

FRBSF ECONOMIC LETTER

2015-31

October 5, 2015

The Economic Outlook: Live Long and Prosper

BY JOHN C. WILLIAMS

The recent Federal Open Market Committee decision to hold off on raising interest rates reflected conflicting signals, with favorable U.S. economic conditions offset by downside risks from abroad. However, the economy continues to make progress toward achieving the FOMC's goals. If developments stay on track, the process of monetary policy normalization is likely to start later this year. The following is adapted from a presentation by the president and CEO of the Federal Reserve Bank of San Francisco to the UCLA Anderson School of Management in Los Angeles on September 28, 2015.

I'm always happy to come to Los Angeles. One of the great pleasures of being president of the Fed's 12th District is that it's probably the closest a kid who studied economics was ever going to get to the entertainment industry. But I was reflecting on my drive in that, after monetary policy being in the news for the past few weeks, for once, I have something in common with Hollywood: Everyone's a critic.

So today I'd like to discuss the outlook, monetary policy, and where I see us headed.

Economic outlook

I shouldn't have to issue a spoiler alert before I say that the Federal Open Market Committee (FOMC) decided to hold off on raising interest rates at our last meeting. I considered it a close call, in part reflecting the conflicting signals we're getting: On the one hand, the U.S. economy continues to strengthen and is closing in on full employment, while on the other, global developments pose downside risks.

The unequivocally good news is that the economic expansion is entering its seventh year with solid momentum. Over the past five years, real GDP growth has averaged a little over 2% 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.

Consumer spending is powering the economy. We've seen real consumer spending increase more than 3% over the past year and auto sales are on pace to reach 17 million vehicles this year—the highest level seen since the early 2000s. Strong fundamentals point to continued solid gains going forward: Despite the recent declines in the stock market, the ratio of wealth to income is close to all-time highs, household debt burden has come down considerably, and real income growth—helped by the drop in energy prices—remains strong. Business spending is on an upswing as well. Overall, I see real GDP increasing at a 2¼% annual rate in the second half of 2015, and GDP growth to be a little above 2% next year.

The labor market continues to improve as well. 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 or exceed full employment on a

broad set of measures by the end of this year or early next year. In particular, I expect the unemployment rate to fall below 5% later this year and remain there through 2016.

This brings me to the question of how to gauge what a healthy, full-employment labor market looks like. The most common metric is the “natural rate” of unemployment—the optimal rate we can expect in a fully functioning economy. Before the recession, it was generally thought to be around 5% (see Weidner and Williams 2011). Since then, there has been a lot of research examining whether the events of the past decade have pushed the natural rate up—say, due to an increasing skills mismatch between workers and jobs—or down, owing to changes in the demographic makeup of the labor force—that is, a greater representation in the workforce of groups that tend to have lower unemployment rates (Aaronson et al. 2015, Daly et al. 2012, and Lazear and Spletzer 2012). My assessment is that there has not been any lasting, significant shift in either direction. My estimate of the natural rate of unemployment today is 5%, consistent with pre-recession estimates. With the current rate at 5.1%, we are very close.

Turning to inflation: It is still lower than I’d like. Based on my favorite measure—the trimmed mean—the underlying rate is stable at just over 1½%. 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, and as the economy strengthens further over the next year, I see inflation moving back up to our 2% goal in the next two years.

There are upside risks to my forecast, specifically an even stronger and faster rebound in housing and a more pronounced 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: There’s the threat of slowdowns and spillovers from abroad, and the dollar could appreciate further.

On raising rates

These domestic and global developments have implications for monetary policy. We’re balancing a number of considerations, some of which argue for a little more 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 being a bit more patient in removing monetary accommodation. For one, 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 (Evans et al. 2015).

This concern is exemplified by downside risks from abroad. Economic conditions and policies from China to Europe to Brazil have contributed to a substantial increase in the dollar’s value. This has held back U.S. growth and inflation over the past year (see, for example, Amity and Bodine-Smith 2015). Further bad news from abroad could add to these effects.

Inflation has been below our 2% target for more than three years now. This is not unique to the United States. Although we ultimately control our own inflation rate, there’s no question that globally low

inflation, and the policy responses this has provoked, has contributed to downward pressure in the United States. As I said, my forecast is that inflation will bounce back, but this is just a forecast, and there is the risk that it could take longer than I expect. With inflation persistently running below our target, some argue that the need to start normalizing monetary policy is not pressing.

Those are some of the main arguments on the side of the ledger arguing for a little more patience. On the other side is the insight of Milton Friedman (1961), who famously taught us that monetary policy has long and variable lags. I like to 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.

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. In contrast, raising rates too late would force us into the position of a steeper and more abrupt path of rate hikes, which doesn't leave much room for maneuver. Not to mention, it could roil financial markets and slow the economy in unintended ways.

Finally, experience teaches us that an economy that runs beyond its potential for too long can generate imbalances that ultimately lead to either excessive inflation or an economic correction and recession. Two recent examples are sobering. In the late-1990s, the expansion became increasingly fueled by the euphoria over the "new economy," the dot-com bubble, and massive overinvestment in tech-related industries. In the first half of the 2000s, the economy became increasingly reliant on irrational exuberance over housing, resulting in house prices spiraling far beyond fundamentals and massive overbuilding. Of course, in both cases, those fantasies burst at great cost to our economy.

I want to be clear that, in raising concerns about the potential for imbalances, I'm not talking about fighting the last war. It is a more general point: When you have a high-pressure economy, with unsustainably high levels of economic activity for a long period of time, people may make decisions based on excessive optimism, rather than sound economic basics. That mentality can happen anytime, but it's emboldened by an economy that's on a tear.

