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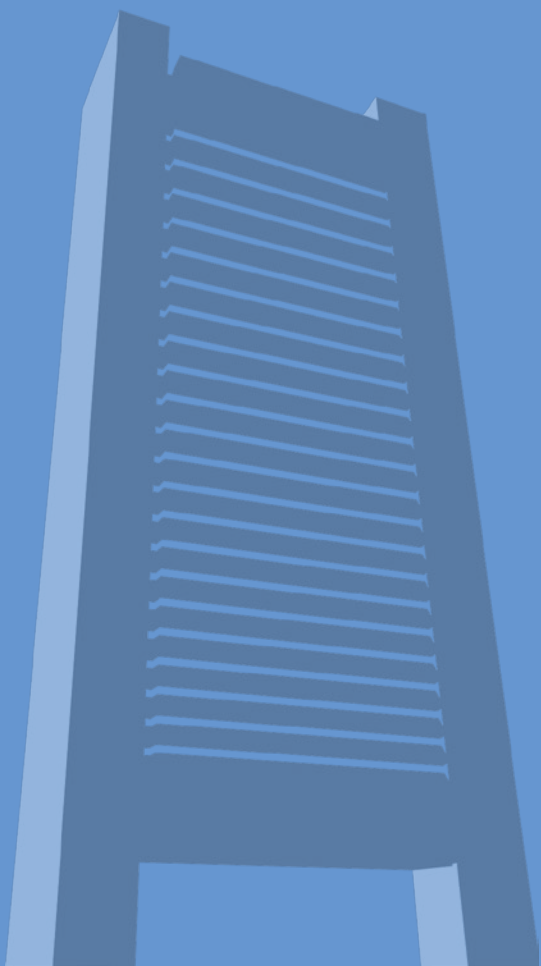

Trends and Transitory Shocks

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Recent Balance Sheet Announcement

- Federal Reserve will begin very gradually shrinking its balance sheet in October
  - Well-communicated announcement
  - Designed to minimize disruption
- As anticipated, largely a non-event for markets
- Balance sheet reduction now essentially on “automatic pilot”
- Short-term interest rates the main tool for monetary policy

Considering the Effects of Recent Events

- The impact of Hurricanes Harvey, Irma, and Maria will significantly cloud the interpretation of the economic data
  - Differentiating between temporary disruptions and ongoing trends will be difficult
  - Difficult to be fully "data dependent" in the near-term

How do Policymakers Resolve Conflicts in the Dual Mandate?

- Dual mandate is now “dueling”
- Monetary policy must be forward looking
  - What is the likelihood that the mandate “misses” will persist?
  - Do Fed policymakers see recent inflation weakness as temporary, or a sign of things to come?
  - Do Fed policymakers see strength in the labor market as temporary, or a sign of things to come?

Preview

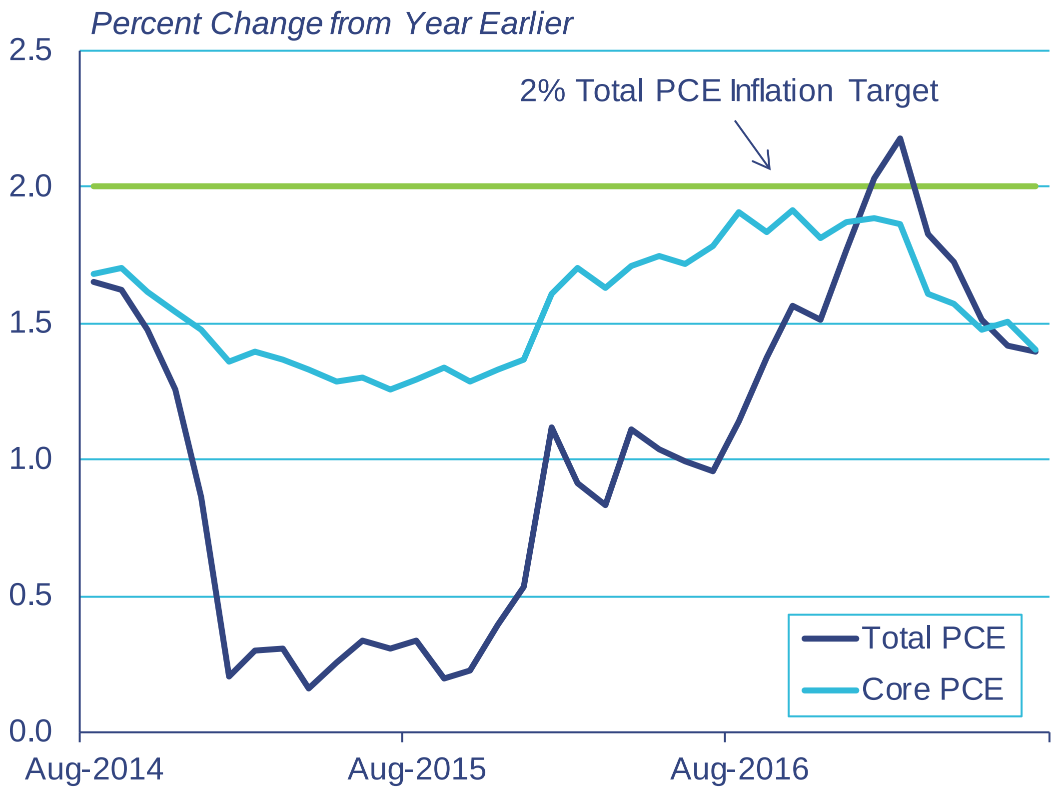
- Consider SEP and private forecasts
- Similar outlook, by the end of next year:
  - Inflation is expected to be close to target
  - The unemployment rate will continue to fall and will be materially below most estimates of a sustainable unemployment rate
- This outcome poses risks
  - Potential that an overheated economy will lead to price or asset-price inflation
  - Risking the sustainability of the recovery

