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Longview: The Economic Outlook

Good afternoon and welcome; it's a pleasure to be here. This is my first time in Alaska and I am looking forward to learning a lot about the local economy during my visit here.

Today I'll give an overview of the national economy and where I see things going, as well as talk about the subject back at the forefront of everyone's Fed conversations: interest rates. This is becoming an annual ritual: In August everyone keeps asking what the Fed will do in September. I'm asked enough about it to just wish that someone would wake me up when September ends. Of course, then they'd start the next annual ritual, asking about December, so there's no avoiding it.

All that talk about September and December reminds me that I should have already issued the standard disclaimer, so here goes: The views expressed here today are mine alone and do not necessarily reflect those of anyone else in the Federal Reserve System.

A broad economy

With that out of the way, I'll turn to the Fed's dual mandate, which is maximum employment and price stability.

I know everyone here understands what the Fed does, but I often find myself returning to the basics these days, as discussions of America's economy and the role of monetary policy take center stage. So please forgive me if it seems I'm just roaming for the moment, but it's important to remember who does what and why. The Fed makes monetary policy, which has a powerful influence on the economy, but it also has its limits: It operates in a relatively constricted area and uses a restricted set of tools. Most importantly, we don't deal with taxes or spending, debts or deficits; instead, we deal primarily with the quantity of money and the rates at which it is lent.

As a Fed policymaker, I see virtually everything through the lens of our dual mandate: What does it mean for jobs? For inflation?

I represent the largest Federal Reserve district, made up of the nine western states, which comprises roughly 20 percent of the U.S. economy, and about 36 percent of its geography, with the gap between the two numbers largely explained by the great expanse of land here in Alaska. With such a large and diverse region, it may not be surprising that when I listen to people from around the district talk about conditions in their areas, it can sometimes sound like they live in completely different countries. There's an old adage about the ocean being merely a collection of billions and billions of drops of water. In the same vein, the overall American economy is a collection of multiple smaller economies. So perceptions of economic health vary, as do reactions to economic changes—welcome to a new kind of tension. Lower gas prices may be great for people in Idaho, for instance, because they put more money in people's pockets, which then gets spent in the local economy. In Alaska and other oil-producing states, they have the opposite effect—depressing tax revenue, hiring, investment, and spending. So I understand that, in some ways, the economy can appear to be a walking contradiction.

Part of what makes the Fed System effective is that, while we're making national policy, we're actively gathering input and information from regions all over the country. I don't just see the blistering hot markets like Seattle and San Francisco, I also see areas negatively affected by the drop in oil prices, like Anchorage, or that were hit harder by the housing crisis than their neighbors, like Las Vegas and Phoenix.

So I listen to all areas of my district, and they feed into my overall policy perspective. But, despite this wide range of economic experience and the ups and downs in the western states, on a macro level things are pretty good, and the American economy is strong.

Employment

With that in mind, I'd like to turn first to national employment.

Our goal is not to have an unemployment rate of zero, instead, it's to be near the "natural rate" of unemployment: That's the rate we can expect in a healthy economy. I see that number as about 5 percent, which means that with the unemployment rate at 4.9 percent, we're right on target. The unemployment rate is obviously not the only measure of labor market health, but the multiple indicators tend to move together and are sending similar signals, with almost universal improvements across them all. Even the metric many people have been worried about, the labor force participation rate, is not the 21st century breakdown some people have feared; in fact, it's back pretty close to what I see as normal. The participation rate takes the labor force and divides it by everyone in the United States over the age of 16, which covers a lot of people who aren't working or looking for a job for perfectly normal reasons; overall, the low participation rate can be explained by demographic factors and longer-term trends, such as baby boomers retiring and young people staying longer in school.[1]

The numbers are actually so positive, it's time to adjust the way we talk and think about them. I should know better by now, but even if I change the channels for an hour or two, I'm constantly surprised by the commentary that seems to miss the larger playing field. In a robust labor market, we simply don't need to create as many jobs as we did when we were trying to climb out of the hole dug for us by the recession. Over the past few years, we've seen outstanding numbers—in 2014 and 2015 the economy added nearly 3 million jobs a year, and 2016 is on track to deliver about another 2¼ million jobs.

That's great news, but the fact is we won't need as much job growth going forward. We're pretty much at full employment now, so the future is less about meeting a goal and more about maintaining a result. That means creating enough new jobs to keep up with the increase in the size of the labor force. That number depends on things like the number of people retiring this year or graduating from school and entering the workforce. The current pace of job gains is well

[1] Aaronson et al. (2014).

above what we need, which I put to be somewhere around 80,000 a month, although estimates range from 50,000 to around 100,000.[2]

So this year's pace of 186,000 jobs a month is over twice as fast as we need to keep up with labor force growth, and, quite honestly, is unsustainable in the long run. We should expect the pace of job gains to slow, and no one should be alarmed when it does—we should only be alarmed, frankly, if we *don't* see that necessary slowdown.

