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Trick of the Light?

The U.S. Economy, Global Growth, and International Risks in Perspective

Good evening. This is my second trip to Singapore, and I'm very pleased to be back—the people, the pace, and especially the food are wonderful. It's been an amazing journey.

As I'm sure you all know, the Federal Reserve's dual mandate is maximum employment and price stability. In its simplest terms, we want everyone who wants a job to be able to find one and for inflation to average 2 percent per year.

I mention it only because when we talk about U.S. monetary policy—particularly when so much recent attention has focused on global turbulence—the discussion can sometimes overlook that these two fundamental goals are central to the decisions we make. It's important to remember that, as a Fed policymaker, I'm always going to view our decisions through the lens of those objectives.

Now is 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.

So having set that baseline, I'd like to talk to you this evening about where we are on each of those goals, where I see the U.S. and global economy headed, and how that informs my views on monetary policy. Importantly, I want to address some of the more prominent concerns that have made headlines lately—the spoiler alert is that it's not as bad as everyone thinks.

Employment

Turning first to U.S. employment, things are looking very good. There are 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 what the exact number is, but I put the natural rate at about 5 percent.

We’ve dipped just below that mark, to 4.9 percent, and I expect the unemployment rate to continue to edge down, reaching the mid-4s by late 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.

Of course, there are other indicators, which have been the focus of much debate and concern—workers who are part-time for economic reasons and the labor force participation rate have received particular attention. There is some worry that these represent a workforce in more trouble than the unemployment rate alone would indicate. But looking more closely at the data, we’ve actually come quite far on both. 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—or what we might more simply call “normal.”¹

A further sign of labor market health is that more people are quitting their jobs. People have greater confidence that they’ll find work, and they’re probably right: Job vacancies are hovering around the highest levels since they started collecting the data back in 2000, and we added 2¾ million jobs in 2015. To sum up, we have either reached or are close to maximum employment across a broad range of markers.

¹ Valletta, Bengali, and van der List (2015) and Aaronson et al. (2014).

U.S. inflation

On the inflation side, we're not quite where I'd like us to be, but recent developments have been very encouraging and add to my confidence that we're on course to reach our goal.

The Fed sets a target of 2 percent average inflation. I want to emphasize the word "average." We don't need inflation to be exactly 2 percent all the time, and small movements in either direction shouldn't lead to alarm. We're looking—on average, in the medium term—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 January Federal Open Market Committee (FOMC) statement explicitly addressed this issue.²

For the past few years, inflation *has* been persistently too low, but we're starting to see some upward movement. Over the past year, the Fed's preferred inflation measure, the personal consumption expenditures price index, stands at 1 percentage point. Measures of underlying inflation like core inflation—which strips out volatile components like food and energy—or the trimmed mean, are running about 1¾ percent over the past year. Fed officials do understand that gas and groceries are important parts of household budgets. It's just that for making policy, we need to look at the underlying trends that give us a better picture of where inflation is likely headed.

² Board of Governors (2016).

All in all, the recent data reinforce my expectation that inflation is on track to move back to 2 percent over the next two years.

The tug-of-war and mixed signals

Current U.S. inflation pressures represent a tug-of-war that is playing out in the overall economy. On one side, falling prices for energy and most imported goods have pulled inflation 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 back to the 2 percent line. When you look at the parts of the American economy that are not traded globally, like housing rents, we're seeing prices increase in a way that reflects a stronger, tightening economy. And in services more generally, inflation is running a touch above 2 percent.

When we look at the U.S. domestic market in isolation, it shows strong growth. We're just contending with outside forces. When the price of oil plummeted by some 70 percent and the value of the dollar increased by over 20 percent, it naturally influenced near-term inflation. But, with oil prices recouping some of their losses and the dollar stabilizing, the effects of these past movements should peter out. That's another reason I'm confident that we're on track to reach our inflation goal.

Mixed signals can also be seen in the way certain sectors are slowing down while the overall economy keeps chugging ahead. Some sectors have underperformed lately, specifically those that are directly affected by the strong dollar, weak foreign demand, and falling energy and commodity prices. But the hardest-hit ones—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.

The forecast

Despite recent financial market volatility, my overall outlook for both the U.S. and the global economy remains largely unchanged over the past few months. I'm not claiming that I can see for miles, but since autumn of last year, I've expected GDP growth to be a bit above 2 percent this year and the unemployment rate to fall to roughly 4½ percent by the end of the year. Some other economists' growth forecasts have been revised down, like the Blue Chip consensus.³ But those numbers are actually now largely in line with what I'm predicting for 2016, which is far from grim.

One reason my U.S. outlook has held steady is that the outlook for the rest of the world hasn't changed much either. That may seem surprising, given the attention paid to financial volatility and melancholia about global growth over the past several months. But despite what might be implied by the public discussion, forecasts of world growth haven't changed that much. For example, the latest forecast for global GDP growth in 2016 from the International Monetary Fund is about 3½ percent, down only one-half percentage point from a year ago and still better than the most recent estimate of 3 percent growth in 2015.⁴

Risks, concerns, and the global economy

So let's talk about the obvious risks and areas of economic concern that endless column inches have been dedicated to chronicling. I'm certainly not dismissing them, and our most recent FOMC statement was pretty clear that our glasses aren't tinted by the rosy hue of U.S. domestic growth.

³ *Blue Chip Economic Indicators* (2016).

⁴ International Monetary Fund (2015, 2016).

