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The Right Profile: Economic Drivers and the Outlook

Good afternoon, it's a pleasure to be here. I gave my first public speech as President of the San Francisco Fed at Town Hall Los Angeles nearly five years ago. I always enjoy coming back. In fact, my last Town Hall event was memorable—the room lost power and I gave my speech in the dark, except for the glow sticks an enterprising staff member ran to the drugstore to get. I still have mine as a memento of that day.

I'll start out by stating something you all know. The Federal Reserve has a dual mandate: maximum employment and price stability. We want everyone who wants a job to be able to find one and for inflation to average 2 percent per year.

I mention this because there are aspects of the current discussion—and worry—about the economy and monetary policy that should be seen in context. The narrative of the punditry can sound alarming, and can give a false impression of what motivates monetary policymakers. Since I'm about to talk about motivations, it's probably a good time to inject the standard disclaimer that the views expressed today are mine alone and do not necessarily reflect those of others in the Federal Reserve System.

With that out of the way, today I'd like to talk about where we are on each of those goals, where I see the economy headed, and put some of those concerns in context. Call it MythBusters: Monetary Policy Edition.

Employment: Career opportunities

I first want to address employment, where things are looking good. "Groovy times" as they said back in the day. We use a variety of measures to gauge the health of the labor market, but the most widely discussed, and most frequently used, is the unemployment rate. Unemployment will never be zero, because in any well-functioning economy, people leave jobs and new people enter the workforce. Economists use the term “natural rate of unemployment” to describe the optimal rate for an economy at full health. It’s hard to know exactly what the number is, but I put the natural rate at about 5 percent.

We dipped just below that, to 4.9 percent, in January. I expect the unemployment rate to continue to come down a bit further, reaching the mid-4s later this year. This is a reflection of steady improvement in a labor market that has fully recovered from the recession and its aftermath, when we saw a peak of 10 percent.

There are other indicators—workers who are part-time for economic reasons or the labor force participation rate, for example—that have been the focus of continued concern. But digging into the data, we’ve actually come quite far on both of those. In fact, while part-time employment for economic reasons looks like it’s still somewhat elevated relative to historical norms, the labor force participation rate now appears to be consistent with its longer-term trend.[1]

A further sign of the health of the labor market is that more people are quitting their jobs—indicating they feel confident that they’ll find another—and they’re probably right: Job vacancies are at the highest levels since they started collecting the data in 2000. We added more than 2½ million jobs in 2015. All in all, we have reached or are close to maximum employment across a broad range of markers.

Inflation: Pressure drop?

On the inflation side, we’re not quite where I’d like us to be, but we’re on course to reach our goal.

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[1] Aaronson et al. (2014).

The Fed sets a target of 2 percent average inflation. You'll generally hear policy wonks and commentators talk about the Fed's "2 percent inflation target"—I do it frequently myself. But I want to emphasize that I just included the word "average." Sometimes we get so caught up in economic shorthand that we forget not everyone is speaking the same language. I don't want to leave the impression that inflation should be exactly 2 percent all the time or that small movements in either direction should lead to alarm. Sometimes we'll be a little lower, sometimes a little higher; this isn't about complete control. What I want—on average, in the medium term—is for inflation to be about 2 percent. Worry should only set in if it's persistently above or below that number.

I'd also like to stress the "above *or* below" part. Many people think that Fed policymakers' concern lies disproportionately with inflation that's too high. They think we view inflation lower than 2 percent as sort of "not great," but see inflation above 2 percent as catastrophic. That's not the case. In my view, inflation somewhat above 2 percent is just as bad as the same amount below. And here's the one place I actually *am* speaking for others in the Federal Reserve System—the most recent FOMC statement explicitly addressed this issue. [2]

With that proviso firmly in place, I will note that inflation currently *is* too low. Over the 12 months of last year, the Fed's preferred inflation measure, the personal consumption expenditures price index, stands at around half a percentage point while core inflation, which strips out volatile components like food and energy, is about 1½ percent. Now, Fed policymakers are often accused of not eating or driving, because we focus more on measures like the latter. It's not that we don't understand that gas and groceries are important parts of people's household budgets. It's just that for policy, we need to look at the underlying trends, and if we got lost in the supermarket or oil fields, we'd miss what the data are telling us about the medium term.

[2] Board of Governors (2016).

In any event, I expect inflation to move back to 2 percent over the next two years.

Current U.S. inflation pressures are playing tug-of-war. On one side, falling prices for energy and most goods are pulling us down, reflecting the strong U.S. dollar and other international developments. On the other, rising prices for domestic services are mostly trying to yank us to the 2 percent line. When you look at the parts of the U.S. economy that are not traded globally, like housing, we're seeing prices increase in a way that reflects a stronger, tightening economy. While it might not be music to renters' ears, the steep increase in rental prices is a reflection of the nation's economic strength. In services more generally, we're seeing inflation running close to our target.[3] There are also increasing signs that wage growth is picking up—which, again, may not sound great to employers, but is actually something we've been waiting for. It's a sign of the economy really powering back, and it will help boost household incomes and prompt even more growth in consumption spending. By at least one commonly cited measure, wage growth has picked up from 2 to 2½ percent in recent months.