Implications for Monetary Policy

- The last time we had unemployment rates trending toward 4 percent (in the late 1990s), the personal consumption expenditures (PCE) measure of total inflation and asset prices had begun to rise
- Followed shortly thereafter by an economic downturn and a significant revaluation in many asset prices
- In my view, appropriate risk mitigation would argue for continued gradual removal of monetary accommodation, even though we are currently below the inflation target

Figure 1: Inflation Rate: Change in Personal Consumption Expenditures (PCE) Price Indices

August 2014 - July 2017

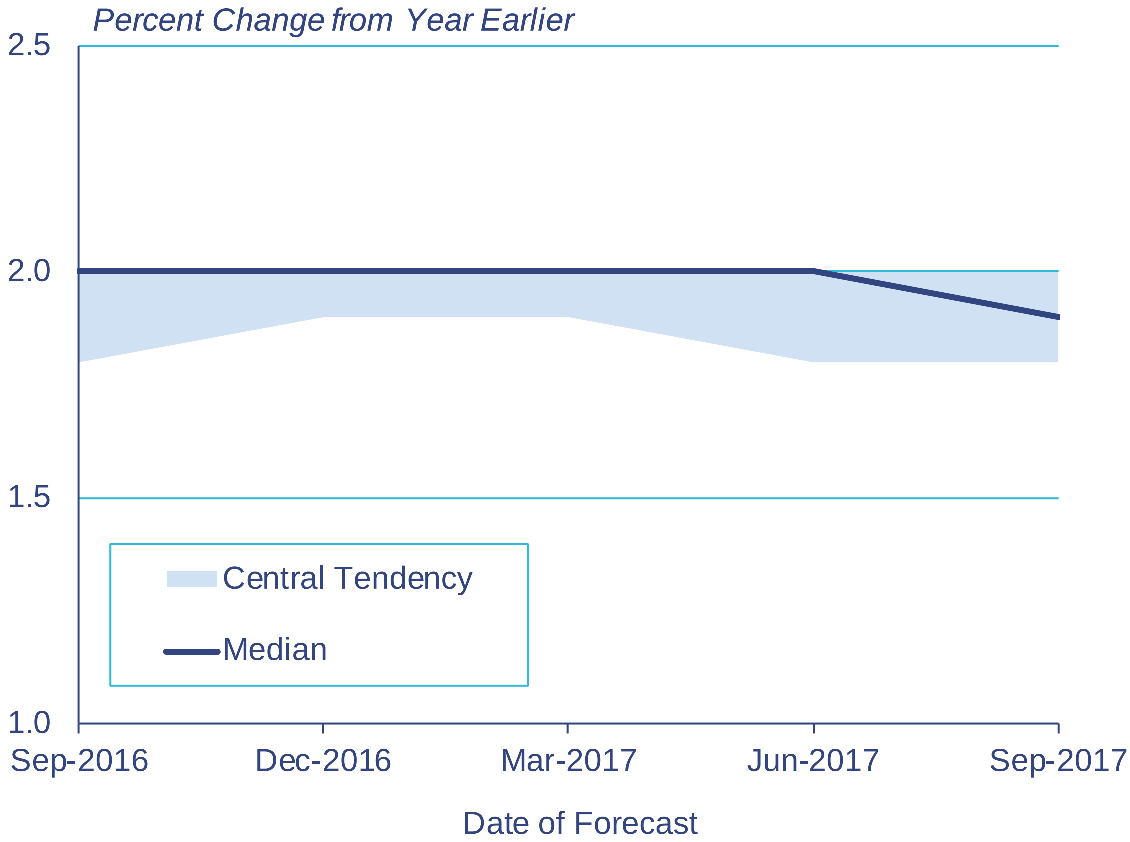


Note: Core PCE excludes food and energy.

Source: BEA, Haver Analytics

Figure 2: PCE Inflation Forecasts for 2018:Q4 from the Summary of Economic Projections

