Confidence, Expectations and Implications for Monetary Policy
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Good morning. Thank you very much for inviting me to speak with you today. I'd like to start by telling you a little bit about my background and my perspective. Then I'll share some thoughts on the economy and the Federal Reserve's progress on meeting our dual mandate objectives. I'll close with some comments on the implications for monetary policy. Before I say more, I have to 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]

I joined the Richmond Fed last January 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.

Consumer and Business Confidence

One thing I've learned, both from my experience in business and from my time at the Fed, is that confidence matters. As a consultant (and as a CFO myself), I saw clearly that confidence was critical for businesses to want to invest and for markets to be willing to finance that investment. Now, I hear the same thing as I meet with business leaders throughout my District.

It's true on the consumer side as well. Common sense suggests—and economists have shown—that confidence is also essential for consumers to spend on big-ticket items. A sudden pullback in their expectations could easily affect consumer spending.

I also believe that today confidence is both more important and more volatile than it used to be. Both good and bad news diffuse significantly more quickly and broadly. We surf the news on our phones 10 times (or more!) per day, and the business media is everywhere, even on planes. But more news doesn't necessarily equate to more confidence.

Relative to a few decades ago, consumers are more exposed and therefore more sensitive. They're more directly invested in the stock market, particularly in index funds that move with the market rather than with company fundamentals. Many households might also still be scarred from the Great Recession; overall, they are saving at rates twice what they did in 2007.

In addition, the business reaction function has gotten faster. Short-termism has increased as activism in the market for corporate control has shifted companies' focus. Just as with consumers, I think firms' resilience is down. They start with lower confidence—another "hangover" from the Great Recession. At the same time, businesspeople tell me the length of the current upturn makes them nervous that another recession might be right around the corner.

The speed of the reaction function may be exacerbated by higher leverage. Corporate debt as a percentage of GDP is at an all-time high. Levered companies—and their creditors—have a bias toward taking action on negative news. This can mean cutting costs, reducing staff or pricing for volume.

Taken together, all these factors lead to an asymmetry in which firms are much more cautious about the downside than they are optimistic about the upside.

Perhaps both consumers and businesses have a higher bar for spending decisions. It's possible that some of the tepid recovery from the Great Recession was a self-fulfilling lack of belief in the strength of the economy. Firms' fear of failure could have prevented them from making investments even in the presence of reasonable returns.

This negative tilt, or asymmetry, continues today. Firms are frustrated with political polarization and uncertainty about trade and regulation. This limits their pricing courage and caps the upside on their spending and investment decisions.

For these reasons, a drop in confidence could lead to lower investment, lower output and eventually lower employment. If employment is placed at risk, consumption won't be far behind. And that would place us in more serious difficulty. Put another way, I don't discount the idea that we could talk ourselves into a recession.

Economic Outlook

In fact, I think the economy is struggling with confidence today.

2018 was great. The unemployment rate reached historic lows, the economy added an average of more than 220,000 jobs a month, inflation ran for a time at our 2 percent target and GDP growth was stronger than it has been in years. But as we entered 2019, I started to hear a lot of concern. The times were good, but the mood was bad.

There were certainly a number of things to be uncertain about, including trade tensions, a slowdown in China, Brexit and market volatility, to name just a few. And especially in the United States: politics. The federal government shutdown hit confidence hard, and I believe this impacted the numbers at the beginning of the year.

But the shutdown ended. Brexit was delayed. Trade deals looked to be settling. International economies seemed on the mend. Markets bounced back. Perhaps the FOMC's shift to a patient stance helped. Accordingly, we saw consumer confidence indices bounce back and that showed up in the consumption data. Consumers still feel confident, have jobs and are willing to spend.

But the roller coaster for business confidence continues. Trade tensions have escalated again, and threats of Mexico tariffs hit business confidence hard—how can you manage your supply chain when you don't know what its cost will be? Mexico may have seen a reprieve most recently, but uncertainty remains around trade talks with the European Union, Japan and, of course, China. And, if tariffs are indeed a tool for a variety of objectives, we will be in a persistently more uncertain place.

