

# From Sustained Recovery to Sustainable Growth: *What a Difference Four Years Makes*

Remarks by

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## INTRODUCTION

Thank you, President Rupkey, and thanks to everyone at the Forecasters Club. I recently gave a talk to some business leaders back in California, and I found myself describing the Fed as an *“amazingly nerdy group of people who pore over data, computer models, and statistical analysis.”* So I hope you’ll take it as a compliment when I say that being here with a bunch of folks who’ve willingly given up their lunch hour to discuss economic forecasting makes me feel right at home.

Like you, I’ve attended many gatherings such as this in the years since the onset of the Great Recession. Sometime after the coffee is poured and the conversation begins, it invariably turns to where things stand with the recovery. Today, I’d like to propose we do something a little different ...

With an economy at full employment, inflation nearing the Fed’s 2 percent goal, and the expansion now in its eighth year, the data have spoken and the message is clear: We’ve largely attained the hard-sought recovery we’ve been after for the past nine years.

In light of this achievement, we need to shift the conversation from *“how do we achieve a sustained recovery?”* to *“how do we sustain the recovery we’ve achieved?”*

I’d like to focus my remarks today on this topic of sustainable growth and to address a related question: *“What will it take to improve the trend line on GDP growth from the historically low pace we experienced during the recovery?”*

When I was last here four years ago, I argued that, although the financial crisis had undeniably left its mark on the supply side of the economy, the primary problem we faced from the perspective of monetary policy was a lack of demand.<sup>1</sup> The unemployment rate was stuck around 8 percent at that time, and the Federal Reserve was determined to get us back to full employment and 2 percent inflation.

Spoiler alert: As our focus shifts to sustainable growth, today I will argue that supply-side factors are the main impediment to growth going forward – and that this calls for actions outside the purview of monetary policy.

I know that you’ve heard from quite a few of my Fed colleagues in the past, so the following disclaimer should sound familiar: The views I express are mine alone and do not necessarily reflect those of anyone else in the Federal Reserve System.

## **FOUR YEARS AGO**

As I begin, I want to take you back in time. The year is 2013. The month is February. Real GDP growth has averaged only about 2-percent annually since the recession ended in 2009 – a very slow pace compared with the other recoveries of the past. At the same time, the level of real GDP per capita is still about 1.6 percent lower than it had been five years earlier, before the recession started. Many forecasters and analysts, myself included, describe the pace of the recovery to be “tepid,” “anemic,” and “disappointing.”

At this moment, it’s still an open question whether a full recovery is even in the cards – especially when it comes to the job market. In fact, there is debate among economists as to whether the unemployment rate will ever return to its pre-recession levels of around 5 percent or if we should adjust to a “new normal” of significantly higher unemployment.

## **THE PRESENT**

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<sup>1</sup> Williams (2013).

What a difference four years makes ... we're now very close to reaching the Fed's dual mandate goals of maximum employment and price stability. In fact, if you do the math, we are about as close to these goals as we've ever been.

The latest jobs report has the national unemployment rate at 4.7 percent and this is right around where economists and the FOMC put the natural rate of unemployment.

Incidentally, the natural rate of unemployment was largely viewed as being in the same neighborhood prior to the onset of the recession. So when it comes to unemployment, the new normal is the same as the old normal. In this one respect, the economy hasn't changed much over the past decade. But, as I'll get to in a moment, other more significant changes have taken place.

Turning to price stability, downward inflation pressures that have held inflation persistently lower than 2 percent for the past several years have faded – and as I mentioned earlier, we're near the Fed's 2 percent goal. I expect that we will reach that goal in the next year or so.

With the attainment of our dual mandate goals close at hand, now is more important than ever for monetary policy to work toward what I like to call a “Goldilocks economy” – an economy that doesn't run too hot or too cold. We want the porridge to be just right.