In the popular discussion, market volatility and global economic developments have taken center stage. I understand the concern, and I'm carefully monitoring how things unfold. But I want to be clear what that means, and to clarify each in turn.

While financial volatility and the accompanying fears have diminished somewhat since the beginning of the year, it's still helpful to address the discussion, because it's a recurring theme. It's often said that the economy isn't the stock market and the stock market isn't the economy, which is very true. Short-term fluctuations or even daily dives aren't accurate reflections of the state of the vast, multilayered U.S. economy.

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 last five recessions. My concern isn't as simple as whether markets are up or down; what's important is how it impacts our monetary policy objectives.

The same holds true for international developments. We live in a global economy and what happens in China or Europe or Brazil isn't contained by national borders; the rest of us necessarily feel the effects. But others' economic fates do not spell our own. The U.S. is affected by what happens around the world, but it is also powered by domestic demand and we make our own monetary policy, which has supported growth and strengthened our economy. The same holds true for other countries. Part of the reason the global economic forecast hasn't changed that dramatically is that countries and central banks have taken policy steps to shore up growth, from Europe to Japan to China.

There are factors slowing global growth, and they're very real. But to some extent, the attention has distorted their size and scope, and it's important to separate the facts from the chatter. The data don't show that the song is over. Europe may be under something of a gray

cloud, but the death of European growth, to paraphrase Mark Twain, is greatly exaggerated. I don't want to evince a stereotypical American overoptimism—and as a native Californian, I will admit to being an optimist in general—but I don't see a looming global crisis. Growth expectations may be slightly tempered, but that's a far cry from the triage bay we were in eight years ago. My view is essentially, let's just stay on track. Let's not get sidelined by the noise and distraction commentary can sometimes cause.

A case in point is China. Yes, growth has slowed, but 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 Something that puts my assessment of China in perspective is that, again, my outlook hasn't really changed. When I look back over my speeches from the past few years, I could easily recycle the passages on China for a talk today.

I mention these shifts in forecast—or lack thereof—because they're significant. Economists are driven by data and we are perfectly happy to revise our estimates as new information comes in or events unfold. We don't even see it as saying we were wrong, we see it as having amended our view based on the data. This is marvelously helpful in everyday life, by the way: Try telling friends or family that you weren't wrong, you've just amended your view based on data.

In any event, China's official decision to lower its growth goal to 6.5–7 percent has been treated by many as a harbinger of economic doom, foreshadowing an unexpected slowdown. But if you look at statements by the government, it's completely consistent with the narrative of the past few years. Growth is going to slow somewhat, but it's not a surprise, and it's not a mark of an impending economic hard landing.

⁵ Williams (2015).

Of course, the effects of China's economy do reverberate globally, and each country and region is affected differently by its neighbors and trading partners. I don't want to sound like I'm preaching from my chair and the comfortable vantage of the U.S. For Asia-Pacific, China's shift will clearly have an effect. Commodity-exporting nations, for example, are going to feel the change. Countries in the region can be, to some extent, a helpless dancer following China's lead; as China pivots, the region is swept along by its steps.

The path for monetary policy

The interconnectedness of economics means other countries are considering how they'll be affected by the U.S. as it continues its policy normalization. I made a point at the beginning of my remarks to highlight that I am a U.S. policymaker, and that my focus is on what's correct for our domestic economy. But I'm not oblivious to the international effects of the decisions we make. I'm familiar with the adage that when the U.S. sneezes, the world catches a cold.

The general concern is that normalization in the U.S. will cause market turbulence internationally. People often point to the "taper tantrum" of a few years ago as evidence of the far-reaching effects of Fed decisions.

There are two main issues: first, raising interest rates; second, the balance sheet, which currently stands at some \$4 trillion.

The Fed has indicated that we expect to raise rates gradually, and we have made that abundantly clear in our communications. We took the first small step with a modest rate hike in December, and the future pace will be, as we've said repeatedly, gradual and thoughtful. As for the balance sheet, there's a ways to go before we start to unwind it, and it won't happen until normalization of the funds rate is well under way. After that, our plan is to shrink the balance sheet "organically," through the maturation of the assets. It's going to take at least six years to

get the balance sheet back to normal, which is in keeping with the overall approach to removing accommodation gradually.⁶

One of the lessons from the taper tantrum is that it's not the policy that causes disruption, it's the uncertainty. The actual tapering did not cause a negative market reaction. Our plans for both rate hikes and the balance sheet are steady and consistently communicated. It's frankly the most telegraphed monetary policy of our lifetimes.

What's important about this, and what's very good news, is that this is essentially the move back to normal. The conversation in the U.S. isn't about another quantitative easing program, or about the need for new forms of policy accommodation. And a well-communicated gradual pace is the essence of boring; it's not a surprise and shouldn't roil markets. The turmoil we're seeing right now is a response to events—concerns about China are about China and concerns about Europe are about Europe. They're not about marginally higher interest rates in the U.S.

I have every faith that those concerns will abate as world growth remains on track, and that policy in the U.S. will not only fail to roil markets, but will be a net positive for everyone—after all, a strong U.S. economy is good for the global economy.

Conclusion

All in all, my outlook is positive. I see continued growth in the U.S., and I don't see the global situation as dire. The ability of governments and central banks to respond to their own needs while navigating global conditions may not be a miracle cure, but it offers stability.

⁶ Carpenter et al. (2015).

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