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Looking Back, Looking Ahead

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The U.S. economy is in good shape, with the labor market at maximum employment and inflation nearing the Fed's goal. Given the progress made on these goals and signs of continued solid momentum, it makes sense to gradually move interest rates toward more normal levels. The actual pace of increases will be driven by the evolution of economic conditions and its implications for achieving the Fed's dual mandate objectives. The following is adapted from a speech by the president and CEO of the Federal Reserve Bank of San Francisco to the 2017 Economic Forecast in Sacramento on January 17.

It's great to be back in my hometown of Sacramento, and especially here at CSU Sacramento. My family has strong ties to Sac State going back to its earliest days. My father received his undergraduate degree in 1950 when classes were held in rented space at Sacramento Junior College. My mother worked in the English department for many years. And my brother did both—he earned his business degree here while an employee of the university. I grew up near the campus and fondly recall biking over the Guy West Bridge to take advantage of the tennis and racquetball courts.

Today I'll cover the progress the U.S. economy has made, where I see things headed, and what this means for monetary policy.

Through the lens of the dual mandate

As a Federal Reserve policymaker, I tend to look at virtually everything through the lens of our dual mandate goals of maximum employment and price stability, and I'll describe economic developments—past, present, and future—through that lens.

I'll begin with maximum employment. Of course, this doesn't require that every man, woman, and child work 24/7, 365 days of the year. Instead, it means we have a number of jobs consistent with a vibrant, healthy economy. Economists tend to think of this in terms of unemployment, rather than employment. Put in those terms, our goal isn't to have an unemployment rate of zero. Instead, it's to be near what economists call the "natural rate" of unemployment, the level where the economy is running neither too hot nor too cold. It's impossible to know exactly what that magic number is, but it's generally thought to be between 4¾ and 5% today (see Board of Governors 2016a, CBO 2016, FRB Philadelphia 2016, and Blue Chip Economic Forecast 2016). By the way, that's about the same number that economists typically thought before the recession, so in this one respect the economy hasn't changed much over the past decade.

With the national unemployment rate now at 4.7%, we've reached that goal. It's worth pausing a moment to reflect on this accomplishment. We are now in the eighth year of the economic expansion. The unemployment rate peaked at 10% in the fall of 2009 in the aftermath of the Great Recession. Since then, it's fallen by more than half, as the economy added over 15½ million jobs.

I've been talking about the national economy so far, but the improvement in the Sacramento labor market has also been dramatic. This area was very hard hit by the housing crash and recession, and the unemployment rate in the Sacramento metropolitan area soared to 12.5% in 2010. Over the past six years, things have improved, with the metro area adding over 120,000 jobs and the unemployment rate dropping to near 5%.

Despite the progress here and across the country, there has been considerable debate whether the standard unemployment rate accurately reflects the strength of the labor market. In particular, some commentators are concerned that a large number of people are standing on the sidelines of the labor market, neither working nor officially counted as unemployed. They point to the sizable decline in the labor force participation rate, which measures the fraction of the population age 16 and over that has a job or is looking for one. The low level of labor force participation raises the possibility that lots of potential workers may still be waiting for the job market to improve further before rejoining the labor market.

Closer examination of this question indicates that the low participation rate is mostly explained by long-term trends, such as the wave of baby boomer retirements and young people staying longer in school (see, for example, Aaronson et al. 2014, Fujita 2014). Staff at the San Francisco Fed along with other researchers have delved deeper into this issue. They took a different tack by treating everybody in the population as potentially in the labor force and constructing a broader unemployment rate—a "non-employment index" (Hornstein, Kudlyak, and Lange 2016). This measure incorporates the unemployed and nonparticipants alike, based on their respective tendency to find jobs. For example, many folks who are out of the labor force say they want a job but are not currently looking for various reasons, while others are in school or retired from a career and may return to work later. When one carefully accounts for the availability of nonparticipants this way, the resulting broad non-employment index is consistent with a labor market at full strength.

This conclusion is reinforced by survey evidence from regular people—by which I mean not just economists. When asked how hard it is to find a job, households' responses are currently right in line with, or even a little better than, the signal we're getting from the unemployment rate (Conference Board 2016, Weidner and Williams 2011).

That's great news about the job market, and it means that we won't need as much job growth going forward as we've seen in the past few years. Because we're at maximum employment now, the future is less about creating an ever stronger labor market, and more about maintaining a healthy one. That means creating enough new jobs to keep up with the increase in the size of the labor force. That number depends on things like the number of people retiring this year or graduating from school and entering the workforce. Relative to past decades, labor force growth has slowed substantially due to an aging population, stabilization in women's participation in the labor force, and other factors. As a result, the number of new jobs we need has dropped as well. I put it at around 80,000 a month currently. Looking ahead, estimates that take account of likely labor force trends imply a range from 50,000 to a little over 100,000 (Bidder, Mahedy, and Wilson 2016 and Aaronson, Brave, and Kelley 2016).