Our aim is to keep the economic expansion on a sound footing that can be sustained for as long as possible. The last thing any of us want is to undermine the hard-won gains we've made since the dark days of the recession.<sup>2</sup>

As it stands today, with the economy in striking distance of our goals, monetary policy still has the pedal to the metal. Even with the rate increase the FOMC announced a couple weeks ago at its March meeting, interest rates remain near historical lows. I'm sure that many, if not most of you, have taken a look at the FOMC's statement which noted that *“the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run.”*<sup>3</sup>

I'm often asked, *“since things are going well, why not just keep our foot on the gas?”* The answer is that lifting it gradually off the pedal prevents the economy from overheating.

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<sup>2</sup> See Williams (2016) for further discussion.

<sup>3</sup> Board of Governors (2017a).

This is why the FOMC took action in March, and why the median view of my FOMC colleagues is for three interest rate increases in 2017.<sup>4</sup> My own view is similar to most of my FOMC colleagues. I should note, however, that given my forecast, along with upside risks, I would not rule out more than three increases total for this year.

I want to emphasize that I see the pace of rate increases as gradual – that is, slower than in past economic expansions – and intended to bring monetary policy back to a normal stance.

Importantly, I am confident that the economy will continue to grow at a healthy pace as we pursue this path of normalization.

### **SLOW PACE OF GROWTH, SLOW GROWTH IN POTENTIAL**

I've spoken a bit about our recent past, and where things stand today. I want to spend the rest of my remarks on the future – particularly as it relates to sustainable growth.

As we move forward, I see the unemployment rate nudging down a bit further, ultimately bottoming out near 4½ percent by the end of the year. Since the unemployment rate already has been hovering at or below most estimates of the natural rate for the past year, this implies a sustained, albeit relatively modest, overshooting of full employment. This, in turn, implies that some slowing of growth slightly below potential will be needed in the future.

The reduction in unemployment has been very impressive. One of the fascinating things that's been going on in the economy is that GDP growth has been almost equally *un*impressive. As I mentioned, I referred to growth as “anemic” when I was here in 2013.

Today, that pace of growth of just above 2 percent during the first half of the recovery is higher than my projection of 1¾ percent real GDP growth for this year and next.

Incidentally, I know that many of you have it higher and that the Blue Chip, for example, forecasts 2.3 percent this year and 2.4 percent next. I'll get into one of the reasons for this difference in a minute – but for the purposes of this discussion, I think we'd all agree that we'd all like to see our economy have the capacity to grow

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<sup>4</sup> Board of Governors (2017b).

faster without creating imbalances.

Recently, a team of economists which included the San Francisco Fed's John Fernald, looked at why GDP growth has been so slow, measured relative to its past relationship with the unemployment rate.<sup>5</sup> Their work suggests that, for the unemployment rate to decline as much as it did, growth over this period must have consistently exceeded its potential. In conjunction with related research, it's clear that the "disappointing" growth in GDP is in part due to slow growth in potential.<sup>6</sup>

## SUPPLY SIDE

This brings us back to the demand-supply distinction I made at the start.

My contention is that now that we've reached maximum employment, demand is not the primary constraint that's holding back further, sustainable expansion. Our focus going forward, therefore, should be on constraints which are largely coming from the supply side of the economy.

As you know, overall economic growth depends broadly on growth in the supply of labor and productivity gains.

Let's start with the supply of labor. In a nutshell, the growth rate of the labor force is shrinking at the very time that demand for workers is rising. We're no longer living in a 1970s and 1980s world, where a wave of young people and women are entering the workforce. The historical transition of women to the labor force is long complete. Baby boomers are retiring.<sup>7</sup> And many prime-age men are beset by health and other challenges that are undermining their willingness or ability to work.<sup>8</sup>

With this as backdrop, over the next decade the labor force in the U.S. is projected to grow at only ½ percent per year,<sup>9</sup> and this represents a considerable drop from the pace we've experienced over the past 40 years. This means that, unlike in the 1970s and '80s, demographics will hold back rather than boost potential output growth.

