

Presentation to Community Leaders, Portland, OR  
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## **Dancing Days Are Here Again: The Long Road Back to Maximum Employment**

Thank you. It's a pleasure to be here.

It's that time of year again, a time when all Americans, regardless of faith or origin, participate in a holiday ritual. I'm talking, of course, about the year in review. So in the spirit of the season, I'd like to take a look back over the past year for the economy and monetary policy, to where we find ourselves today, and where I see us headed.

As usual, I'll add the disclaimer that my remarks today are mine alone and do not necessarily reflect those of others in the Federal Reserve System.

### **The economic snapshot**

The headline is that we're now in the seventh year of the expansion and the economy still has a good head of steam. Consumer spending continues to increase at a solid pace, auto sales should come in at their highest since the early 2000s, and strong fundamentals point to continued strength going forward.

There are some upside risks to the outlook, specifically an even stronger and faster rebound in housing. And there are, of course, downside risks: the threat of slowdowns and spillovers from abroad, or the dollar appreciating further.

And then there are the big issues. The Fed is charged with maximum employment and price stability. Looking over our dual mandate, how have we fared?

### **Employment**

On the employment side, things are going very well.

We're on pace to add about 2½ million jobs this year, and we've met one marker on the unemployment rate. Because unemployment will never be zero—in any healthy economy, there will be turnover, with people leaving jobs and new people entering the workforce—economists use something called the “natural rate” of unemployment. Broadly, it's the optimal rate in a fully functioning economy. I put the natural rate at 5 percent, and we've already reached that threshold. I expect the unemployment rate to continue to edge down, falling below 5 percent either this year or next and stay there until 2017.

Of course, the unemployment rate alone doesn't tell the whole story. There are other factors and measures that reflect the complexities of the American workforce and how people have fared in the aftermath of the recession.

Most discussed—and for many, the most worrisome—is the labor force participation rate, which is still significantly lower than it has been in the past. On the surface, this can appear alarming. But digging deeper it is, by and large, explicable and relatively benign.

As a primer: The “labor force” is made up of people who are either employed or unemployed but actively looking for work. The labor force participation rate divides that group by the total working-age population—that is, everyone over the age of 16. It's a very basic ratio that's affected by myriad factors. In the '60s and '70s, for instance, women entered the workforce in greater numbers and the labor force participation rate shot up.

Since the start of the recession, the participation rate has come down substantially. Some people are concerned that this is indicative of a portion of society that was hit hard by the recession and sidelined in the recovery—people who want to work but have given up looking, either out of pessimism over the job market or fear that an extended time out of work has rendered them fundamentally unemployable.

But much of the decline in the labor force participation rate can be explained not by disheartened workers, but by demographic and social shifts.<sup>1</sup>

First is the aging of the population. The baby boomers are entering retirement and people are living longer. Remember, the participation rate counts *everyone* over 16, so my happily retired parents count as “out of the labor force,” even though, in their 80s, few people would still be working. Second is that younger people aren’t working as much as they used to. But this is partly because many have extended their education or gone back to school, and fewer are working when they’re there. Third is an increase in people deciding they’d rather have single-income families.<sup>2</sup> For whatever reason, they’ve traded a second paycheck for spending more time at home, whether it’s for child care, leisure, or simply that it’s a better lifestyle fit. Each of these groups is made up of people who are not working, but doing so for personal or demographic reasons. As their numbers swell, it will, obviously, push the participation rate down.

As for the area of concern, we’re emerging from the deepest, longest recession since the Great Depression. And it’s true that a lot of people did give up looking for work. A key indicator is the somewhat unfairly named “prime-age males” cohort, who are 25–54. This group has historically been a constant in the American workforce, but in the wake of the recession, its participation fell sharply. However, as the labor market has improved, that number has largely stabilized over the past two years, as has the overall participation rate.

The last factor to consider is whether there are people who will reenter the labor force and pull the participation rate back up. The “marginally attached” for instance, a group made up of people who are ready and able to work and who’ve searched for jobs in the past year but who

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<sup>1</sup> See, for example, Fujita (2014).

<sup>2</sup> See the Bureau of Labor Statistics news releases, “Employment Characteristics of Families” (archived at [http://www.bls.gov/schedule/archives/all\\_nr.htm#FAMEE](http://www.bls.gov/schedule/archives/all_nr.htm#FAMEE)).

aren't currently looking. The assumption would reasonably be that this group is poised to return to the labor force. First off, these numbers have come down a lot, falling by over 12 percent in the past year alone. In addition, my staff has found that, over the past few years, their reentry rate back into the labor force has actually fallen. When you combine this with the aging workforce, it looks unlikely that participation will rise. This is supported by other research from both within and outside the Fed System.<sup>3</sup> Overall, the evidence suggests that, even with a quite strong economy, we won't see a significant number of people come back into the fold.

I know this has been a tough journey for a lot of people, and many are still struggling. But putting the recovery in perspective, we've come a very long way and we should be heartened by the progress. Since the dark days of late 2009, we've added 13 million jobs. More than 3 million of those came last year, and most of those were full time.

Looking forward, I see a labor market that's growing ever stronger and will reach maximum employment on a broad set of measures later this year or early next year.

## **Inflation**

The inflation side of the equation is where the winds are blowing colder than I'd like. For those of us who lived through the '70s and '80s, the need for higher inflation seems anathema to a healthy economy, but that's where we are right now. Inflation is like wine—a little bit is actually good for you. And right now our glass isn't full enough. The Fed's target rate is 2 percent, and inflation has been obstinately below that for 3½ years now. Over the past year, it's been stuck at a little above zero.

