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The Recovery's Final Frontier?

Good morning, it's a pleasure to be here. I'd like to give you the "straight, no chaser" view today; my outlook on the economy, where we are, where we're headed, and what that means for monetary policy going forward. While the headline is not quite "man bites dog," I'm happy to say that, overall, things are looking better and better—and are actually quite good. Our employment goal is in sight, though there's still some way to go until we can say the same for inflation. And that means these continue to be interesting times for monetary policy.

As always, my views are mine and mine alone and do not necessarily reflect those of others in the Federal Reserve System.

Interpreting first-quarter growth

A good deal of the recent commentary—and concern—has focused on the admittedly weak official reading of first-quarter gross domestic product (GDP), which was essentially flat. There's been a lot of speculation about what it all means: Is it an indication that the recovery is stalling? What does it mean for employment? At the risk of sounding like an apostate, it actually doesn't bother me too much. Because on closer inspection, and with alternative analysis, the numbers were much better than they seemed.

The government agency that computes GDP and related economic statistics, the Bureau of Economic Analysis, uses a bottom-up method to account for seasonal adjustments to arrive at its overall numbers. They do this for a number of reasons that are appropriate for their purposes. But for monetary policy, it's preferable to have the most accurate reflection of the broader economy. Research at the San Francisco Fed and elsewhere has highlighted that even after the BEA's seasonal adjustment, first-quarter GDP growth tends to come in well below that in other quarters.[1] To get a measure that avoids seasonal patterns, SF Fed economists ran a second round of seasonal adjustment, not just on GDP, but on gross domestic income (GDI) and something called GDP Plus, a new measure of economy-wide activity that combines GDP and GDI and strips out the extraneous noise.[2]

After making this modification for recurring seasonal patterns, the data show GDP actually grew about 1½ percent in the first quarter. GDI and GDP Plus grew at about 3 and 2¾ percent, respectively.

Based on these revised numbers, and relative to trend growth of around 2 percent, the first quarter appears to have been more or less on track. More recent data on spending have also been encouraging, indicating the economy is still on a solid trajectory with a good deal of forward momentum. Looking forward, I expect growth to average about 2¾ percent for the remainder of the year, then slow to a more sustainable pace next year.

International outlook

Since I'm speaking to an organization that has "international" in its title, I suppose it would be impossible to avoid the subject of risks from abroad, particularly as they've been dominating the headlines the past several weeks.

A full global forecast would take up more time than I have—and more patience than you have—so I'll focus on the two countries everyone cares about most: China and Greece.

[1] Rudebusch, Wilson, and Mahedy (2015). See also Gilbert et al. (2015), Groen and Russo (2015), Liesman (2015), and Stark (2015).

[2] For more information on GDP Plus, see Aruoba et al. (2013) and http://www.philadelphiafed.org/research-and-data/real-time-center/gdpplus/.

I visited China recently, and I arrived fully cognizant of the concerns people highlight—slower growth, the unsustainability of the current export-driven model, debt buildup, bubbles in the equity and housing markets, the risk of falling investment, and the overall international implications of those risks. But I have to say that, after talking to officials and academics there, I was a lot less concerned about China's near-term economic outlook on my return flight than I was heading over.

The Chinese government is again facing a tradeoff between their short-run growth goal and their longer-term reform agenda. But it's clear that when the Chinese authorities see growth slowing, they take steps to keep it near their target level. Many of the issues that overseas commentators are worried about can be addressed with fiscal and other policies, and China has shown that it has both the will and the leeway to take the necessary policy actions.

They are also realistic about what that target growth level should be. The days of double-digit growth are behind China. Most economists and officials there understand that the number is likely to move even lower than the current target of 7 percent, due to multiple factors including demographics and the simple fact that years of economic success have moved China into a bracket in which there's a lot less road to make up and therefore less growth required to power to the top. They know they can't aim for an outdated growth target.

The cost of taking this measured approach may be extending the horizon for some of their reforms. Nonetheless, it's clear that they've continued to make progress on the reform agenda, including financial market liberalization, movements towards internationalization of the renminbi, and a move to a more market-oriented economy.