Last year job gains averaged about 180,000 a month. That's more than twice as fast as we need to keep up with the trend in labor force growth and, quite honestly, is unsustainable in the long run. With job gains continuing to outpace labor force growth for some time, I expect the unemployment rate to edge down over the next year, bottoming out around 4½%—a very strong labor market by any standard. Looking further into the future, I expect job gains to slow to a pace more in line with the growth in the labor force.

I have focused on the labor market so far, so I'll turn briefly to the outlook for GDP growth. Real (inflation-adjusted) GDP increased by 2% last year, and I expect growth this year and next year to slow somewhat to a pace close its trend rate. My estimate of trend GDP growth is between 1½ and 1¾% per year, which reflects slowing longer-run trends in labor force and productivity growth (Fernald 2016).

Turning to our second mandate of price stability, the Fed's monetary policy committee—the Federal Open Market Committee, or FOMC for short—has set a long-run goal of 2% inflation (Board of Governors 2016b). Inflation has been running persistently below that goal for several years. Over the past couple of years, the strengthening of the dollar and declines in energy prices have pushed inflation down, but these influences have been fading. To cut through some of the noise, it's useful to look at measures of inflation that strip out volatile prices and provide a clearer view of the underlying trend. These suggest that underlying inflation is running about 1¾%. So, we're not quite at our target yet, but we're getting closer. The combination of fading transitory factors and a strong economy should help us get back to our 2% goal in the next couple of years.

To sum up, the economic expansion remains on track well into its eighth year. The labor market is strong, the economy has good forward momentum, and inflation is moving towards our goal. There are, of course, risks to the outlook—there always are. No forecaster has a perfect crystal ball. Although much of the discussion of late has been about uncertainty regarding fiscal and other federal policies, there are numerous other factors both domestic and abroad that may cause our economy to do better or worse than currently predicted. But I, like most of my colleagues, view these as both broadly similar in magnitude to the past and roughly balanced between the upside and the downside (Board of Governors 2016a).

Monetary policy

So, taking this all together, what does it mean for interest rates? As I said at the start, I look at this through the lens of the dual mandate goals of maximum employment and price stability. In the context of a strong economy that has reached our maximum employment goal and with inflation nearing our price stability goal, it makes sense that the FOMC has undertaken a process of raising interest rates from their historical low levels. We've made two rate hikes so far, the most recent at our December FOMC meeting, bringing the target range for the federal funds rate to 50–75 basis points. This rate increase was an appropriate small step in the process of removing monetary stimulus put in place during the recession.

Even with the most recent increase in interest rates, the stance of monetary policy continues to support economic growth. Looking ahead, further gradual increases in the target fed funds rate will likely be appropriate to bring monetary policy back to a more normal setting consistent with an economy at full strength. I should be clear: In arguing for gradual increases in interest rates over the next few years, I'm not aiming to stall the economic expansion. In fact, it's just the opposite: My aim is to keep it on a sound footing so that it can be sustained for as long as possible (Williams 2016).

History teaches us that an economy that runs too hot for too long can generate imbalances, eventually leading to excessive inflation, asset market bubbles, and ultimately economic correction and recession. A gradual process of raising rates reduces the risks of such an outcome. It also allows a smoother, more calibrated process of normalization that gives us space to adjust our responses to any surprise changes in economic conditions. If we wait too long to remove monetary accommodation, we hazard allowing imbalances to grow, requiring us to play catch-up, and not leaving much room to maneuver. Not to mention, a sudden reversal of policy could be disruptive and slow the economy in unintended ways.

As I said, my goal is to sustain the economic expansion. The best way to accomplish that is by supporting a pace of growth consistent with the economy's potential and 2% inflation. I fear that if we allow the economy to overshoot this mark by too much, eventually we will need to reverse course to bring the economy back on track. The experience of past business cycles shows that this is a hard, if not impossible, act to pull off, and ultimately ends in recession. A gradual process of removing monetary accommodation reduces this risk.

Summary

Although it has been a long, hard road back from the recession, the American economy is in good shape and headed in the right direction. We've reached our employment goal, and inflation is well within sight of and on track to reach our target. Given the progress we have made and signs of continued solid momentum in the economy, and consistent with our agreed-upon monetary policy approach, it makes sense for the Fed to gradually move interest rates toward more normal levels. As always, the actual pace of rate increases will be driven by the evolution of economic conditions and its implications for achieving our dual mandate objectives.

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