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Looking Forward: The Path for Monetary Policy

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The U.S. economy is on solid footing. The labor market is nearing full employment, and inflation should move back toward the Federal Open Market Committee's target. A likely gradual removal of highly accommodative monetary policy could begin at any upcoming FOMC meeting. However, the exact timing will be driven by the incoming data. The following is adapted from a presentation by the president and CEO of the Federal Reserve Bank of San Francisco to the New York Association for Business Economics in New York on May 12.

It's a pleasure to be in New York. I'd like to give an overview of the economy today and where I see us going. I'll address some of the questions I've been hearing most frequently, and talk about the trajectory of monetary policy going forward.

Disappointing first quarter

There are two questions I'm asked on an almost daily basis right now, so I'll preempt the Q&A and get to them right off the bat. One of them is: Given first-quarter weakness, am I revising my outlook for the year? So far, I've been relatively upbeat about the economic outlook and the direction we're heading. The answer leads me to something I say frequently: We need to look at data over the longer term. We can't get distracted by blips and temporary downs—or ups for that matter.

The data I'm looking at convince me that we're still on solid footing. Yes, in recent months, spending and employment numbers have come in a little weaker than we had anticipated. However, for the past four years, first-quarter real GDP growth has averaged more than 2 percentage points lower than during the rest of the year. While there is no single culprit, weather has definitely been a villain. It affected huge swaths of the country, even where the winter itself wasn't debilitating. A business contact of mine in the trucking industry told me that, while this winter was not as bad as the previous one, it was still one of the worst on record for delayed and canceled shipments. We were also affected by the West Coast port slowdown, which slowed economic activity.

With that in mind, and looking at the past several years, I expect that 2015 will match the pattern that's emerged: After a disappointing first quarter, we should see above-trend growth for the rest of the year. Further data to support this forecast can be found in a new measure of economic activity that may paint a better economic picture than GDP alone, called GDP Plus (Aruoba et al. 2013, FRB Philadelphia 2015). It's a measure that factors in both GDP and GDI, or gross domestic income, and filters out some of the noise. GDP Plus grew at an annual rate of 1.7% in the first quarter and averaged 3% growth over the past four quarters.

Something I really want to stress is that it's important that we don't jump to conclusions—or policy decisions—based on noisy data. As more information comes in, we'll have a better picture of where the economy is headed. We'll have two additional months of data going into the next Federal Open Market Committee (FOMC) meeting, which should paint a more complete picture than we have now. Either way, there's no pressure to decide on the future path of policy today, so I am in "wait and see mode," with a keen eye on the data.

My bottom line on the economy is: The fundamentals are sound. The underlying momentum in job growth remains solid. I expect wage growth to continue to rise and consumer confidence to continue to pick up steam. Monetary policy will remain highly accommodative—regardless of what may or may not happen with rates this year—which will spur spending.

Being based in San Francisco means I'm seeing evidence of the positives all around; some sectors aren't so much hot as akin to the sun's surface. A tech executive recently told me that competition for talent is so fierce that some firms are offering raises of 20% or more, along with perks including housing, which is no small amenity in the Bay Area. I think New Yorkers can feel our pain, since San Francisco only recently took the title of "most expensive rental market" in the United States—while this is great for property owners, I can say with confidence that the renting population of San Francisco would be delighted if you'd take the title back. Commercial real estate is booming as well, with financing readily available on generous terms. All in all, things continue to look good.

Employment

They're looking very good on the jobs front as well. When we talk about maximum employment, one-half of the Fed's mandate, we're generally referring to the natural rate of unemployment—the lowest rate we consider normal in a healthy economy. Economists typically put it somewhere between 5 and 5½%; my own view is that 5.2% is the right number. We're obviously nearing that goal, and I think that we'll get to, or even below, 5% by the end of the year. Which, considering the peak of 10% during the worst of the recession, is remarkable progress.