As for Greece, an ultimate decision appears to be a moveable feast. What I can say is this: Yes, there are risks, but I see them as unlikely to overturn the otherwise strong fundamentals of the U.S. economy. The financial situation there is certainly precarious. And the possibility of a Greek exit from the euro is looming larger.

It is a tragedy for Greece that it finds itself on the brink of an even more severe financial crisis and further economic turmoil. But it can perhaps be heard as a soothing chorus that the direct exposure of foreign investors is relatively limited, and the European Central Bank appears to have the means and will to limit the financial fallout that could affect the rest of the euro area. While a worst-case scenario of a Greek exit from the euro leading to sizable financial and economic impacts on the global economy cannot be ruled out, it remains an unlikely tail risk.

Employment

Returning to the U.S., there were some concerns that the apparent slowdown in spending growth could spill over to employment, but the signs from the labor market have been consistently resilient and positive. Not only has there been solid job growth, but the data show most of those new jobs are full-time and higher paying. We have also seen a dramatic decline in long-term unemployment over the past few years. In fact, a wide set of measures of labor market conditions have continued to show improvement across the board.

Most importantly, our employment goal is in sight. Economists tend to think of full employment as having reached the “natural rate” of unemployment, the rate we should expect in a fully functioning economy. Most put it between 5 and 5.5 percent; my estimation, to be exact, is 5.2 percent. So, with the unemployment rate now at 5.3 percent, we are obviously tantalizingly close. My forecast sees the unemployment rate continuing to edge down, falling to around 5 percent by the end of this year, and even drifting slightly below 5 percent next year.

Of course, there are other measures of labor market underutilization. As I said, we’re making good progress across a broad spectrum of indicators. For instance, people who’ve dropped out of the labor force but still want to work. That figure has come way down and is now about where you'd expect it to be given the overall state of the labor market.

But there are other areas that suggest there may be some lingering slack. One is the still large number of part-time workers who would rather be full time. So-called involuntary part-time work soared during the recession and has remained unusually high during the recovery. The question we're asking is: How much of that is due to an economy that still hasn't reached full strength and how much is due to more persistent influences? Recent research by SF Fed staff shows that most of the rise in involuntary part-time work was, in fact, related to the economic downturn. But there is an outside component—largely reflecting changes in industry employment shares and demographics—that may account for much, if not all, of the rest of it.[3] We aren't yet sure about the life span of these factors; they could dissipate over time, or they could reflect a permanent shift—another "new normal" of the post-recession world. But when you take them into account, they point to the current rate of involuntary part-time employment being more or less in proportion, slack-wise, to other indicators.

So, while I have the policymaker's curse of approaching things with a certain amount of trepidation, it looks like the labor market is bringing home a good report card in just about every class.

Another positive sign is the recent increases in wages. For some time, there was concern that wages were somehow immune to the recovery's positive influences. In fact, the stagnation in wage growth wasn't particularly surprising, because history and experience show us that wages don't usually start to pick up until the economy nears full employment.[4] Now that wage growth is starting to take off, based on the most comprehensive indicators, it offers further confirmation

[3] Valletta and van der List (2015). See also Cajner et al. (2014).
[4] Daly and Hobijn (2014, 2015).

that the labor market is nearly healed. While businesses aren't always thrilled about the prospect of paying workers more, this pickup is a sign of a healthy economy. It's good for the labor market, household income, and consumer spending, and is therefore good for business. In fact, what's really been missing in this recovery is wage growth of around 3 or 3½ percent. That's the rate I'd expect in a fully functioning economy with a 2 percent inflation rate. Now we're starting to see that come to fruition, and it's a good sign.

The employment side of our mandate has made tremendous progress over the past few years, and taken together, all signs point to a labor market that is zeroing in on full employment.