There are reasons for the depressed level of inflation, in particular the rise in the dollar and the fall in oil prices. Those effects should peter out, but they've had a downward influence on inflation at a time we've needed it to rise. Another special factor is that health-care prices

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<sup>3</sup> See Krueger (2015) and Stephanie Aaronson et al. (2014).

have been rising much more slowly than we're used to and that's pushing down the inflation rate as well. This is in part due to legislation that holds down payments to hospitals and other providers. These effects may prove to be transitory as well.

I know that people don't always feel the reality of inflation being too low. The average person in a supermarket checkout line probably doesn't. People often ask if Fed officials eat or drive, because we favor inflation measures that strip out food and energy. For the average household, those are obviously important. But for formulating monetary policy and analyzing data, policymakers need to look at underlying trends. That's why I look at measures that remove the volatile components, like the trimmed mean rate that the Dallas Fed came up with.<sup>4</sup> By that measure, we're not as far from our goal as it first appears. The trimmed mean puts the underlying inflation rate for the past year at 1.7 percent—still below our 2 percent target, but not by much.

Looking ahead, as the effects of the dollar and oil prices ebb, and as the economy strengthens further, I see inflation moving back up to our 2 percent target within the next two years.

### **Monetary policy normalization**

With real progress on our goals, the conversation has turned to normalizing policy. That is, raising interest rates. There are a number of opinions out there, many of which wind up in my inbox.... From my perspective, the song remains the same: We've made remarkable progress and the economy is on the cusp of full health. The first step in bringing policy closer to normal was when we ended QE. The next appropriate step is to raise rates. My preference is sooner rather than later for a few reasons.

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<sup>4</sup> See <http://www.dallasfed.org/research/pce/>.

First, Milton Friedman famously taught us that monetary policy has long and variable lags.<sup>5</sup> Research shows it takes at least a year or two for it to have its full effect.<sup>6</sup> So the decisions we make today must take aim at where we're going, not where we are. The economy is a moving target, and waiting until we see the whites of inflation's eyes risks overshooting the mark.

Second, experience shows that an economy that runs too hot for too long can generate imbalances, ultimately leading to either excessive inflation or an economic correction and recession. In the 1960s and 1970s, it was runaway inflation. In the late 1990s, the expansion became increasingly fueled by euphoria over the "new economy," the dot-com bubble, and massive overinvestment in tech-related industries. And in the first half of the 2000s, irrational exuberance over housing sent prices spiraling far beyond fundamentals and led to massive overbuilding. If we wait too long to remove monetary accommodation, we hazard allowing these imbalances to grow, at great cost to our economy.

Finally, an earlier start to raising rates would allow a smoother, more gradual process of normalization. This gives us space to fine-tune our responses to any surprise changes in economic conditions. If we wait too long to raise rates, the need to play catch-up wouldn't leave much room for maneuver. Not to mention, it could roil financial markets and slow the economy in unintended ways.

My preference for a more gradual process also reflects that the economy, for all its progress, still needs some accommodation. We don't need the extraordinarily accommodative policy that has characterized the past several years, but the headwinds we're facing—the risks from abroad, for instance, and their impact on the dollar—call for a continued push. Not with a bulldozer, but a steady nudge.

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<sup>5</sup> Friedman (1961).

<sup>6</sup> Havranek and Rusnak (2013).

That brings me to another point. Monetary policy has played a crucial role in getting us back on track.<sup>7</sup> We're heading towards an economy that's near full strength—we're not quite across the finish line, but it's definitely in sight. As we head towards it, it's important to recognize what monetary policy can and can't do—not to mention what it should and shouldn't.

The job of monetary policy is to get the economy to full strength with 2 percent inflation and keep it there, using the tools available to us. That's a relatively limited kit and is restricted largely to money in the system and the rates at which it is lent. How the economy develops and performs in the long run depends on a host of other factors that are outside our purview.

What comes next is addressing long-run trends in productivity and the quality of the labor force, and those are determined by the investments we make in technology and education, by tax policies and long-term fiscal decisions.<sup>8</sup> That's what's going to shape the economy over the next decade, and that conversation extends far beyond the Federal Open Market Committee meeting room.

### **New normal**

As that decade begins to unfold, we should be aware of what economic strength will look like. Some might ask, if accommodative policy helps the economy so much, why don't we just keep rates low forever? The answer is that it's not economically healthy and it's not sustainable. The Fed can't deliver, say, 4 percent growth for the next 10 years just because of easy monetary policy. We have to operate within the established economic environment and foster growth within those parameters.

It's not surprising that the pace of employment growth and the decline in the unemployment rate have slowed a bit this year relative to last. When unemployment was at its 10

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<sup>7</sup> Swanson and Williams (2014) and Williams (2014).

<sup>8</sup> See Fernald and Jones (2015) regarding technology and education.

percent peak, 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 has to start slowing. In fact, once the economy is operating at full strength, we're only going to need between 60,000 and 100,000 new jobs a month to keep up with the growing labor force.<sup>9</sup> And as the next year unfolds, we want to see a steady pace of economic growth at around 2 percent. Commentators may call this disappointing, and it was when we were climbing out of the hole the recession left. But in a healthy economy, it's what strong, steady growth looks like. As I said, running too hot for too long has serious risks.

## **Conclusion**

All in all, things are looking good. We've come a long way since the worst of the recession and made significant progress this year. Going forward, I expect things to continue on this positive trajectory.

This is my last public speech of the year, and I'm very pleased to be doing it in Portland with you all. So I'd like to extend my thanks to you; I'm much obliged for such a pleasant stay.

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<sup>9</sup> Daniel Aaronson et al. (2014).



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