The U.S Economic Outlook and Monetary Policy

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The views expressed by the author are her own and do not necessarily reflect those of the Federal Reserve System, its governors, officers or representatives.

I'm pleased to be in Lincoln with members of our Omaha Branch office board of directors. As a regional Federal Reserve Bank president, I gain important insights about the economic landscape of our District from visits like this one, where I have the opportunity to meet with business and community leaders. Your comments and concerns about the economy, combined with economic data and analysis, help inform my own views on monetary policy.

My remarks this evening will focus on the state of the economy and the current stance of monetary policy. In particular, I want to highlight some key dynamics of the labor market, as we are experiencing the confluence of several cyclical and structural trends that are collectively reshaping the job market in Nebraska and the nation as a whole.

Before I continue, however, I want to note that these are my own views and are not necessarily representative of others in the Federal Reserve System.

The Nebraska Economy

As we heard earlier tonight, the Nebraska economy is relatively strong and its unemployment rate is historically low. I'd like to use the lens of the labor market to describe the opportunities and challenges that the state faces as you collectively work to build and support a strong economy.

Relative to the nation, Nebraska has a strong labor market with an unemployment rate below the U.S. national average. Just over a decade ago, prior to the financial crisis, Nebraska had an unemployment rate of about 3 percent. Following the financial crisis and during the recession that ensued, Nebraska's unemployment rate rose to about 5 percent, far less than the national unemployment rate, which rose to 10 percent. And at this current point in the ongoing

economic expansion, Nebraska's unemployment rate is 2.7 percent, suggesting that the labor market is tighter now across the state than it was back in 2007.

This is very good news for the state as a whole, but it masks several underlying trends that reveal that this improvement has not been experienced equally across all parts of the state and for all workers in the economy. Within Nebraska, employment growth has been concentrated in metro areas, particularly in Omaha and Lincoln, while the rural parts of the state have struggled. During the past four years, employment in Nebraska's metro areas has grown at an annual rate of 1.5 percent, while in that same time there has been no employment growth in non-metro areas of the state. This widening divide of economic opportunities between rural and metro areas represents a growing concern for our region and is a topic that the research staff at the Kansas City Fed will be analyzing.

A second important trend that has broad implications for Nebraska's economy is the ongoing demographic shift in its population. During the past decade, Nebraska's population of individuals age 16 and above has grown by 8 percent. But a large share of this population, the baby boomers, are moving toward retirement, which implies that the labor force of available workers may not be growing as quickly. In fact, the number of prime-age individuals in Nebraska, those aged 25 to 54, has actually declined by 3½ percent over the past decade. If this trend continues with an aging population that is not fully replaced by the next generation of workers, this will create a significant headwind for growth prospects for the state economy.

And a third trend influencing the labor market is the ongoing shift in the types of skills employers demand. In the past 40 years, advances in technology and computing, along with shifts toward an increasingly global economy, have dramatically altered the employment opportunities that firms are seeking to fill. Jobs that were available in the past to workers with a

high school degree, such as assembly line work in manufacturing plants and clerical jobs in offices, have largely been automated. As those jobs have gone away, new jobs have emerged, but many require technical skills that workers need to obtain through training programs or advanced education.

How best to prepare our youth and young workers for success in this economy is a challenge facing Nebraska, along with the rest of the country. In particular, young men are struggling to adapt to this shift in employment opportunities. A recent article in the Kansas City Fed's *Economic Review* by Didem Tüzemen describes how this shift has contributed to an increased number of prime-age men who are leaving the labor force.[1] Those men typically have only a high school diploma and perhaps some college education. For Nebraska, the share of prime-age men who are actively engaged in the labor force has declined by 1 percent during the past decade, which implies that approximately 10,000 men who would have been working in Nebraska's economy a decade ago are now sitting on the sidelines and not looking for work because their skills are not in demand by employers.

But this is also a national dilemma with no easy answers. In addition to the slowdown in the growth rate of the labor force due to the retirement of baby boomers, the missing prime-age male workers are another headwind on the national economy's productive capacity.

Let me turn now to the outlook for the U.S. economy which, from a cyclical perspective, looks very robust, aside from this very challenging issue.

The U.S. Economic Outlook

[1] Tüzemen, Didem. "Why Are Prime-Age Men Vanishing from the Labor Force?" Federal Reserve Bank of Kansas City. Economic Review, First Quarter, 2018.

Almost nine years into the current expansion, the U.S. economy has, by most accounts, achieved full employment while maintaining a low and stable inflation rate. Preliminary estimates suggest that real GDP — our broadest measure of economic activity — grew at an annual rate of just under 3 percent in the second half of last year. Looking ahead, most forecasters expect continued moderate growth somewhat above the economy's potential growth rate of roughly 1¾ percent to 2 percent. Such growth will likely lead to tighter conditions in labor and product markets and, possibly, higher inflation. As a result, the Federal Open Market Committee—the Fed's monetary policymaking body—has been gradually removing monetary accommodation by slowly increasing its target interest rate and allowing its balance sheet to shrink.

That's my outlook in a nutshell. Let me now provide some details in support of my perspective.