More broadly, Brexit is back, with the potential to be even messier than we were anticipating. International economies are weakening again. The federal debt ceiling hasn't been lifted. And, even more than a year out from the next presidential election, I hear business leaders getting nervous about the political noise. All these anxieties have the potential to build.

All told, business confidence is fragile, uncertainty is increasing and I'm increasingly concerned about both. If they deteriorate further, that could affect growth, investment, pricing and employment.

Inflation

In the presence of fragile confidence, what can a central bank do? We can aim to deliver on our mandates for maximum employment and price stability, which in turn create an environment stable for businesses and stable for consumers. In such an environment, few consumers face the risks of job loss and disruption. Low and steady inflation makes tomorrow's prices uninteresting, so that business as usual can continue today.

At present, I think it's safe to say we are doing well on our employment mandate. Of course, there are still people who want to work who can't find a job and troubling disparities across racial, ethnic and regional lines—but overall, the labor market is historically strong.

With respect to price stability, core PCE inflation has been running persistently below our 2 percent target. To be frank, I'm torn as to how large a concern this presents. On one hand, some of the current low inflation is due to transitory factors, such as changes in the methodology for calculating apparel prices. Part is also due to the first quarter "confidence shock" I discussed, which likely limited firms' pricing courage.

On the other hand, running systemically below the target feels like a problem that should be addressed. But, if you will give me a third hand, if we just reported with no decimals, we would be at target and would have been in most years.

You might say we're a victim of our own high standards. I'm old enough to remember the 1970s and 1980s and the painful lengths the Fed went to in order to tame inflation. Running within a few tenths of a point of target would have seemed unimaginable to the Fed leaders at that time. Looking at the big picture, inflation has been, and continues to be, low and steady and not the concern of businesses nor consumers—and that is the real goal.

Let me turn now to some of the factors that determine inflation. The standard economic theory is clear enough about the short run: Interest rate moves affect the real economy, with some lag. In turn, these changes in the real economy affect inflation through the Phillips curve. As firms pay more for labor, they raise prices accordingly. Over the longer run, credible monetary authorities set and build a track record of delivering against inflation expectations, which become a benchmark for businesses and consumers.

I was in business for 30 years. How do I think inflation works in practice?

Most companies in most industries have settled pricing routines that are slow to change. These routines begin with inflation expectations and are also grounded in what firms perceive about their competitors' and customers' reaction functions. Costs matter, of course, as the Phillips curve implies, and are particularly important when they're highly visible and industry-wide, as in the case of steel tariffs or a spike in oil prices. But right now, the Phillips curve doesn't look to be having the effect on pricing one might expect. Part of that is perhaps because the labor share of content has declined in many industries, making labor costs less of a factor.

I would also point to what firms perceive about their ability to raise prices for their customers. This isn't a big issue in many service businesses, like construction or a barber shop, where higher wages create a margin squeeze that more directly drives higher prices. But it's worth taking a look at consumer goods, particularly durable goods, where inflation has been basically nonexistent for 25 years. Big-box stores have taken share by building their strategy around low prices, and they achieve that strategy by exerting significant pressure on their suppliers. Firms' purchasing departments have become increasingly sophisticated, leveraging global supply chains and private label alternatives. Internet transparency has made it easy for consumers to shop around and for new entrants to challenge established firms on price. And, as I've discussed, even with inflation expectations well-grounded for the economy as a whole, lack of confidence can affect firms' willingness to raise prices in their particular sector.

But corporate margins are up. How can this be happening when prices are being squeezed? Firms are investing significantly in efforts to capture more "effective" prices without raising list prices. Reducing the thread count in a sweater, introducing new "premium" products, reducing discretionary terms or adding on extra fees have all been ways firms have been able to maintain or even increase their margins without raising prices. Our metrics reflect some, but not all, of these practices.

