Presentation to the Symposium on Building the Financial System of the 21st Century: An agenda for China and the United States
Armonk, NY
By John C. Williams, President and CEO, Federal Reserve Bank of San Francisco
For delivery on September 19, 2015

China, Rates, and the Outlook: May the (Economic) Force Be with You

Good afternoon, and thank you.

There are few certainties in life, but I was pretty sure that people were going to want to hear something about U.S. monetary policy today. It used to be that at cocktail parties, saying you worked for the Fed was the small-talk kiss of death. This is one of the few times in history people actually move *towards* Fed economists in social situations.

Since this is a conference on China, I will, of course, address that topic as well. But I've learned that if you bury the lede, it doesn't make people hang on your every word until you arrive at the good part—it just makes people fidget until you get there. So I'll start at home, with my views on the economic outlook and monetary policy, and then work my way to the other side of the globe.

Now is a good time to emphasize that the views expressed here today are mine alone and do not necessarily reflect those of others in the Federal Reserve System.

Economic outlook

The big headline is that the Federal Open Market Committee decided to hold off on raising interest rates this week. It was a close call in my mind, in part reflecting the conflicting signals we're getting. The U.S. economy continues to strengthen while global developments pose downside risks to fully achieving our goals.

Let me start with the unequivocally good news. Over the past five years, real GDP growth has averaged a little over 2 percent and the unemployment rate has fallen by nearly a percentage point per year. I expect that pace of recovery to continue, despite strong global headwinds. The unemployment rate is at or very near its longer-term normal, or natural rate, we're on pace to add 2.5 million jobs this year, and job vacancies are the highest they've been since they started collecting the data back in 2000. Given the progress we've made and the momentum we're seeing, we should reach full employment on a broad set of measures by the end of this year or early next year.

However, inflation is still lower than I'd like. Based on my favorite measure—the trimmed mean—the underlying rate is stable at just over 1½ percent. To understand why inflation has remained low despite an economy nearing full employment, we have to look beyond our shores. The rise of the dollar and the fall in oil prices over the past year have lowered import prices and pushed the inflation rate down. Based on past experience, these effects should prove transitory. As they dissipate, I see inflation moving back up to our 2 percent inflation goal in the next two years.

There are some upside risks to my forecast, specifically an even stronger and faster rebound in housing and a spending boom from lower energy prices. So far, lower oil prices haven't caused much of a surge in consumption, but as people get used to paying less, that could change. And there are, of course, the downside risks: The dollar could appreciate further and there's the threat of slowdowns and spillovers from abroad.

On raising rates

Regarding monetary policy, we're balancing a number of considerations, some of which argue for greater patience in raising rates and others that argue for acting sooner rather than later. Our decisions reflect a careful judgment about the relative risks and merits of those factors.

I’ll start with the arguments for continued patience in removing monetary accommodation. First, we are constrained by the zero lower bound in monetary policy and this creates an asymmetry in our ability to respond to changing circumstances. That is, we can’t move rates much below zero if the economy slows or inflation declines even further. By contrast, if we delay, and growth or inflation pick up quickly, we can easily raise rates in response.[1]

This concern is exemplified by downside risks from abroad. One such risk is the financial turmoil and economic slowdown in China, which I’ll get to shortly. More generally, economic conditions and policy overseas, from China to Europe to Brazil, have contributed to a substantial increase in the dollar’s value, which has held back U.S. growth and inflation over the past year.[2] Further bad news from abroad could add to these effects.

That brings me to inflation, which has been under our target for over three years. This is not unique to the United States—inflation is very low in most of the world. Although we can ultimately control our own inflation rate, there’s no question that globally low inflation, and the policy responses this has provoked, have contributed to put downward pressure on inflation in the U.S. Although my forecast is that inflation will bounce back, this is only a forecast and there remains the danger that it could take longer than I expect.

Those are arguments on the side of the ledger arguing for more patience. On the other side is the insight of Milton Friedman, who famously taught us that monetary policy has long and variable lags.[3] I use a car analogy to illustrate it. If you’re headed towards a red light, you take your foot off the gas so you can get ready to stop. If you don’t, you’re going to wind up slamming on the brakes and very possibly skidding into the intersection.

---

[1] Evans et al. (2015).
[2] See, for example, Amiti and Bodine-Smith (2015).
[3] Friedman (1961).

In addition, an earlier start to raising rates would allow us to engineer a smoother, more gradual process of policy normalization. That would give us space to fine-tune our responses to react to economic conditions; raising rates too late would force us into the position of a steep and abrupt hike, which doesn't leave much room for maneuver. Not to mention, it could roil financial markets and slow the economy.

In considering the monetary policy choices, it's important to remember that we're in a very different place now than when we first instituted extremely accommodative policy. The economy has come a long way since the dark days of late 2009, when unemployment hit its 10 percent peak. Now we're down to 5.1 percent and we've added over 12 million jobs, more than three million of them last year. Even better, most of those were full-time. It's been a tough journey back, and monetary policy has played a crucial role in healing a once-ailing economy.[4]

In the past, I have found the arguments for greater patience to clearly outweigh those for raising rates. The labor market was still far from full strength and the risk to the recovery's momentum was very real. As the economy closed in on full employment, the other side of the ledger started gaining greater weight and the arguments have moved into closer balance.