One of the key drivers of the expansion has been consumer spending. Consumers maintained a moderate pace of spending during this economic expansion, generally in line with the moderate pace of income growth we have been seeing. Looking forward, I expect consumers to continue providing a significant amount of support for this economic expansion, as jobs continue to be added and wage growth is beginning to pick up in response to a tightening labor market. Recent changes to personal taxes will likely provide a modest boost to household spending this year and allow households to pay down debt, which has continued to grow throughout the expansion. Over time, the contribution of the tax plan to consumer spending is likely to fade, but still remain positive for spending as labor market conditions tighten.

Additional momentum to the economy has come from business spending on plant and equipment. Business investment grew almost 6¼ percent in 2017, which represents a welcome

step up from the negligible rate of growth during the previous three years. Equipment investment in particular has strengthened in response to stronger global demand for U.S. manufactured goods and commodities. In the last four quarters, it grew almost 9 percent.

Looking ahead, the lower corporate tax rate and more favorable tax treatment of investment spending are expected to provide a further modest boost to business spending in the coming years. Longer-term factors, however, such as sluggish productivity growth and a subdued rate of growth in the working-age population, are likely to remain a drag on investment spending going forward. Intangible investment, such as in intellectual property and technological know-how, is likely to continue growing in importance relative to investment in physical structures and machinery.

The housing sector presents more of a mixed picture, with residential investment fluctuating around a moderate upward trend that is likely to persist. Construction activity is constrained by a shortage of qualified workers, difficulty obtaining financing by small builders, and the limited availability of undeveloped land in desired locations. Single-family sales are being significantly constrained by limited home listings. In contrast, demand for housing remains very strong. Many young adults who moved in with their parents or found housemates following the Great Recession would now like to form their own households but are finding a lack of moderately-priced apartments and houses. Similarly, families who would like to upgrade from starter single-family homes are also finding a limited number of homes available for sale. With strong demand but limited new supply, rents and sales prices are likely to continue to move up briskly, even as mortgage rates normalize from the very low levels of recent years.

Finally, the national economy will get a small boost in growth from federal government spending. The two-year budget agreement that Congress recently passed raises spending caps for fiscal year 2018 and 2019, allowing nearly $400 billion in additional spending.

With this outlook, I view inflation dynamics as broadly consistent with the Federal Reserve's goal of price stability. Year-over-year inflation is currently running just under the Federal Reserve's objective of 2 percent as measured by the personal consumption expenditure price index. But I would expect to see inflation rising this year to around 2 percent. This increase reflects continued economic growth at or above its long-run potential, a further tightening of labor markets, and rising import prices stemming from strong global demand.

Risks to the outlook appear to be predominately to the upside. The sectors that were headwinds on growth in the final quarter of last year suggest considerable momentum going into the current year. Imports, which subtracted almost 2 percentage points from the fourth quarter growth rate, point to considerable domestic demand. Likewise, inventories, which subtracted 0.7 percentage point from overall economic growth, should be a source of strength this year as producers restock their shelves. In addition, as I will discuss in a moment, monetary policy remains highly accommodative, and the recently enacted tax cuts and federal government spending increases suggest fiscal policy has turned more stimulative. On top of these domestic demand factors, a synchronized global recovery, in which foreign demand for our goods and services ,remains quite solid, should contribute to the momentum going forward.

Monetary policy

Let me now turn to a review of monetary policy. Although we have largely achieved our objectives for maximum employment and price stability, the stance of monetary policy remains

quite accommodative. The federal funds rate, which is the overnight interest rate the Federal Reserve targets, remains well below estimates of its longer-run value of around 3 percent.

In addition, the Federal Reserve's balance sheet remains extraordinarily large by historical standards due to the FOMC's large-scale purchases of longer-term Treasury and agency debt beginning in 2008. These programs, commonly referred as quantitative easing or QE, ended in October 2014, and the process of shrinking the Fed's balance sheet to reduce our holdings of Treasury and agency securities started last fall. By the end of this year, however, only about a quarter of the increase to the Fed's balance sheet resulting from the first round of large scale asset purchases will be unwound.

These holdings of longer-term assets were intended to put downward pressure on longer-term interest rates. Many investors responded, as would be expected, by purchasing riskier assets in a reach for higher yield. As a result, asset prices may have become distorted relative to the economic fundamentals. The very slow pace of our balance sheet normalization may still be contributing to a buildup of various financial imbalances. While until recently, financial markets remained remarkably stable, it is not uncommon to see volatility rise when asset prices become inflated and investors struggle to find a new equilibrium.

What then should the stance of monetary policy be at this stage in the business cycle? Monetary policy can be a useful tool to lean against the ups and downs of the business cycle, but it is not well suited to address structural problems in the economy such as job polarization. When economic conditions reflect the combination of full employment, price stability and trend economic growth—as they more or less do now—monetary policy should be a neutral influence on the economy. But the current setting of our target interest rate is still well below neutral. It

is, therefore, important that the FOMC continue on its current path of policy normalization with gradual increases in the target federal funds rate.

Conclusion

In closing, the good news is that the U.S. economy is currently growing at a moderate pace, with full employment and price stability. As always, some regions and industries are doing better than others but, on the whole, economic conditions are good. At the same time, monetary policy remains accommodative. To sustain the expansion without pushing the economy beyond its capacity limits and creating inflationary pressures, it will be important for the Federal Reserve to continue its gradual normalization of interest rates. Given the current momentum in the economy, the FOMC will need to carefully calibrate its policy to lean against a potential buildup of inflationary pressure or financial market imbalances.