Implications for Monetary Policy

What are the implications of this for monetary policy?

Expectations are deeply grounded in firms' pricing routines. This became clear in 2009 during the downturn when prices didn't drop as much as one might have feared and again last year when they didn't increase as much as expected, despite a strong economy. Expectations are very hard to shift. Recognize this as success, not failure.

As a result, short-term interest rates are a blunt instrument. I do believe they work over time but with long lags and an imprecise impact. Small rate moves are unlikely to do much to move settled routines. And large moves run the risk of targeting 2 percent but delivering 4 percent.

What's happening sector-by-sector in the real economy can help or hurt the transmission of any rate moves. Right now, with productivity up relative to the past few years, accommodation is not having its usual effect. The consumer sector factors I discussed earlier also dampen inflation today, as do health care regulation, the decline in unionization and industries (like utilities) that passed tax cuts on to customers. There is some potential offset from tariffs; but retaliatory tariffs and resulting industry overcapacity could take pricing the other way. Net, today, these “real” drivers may be having a much more significant impact than monetary ones.

As a result, humility is a monetary policy virtue. The data aren’t perfect, and inflation may well be closer to target than one might think, as suggested by measures like the Dallas trimmed mean. It strikes me as tricky to intervene in pursuit of an imprecise benefit; if one tries too hard to use low rates to get reflation, you might end up, not for the first time, with excess leverage and frothy valuations. And, with the Phillips curve so “flat,” there are likely especially long lags in the effects of rate moves. The FOMC shifted its stance in January; it will take inflation some time to react to the significant flattening signaled in the future rate path—even as we may experience even lower unemployment.

I want to help lower the volume. The more one says you’re short of target, the more you risk convincing people that you won’t hit that target. Firms don’t move their expectations a tenth of a point at a time, they move them in whole numbers. In that context, inflation expectations are pretty stable. I hope to help keep them that way by not messaging a self-fulfilling prophecy.

Finally, we all have to avoid complacency. The Fed has worked hard over the past three decades to keep inflation expectations anchored, but as future generations forget about the Great Inflation, we have to remember that anchored expectations are not a right—they are earned. An economy can run so hot for only so long before creating conditions you’ll regret.

The Fed held a recent conference on potential monetary policy frameworks. The perspectives just outlined inform my views. I support changes that acknowledge the imprecision of what the FOMC is trying to do, say by establishing a target range for inflation and looking at multiple metrics, as Canada has done. But I’m wary of trying to do too much. I’m not yet convinced about strategies (beyond zero lower bound forward guidance) that commit to taking actions in the future. Will those strategies really be understood and believed? Given settled routines and embedded expectations, will they have the desired impact? And if not, what will future policymakers be signed up for? I note the research that suggests multiple equilibria given the zero lower bound[2] and fear that moving too quickly while focused on inflation risks could, in turn, focus attention on inflation in ways that lower expectations, creating a low rate/low inflation scenario like that found in Europe and Japan.

Now, the question you're really waiting for me to answer—what does all this mean for the path of interest rates? In my view, with inflation muted, there isn't much case for stepping on the brakes. With unemployment so low and consumer spending so healthy, it's equally hard to make a case for stepping on the gas.

As I've discussed today, I don't see the current levels of inflation or inflation expectations as a trigger for additional accommodation. The potential to use rate changes to alter firms' settled routines is small, and the potential cost of overreaching, as I outlined earlier, feels real.

That said, I am tracking closely the environment for growth, which includes not only hard data, but also the softer—and vital—information on consumer and business sentiment. If confidence falters sharply, I would certainly make the case to my peers that we should pay attention to it and do what we can to support continued economic expansion.

Thank you, and I look forward to your questions.

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

[2] Jess Benhabib, Stephanie Schmitt-Grohé, and Martín Uribe, "The Perils of Taylor Rules," *Journal of Economic* Theory, January 2001, vol. 96, nos. 1-2, pp. 40-69.