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The Economic Outlook: Live Long and Prosper

Good afternoon, and thank you.

It's a pleasure to be in Salt Lake City. I should extend my congratulations to the Utah Utes for their win over the Ducks last week—62–20! Of course, Oregon is also part of the Fed's 12th District, and as president, I try not to take sides on any games. Except Giants versus Dodgers.

A lot has happened, economically speaking, since I was last here a few years ago. So today I'd like to give an update on the outlook, monetary policy, and where I see us headed. Before I get going, I should stress that the views expressed here today are mine alone and do not necessarily reflect those of others in the Federal Reserve System.

Economic outlook

I shouldn't have to issue a spoiler alert before I say that the Federal Open Market Committee 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 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.

Consumer spending is powering the economy. We've seen real consumer spending increase more than 3 percent 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 percent annual rate in the second half of 2015, and GDP growth to be a little above 2 percent 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 percent 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 percent.[1] 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.[2] My assessment is that there has not been any lasting, significant

[1] Weidner and Williams (2011).
[2] Aaronson et al. (2015), Daly et al. (2012), and Lazear and Spletzer (2012).

shift in either direction. My estimate of the natural rate of unemployment today is 5 percent, consistent with pre-recession estimates. With the current rate at 5.1 percent, 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 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, and as the economy strengthens further over the next year, I see inflation moving back up to our 2 percent 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.[3]

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.[4] Further bad news from abroad could add to these effects.

Inflation has been below our 2 percent 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 U.S. 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, who famously taught us that monetary policy has long and variable lags.[5] 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

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

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 any time, 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.[6]

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.

What to expect when you're expecting a new normal

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

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 percent 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.[7] 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 percent. 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.

Thank you.

[7] Aaronson et al. (2014).

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