September 2016 - September 2017

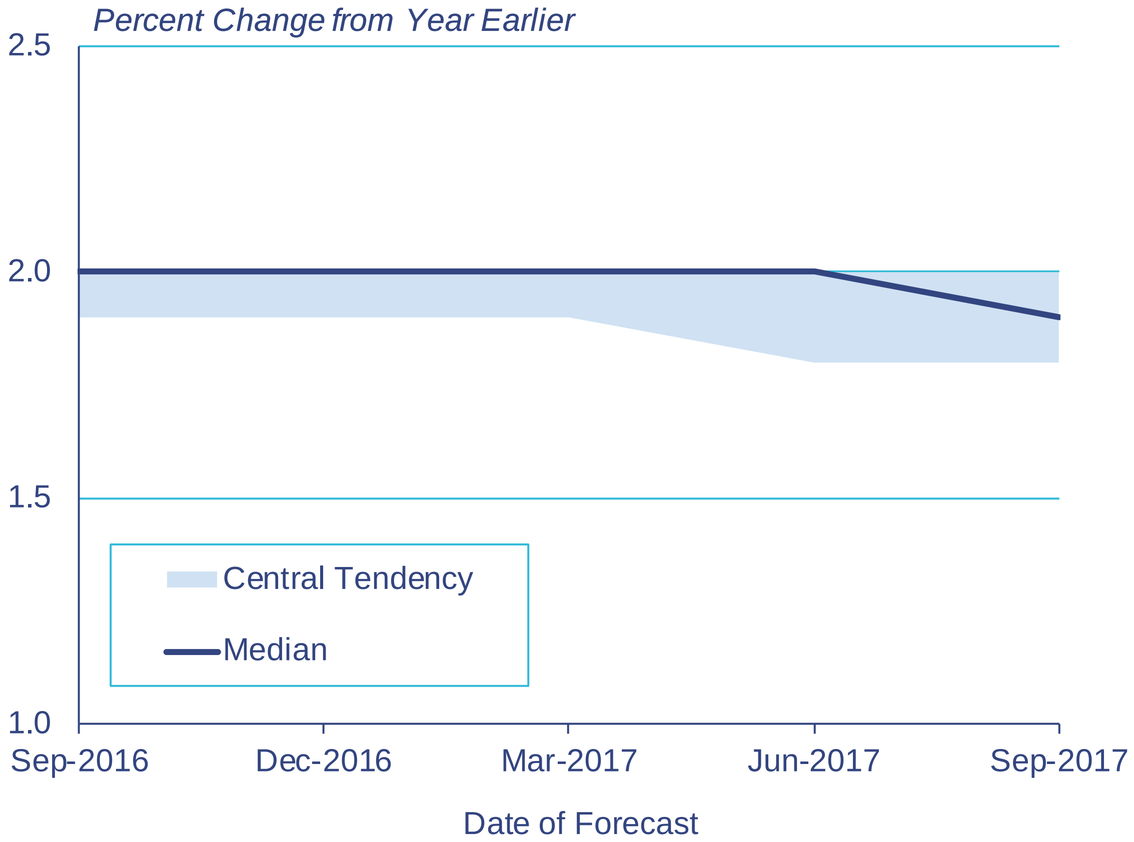


Note: The central tendency excludes the three highest and three lowest observations.

Source: FOMC, Summary of Economic Projections (SEP)

Figure 3: Core PCE Inflation Forecasts for 2018:Q4 from the Summary of Economic Projections

September 2016 - September 2017

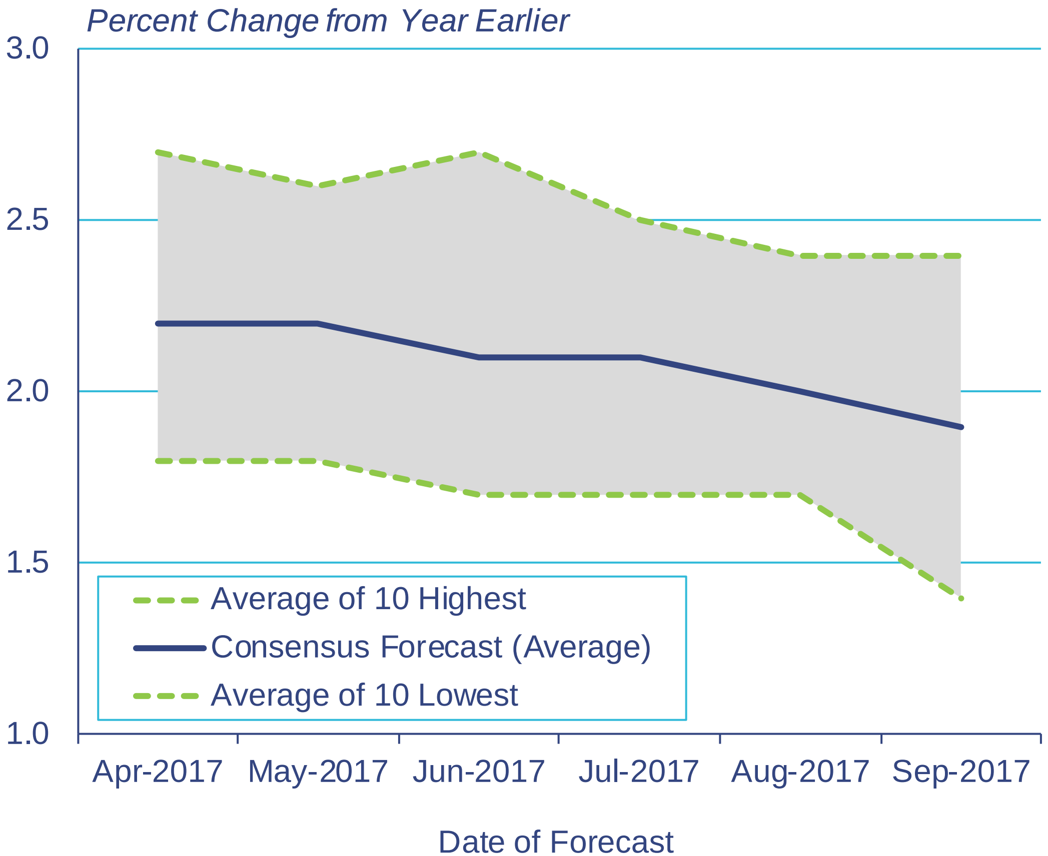


Note: The central tendency excludes the three highest and three lowest observations.

