A View of the Fed's Policy Path

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- Atlanta Fed president and CEO Raphael Bostic presents his view of the Fed's policy path on October 23 to the Louisiana Committee of 100 in Baton Rouge.

- Bostic has revised up his 2018 projection as a result of higher-than-expected GDP growth numbers in the second and third quarters, and he has the sense that economic growth is on a strong trajectory.

- Bostic has also moved up his 2019 forecast a bit in light of the performance of the consumer over the past two quarters. However, he says caution remains with firms and households regarding longer-term investments.

- Bostic: The potential for changes in trade policy to affect the costs of production—through either direct tariffs, supply-chain disruptions, or firms switching to higher-cost routes to import supplies—remains a risk to his inflation outlook.

- Citing Atlanta Fed research, he cautions against letting the economy slip too far into high-pressure periods that ultimately impose heavy costs on many people across the economy. Facilitating a prolonged period of low—and sustainable—unemployment rates is a far more beneficial approach.

- Bostic believes that, in the current environment, the Fed should shift into a neutral monetary policy stance. While there is some uncertainty surrounding estimates of neutral, his assessment is that we are still a few rate hikes away.

I'm delighted to be in Baton Rouge and to join you at this business roundtable today. I know the Louisiana Committee of 100 shares the Atlanta Fed's goal of fostering economic prosperity for everyone in our communities.

The work you have championed to improve regional workforce development at the Cyber Innovation Center and early childhood care and education through the Louisiana Early Childhood Business Roundtable are just two examples of where your efforts dovetail with ours.

I'd like to recognize two folks attending this afternoon: Jude Melville of Business First Bank is a member of the Atlanta Fed's Community Depository Institutions Advisory Council, and Stephen or "Stevie" Toups of Turner Industries is a member of our Energy Advisory Council. Thank you both for being here and for your service to our Bank.

Before I get too far into my remarks, I'd like to do a commercial. As many of you may know, we have an outreach program at the Atlanta Fed that we call REIN—the Regional Economic Information Network. Our regional executives, like Adrienne Slack here in Louisiana, and their staffs spend nearly all of their time out in the field, meeting with business leaders like you to get your take on economic trends, opportunities, and challenges. Through these meetings, they bring me real-time, real-world stories that paint a forward-looking picture of the economies in the Sixth Federal Reserve District and help inform my thinking on policy directions. So I have a request for you: When Adrienne or someone from our REIN team calls you, please take the call and meet with them. Only with your help can I have the best information possible when deliberating on policy.

In my comments today, I'd like to provide my latest view of the economy and my economic outlook. I'll share some thoughts on how my outlook has evolved since the beginning of the year. Then I'll offer my views on what the Federal Reserve is trying to achieve with our current monetary policy path and what might happen if we fail to act.

Before I begin, let me say that I am offering only my personal opinions today. I'm not speaking for anyone else in the Federal Reserve System or for the Federal Open Market Committee, or FOMC.

Current economic conditions

The economy is in a good place. So good, in fact, that as I was sitting down to write this speech, I struggled to come up with sufficient variations on the word "strong." Strong has many definitions that can describe physical prowess, the intensity of an odor or flavor, and, in physics, a type of force between particles. But one definition stands out to me as particularly apt to describe the economy at this moment: *strong*—able to withstand great force or pressure.

At the moment, there are headwinds in the form of tariffs, trade restrictions, and market volatility, each with the potential to disrupt economic activity and materially slow growth. There are also tailwinds in the form of recent tax reform and fiscal stimulus, with the potential to push economic growth up well beyond its longer-run potential.

Yet, after digging through the data, consulting our economic models, and gathering a Main Street perspective from our extensive network of business contacts, I come away with the sense that economic growth is on a strong trajectory. It's on solid footing and hasn't been materially pushed higher or lower.

That does not mean that the trajectory for the economy is immovable. As I will note later, there are ample reasons for a central banker like me to be concerned. But, from my perspective, the economy is performing well enough to stand on its own without support from accommodative monetary policy.

On Friday, we will get our first reading on real gross domestic product (or GDP) in the third quarter. Many analysts expect growth in the 3 ½ percent range. Our own in-house tracking model—GDPNow—has an estimate that is slightly higher than that.

It's important to put that 3 ½ percent figure in some context. Over the entire economic expansion, 37 quarters so far, real GDP growth has risen at an annualized rate of 2.3 percent. Given that trend, one quarter above 3 percent growth is not all that unusual. However, on the heels of the second quarter's 4.2 percent annualized increase in real GDP, this may suggest that the economy is shifting into a higher gear.

Economic outlook

As a result of these higher-than-expected GDP growth numbers in the second and third quarters, I've revised up my 2018 projection. I have also moved up my 2019 growth forecast a bit in light of the performance of the consumer over the past two quarters. But a note of caution remains with firms and households regarding longer-term investments.