I am starting to see signs of imbalances emerge in the form of high asset prices, especially in real estate, and that trips the alert system. One lesson I have taken from past episodes is that, once the imbalances have grown large, the options to deal with them are limited. I think back to the mid-2000s, when we faced the question of whether the Fed should raise rates and risk pricking the bubble or let things run full steam ahead and deal with the consequences later. What stayed with me were not the relative merits of either case, but the fact that by then, with the housing boom in full swing, it was already too late to avoid bad outcomes. Stopping the fallout would've required acting much earlier, when the problems were still manageable. I'm not assigning blame by any means, and economic hindsight is always 20/20. But I am conscious that today, the house price-to-rent ratio is where it was in 2003, and house prices are rapidly rising. I don't think we're at a tipping point yet—but I am looking at the path we're on and looking out for potential potholes.

In considering the FOMC's 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. We've added over 12 million jobs, more than 3 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 (see Swanson and Williams 2014 and Williams 2014).

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% 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.

What to expect when you're expecting a new normal

As we make our way back to an economy that's at full health, it's important to consider what constitutes a realistic view of the way things will look. The pace of employment growth, as well as the decline in the unemployment rate, has slowed a bit recently...but that's to be expected. When unemployment was at its 10% peak during the height of the Great Recession, and as it struggled to come down during the recovery, we needed rapid declines to get the economy back on track. Now that we're getting closer, the pace must start slowing to more normal levels. Looking to the future, we're going to need at most 100,000 new jobs each month (Aaronson et al. 2014). In the mindset of the recovery, that sounds like nothing; but in the context of a healthy economy, it's what's needed for stable growth.

As the next year unfolds, what we want to see is an economy that's growing at a steady pace of around 2%. If jobs and growth kept the same pace as last year, we would seriously overshoot our mark. I want to see continued improvement, but it's not surprising, and it's actually desirable, that the pace is slowing.

Conclusion

The economy is on solid footing and a good trajectory. There are risks, as there always are in life. And there's always the possibility of what British Prime Minister Harold Macmillan said when asked what worried him most: "Events, dear boy, events." But all in all, things are looking up, and if they stay on track, I see this as the year we start the process of monetary policy normalization.

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

References

- Aaronson, Daniel, Luojia Hu, Arian Seifoddini, and Daniel G. Sullivan. 2014. "Declining Labor Force Participation and Its Implications for Unemployment and Employment Growth." FRB Chicago *Economic Perspectives* 38 (fourth quarter), pp. 100–138. <https://www.chicagofed.org/publications/economic-perspectives/2014/4q-aaronson-etal>
- Aaronson, Daniel, Luojia Hu, Arian Seifoddini, and Daniel G. Sullivan. 2015. "Changing Labor Force Composition and the Natural Rate of Unemployment." *Chicago Fed Letter* 338 (May 8). <https://www.chicagofed.org/publications/chicago-fed-letter/2015/338>

- Amiti, Mary, and Tyler Bodine-Smith. 2015. "The Effect of the Strong Dollar on U.S. Growth." *Liberty Street Economics* blog, FRB New York, July 17. <http://libertystreeteconomics.newyorkfed.org/2015/07/the-effect-of-the-strong-dollar-on-us-growth.html>
- Daly, Mary, Bart Hobijn, Ayşegül Şahin, and Robert G. Valletta. 2012. "A Search and Matching Approach to Labor Markets: Did the Natural Rate of Unemployment Rise?" *Journal of Economic Perspectives* 26(3), pp. 3–26.
- 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.
- Lazear, Edward P., and James R. Spletzer. 2012. "The United States Labor Market: Status Quo or A New Normal?" In *The Changing Policy Landscape*, Proceedings of the 2012 Jackson Hole Economic Policy Symposium. Kansas City: Federal Reserve Bank of Kansas City. https://www.kansascityfed.org/publicat/sympos/2012/Lazear-Spletzer_final.pdf
- 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.
- Weidner, Justin, and John C. Williams. 2011. "What Is the New Normal Unemployment Rate?" *FRBSF Economic Letter* 2011-05 (February 14). <http://www.frbsf.org/economic-research/publications/economic-letter/2011/february/new-normal-unemployment-rate/>
- 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>

Recent issues of *FRBSF Economic Letter* are available at
<http://www.frbsf.org/economic-research/publications/economic-letter/>

2015-30	Can We Rely on Market-Based Inflation Forecasts? http://www.frbsf.org/economic-research/publications/economic-letter/2015/september/market-based-inflation-forecasting-and-alternative-methods/	Bauer / McCarthy
2015-29	Assessing Supervisory Scenarios for Interest Rate Risk http://www.frbsf.org/economic-research/publications/economic-letter/2015/september/assessing-basel-bank-supervision-scenarios-for-interest-rate-risk/	Christensen / Lopez
2015-28	Measuring Monetary Policy's Effect on House Prices http://www.frbsf.org/economic-research/publications/economic-letter/2015/august/measuring-monetary-policy-effect-on-house-prices-speech/	Williams
2015-27	Residual Seasonality and Monetary Policy http://www.frbsf.org/economic-research/publications/economic-letter/2015/august/residual-seasonality-and-monetary-policy/	Rudebusch / Wilson / Pyle

Opinions expressed in *FRBSF Economic Letter* do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco or of the Board of Governors of the Federal Reserve System. This publication is edited by Anita Todd. Permission to reprint portions of articles or whole articles must be obtained in writing. Please send editorial comments and requests for reprint permission to Research.Library.sf@sf.frb.org.