Source: FOMC, Summary of Economic Projections (SEP)

Figure 4: Blue Chip Forecasts for PCE Inflation in December 2018

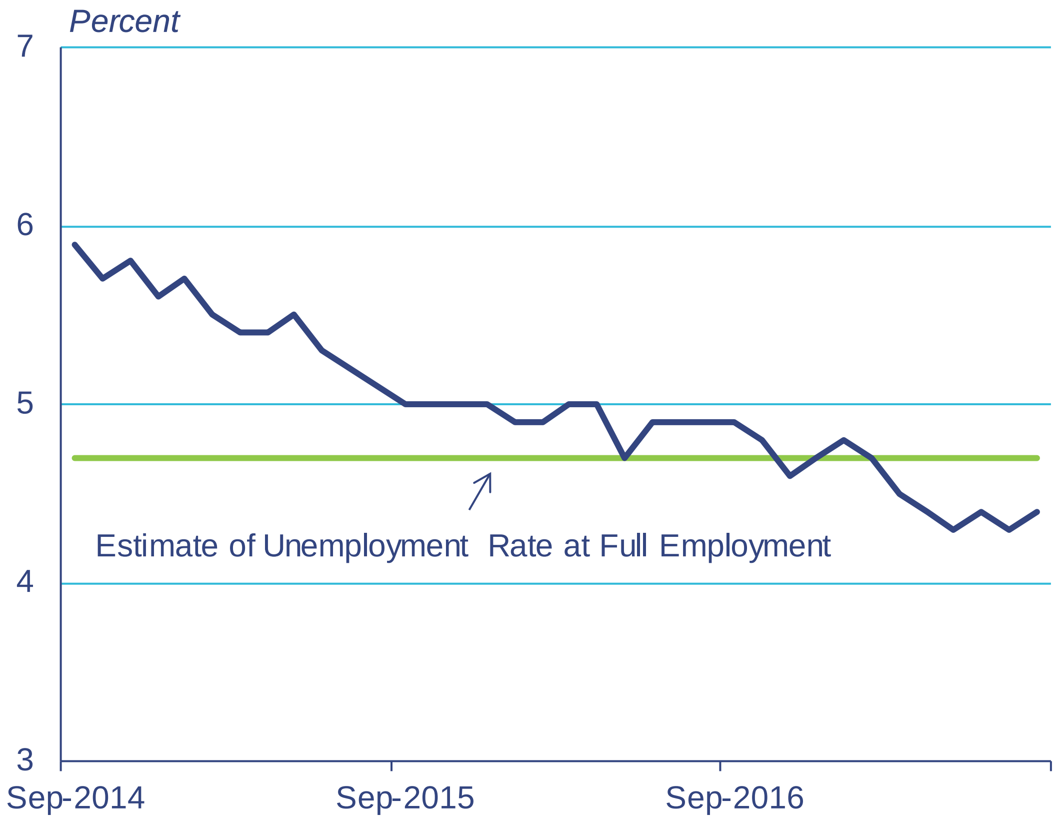
Forecasts as of April 2017 - September 2017