Now let's look at productivity ... As you know, productivity growth has been exceptionally weak over the past five years. I'd imagine some of you are asking, *"this guy is coming to us from the backyard of Silicon Valley and he's talking about weak productivity"*

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<sup>5</sup> Fernald et al. (2017).

<sup>6</sup> Fernald (2016).

<sup>7</sup> Aaronson et al. (2014).

<sup>8</sup> Krueger (2016).

<sup>9</sup> Congressional Budget Office (2016).

*growth? Aren't the streets clogged with self-driving cars out there?"*

Well, first let me say that, as I'm sure you'd attest, productivity is a notoriously tricky thing to measure. In the tech sector in particular, we hear the common refrain that economists are using outdated methods to quantify the pace of productivity growth. There is some truth to that critique, but the resulting measurement distortion appears small, and it's not at all clear that it has gotten noticeably worse over time.<sup>10</sup>

With that said, there is a considerable difference between today's innovation economy and the tech boom of the 1990s, when many of the new innovations were designed to make businesses more efficient and productive. Today, many new innovations are aimed at our leisure time. Sharing cat videos or finding where Pokémon is hiding can enrich our lives but not necessarily our productivity.

Turning back to the data ... Over the past 40 years, total-economy productivity growth has typically averaged between 1 and 1¼ percent per year, and I maintain this is a reasonable benchmark moving forward.<sup>11</sup> In fact, with growth in the average educational attainment of our labor force slowing down, one important source of past productivity gains is fading.<sup>12</sup> Barring the introduction of a major game-changing innovation for businesses (which are notoriously hard to predict), it's going to be very difficult to get far above that rate of productivity growth. Combining that near 1 percent figure with labor force growth of 0.5 percent yields my trend growth estimate of 1.6 percent.

I recognize that this figure is lower than many estimates out there -- and that difference may explain why my forecast of 1¾-percent GDP growth over this year and next is also lower than many private forecasters. But, I find the data and research compelling that the new normal for growth is much lower than in past decades.

## **THE LIMITS OF MONETARY POLICY**

Four years ago, when we were addressing a lack of demand, there was a major role for monetary policy to play. Four years later, as we set our sights on supply, the limits of our monetary policy toolkit are more telling.

Unshackling the economy from these supply-side restraints is instead the purview of things like federal fiscal policy, state and local legislative actions, philanthropy, business investment, public-private partnerships, etc.

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<sup>10</sup> Byrne, Fernald, and Reinsdorf (2016).

<sup>11</sup> Byrne et al. (2016) and Gordon (2016).

<sup>12</sup> Bosler et al. (2016).

The public and private decision makers who work in these realms have it within their toolkits to spark growth and innovation, if they so choose ... to invest in priorities like education, training, safer and healthy neighborhoods, and infrastructure. All these things serve to build human capital and support a growing, productive workforce – supply-side factors that can move the trend line on potential growth.

This does not mean that the role of monetary policy is any less important moving forward. To promote sustainable growth, it is critically important that the Fed continue to make data-driven decisions to keep the economy from overheating and to protect the hard-won gains we've made.

Meanwhile, I believe strongly that any institution that has a stake in the future of American prosperity has a role to play in moving the ball forward.

The San Francisco Fed is a founding member of a wonderful coalition called SPARCC – and in fact, I'll be participating in an event with our partners tomorrow. They include investors and community stakeholders alike – united in the belief that, if we can bring investment in things like education, public health, and transit to underserved communities, then ultimately we all benefit. As the organization's motto says, we all do better when everyone thrives.

## CONCLUSION

As I wrap up, I must say that, although it's always wonderful to talk with you, I much prefer being able to do so in light of more than seven years of economic expansion, inflation near 2 percent, and a new normal for unemployment which thankfully looks a lot like the old, pre-recession normal.

It's great to be able to ask questions like *how do we sustain the recovery we've achieved?* – to be able to look at sustainable growth post-recovery, rather than having to focus on creating a sustained recovery.

Like I said, what a difference four years makes! Thank you all very much.

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