The New Environment for Monetary Policy

Thomas I. Barkin
President, Federal Reserve Bank of Richmond

Greensboro Chamber of Commerce Economic Forecast Luncheon
Greensboro, North Carolina
November 13, 2019

Thank you very much for inviting me to join you this afternoon. Today, I'd like to talk with you about how I interpret current economic data through the lens of monetary policy. Please note that the views I express are my own and not necessarily those of my colleagues on the Federal Open Market Committee (FOMC) or in the Federal Reserve System.[1]

Economic Outlook

Before I talk about the data, let me say a few words about my background and perspective. I joined the Richmond Fed almost two years ago after a 30-year career in consulting at McKinsey, where I had roles including chief financial officer and leading our offices in the South. I've spent my professional life helping firms make decisions about hiring, compensation and prices, and I've made a lot of those decisions myself. So I hope I'm bringing a different perspective to the FOMC. My colleagues on the committee are some of the most talented macroeconomists, bankers, academics and financial regulators in the country. But as the only committee member coming from management, I approach things differently.

So what am I seeing? Overall, I believe the economy remains healthy. GDP growth was 1.9 percent in the third quarter. It has averaged 2.3 percent year to date, which is above the trend of around 2 percent you'd estimate from the sum of population and productivity growth.

That growth is being strongly supported by consumers. Households are spending, and that's important because consumer spending accounts for nearly 70 percent of GDP. Housing demand has rebounded over the past several months, and auto spending has continued to be strong. Both of these are reliable indicators of the strength of consumer mindsets. And even with some recent drops, consumer confidence is near all-time highs.

What's behind that confidence? Primarily, it's the strength of the labor market. The unemployment rate is near a 50-year low, at just 3.6 percent in October. In fact, there are roughly 1 million more job openings than there are people looking for work; and there have been more jobs than job seekers since March of last year, the first time that's happened in the 20-year history of this data series. Initial claims for unemployment insurance, a rough measure of layoffs, are as low as they've been since the late 1960s in absolute numbers, despite population growth. And wages are increasing while inflation remains muted. In October, wages were up 3 percent over the year before, while inflation has been running around 1.7 percent, just under our 2 percent target. These increases in real wages matter.

Although job growth has slowed some, which you'd expect to see as we near trend and markets tighten, we're still averaging nearly 170,000 new jobs per month this year. That's above "breakeven"—the Atlanta Fed estimates we need 107,000 jobs per month to maintain current unemployment levels. So, the economy remains sound.

There are headwinds, though, mostly driven by uncertainty around trade and politics. Between Brexit, the Middle East, immigration, and the ongoing negotiations with China—to name just a few—it's been a roller coaster both here and abroad. And we're seeing international economies struggle. GDP growth has slowed in China and stalled in the eurozone. In the second quarter, growth was actually negative in Germany, Europe's largest economy. There's a risk that weakness will affect us. Here at home, manufacturing activity has slowed amid trade concerns.

Against this background, it's not surprising that we've seen weakness in business investment. It shrank 3 percent in the third quarter. And the bond market has sent some concerning signals lately. The yield on 10-year Treasuries has been very low given the overall strength of the economy and has actually been lower at times than the yield on 2-year Treasuries. As you probably know, such an inversion of the yield curve is historically a good predictor of a recession. But is that what the yield curve is signaling now, or are we just seeing a move toward higher-yielding safe assets at a time when international rates are historically low?

Overall, I think it's safe to say the economy is giving us conflicting signals. The strength of consumption and the labor market might be saying "hold" or even "raise rates," while the softness of investment, inflation and the bond market might be saying "lower rates." How have policymakers thought about it?

In 2018, the risk seemed to be the economy "overheating." With interest rates well below "normal" levels, strong GDP growth, fiscal stimulus and a tight labor market, we raised the target rate four times, with many FOMC participants projecting additional rate increases the following year. But in early 2019, political and global turmoil signaled more risk to the downside. The committee decided to pause and take a patient approach, with a much flatter projected rate path.

Then, with inflation muted, continued uncertainty and international weakness, we lowered the target rate 75 basis points over the past three meetings. The FOMC's decision to lower rates doesn't mean a recession is imminent. But it does reflect the fact that there is a lot of uncertainty about the outlook, particularly with respect to global growth and the impact of trade. So it seems prudent to take out some "insurance," as Chair Powell said in July. A year ago, FOMC participants were projecting 2020 rates more than 130 basis points higher than their most recent [SEP] projections. That's powerful support for our economy.

The New Environment

Now, let's take a step back from the data and recognize that monetary policy is operating in a new and different environment.

What do I mean by that? When I was in school, I learned about both monetary policy and fiscal policy. The key fiscal policy levers were spending and taxation. But today, I think we have to broaden the definition of fiscal policy to incorporate the climate for business. That includes trade actions and trade uncertainty, regulatory changes and regulatory uncertainty, geopolitical challenges and domestic politics.

