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Monetary Policy and the Economic Outlook: A Fine Balancing Act

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The economy is in a good place. Unemployment is low and confidence is high. The challenges to address are good ones: keeping the expansion going, bringing inflation up to its 2% target, and using this period to normalize monetary policy in general and interest rates in particular. The years ahead will require a balanced approach, guided by the data. The following is adapted from remarks by the president and CEO of the Federal Reserve Bank of San Francisco at the 54th Annual Economic Forecast, Phoenix, AZ, on November 29.

Today I'm going to talk about current conditions in relation to growth and employment, and I'm going to shed some light on the number one topic of the day for U.S. monetary policy: the fact that inflation remains stubbornly low despite a strong economy. I'm then going to give my perspective as a policymaker and explain what that means for how I approach my work at the Federal Reserve Bank in San Francisco and at the Federal Open Market Committee, or FOMC.

When people think about the Fed, they tend to think about us as getting up in the morning and setting interest rates. But what many people don't realize is we do that within a specific framework and we're guided by a long-term strategy (Board of Governors 2017).

The Federal Reserve System has two goals, both set by Congress: maximum employment and price stability. We lay out our strategy for achieving these goals in regular statements. At the moment, we're in particularly interesting times because there's a certain tension between our two primary objectives: It's a balancing act managing a growing economy with very low inflation.

And that's something I'm going to go into detail on: How policymakers deal with the pleasant challenge of a strong economy and minimal inflation.

Economic outlook

So, what is the current state of the economy? I'm going to take growth, employment, and inflation each in turn.

Despite the terrible human tragedy caused by recent hurricanes in the Southeast and the wildfires in my home state of California, the economic expansion remains on track. I see the economy continuing on a moderate growth path over the next few years. Our overall measure of the economy, gross domestic product or GDP for short, grew at an annual rate of 3% in the third quarter based on the initial estimate, and I forecast growth will average 2.5% for 2017, before slowing back down toward its trend pace over the next few years.

My role as a policymaker is to keep this expansion going for as long as possible, and that means maintaining a sustainable pace of growth consistent with labor force and productivity growth.

If you weren't overly impressed with my GDP figures, you should be blown away with the unemployment rate, which stands a touch above 4%. We've not only achieved our maximum employment goal, we've exceeded it. It may sound strange to say that we can exceed full employment when four out of every hundred potential workers is unemployed. But the way economists think about unemployment is that, even in a very strong economy, there will always be a certain number of people who are either between jobs or who have recently joined the labor market. Although we'll never reach an unemployment rate of zero, a rate in the 4% range is clearly a sign of a very strong labor market.

We're on track to add 2 million jobs to the economy this year and with continued strong momentum in the labor market, I expect the unemployment rate to continue to drift downward, bottoming out at around 3¾% next year.

As I said earlier, one of the Fed's two monetary policy goals is maximum employment, so our report card's looking very good on that front.

The other goal is price stability, and this is where we've faced some challenges. The inflation goal we've set for ourselves is 2%, but over the past few years it's remained stubbornly below that and currently stands at 1.6%. Now, let's be honest: Most Americans are very happy with the status quo. They have no desire to see prices rise rapidly and neither do I.

In fact, there's something called the misery index, which is a combination of inflation and unemployment. The higher that number, the more miserable people tend to be. The misery index has been running at 6½% so far this year. For context, in 2011 when we were dealing with the fallout of the crisis it was around double that figure and in 1980, if you can remember those dark days, it reached an all-time peak of over 20%. The average American should be far from "miserable" about the current state of the economy.

But for policy wonks and economists, low inflation against a backdrop of such strong employment numbers seems a bit surprising. The newspapers would have you believe that it's a mystery of Sherlock Holmes proportions. However, at the Fed in San Francisco we've done some good old-fashioned detective work and we're fairly sure we have a handle on why it's so low (Mahedy and Shapiro 2017).

My staff found that inflation rates for prices that tend to move up and down with the economy have recovered. But inflation for things that tend to be less sensitive to the economy have fallen or remained low. This includes price drops for pharmaceuticals, airline tickets, cell phones, and education. For example, Verizon and AT&T were in a price war for much of the early part of this year, which pushed down the cost of your phone bill.

An even bigger contribution to low inflation has come from the health-care sector, where mandated cuts to Medicare payment growth have muted price rises in overall health-care services.

On top of the lack of price rises in these categories, there tends to be a delay in the effect of a strong labor market on prices. It typically takes about 12 months for a shift in the economy to have its full effect on inflation. With the economy doing so well this year and based on the historical pattern, I expect to see a rise in inflation in 2018. In this regard, it's important to remember that things like salaries and contracts tend to be negotiated on an annual basis, so it often takes a while for wages and prices to respond to the tightening labor market.

So, the next time you see a headline about stubbornly low inflation, you can smile to yourself, knowing that the mystery isn't all that mysterious after all.

Monetary policy

Now that I've given you a deep dive into growth, employment, and inflation, I'm going to discuss what that means for how I think about monetary policy and interest rates.

The challenge for policymakers is that at present our two goals, maximum employment and price stability, are somewhat in conflict with one another. As I've explained, with such strong employment numbers we would normally expect to start seeing inflationary pressures building. But the unusually low prices of certain goods and services, combined with the lagged effects of the economy on inflation, means we have this unexpected situation where we're acing one goal, while struggling with the other.

The usual remedy for undesirably low inflation is to keep interest rates low. But to add to the complexity of the situation, the Federal Reserve is in the process of what we call "normalizing" monetary policy.

In practice this means slowly stepping back from the extraordinary support the Fed provided for the economy during the recession and thereafter. We are in the process of gradually raising interest rates and reducing the holdings of long-term assets on our balance sheet. Sometimes I get asked why we even need to normalize policy, when monetary stimulus had such a positive effect. Why not keep interest rates low, in the hopes of giving the economy a further boost?

But the reality is that, if we don't move interest rates back up to more normal levels, we risk undermining the sustainability of the expansion and creating conditions that could lead to a recession down the road.

As long as the data continue to show steady growth and we see the uptick in inflation that we're expecting, my own view is that we should continue to raise interest rates slowly over the coming year.

I started talking about the framework and goals for the Fed and the FOMC. That our two main goals are in conflict with one another means these are challenging times for policymakers. But I want to emphasize that these are the kinds of challenges we like to be faced with.

In the same way that there's a lag between a falling unemployment rate and its effect on inflation, the effects of the decisions taken by the FOMC next year may not be realized until 2019 or even 2020. So, at the Fed we use data to guide us and help us walk the tightrope between keeping the economy on an even keel and normalizing interest rates. Monetary policy is both a balancing act and a long game.

Conclusion

Ladies and gentlemen, the economy is in a very good place. Unemployment is low and confidence is high. While low inflation remains a challenge for someone in my position, I imagine most of you aren't overly concerned about a 1.6% inflation rate!

As we wrap up 2017 and look ahead to 2018, the problems we face are good ones: How to keep the economic expansion going, how to bring inflation up to its 2% target, and how we use this period to normalize monetary policy in general and interest rates in particular.

The years ahead will be about taking a balanced approach, and my guiding principle will always be to follow the data.

I'd like to wish you a very happy holiday season, and a healthy and prosperous new year.

John C. Williams is president and chief executive officer of the Federal Reserve Bank of San Francisco.

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