While we're on the subject of employment, I'd like to issue a plea to my friends in the commentariat to not fixate on each individual data point, even an important one like the jobs number. And here's where I get to trot out my most overused line: I and the rest of the Fed policymakers love saying we're "data dependent." It's a constant refrain and it's absolutely true. But there's a difference between being data dependent and being data-point dependent, as one of my colleagues put it. No one should get caught up on a particularly bad—or a particularly good—jobs report. Or a month's inflation numbers. Or even quarterly GDP growth. All the indicators should be examined in their entirety to tell us the state of the economy and where it's likely headed.

Individual reports, and even short-term trends, can give a false perception. There are a few things to keep in mind when looking at the data. One is the standard disclaimer that gets lost in the headlines, that the first round of numbers is preliminary and can be very noisy. Another is

[2] See for example Aaronson, Brave, and Kelley (2016) from the Chicago Fed.

that getting caught up in monthly or even quarterly changes is unhelpful—one good jobs report doesn't spell instant success, just as one bad inflation report doesn't make us an economic basket case. We should, instead, try to understand and parse these sorts of month-to-month movements. Instead of simply labeling them as noisy, we look for the source of the cacophony.

There's a lot of analysis involved in getting to the bottom of some of it. Which answers one of life's great mysteries: Why do economists exist? We're here to dig through the data and uncover hidden trends. Doing that, we can see external forces at work—for example, even after two revisions, the May jobs report showed just 24,000 new jobs, causing speculation that the economy might be walking down the boulevard of broken dreams. But that report was inordinately affected by special factors, including the Verizon strike and the effects of weather. After adjusting for these, job gains remained solidly above trend, so the report was less shocking than some commentators made it out to be.

Inflation

Turning to the other side of the ledger, inflation is on course to meet our 2 percent goal. Although it's been persistently below target over the past several years, recent data look more favorable. Over the past year, the strengthening of the dollar and falling energy prices have pushed inflation down, but these influences should fade over time. To cut through some of the noise, it's useful to look at measures of inflation that strip out volatile prices and provide a clearer view of the underlying trend. Those measures suggest that underlying inflation is in the

1½ to 1¾ percent range. We're not quite at our target, but the strength of the labor market should help us along.

The outlook

One of the reasons I'm confident in our progress is that my U.S. forecast today is not much different than it was a month ago, or, frankly, than it was in December when we first raised rates. I continue to see evidence that, overall, the economic expansion remains on track. Consumer spending is strong, the labor market is running apace, and household balance sheets are improving. All in all, I see a strong domestic economy.

Internationally, Brexit has been dominating the headlines, and people have been worried that it might push the U.K. into recession and how it might weigh on Europe. But there's no sign that it will have enough of an impact to knock our economy off course. In fact, from a global standpoint, the discussion about the effects of Brexit is a reminder that we're doing a lot better than most of the rest of the world.

Everyone's favorite topic: Rate hikes

Now is when I come around to the subject of interest rates. In the context of a strong domestic economy with good momentum, it makes sense to get back to a pace of gradual rate increases, preferably sooner rather than later. I have a few reasons for saying that.

First, Milton Friedman famously taught us that monetary policy has long and variable lags.[3] Research shows it takes at least a year or two for it to have its full effect.[4] So the decisions we make today must take aim at where we're going, not where we are. I liken it to a car: When you're nearing the intersection, you ease off the gas so you can be ready to stop. You don't wait until you get right in front of the red light; that would force you to slam on the brakes, and might propel you into the middle of the intersection. Likewise, if we wait until we see the whites of inflation's eyes, we don't just risk having to slam on the monetary policy brakes, we risk having to throw the economy into reverse to undo the damage of overshooting the mark. And that creates its own risks of a hard landing or even a recession.

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.

[3] Friedman (1961).
[4] Havranek and Rusnak (2013).

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, 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.

Monetary policy has absolutely played a crucial role in getting us back on track.[5] We've achieved our mandate of full employment and we're heading towards 2 percent inflation. But, 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 maximum employment and steady 2 percent inflation, using the tools available to us. As I said earlier, 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 and ability to influence.

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.[6] 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.

[5] Williams (2014).
[6] See Fernald and Jones (2014) regarding technology and education; see also Williams (2016).

New normal

As we look to the future, 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, 3 or 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.

As I said earlier, we're only going to need somewhere around 80,000 new jobs a month to keep up with the growing labor force. Some may call this disappointing, and it was when we were climbing out of the hole the recession left. But this is the new normal, as is trend growth of a little over 1½ percent going forward. If we want to bend the curve, it's not going to be through monetary policy. It's going to be through legislative policies that have a chance at fundamentally changing the direction of growth—like longer-term investments in human and physical capital like education and infrastructure.

Conclusion

The Cliff's Notes version is this: Despite the very real struggles that some parts of the country, including Alaska, are facing, the broader national economy is in good shape: We're at full employment, and inflation is well within sight of, and on track to reach, our target. Under these conditions, it makes sense for the Fed to gradually move interest rates toward more normal levels.

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