Source: Blue Chip Economic Indicators, Special Question

Figure 5: Civilian Unemployment Rate

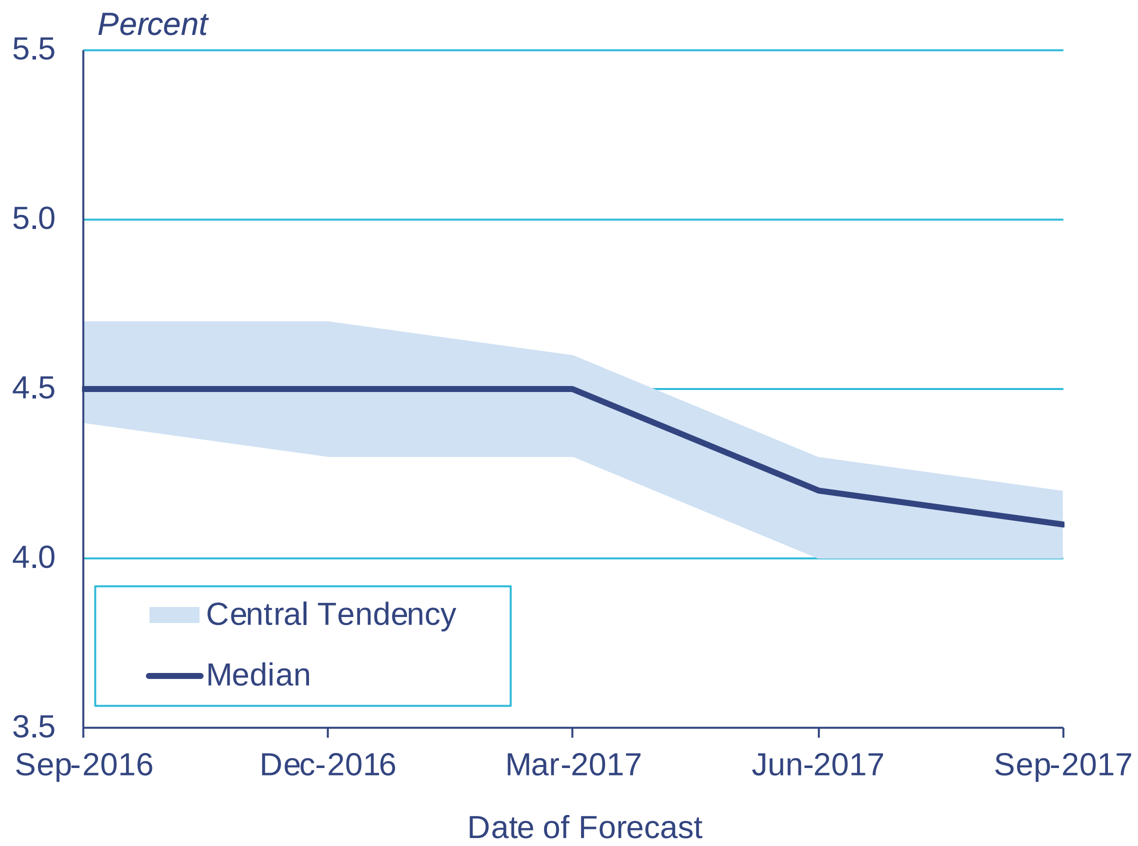
September 2014 - August 2017



Source: BLS, Haver Analytics

Figure 6: Unemployment Rate Forecasts for 2018:Q4 from the Summary of Economic Projections

September 2016 - September 2017

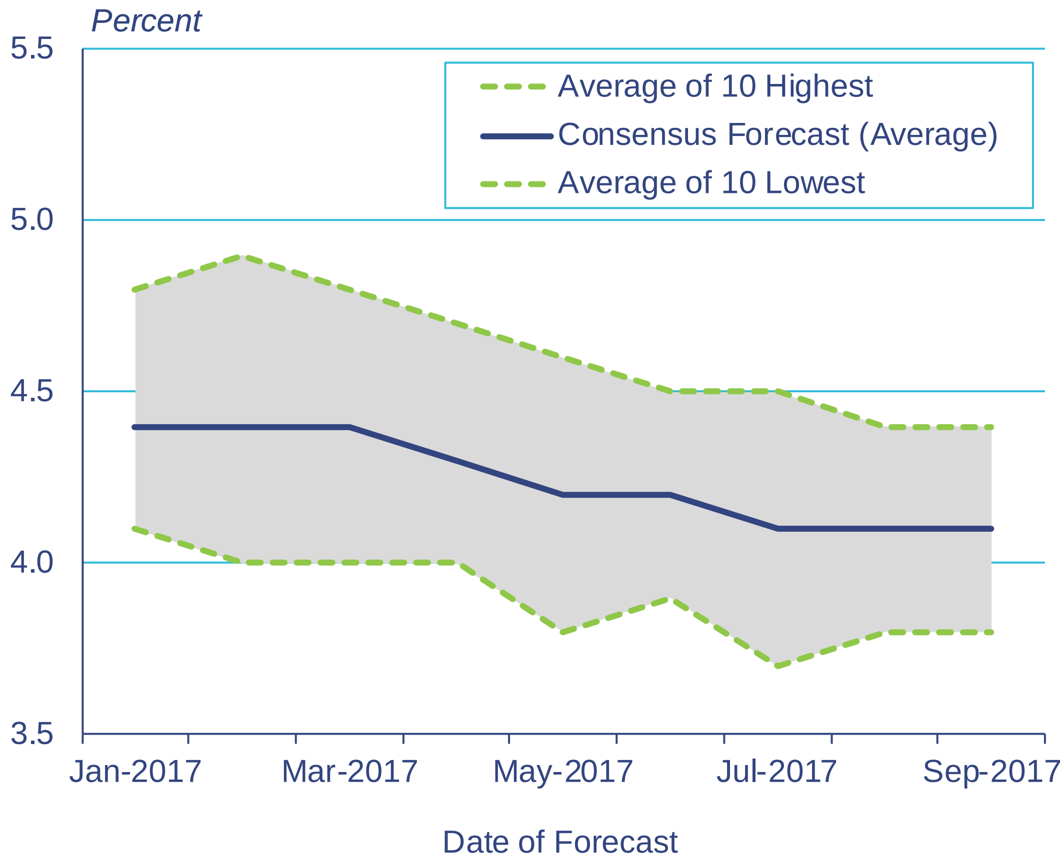


Note: The central tendency excludes the three highest and three lowest observations.