That said, I do see the risks as being tilted to the upside. Should consumer spending hew to a higher growth trajectory, I suspect that would prompt firms to respond by ratcheting up expansionary investment.

Uncertainty from tariffs and recent changes in trade policy remain a feature of the economic landscape. That appears to be particularly true for Louisiana and its deep connection to oil and gas exploration. A Brookings Institution report released earlier this year identified Louisiana as highly exposed to the tariffs on steel and aluminum imports, ranked only behind Missouri in terms of its share of imports. So I imagine this is something you're all thinking a lot about.

However, by all appearances, the majority of firms have remained resilient in the face of these risks. Businesses have yet to suggest that uncertainty regarding tariffs and trade policy has significantly changed their plans for employment, sales revenue, or capital spending.

Costs are the one area where I have picked up a potential impact from changes in trade policy. Firms in my district are describing an upward shift in their cost structure. However, we have not yet seen a significant pass-through of higher costs into the final consumer space. Inflation remains stable, hovering around the FOMC's 2 percent objective.

Still, the potential for changes in trade policy to affect the costs of production—through either direct tariffs, supply-chain disruptions, or firms switching to higher-cost routes to import supplies—remains a risk to my inflation outlook.

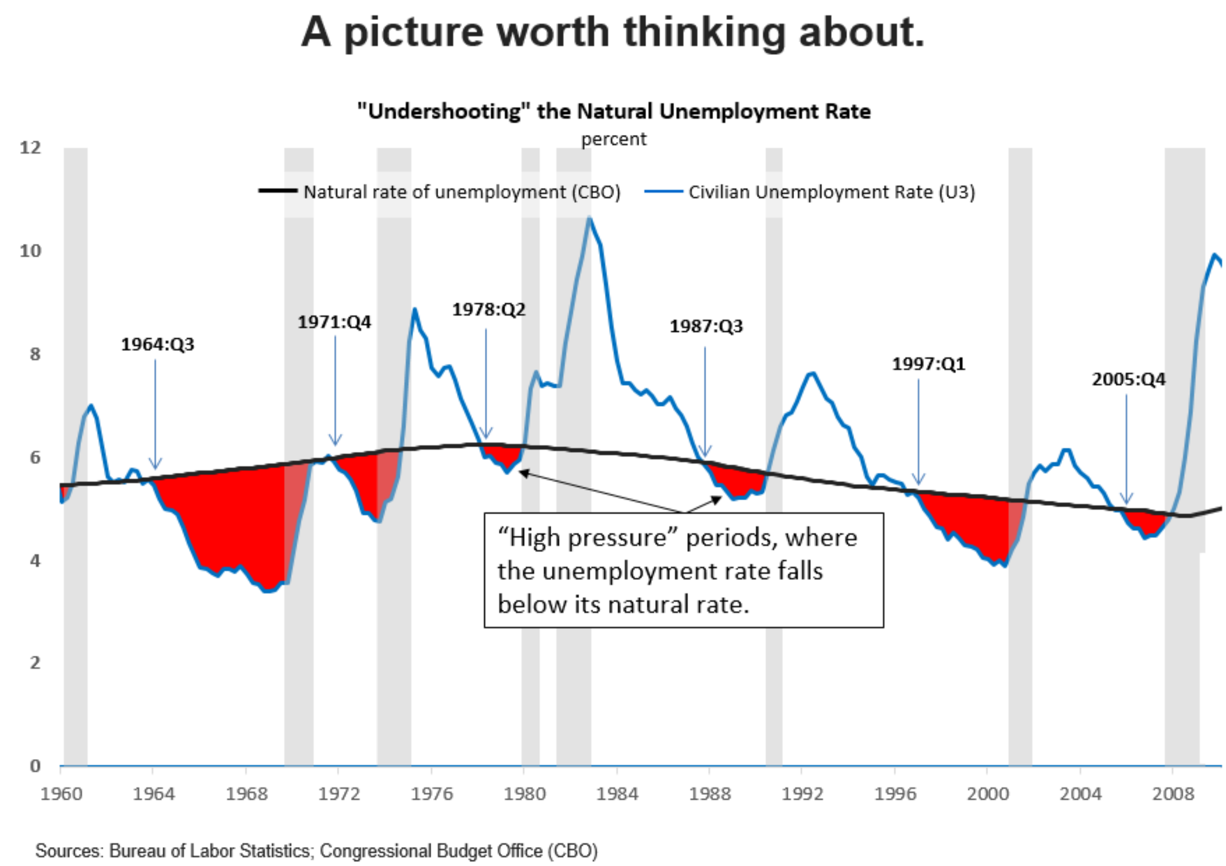
Monetary policy: Shifting to neutral

Given the current strength of the economy and that retail prices are already "on target," I supported the 25 basis point increase in the federal funds target range to 2 to 2 ¼ percent at the September FOMC meeting. And, unless the data talk me out of it, I view a continued, gradual removal of policy accommodation as appropriate until we get to a neutral policy rate.