But I do see more slack in the labor market than the standard unemployment rate alone indicates. Taking into account the other measures of labor market health—people who are part-time but want full-time work, people who want a job but stopped looking—I think that even when we hit my estimate of the natural rate, there will be some lingering bruises. Thankfully, if my growth forecast comes to pass, we'll see those workers come back into the fold and reach what I consider to be full employment across multiple indicators by next year.

Inflation

That's the unambiguously positive news—or as unambiguous as policymakers are wont to get, as anyone who's read an FOMC statement can attest to. That does not mean, however, that there aren't areas that warrant close attention.

I said I'm currently hearing two questions quite persistently, and the second one is: Why am I confident that inflation will move back up towards the Fed's 2% goal? Given that wage and price pressures have been persistently low, given inflation's further drop, given low inflation abroad, why would I be optimistic?

There are a few factors that convince me. First, recent low inflation numbers are consistent with an economy that, while rebounding, is still not operating on all cylinders. That is, we're not seeing anything out of the ordinary. Wage growth in particular has been sluggish. There's been some upward movement, but not what one would consider representative of a fully recovered economy.

There are a few reasons for that.

My research staff has been studying a feature of the last recession with the imaginative name "downward nominal wage rigidity." Put simply, employers were loath to cut pay during and after the Great Recession. As a result, wages remained stagnant to make up for the pay cuts that never came, but businesses wanted to impose (Daly and Hobijn 2015). As the economy picks up, these pent-up wage cuts will dissipate, the gap will close, and we should see wages start to rise more strongly.

This lagging effect of economic recovery on wage growth is a recurring pattern (Daly and Hobijn 2014). We've seen in prior recessions that wage growth doesn't tend to really pick up until the economy nears full employment. I'm therefore not particularly surprised that the acceleration in wage growth has been slow to materialize.

Another thing to consider is that wage growth doesn't really dictate inflation's path. When dealing with something as vast and varied as the U.S. economy, it's important to mine prior experience. To some extent, economics is an active example of William Faulkner's famous dictum that "The past is never dead. It's not even past." History has shown that wage growth has not been a strong indicator of where inflation is going or when it will arrive—even though theory says it should.

Obviously, rising wages are healthy for the economy. They're a positive sign for the recovery and the country. But looking at patterns in prior recessions and the history of monetary policy, they're not an indicator of overall inflation one way or another. That means that I'm not surprised by their slowness to rebound and I'd be disinclined to lose sleep were they to rebound sharply—at least inasmuch as relates to their contribution to inflation.

The second factor to consider is that the past drops in import and oil prices have been holding inflation down, but these effects will dissipate, assuming import and oil prices stay relatively stable.

U.S. import prices have been depressed because growth and inflation have generally been low in Europe, China, and Japan, the biggest economies outside the United States. That has led both central banks and governments abroad to take strong policy actions to stimulate their economies. Of course, the textbooks tell us that one result of this will be weakened currency, which means the dollar gains strength in comparison. This is a standard function of monetary policy. However, it also means that, as the dollar's value has risen, it has lowered the prices we pay for imported goods and services, which in turn has pushed down the U.S. inflation rate.

Energy prices have also dropped dramatically, as every American well knows. The fall in oil prices is having an enormous impact because energy is a significant part of the average consumer's spending basket. As prices for oil and gas have come down, they've also taken inflation with them.

Anyone who knows me, or has listened to my speeches, will notice three recurring themes. The first, and foremost, is that monetary policy is data-driven. I am so data-focused that I literally had a T-shirt made to express my personal policy mantra. The second is that I think patterns and history are important indicators of our economic present and future—they are, frankly, just another form of data to be mined. As is the case with the effect that wages have on overall inflation, sometimes the theory doesn't play out in practice, and history is an eloquent teacher. The third is that I believe policymakers have to be very careful about not reacting to blips. This again is an extension of the "data, data, data" view: We have to look at what's happening in the economy not just today, not just this month, but over the medium term, analyzing trends and looking at multiple indicators.