Source: FOMC, Summary of Economic Projections (SEP)

Figure 7: Blue Chip Forecasts for the Unemployment Rate in 2018:Q4

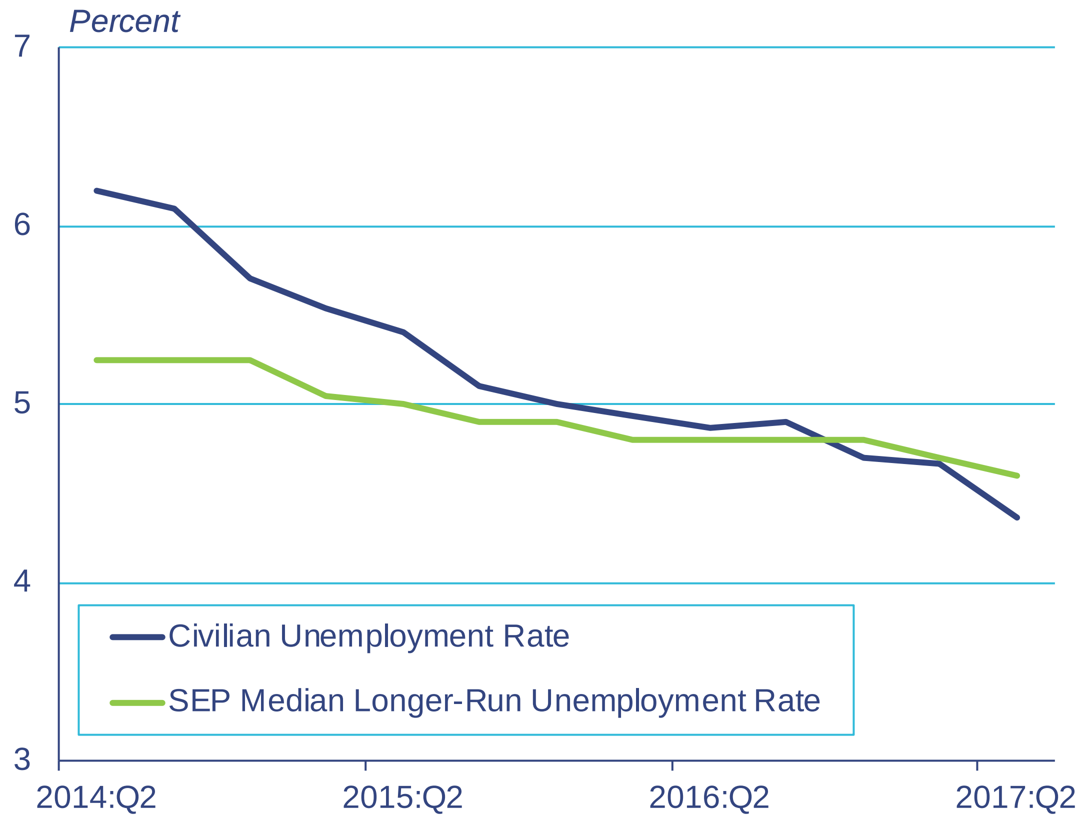
Forecasts as of January 2017 - September 2017



Source: Blue Chip Economic Indicators

Figure 8: Civilian Unemployment Rate and SEP Estimates of the Longer-Run Unemployment Rate

2014:Q2 - 2017:Q2

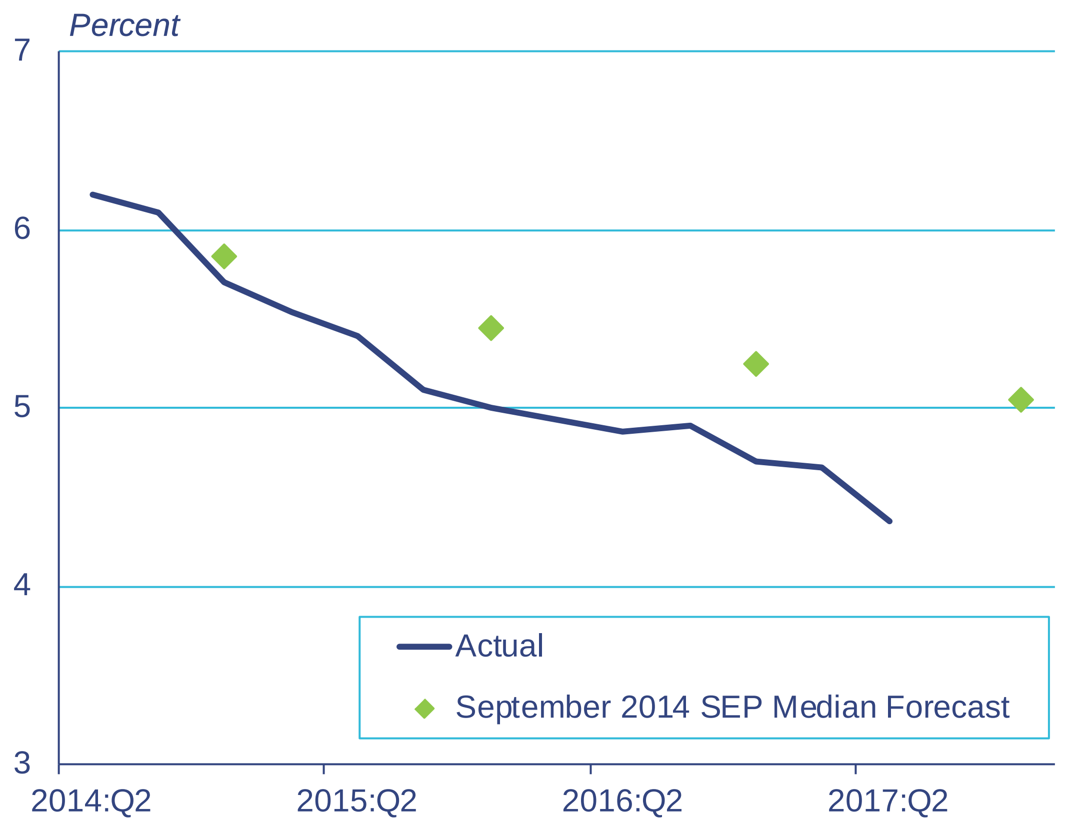


Note: Prior to June 2015, SEP medians are not reported. Proxies for the medians are calculated from the distribution of participants' projections reported in ranges of tenths in the meeting minutes.