With the roller coaster I mentioned, it's been tough for businesses to feel like they're on solid ground. Economists from Northwestern, Stanford and the University of Chicago have developed an "economic uncertainty index" that gauges the degree of uncertainty in 24 different countries. Their "global" index hit its all-time high in August.[2] In the third quarter Duke CFO survey, more than half of CFOs said they were less optimistic about the U.S. economy than they had been the previous quarter.

The climate for business is already a challenge. Tariffs are taxes and—unless businesses shift their supply chains—impose direct costs on target industries. International economies are struggling as they try to adapt to changes in the global trade regime that the United States created after World War II. When financial markets react to the news cycle, as they did earlier this year, you see an impact on consumer spending. And health care regulation has to be affecting health care firms' investment plans.

Uncertainty is having an impact too. Uncertainty raises the threshold for action.[3] It dampens business confidence, which can lead to lower investment, less hiring and potentially even less confidence in pricing. After all, how can you invest when you don't know the rules? Hearkening back to my days as a CFO, I think of it as equivalent to an increase in investment hurdle rates. Firms today are frustrated with political polarization and uncertainty about regulation. They tell me they're not scaling back yet, but they're reluctant to double down. For these reasons, I don't discount the idea that we could talk ourselves into a recession—particularly if the uncertainty begins to affect consumer confidence and spending.

Uncertainty also lessens the effectiveness of traditional policy, both fiscal and monetary. For example, the country is running historically large deficits, and Congress passed a significant tax cut in late 2017. Normally, one would imagine these traditional fiscal policy levers should boost the economy. In early 2018, we did see strong growth and an investment boom. But those numbers dropped quickly as trade concerns came to dominate the headlines and outweighed the impetus from fiscal stimulus.

Turning to monetary policy, uncertainty can also dampen the impact we might expect from any policy “stance.” We typically think that accommodative monetary policy stimulates the economy. But in the presence of high uncertainty—nearly all of which is generated by forces extraneous to what the FOMC does—we risk not getting the same “bang for the buck.” The stimulus could be outweighed by perceived risks to future cash flows. We might also view an accommodative monetary policy stance as powerful in shaping financial market valuations. But again, high uncertainty scrambles the signals. Financial markets are being moved by trade these days rather than by our policy stance.

Policy Options

If the current uncertainty is temporary, then the right course of action is to see through it the way we might see through movements in the more volatile components of inflation. The divergence we see between strong consumption and weaker investment may well be signaling that the uncertainty won’t persist. The recent headway made on trade negotiations may lessen our downside, as might the progress being made in the Brexit negotiations.

But if we’re in a more uncertain environment for the long term, we’ll have to recognize that even though we have tools to use, they’re potentially less effective. For that reason, I’m closely monitoring whether the recent “insurance” the FOMC purchased will have its intended effect.

More broadly, the Fed is undertaking a review to ask if we have the right monetary policy strategy and tools to achieve our dual mandate, given low inflation and the risk of returning to the zero lower bound in the current environment. A number of topics are on the table, including “makeup” strategies for inflation shortfalls, balance sheet policies, forward guidance and communications strategies.

I won’t go into detail about these various options today, but I will say that in general I’m hopeful we can develop a portfolio of tools to help us support the economy, as I’m skeptical that any one tool can truly overcome significant fiscal headwinds.

That’s why, in my view, it’s even more important to step up on the fiscal side and improve the climate for business. The biggest boost to our economy would come from lessening the uncertainty and lowering the volume. That would build business confidence, build consumer confidence and lead to increased investment, spending and hiring. Look at the market reaction when it seemed like there was a Brexit deal. Originally, leaving the eurozone was viewed as a calamitous choice. Now, markets are so relieved that the rules are clear, they reward the decision. American businesses are creative. Give them the rules—almost any set of rules—and they will make things happen.

The Future

Where do we go from here? I actually don't have an answer to that question. But I think we face three meaningful conflicts that I am watching closely. First, U.S. consumer spending is strong, but U.S. investment is weak. The leading indicators are still robust, as I said, but will that remain the case if business investment weakens further? Second, the U.S. economy is strong, but international economies are weak. I heard an economist say that historically, we don't import recessions—we export them. But will that still be the case in our increasingly globally connected economy? Third, the bond market is pessimistic, but the stock market is still upbeat. Experience says to listen to the bond market—but is the bond market sending us the same signals it used to when rates are so low?

Those are enough questions from me. Now, I'd love to hear yours.

---

[1] Thank you to Jessie Romero for assistance preparing these remarks.

[2] Scott R. Baker, Nicholas Bloom, and Steven J. Davis, Economic Policy Uncertainty Index.

[3] Nicholas Bloom, "The Impact of Uncertainty Shocks," *Econometrica*, May 2009, vol. 77, no. 3, pp. 623-685