It's also worth noting that wages in the aftermath of the recession may be acting out of character. During the recession, wage growth didn't slow as much as might have been expected. Then, during the recovery, wage growth stagnated, even as the labor market made solid gains. Recent research by my staff suggests that this puzzle may be in part because of who was entering and leaving the workforce.[4] During the recession and early in the recovery, wages stayed higher than expected because most of the people who lost their jobs were the ones making less. More recently, as the labor market has strengthened, the pattern has reversed. Many workers who were either on the sidelines or working part-time started finding full-time jobs. Because they're new, the vast majority of these workers earn less than other employees, which pushes down the overall

[3] Glick (2015).
[4] Daly and Hobijn (2016).

average. Once you adjust for this factor, upward wage pressures are even stronger than the headline numbers suggest.

So if we look at the domestic market in isolation, it shows strong growth. We're just contending with outside forces. As the price of oil dropped by some 70 percent and the value of the dollar increased by over 20 percent, it naturally influenced near-term inflation. But the effects should peter out. One reason economists can comfortably say that these factors are transitory, or at least stabilizing, is that it's incredibly unlikely that oil will fall another 70 percent. There is a basement on how low energy prices can go. That's why I'm confident that we're on track to reach our inflation goal.

Mixed signals and the equalizer

Another area of mixed signals is that certain sectors are slowing down at the same time the overall economy keeps chugging ahead. Sectors that are directly affected by the strong dollar, weak foreign demand, and falling energy and commodity prices have underperformed recently. But the hardest-hit sectors—manufacturing, drilling and mining, and agriculture—account for a relatively small share of employment and GDP. By contrast, the large domestic services sector—including restaurants, health care, and business services—is doing quite well, and makes up the huge majority of American jobs. In last year's impressive jobs growth, 93 percent were in services, including government.

Risks and concerns—lightning strikes?

Still, as endless column inches have been dedicated to chronicling, and as the Fed itself mentioned in the last FOMC statement, there are areas of economic concern. In particular, economic developments abroad and market volatility have taken center stage in discussions of the U.S. economic outlook.

Of course, I am aware of, and closely monitoring, potential risks. But I want to be clear what that means. It's often said that the economy isn't the stock market and the stock market isn't the economy. That's very true. Short-term fluctuations or even daily dives aren't accurate reflections of the state of the vast, intricate, multilayered U.S. economy. And they shouldn't be viewed as the four horsemen of the apocalypse. Remember, the expansion of the 1980s wasn't derailed by the crash of '87, and we sailed through the Asian financial crisis a decade later. I say "remember"—some of you here will actually remember and others will remember it from your high school history class.

From a policymaker's perspective, my concern isn't as simple as whether markets are up or down. Watching a stock ticker isn't the way to gauge America's economic health. As Paul Samuelson famously said, the stock market has predicted nine out of the past five recessions. What's important is how it impacts jobs and inflation in the U.S.

At the risk of puncturing some of the more colorful theories about what drives the Fed, I lay before you the cold, hard truth: Fed policymakers are even more boring than you think. Because all we see is our mandate. How does this affect American jobs and growth? What does this mean for households' buying power?

The same holds true for international developments. Of course we are closely watching situations abroad. But not because we should act in response to, say, financial volatility in China. We monitor developments in China, Brazil, South Africa, and more because we're on alert for how spillovers could affect our goals at home. We live in a global economy, not an inoculated city. What happens in China or Brazil isn't contained by national borders; the rest of the world necessarily feels the effects and they easily breach the gates of the West. But others' economic fates do not spell our own. Yes, global markets affect U.S. growth; but we are also powered by domestic demand and have the ability to make our own monetary policy. With the policy tools at our disposal, we can continue to achieve our employment and inflation goals. Ultimately, monetary policy has been supporting the expansion of the U.S. economy, allowing it to become stronger and stronger, and the domestic demand we're seeing reflects its underlying might.

Despite recent financial volatility, my overall outlook for the U.S. and the global economy remains unchanged. There is plenty of concern about China's slower pace, but as I said last year, this largely reflects a pivot from a manufacturing-based economy to one driven by domestic consumption and services—the exact engines that are currently powering U.S. growth.[5]

Monetary policy: Data dependent

So what does all this say about monetary policy? A lot of people make jokes about economists having the only job in the world where you can constantly change your answer and not get fired—my mother, by the way, is one of them. But what we actually do is adjust our forecasts as we get more data. A few years ago, for instance, I viewed the natural rate of unemployment as about 5½ percent. As more data came in and as we learned more about the shape of the recovery, I reassessed. This is just to put into context that when I look at my December forecast and compare it with my outlook for unemployment and core inflation today, there's virtually no change. The shifts in my forecast amount to just one-tenth of a percentage point.

I therefore continue to see a gradual pace of policy normalization as being the best course. My preferred route is a gradual path of increases. This reflects the fact that the economy still needs a gentle shove forward from monetary policy, as we continue to navigate the headwinds from weakness abroad and their effects on the dollar and commodity prices.

[5] Williams (2015).

I want to emphasize, of course, that I don't have this on remote control; the path of policy remains data dependent. Anyone who knows me knows that data-dependency is the irresistible force of my policymaking decisions—I literally made T-shirts about it. As I get more data and other information, I'll adjust my views of the outlook for employment, inflation, and the appropriate path for monetary policy accordingly.

Conclusion

Despite the Sturm und Drang of international and market developments, the U.S. economy is, all in all, looking pretty good. I still expect to see U.S. GDP growth of about 2¼ percent for 2016. I still expect unemployment to edge down to about 4½ percent by late in the year. And I still see inflation edging up to our 2 percent goal within the next two years. So I'm not down—it all looks good to me.

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