Source: FOMC, Summary of Economic Projections (SEP); BLS; Haver Analytics

Figure 9: Civilian Unemployment Rate: Actual and Forecast from the Summary of Economic Projections

2014:Q2 - 2017:Q4

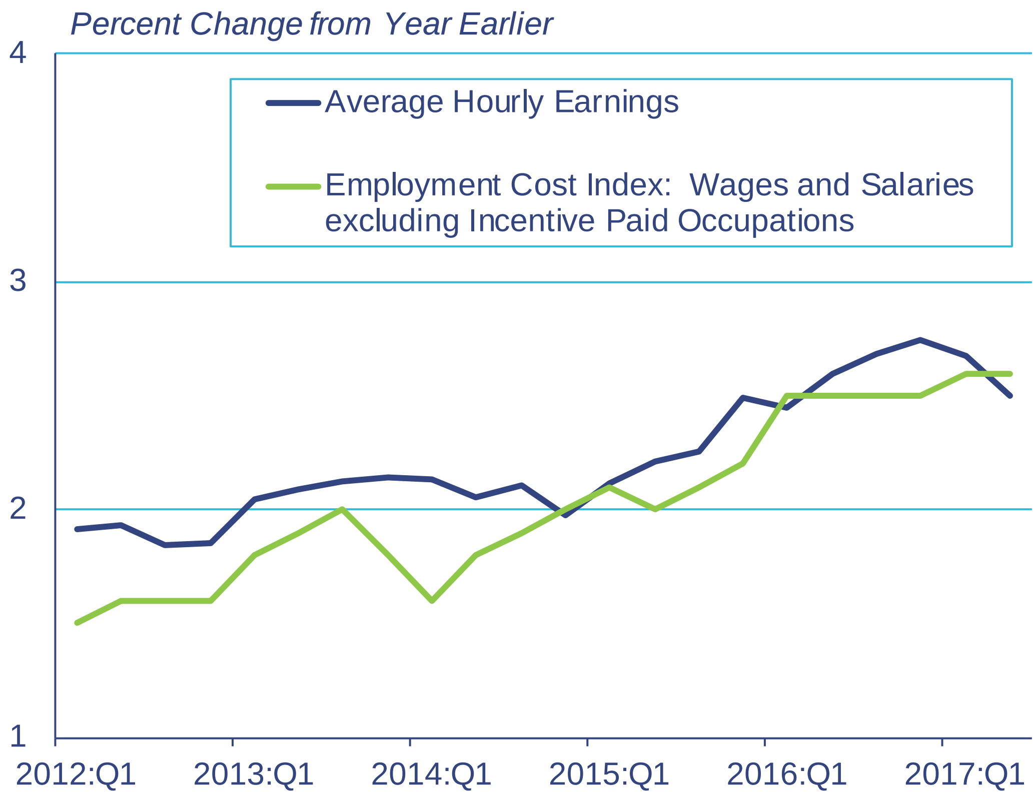


Note: Prior to June 2015, SEP medians are not reported. Proxies for the medians are calculated from the distribution of participants' projections reported in ranges of tenths in the meeting minutes.

Source: FOMC, Summary of Economic Projections (SEP), September 17, 2014; BLS; Haver Analytics

