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Data Is the New Black: Monetary Policy by the Numbers

Good morning and welcome. It's a pleasure to have everyone at the San Francisco Fed.

Seeing as this is a conference on East Asia, and as I recently returned from a trip to the region, I thought I'd say a few words about that visit. Then I'll give a brief U.S. economic outlook, after which I'll tell you the exact date we will be raising rates. Before anyone calls their broker, that was a joke.

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

China

As I said, I recently returned from a trip that included Singapore, Hong Kong, and China. The full debrief would be too lengthy to recount here, so I'll keep my remarks to the subject most on people's minds: China.

It's fair to say that many current discussions of China on this side of the world have turned from a once awed envy of its extraordinary rise to a pessimistic prognostication of an imminent hard landing. People point to slower growth, the unsustainability of the current export-driven model, concern about debt buildup, and the risk of falling investment. This translates into worry about the repercussions both regionally and around the globe.

This is a subject I heard in every meeting and every conversation. I have to say that after having firsthand discussions with officials, analysts, and policymakers in the region, I walked away a lot less concerned about China's near-term economic outlook than when I walked in.

The main issue is that the Chinese government is facing a trade-off between their short-run growth goal and their longer-term reform agenda. For instance, late last year they instituted a number of reform initiatives that clamped down on local government borrowing. This was intended to rationalize credit allocation, but it was also having a negative effect on growth, in no small part because it impacted infrastructure investment, a key engine of growth for China these days.

This is where response clearly indicates intent. In this case, the government eased up and postponed those reforms to maintain solid economic growth. This has happened in a number of instances; when the Chinese authorities see growth slowing, or other negative economic impacts, they take steps to keep growth 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 proven again and again to have both the will and the leeway to take the necessary policy actions. I'm confident that they will do so again if needed.

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 7 percent target, due to myriad factors including demographics and the simple fact that years of prosperity and 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. In fact, you hear the phrase "new normal" just as much in China as you do here. For us, it's the possibility of changing norms in a post-recession economy. For them, it's an acknowledgment that they can't look to meet some 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 strong progress on the reform agenda, including financial market liberalization, movements towards internationalization of the renminbi, and a move to a more market-oriented economy.

Of course, nothing is certain, and China still faces daunting challenges as it makes its way down the reform-agenda road. But all in all, I came back from Asia with a firm sense of two things: First that, to paraphrase Mark Twain, reports of China's economic death are greatly exaggerated, and second, Singapore is way too hot to wear a suit and tie.

Reading the tea leaves of first-quarter growth

Turning to our side of the globe, the official reading of first-quarter real gross domestic product (GDP) growth was admittedly very poor. However, on closer inspection, the numbers weren't nearly as bad as they appeared. Research at the San Francisco Fed and elsewhere has highlighted unusual seasonal patterns in the GDP numbers, with first-quarter growth tending to come in well below that in other quarters.[1]

The Bureau of Economic Analysis uses a bottom-up method to calculate seasonal adjustments at a narrow level 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 better to have the most accurate reflection of the broad economy. 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]

[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/.

After correcting for recurring seasonal patterns in this way, the data show GDP actually grew about 1½ percent in the first quarter. GDI and GDP Plus growth were about 3 and 2¾ percent, respectively. Based on these corrected numbers and relative to trend growth of about 2 percent, growth appears to have been roughly on track in the first quarter. More recent data on spending have 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 next several quarters, then slow to a more sustainable pace next year.

Employment

Despite the mixed signals we're getting on spending growth in the first quarter, the signs from the labor market have been consistent, marked by continued, solid improvement. Not only has there been strong job growth, but the data show most of those new jobs are full-time and higher paying. A wide set of other measures of labor market conditions have continued to trend upward as well.

This is all welcome news, but it does provoke the question: When will we have reached our employment goal? The simple answer is when we hit the natural rate of unemployment, which in my estimation is 5.2 percent. The data convince me that we'll be there before the end of the year. But there are other measures of labor market underutilization that suggest there's additional labor market slack out there. As I said, we're making good progress across most measures of the labor market. One is unemployed people who've dropped out of the labor force but still want to work, for instance. The good news is that that figure has come way down and is now just where you'd expect it to be given the modest amount of overall slack in the labor market.

One remaining puzzle is the still large number of people working part-time who want to be full time. So-called involuntary part-time work soared during the recession and has remained unusually high during the recovery. The question here is, how much of that is due to an economy still not at full strength and how much is due to other, 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 high rate of involuntary part-time work.[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.[4] But they suggest that the current rate of involuntary part-time employment does not indicate a level of slack that is out of proportion with other indicators.

Another positive sign regarding the labor market is the increases we are seeing in wages. For some time, there was concern that this was an area seemingly immune to the recovery. In actuality, the stagnation in wage growth wasn't particularly surprising, because history and experience show us that wage growth doesn't really start to pick up until the economy nears full employment. Now that wage growth is starting to take off across multiple measures, it further confirms that the labor market is nearly healed. While businesses aren't always thrilled about the prospect of paying workers more, a pickup in wages is a sign of a healthy economy. It's good for the labor market, good for household income, good for consumer spending, and therefore good for business. In fact, what's really been missing in this recovery is wage growth that's 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.

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

Taken together, all signs point to a labor market that has made huge progress over the last few years and is zeroing in on full employment. We may not have far to go to close the remaining gap, though there is still some work to be done. As I mentioned, I see us reaching full employment by later this year.

As we make our way to an economy that's fully back on track, it's important to consider what we should expect along the way. The pace of both growth and the decline in the unemployment rate have slowed recently, and 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 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, we're near the end zone, and there are fewer yards to go. 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 and the economy would overheat. 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. Even with the positive signs I've mentioned, inflation is still well below our 2 percent goal. In fact, it has remained stubbornly below 2 percent for over three years now. The low rate of inflation today is in part due to transitory factors like the recent fall in energy prices and the strength of the dollar.[5] Now we're seeing oil edging higher and the dollar edging lower, so the downward pressure from those factors 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's a forecast, not a reality. In that regard, recent inflation

[5] Williams (2015).

readings are okay—“okay” being a technical economic term—but I have yet to see convincing signs that the underlying trend in inflation has bottomed out and is poised to move back to 2 percent. So 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 in sight, 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.

Implications for monetary policy

Which leads to the part people really care about: What does this mean for interest rates? 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, as my discussion of first-quarter growth attests. Until I have more confidence that inflation will be moving back to 2 percent, I’ll continue to be in wait-and-see mode regarding raising interest rates. That doesn’t mean I’m changing my forecast; it means economic forecasting and the data-based assessments required to make enormously impactful policy decisions are two different things. I’ll be looking at the evidence, and 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

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

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 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.

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, despite some mixed signals from the data from earlier in the year. I see growth on a good trajectory, full employment in sight, 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 couldn't anyway. 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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[7] Friedman (1961).
[8] Havranek and Rusnak (2013).

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