I want to be clear here. My assessment is that monetary policy has not yet reached a neutral stance. We are still providing accommodation. Let me use the analogy of driving a car: if the economy is the car and the driver is the FOMC, in my view we are still giving the economy gas at the moment. We have yet to pump the brakes.

High-pressure economies: A policy consideration

Here's a picture I've been thinking a lot about lately (see the next figure). I think it explains an important conversation monetary policymakers are having at the moment. The blue line in the figure is the official unemployment rate from the Bureau of Labor Statistics. The black line is what's referred to as the natural rate of unemployment. This one is the current estimate from the Congressional Budget Office (or CBO).



As the CBO defines it, the natural rate is "the unemployment rate that arises from all sources other than fluctuations in demand associated with business cycles." These "other sources" include frictions like the time it takes people to find a job or frictions due to a mismatch between the set of skills workers currently possess and the set of skills employers want to find.

I think it is important to point out that we do not observe the natural rate directly. It's something we infer from statistical models, other labor market indicators, and indicators of wage and price pressure.

So, there's some uncertainty about that black line, and it can be substantial. But let's set that aside for the moment.

When the actual unemployment rate dips below the natural rate—highlighted as the red areas in the figure—the economy has moved into what economists call a "high-pressure period." For simplicity, you can think of this as moving beyond full employment.

And I think here's the interesting policy conundrum. What happens at the end of every high-pressure period? A recession or gray bar in the figure. The real question is why. One view is that it is because monetary policy tends to take on a much more "muscular" stance—some might say too muscular—at the end of these high-pressure periods to combat rising nominal pressures.

The other alternative is that the economy destabilizes when it pushes beyond its natural potential. These high-pressure periods lead to a buildup of competitive excesses, misdirected investment, and an inefficient allocation of societal resources. A recession naturally results and is needed to undo all the inefficiencies that have built up during the high-pressure period.

Yet, some people suggest that deliberately running these high-pressure periods can improve outcomes for workers in communities who have been less attached to the labor market, such as minorities, those with lower incomes, and those living in rural communities. These workers have long had higher unemployment rates than other workers, and they are often the last to benefit from periods of extended economic growth.

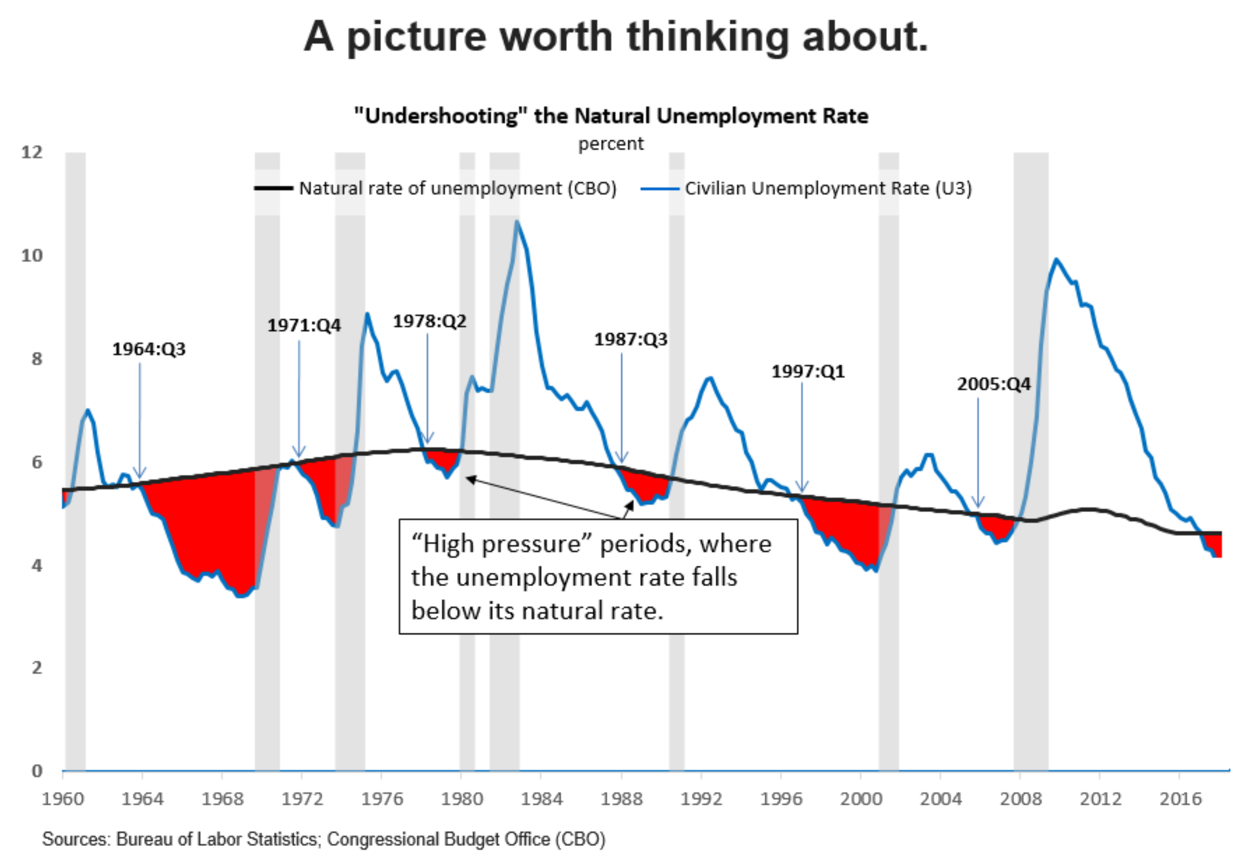
For example, research has shown that the gap between the unemployment rates of minority and white workers narrows as recoveries endure. So, the argument goes, allowing the economy to run further and longer into these red areas on the chart provides a net benefit to these under-attached communities.