Looking forward, I expect that we'll reach our maximum employment mandate in the near future and inflation will gradually move back to our 2 percent goal. In that context, it will make sense to gradually move away from the extraordinary stimulus that got us here. We already took a step in that direction when we ended QE3. And given the progress we've made and continue to make on our goals, I view the next appropriate step as gradually raising interest rates, most likely starting sometime later this year. Of course, that view is not immutable and will respond to economic developments over time.

China

[4] See Swanson and Williams (2014) and Williams (2014).

Which brings me, in a roundabout way, to the subject of China. You always want to avoid pontificating to a roomful of experts, so let me be clear that my view of China is through the lens of a U.S. policymaker.

China has garnered almost as much editorial ink in the past month as U.S. presidential candidates—which may or may not be a complimentary comparison. I don't want to sound pejorative by calling some of the commentary "hand-wringing"—though to be fair, some of it has been downright apocalyptic—but I don't see the situation as dire. I've said publicly over the past few months that after going to China, and after talking to academics and officials there, I came away a lot less concerned than when I arrived. And I have to say that recent events have not changed my thinking to any serious extent.

This is where I'll reuse one of the more helpful quotes for forecasting: "It's difficult to make predictions, especially about the future." With the dangers of prognostication acknowledged, I'll tread into that territory anyway.

The China story is remarkable, and its growth over the past 30 years has been unprecedented.[5] But now China's at something of a crossroads, facing tradeoffs in their goals, dealing with a new normal for growth expectations, and pivoting to a new source of economic momentum.

It's important to see the situation not through the filters of our own paradigms, but from the perspective of China's unique position. China is not the U.S. Or the U.K. Or Japan. Its goals, structure, government, and place on its growth trajectory are very different, and looking to impose foreign expectations on China's markets or actions can lead one astray.

Growth versus reform

[5] See Zhu (2012).

In a nutshell, China is facing a tradeoff between its short-term growth goals and its longer-term reform agenda.

China's government has made it abundantly clear that it is willing to intervene when necessary, ensuring that growth stays on its target path, even if that means extending the timeline on reform. That willingness to do "whatever it takes" to keep growth on target is what made me less worried about a hard landing for China.

Of course, that very disposition for intervention is the source of much hue and cry on this side of the globe. China has made important incremental steps on the road to liberalization, and from the perspective of a fully open, free-market, Western-oriented paradigm or advocacy, the recent stock market interventions seem anathema to that goal. But that's a view through a narrow lens that may obscure the bigger picture.

For all its moves towards liberalization, China's markets are not the same as ours. Yes, they have a reform agenda, but it's a mistake to think that in the foreseeable future China will have fully open capital and financial markets in the way that we in the U.S. and other countries think about them. They are relaxing their grip on the exchange rate—allowing the renminbi to respond to economic news, letting its value be more market-determined—and as a policy approach, this is a positive; it's something we as economists wanted to see happen. But it's very clear that China is not going to let its exchange rate float completely freely. They'll continue to have buffers to ensure that, should some dramatic event unfold, they can step in again and stop that interfering with their other goals. To some extent, we can see these moves as something akin to beta-testing liberalization. It is happening, which is a remarkable shift. But completely free, open markets are not in the cards, and the government has made clear that those are not their intention.

This, incidentally, is why talk about the renminbi replacing the dollar as an international reserve currency is unrealistic. The role of a reserve currency is to be a harbor during a storm; it's where people flock when the unexpected happens. As we saw in the financial crisis, as we've seen in other crises, the market's instinct is, when in doubt, go to the dollar. As long as China has controls in place to mediate the free flow of money, the dollar will be the refuge, not the renminbi.

In the context of China's dual—oftentimes conflicting—goals, the recent stock market intervention by the government should be seen as what I believe it was: A move to keep growth on pace. It's a pattern we've seen before. When the Chinese authorities see growth struggling, or other economic warning lights, they take steps, including reversing or postponing reforms, to keep growth at pace. Fiscal and economic policymakers can pull a number of levers and the Chinese government has proved again and again its willingness to do just that.

China's growth rate

In balancing these objectives, the Chinese government has realistically moderated its expectations for growth. For decades we all marveled at China's double-digit growth, and there was, perhaps, some expectation that it would persist in perpetuity. But growth like that is unsustainable. If you look at the progression of Japan, for instance, from the 1960s to the 1980s, or South Korea from the 1980s to the 2000s, you see the pattern China will likely follow.[6] At low income levels, growth can be rapid, because low domestic wages make exports very competitive and there is so much untapped potential in moving workers to more productive pursuits.