That's why we should be very circumspect about reacting to short-term fluctuations in commodity or other import prices. Just as the Fed didn't immediately intervene in the spring of 2011, when inflationary pressures from oil and import prices were going up, we shouldn't jump the gun now that they've gone down. I take a perspective that looks one or two years ahead, which research shows is the minimum amount of time it takes for monetary policy to have its full effect (Havranek and Rusnak 2013). What I'm considering is what impact those factors that are currently unfolding—movements in the U.S. economy, weakness abroad, oil prices—will have not next week or next month, but later this year and the year after that and the year after that. My goal is policy that meets the needs of the path we're on, not where we're standing this second.

With that in mind, history and experience show that energy price swings leave an imprint on inflation in the short term, but don't affect underlying inflation rates over the medium term (Evans and Fisher 2011, Liu and Weidner 2011). The same holds true for movements in the exchange value of the dollar: They obviously affect inflation in the short run, but they don't have much of an impact further down the road (Gust, Leduc, and Vigfusson 2010).

I'm therefore looking at underlying rates of inflation. Fed economists are frequently accused of neither eating nor driving, because we prefer to measure "core" inflation, which excludes food and energy prices. For the average consumer, those matter a lot—you can't talk about what a dollar can buy if you don't look at those products. But for economic trends, and for guiding monetary policy, measures of inflation that remove the most volatile components, like core or "trimmed mean" inflation, give a better lay of the land (see FRB Dallas 2015).

What I see when I look at the data that strip out the short-term volatility is an economy with good momentum, that's nearing full employment, with an inflation trend that's running about 1½%. As things continue to get better, I see the strengthening domestic economy driving inflation gradually back to 2%.

The third factor I want to highlight is that the vicissitudes of foreign economies do not control America's fate. What happens abroad is clearly important to our economy, and effects can and do easily cross borders. But the current international situation is not unique to this recovery. We've seen time and time again that the United States can use monetary policy to meet its inflation goals regardless of the direction inflation takes elsewhere around the globe. Given historical precedent, I'm confident that we can control inflation through monetary policy actions now as well.

Impact on monetary policy

What everyone wants to know, of course, is when we'll begin liftoff. As I have made possibly overly clear, the exact timing will be driven by the data. They may push us a little in one direction or the other, and there will be a lot of discussion and debate. Every FOMC meeting is on the table. That's what it means to be data dependent.

To be able to even entertain such a move is a tremendously positive sign: It highlights how much the economy's improved, that unemployment has come way down, and that we may be able to start cutting back on accommodation because of that strength. I recognize that not everyone shares my rosy view, or even thinks that 2015 is a good year to take action. There are a number of people who think we should wait until inflation is very close to or has crossed the finish line. Their overarching concern is that a premature rate hike would allow inflation to fall further and possibly derail the recovery. They're wondering what the rush is.

The first thing to point out is that, when the Fed raises rates, it will not be instituting tight policy, merely easing back on exceptionally accommodative policy. We've had over six years of this stance, and accommodation will continue to characterize monetary policy for some time. Rate rises will likely be gradual, and the Fed's $4 trillion-plus balance sheet will continue to provide substantial stimulus. We're not pulling the rug out from underneath the economy.

Second is the factor I mentioned previously: Monetary policy, as Milton Friedman (1961) famously wrote, has long and variable lags. As I said, it usually takes a year or two for policy to have its full effect, so decisions need to be made with that in mind. It's like driving a car: You take your foot off the gas when approaching an intersection. The data convince me that inflation will move back up to our target as the economy strengthens and we close in on full employment. By waiting until we're face-to-face with 2% inflation, we could need to slam on the brakes or even skid through the intersection. Overshooting the mark would force us into a much more dramatic rate hike to reverse course, which could have a destabilizing effect on the markets and possibly damage the economic recovery. The decision to raise rates is actually three decisions: Not just when, but how quickly and how high. I see a safer course in a gradual increase, and that calls for starting a bit earlier.

Conclusion

The Fed has a lot of decisions ahead, and people have a lot of opinions about those decisions. But the outlook is positive. We're nearing full employment and inflation is on track to return to our 2% goal. We're not out of the tunnel yet, but we can definitely see the light at the end. And, in case you missed it, policy will be data dependent.

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