But the key question isn't whether the high-pressure economy brings new people from disadvantaged groups into the labor market. Rather, the right question is whether these benefits are durable in the face of the recession that appears to inevitably follow.

This question was explored in a research paper by Atlanta Fed economist Julie Hotchkiss and her research colleague Robert Moore. Unfortunately, they found that while workers in these aforementioned communities tend to experience greater benefits from these high-pressure periods, the pain and dislocation associated with the aftermath of the subsequent recession is just as significant, if not more so.

Importantly, this research tells me we ought to guard against letting the economy slip too far into these high-pressure periods that ultimately impose heavy costs on many people across the economy. Facilitating a prolonged period of low—and sustainable—unemployment rates is a far more beneficial approach.

Let's fast forward to where we are now (see the next figure). The CBO's estimate of the natural rate is at 4.6 percent. Again, there is some uncertainty about where exactly that natural rate line lies. My estimate is about ½ percentage point below that. And it could be even lower. Given the general uncertainty about that line in real time, and given the current absence of accelerating inflationary pressures, we can't completely dismiss that possibility. Although, with the unemployment rate at 3.7 percent—a 49-year low—it seems likely that we're at least at our full employment mandate.



Going forward, I intend to weigh the risk of acting too swiftly and choking off the expansion against the risk of having the economy overheat and get into a situation with rising inflation and inflation expectations that would necessitate a muscular policy response. My thinking will be informed by the evolution of the incoming data and from what I'm able to glean from my business contacts. And while I wrestle with that choice, one thing seems clear: there is little reason to keep our foot on the gas pedal.

Inflation is at 2 percent, employment is at or near full employment, and the overall economy is strong. These are facts that are consistent with (at least) achieving the Fed's dual mandate. Moreover, the current data on both consumers and businesses suggests they are acting with prudence.

Household incomes are rising amid continued job gains. Consumer attitudes have risen to relatively high levels. And measures of indebtedness such as the debt-service ratio and the household financial obligation ratio have fallen to and remain at multi-decade lows. Together, these fundamentals would suggest ample room for further acceleration in household purchases. Yet, much of the recent strength in consumer spending has been in services and nondurables, not in goods associated with longer-term commitments.

Turning to the business investment picture, here, too, my sense is that growth will continue on at a moderate pace but not move markedly higher. I’m basing this assessment largely on the feedback I’ve heard from firms in my district either through surveys or from face-to-face interactions. These business leaders have struck a largely upbeat tone regarding the current environment, with the majority reporting that demand roughly matched or was slightly above their expectations. That said, my contacts generally indicated that they have not materially revised their outlooks for the remainder of 2018 and 2019.

Even against a backdrop of tax reform and fiscal stimulus, what we hear from business leaders is that they have not yet bought into a significant and persistent pickup in demand beyond their current capabilities to meet that demand.

In that environment, we ought to shift into neutral. While there is some uncertainty surrounding estimates of neutral, as evidenced by the latest Summary of Economic Projections from the FOMC, my assessment is that we are still a few rate hikes away. At that point, after our policy foot is off the gas, but not on the brake, I will look to see if consumers and businesses continue to act in ways that do not suggest a buildup of excesses. If that continues, it will give me confidence that the economy is on a sustainable path.

Thank you for listening, and now I would be happy to take some questions.