Figure 10: Wage Growth for Private Industry Workers

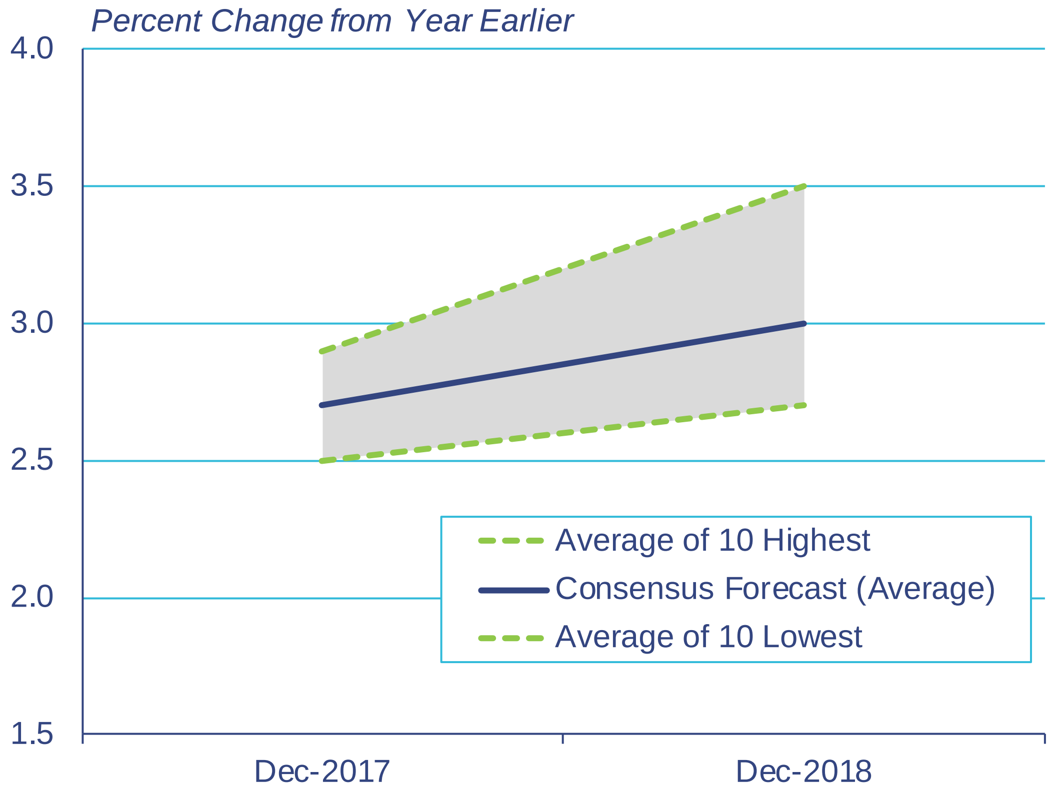
2012:Q1 - 2017:Q2



Source: BLS, Haver Analytics

Figure 11: Blue Chip Forecast for Growth in Average Hourly Earnings

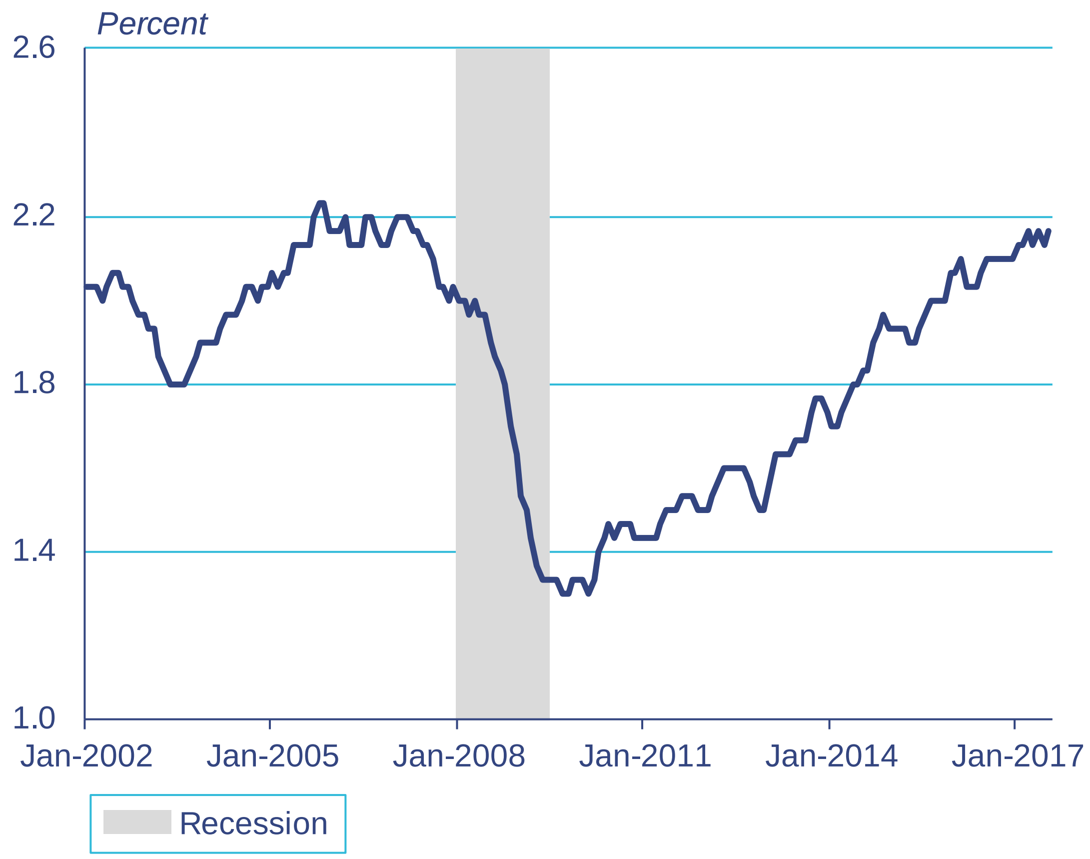
Forecast as of September 2017



Source: Blue Chip Economic Indicators, September 10, 2017, Special Question

Figure 12: Job Leavers: The Quits Rate

January 2002 - July 2017



Note: The quits rate is the number of quits during the entire month as a percent of total employment. Pictured above is the three-month moving average.

Source: BLS, NBER, Haver Analytics

Concluding Observations

- The weakness in inflation readings appears to be transitory, but some one-time declines in individual prices will not fall out of annual averages until next spring
- In contrast, the recent hurricanes will likely place some upward pressure on measured inflation over the next several months, a transitory shock in the other direction

Concluding Observations (Continued)

- However, the declines in the unemployment rate below the level most see as sustainable seem likely to be more long-lasting
- Expect that tight – and tightening further – labor markets will result in higher wages and prices over time
- Economy risks pushing past what is sustainable, raising the probability of higher asset prices or inflation
- Lowering the probability of such an outcome seems advisable. As a result, it is my view that regular and gradual removal of monetary accommodation seems appropriate