But as income or GDP per capita rise, these advantages begin to ebb, and growth naturally slows. The pattern is clear, with a rapid decline in the growth rate and eventual leveling out as domestic income and wages rise. This is the natural progression of economies moving into

[6] Liu (2015)

maturity. The further they have to go, the faster they can grow; but once they've come to a place like Japan or Korea—that is, around 80 or 90 percent of U.S. per capita GDP—their growth expectations will be lower because they're closer to the finish line. China obviously isn't close yet, but it's a good indicator of how much further it can go. What China's accomplished has been amazing—but we also called Japan a growth miracle and Korea's success was remarkable as well. There were challenges along the way for both countries, but ultimately, what slowed growth was entering the middle-income bracket and the inevitability of slower growth for wealthier countries.

The officials and economists I spoke to in China know that not only are the days of 10 percent growth behind them, but that it will move below the current 7 percent target. Seven will likely become 6, which will become 5, and so on as their economy moves into a middle-income economy and progresses to a high-income one.

Shift in focus

Of course, China faces challenges in continuing that advance. One is a refocus of its economic engine. Given the global environment, how do they successfully pivot their economy to more domestic consumption, moving the emphasis more toward services and away from manufacturing? That's clearly a challenge, but also a central objective of the government.

For people who have concerns about China, one of the red flags they point to is that industrial production has slowed a lot, more so than the economy overall. I fall on the side of commentators who've pointed out that this isn't surprising.[7] China's been talking for years about switching from industry to services. They're moving from making steel and concrete to making consumer goods. One of the interesting things I heard this summer was the plan to build more tourism in China for China. That's something that's virtually nonexistent at the moment. They

[7] See, for example, Lardy (2015).

don’t have the abundance of recreational resources we do; in California alone, you can go skiing or surfing, to wine country or Disneyland. As high- or low-brow as you want it, we as Americans have become incredibly used to spending our leisure dollars domestically. That’s something China’s looking to do for itself.

When you look at where China’s priorities lie—in switching to services, in expanding tourism—it makes absolute sense that industrial production is slowing.

Liberalization and the impact of risks from abroad

I’ve mentioned that China is seen by some as a risk; but conversely, what effect does U.S. policy have on them? Right now, China is more susceptible to the shifts in U.S. monetary policy. But as they liberalize their exchange rate, it will automatically adjust to changes in situations around the world. This is a huge advantage and an automatic stabilizer. When China pegs to the dollar, they’re too linked to U.S. policy, so that when the U.S. tightens or loosens, they effectively follow suit. By allowing market-based influence, China will have a buffer when the U.S. economy is moving in a different direction than theirs. And that’s going to make it easier in the end for China to manage its economy.

An outside observer might ask why they haven’t done this already. I think that China was wary that unpegging would’ve interrupted the double-digit growth. When a country’s exchange rate and capital flows suddenly start shifting around dramatically, it can interfere with the ability to deliver on growth targets. As China’s growth targets have come down, and as they begin to shift away from an export-reliant economy, instead fueling itself via domestic consumption, they can start allowing their exchange rate to move—though again, it won’t be the free floating exchange rate that we have.

Conclusion

This is all just one economist's take. As I said, it's difficult to make predictions. And to use another famous quote, "I'm not young enough to know everything." But I will say this: The U.S. economy is on solid footing and trajectory. Global developments definitely present significant challenges and risks, but overall I am quite positive about the outlook for the U.S. economy.

Thank you.

References

Amiti, Mary, and Tyler Bodine-Smith. 2015. "The Effect of the Strong Dollar on U.S. Growth." *Liberty Street Economics*, Federal Reserve Bank of New York. July 17. http://libertystreeteconomics.newyorkfed.org/2015/07/the-effect-of-the-strong-dollar-on-us-growth.html

Evans, Charles, Jonas Fisher, Francis Gourio, and Spencer Krane. 2015. "Risk Management for Monetary Policy Near the Zero Lower Bound." *Brookings Papers on Economic Activity*, March. http://www.brookings.edu/about/projects/bpea/papers/2015/risk-management-monetary-policy-zero-lower-bound

Friedman, Milton. 1961. "The Lag in Effect of Monetary Policy." *Journal of Political Economy* 69(5), pp. 447−466.

Lardy, Nicholas R. 2015. "False Alarm on a Crisis in China." *The New York Times*, August 26. http://www.nytimes.com/2015/08/26/opinion/false-alarm-on-a-crisis-in-china.html

Liu, Zheng. 2015. "Is China's Growth Miracle Over?" *FRBSF Economic Letter* 2015-26 (August 10). http://www.frbsf.org/economic-research/publications/economic-letter/2015/august/china-economic-growth-miracle-slowdown/

Swanson, Eric T., and John C. Williams. 2014. "Measuring the Effect of the Zero Lower Bound on Medium- and Longer-Term Interest Rates." *American Economic Review* 104 (10, October), pp. 3,154–3,185.

Williams, John C. 2014. "Monetary Policy at the Zero Lower Bound: Putting Theory into Practice." Working paper, Hutchins Center on Fiscal and Monetary Policy at Brookings. http://www.brookings.edu/research/papers/2014/01/16-monetary-policy-zero-lower-bound-williams

Zhu, Xiaodong. 2012. "Understanding China's Growth: Past, Present, and Future." *Journal of Economic Perspectives* 26(4), pp. 103–124.