017. While there has been some weakness in the higher-frequency consumer data, I view high consumer confidence as consistent with the fundamental underpinnings of consumer spending that I discussed a moment ago, and suggestive that what we are seeing now will turn out to be a pause by consumers after a very strong fourth quarter.

Figure 6 shows that the Blue Chip forecasters seem to share my optimism. For much of 2017, the forecasters had expected U.S. real GDP for 2018 to result in growth of 2.4 percent. However, with the significant reduction in taxes and the increases in government spending, as well as the continued improvement in the national economies of trading partners, the consensus forecast now anticipates real GDP growth to be 2.8 percent for the year. Such a rapid increase is likely to be primarily driven by the fiscal stimulus. It remains to be seen, however, what signal Blue Chip forecasters may take from the more recently released weaker consumption data.

Outlook for Inflation

Some observers of Federal Reserve policy have been concerned about the low inflation readings for much of 2017. I have viewed those soft data as likely to be transitory, reflecting sharp temporary changes in relative prices – such as modifications in wireless service pricing by U.S. mobile carriers last spring. Recent data have given me more confidence in that assessment.

Figure 7 shows the Blue Chip consensus forecast for inflation as measured by the Consumer Price Index (CPI) for 2018. The Blue Chip survey focuses on the CPI, which tends to run approximately 20 to 30 basis points higher than the Federal Reserve's preferred inflation index, the personal consumption expenditures (PCE) index. The figure shows that in the first quarter of 2017, forecasters expected that 2018 CPI would be running at 2.3 percent, consistent with the Fed's 2 percent inflation target using the PCE measure of inflation. However, in the spring of 2017, with some large relative price changes, forecasters began to lower their expectations for 2018 inflation – reaching estimates as low as 1.9 percent by late summer. More recently, their forecasts for 2018 CPI inflation are back where they were in early 2017.

Figure 8 illustrates how the data have changed more recently, by averaging the PCE inflation data over one year, over six months, and over three months. The year-over-year change in the PCE index remains somewhat below the Federal Reserve's 2 percent target, as some of the soft data from last spring have lowered this 12-month change. However, more recent readings that exclude those spring observations (that is, the six month data and the three month changes) show a rate of inflation above our 2 percent target.

One final factor that may have temporarily elevated the index is oil prices. **Figure 9** provides a similar chart for the inflation measure that excludes the volatile food and energy prices, the so-called *core* PCE inflation rate. More recent readings for core inflation suggest that we have been right at our 2 percent target for the past three and six months.

Labor Market Developments

Another factor that gives me some confidence that the Fed will continue to hit the inflation target is the strength of the labor market. **Figure 10** shows that the number of individuals filing initial claims for unemployment insurance is at low levels not seen since the late 1960s and early 1970s, when the labor force was considerably smaller than it is today. This likely reflects a number of positive factors, including: strong demand for workers that derives from a strong pace of sales for goods and services; employers' reluctance to lose employees, given the difficulty they would face in hiring replacement workers; and the fact that potential employees who lose or switch jobs are able to find new employment without suffering a spell of unemployment.

Another way to assess labor market tightness is to look at labor flows – in other words, how workers move between being employed, unemployed (not working, but looking for work), and out of the labor force (neither employed, nor looking for work).[4] **Figure 11** shows the flow from being employed to unemployed. Official data for gross worker flows begin in the early 1990s, and consistent with the data on initial claims, the employment-to-unemployment flow is near a recent low.

Figure 12 shows the flow from being out of the labor force to being unemployed. This is near the early 2001 series low, reflecting that when workers decide to enter or reenter the workforce, they find employment opportunities quickly.

Figure 13 shows the flow from being out of the workforce into employment. This series is at a recent high, reflecting that in a tight labor market more potential workers are being drawn into the workforce. While this is a particularly good sign for hard-to-employ workers, it also highlights a potential future problem: the supply of workers outside of the labor force and willing to reenter the labor market will become a constraint over time.[5]

As we experience the welcome development of more workers entering employment from outside of the workforce, there will be an increasing need for training and other aspects of workforce development. As I mentioned at the outset of the talk, that is one of the areas that the Springfield team has chosen to focus on for their Working Cities Challenge initiative.[6]

Of course, with labor markets tight, some employers will attempt to attract new employees by offering higher wages and benefits, raising the average compensation paid to many employees over time. **Figure 14** shows the employment cost index measure of wages and salaries for private industry workers, excluding incentive-paid occupations. This wage measure, along with a number of others, has been gradually trending upward over the past several years. As the labor market continues to tighten – which would be consistent with the 2.8 percent Blue Chip forecast for 2018 real GDP growth – one would expect to see continued upward pressure on wages and salaries.

Concluding Observations

In summary and conclusion, I would say that the economic data have been quite good, monetary policy remains accommodative, and fiscal policy has just become quite a bit more stimulative. While a tight labor market provides definite advantages – such as employment opportunities for workers who have struggled to find a job – nonetheless, providing *too much* stimulus from either monetary or fiscal policy at this stage of the economic cycle could threaten to create a so-called "boom and bust" economy, which policymakers certainly want to avoid.

To keep the economy on a sustainable path, I expect that it will be appropriate to remove monetary policy accommodation at a regular but gradual pace – and perhaps a bit faster than the three, one-quarter point increases envisioned for this year in the assessment of appropriate policy from the December 2017 FOMC meeting. This expectation assumes, of course, the data continue to come in more-or-less consistent with my outlook.

Thank you.

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[1] The Working Cities Challenge is an initiative of the Federal Reserve Bank of Boston, designed to lead smaller cities through a rigorous process that builds cross-sector collaboration to solve issues impacting the lives of these cities' lower-income residents. Grounded in Boston Fed research, the Challenge encourages leaders from the public, private, and nonprofit sectors to advance proposals that tackle complex challenges facing smaller post-industrial cities and achieve large scale impact across communities. Included in the initiative is a grant competition designed to accelerate promising work already underway. For more information, see: https://www.bostonfed.org/workingcities.

[2] The Federal Reserve measures inflation by the annual change in the price index for personal consumption expenditures, or PCE.

[3] In some ways, increased volatility may help to enhance financial stability if it moves market participants to more appropriately assess the risks in their investments.

[4] The stock of unemployed workers, as well as the net job creation in any month, are the net result of a huge number of such flows among employment, unemployment, and those not in the labor force.

[5] Because many of those not in the labor force are pursuing education, retired, disabled, or attending to family care, there is a limit to the number of workers not currently in the labor force who can plausibly meet the demand for new workers. At some point, the available supply of workers will become a constraint on our ability to grow, although I do not believe that we are there just yet.

[6] For more information on the Springfield Working Cities Challenge effort, see: https://www.bostonfed.org/workingcities/massachusetts/round2/cities/springfield. Also see: https://springfieldworks.net/.