However, as we make our way back to an economy that's at full health, it's important to consider what we should expect along the way. The pace of output and employment growth, as well as the decline in the unemployment rate, have slowed recently…but that's to be expected. Last year the economy added slightly more than 3 million jobs. So far this year, we're on track to add about 2.5 million, with a further slowdown likely. 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 a fast pace of decline. With the goal in sight, however, the urgency is not the same. Then, we needed to create lots of jobs to get the economy back on track; now that we're getting closer, the pace of job gains needs to start slowing to more normal levels.

Looking towards next year, what we really 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.

Inflation

Of course, nothing is perfect. I generally think of myself as an optimist, and as someone once said, “Being an optimist after you’ve got everything you want doesn’t count.” Accordingly, even with the positive signs I’ve mentioned, I still don’t have everything I want: Inflation is still well below our 2 percent goal. In fact, it has been virtually intransigent, stubbornly refusing to meet our goal for over three years now.

Today’s low rate is in part due to transitory factors like the past fall in energy prices and the strength of the dollar.[5] With oil prices having moved back up from past lows and the dollar retracing some of its past gains, their effects on inflation will recede. In addition, with the economy nearing full strength, we should start seeing signs that underlying inflation trends are coming back up.

But, so far, that remains a forecast, not a reality. Recent inflation readings are fine, to use a technical economic term. But they haven’t yet shown convincing signs that the underlying trend has bottomed out and is poised to start moving back up to 2 percent. In a nutshell: the inflation data haven’t been discouraging, but they haven’t been as encouraging as I would like, either.

Nonetheless, I still expect inflation to move back up to our target over the next couple of years. With a strengthening economy, special factors dissipating, wages on the rise, inflation expectations stable at 2 percent, and, importantly, full employment right around the corner, I see all the factors in place to meet our inflation goal by the end of next year.[6] But the point of being data dependent is that information drives your decisions; and while my forecast looks great, I am wary of acting before gathering more evidence that inflation’s trajectory is on the desired path.

[5] Williams (2015).
[6] See Nechio (2015) regarding inflation expectations.

Implications for monetary policy

Which leads to everyone's favorite question: What does this mean for monetary policy? By which, I obviously mean interest rates, which is apparently what most people care about.

As I say without fail, policy is data dependent. And the difficulty of being data dependent is that data can be all over the place. Until I have more confidence that inflation will be moving back to 2 percent, I'll continue to be in wait-and-see mode. That doesn't mean I'm changing my forecast; it means economic forecasting and the data-based assessments required to make impactful policy decisions are two different things. I'll be looking at the evidence, and, as I've said almost as much as I've uttered the phrase "data dependent," every FOMC meeting is on the table.

I still believe this will be the year for liftoff, and I still believe that waiting too long to raise rates poses its own risks. I know not everyone agrees and there are those who believe we should wait until we're nipping at the heels of 2 percent. My reasons for advocating a rise before that happens remain the same. Monetary policy has long and variable lags, as Milton Friedman famously taught us.[7] Specifically, research shows it takes at least a year or two to have its full effect.[8] We're therefore dealing with my favorite analogy: The car speeding towards a red light. If you don't ease up on the gas, you'll have to slam on the brakes, possibly even skidding into the intersection. Waiting until we're close enough to dance with 2 percent means running the very real risk of having to dramatically raise rates to reverse course, which could destabilize markets and potentially derail the recovery. I see a safer course in starting sooner and proceeding more gradually.

[7] Friedman (1961).
[8] Havranek and Rusnak (2013).

It’s also important to remember that when we do raise rates, we will not be instituting tight policy; we’ll be easing back on extremely accommodative policy, and those are two very different things. Policy will continue to be accommodative, and the Fed’s $4 trillion-plus balance sheet will continue to provide substantial stimulus. There’s no need to worry that we’re cutting the legs out from underneath the economy.

Conclusion

All in all, things are looking good. I see growth on a solid trajectory, full employment just in front of us, wages on the rise, and inflation gradually moving back up to meet our goal. I can’t tell you the date of liftoff, but I can say that it’s going to be an interesting rest of the year for monetary policy, and the Fed in general. Thank you.

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